Ballard Spahr LLP

INVESTMENT MANAGEMENT

Recent Investment Management Developments

July 2015

Below is a summary of recent investment management developments that affect registered investment companies, private equity funds, hedge funds, investment advisers, and others in the investment management industry.

FINRA CEO Criticizes Department of Labor's Proposed Regulations on Fiduciary Advice

Financial Industry Regulatory Authority (FINRA) Chief Executive Officer Richard Ketchum has criticized a proposal by the U.S. Department of Labor (the Labor Department) that would establish a fiduciary duty applicable to retirement investment advisers.

The Labor Department's proposal would require retirement investment advisers and their firms to acknowledge formally a fiduciary status and enter into a contract with their customers to commit to the standard. Acting in accordance with the standard would include giving advice that is in the customer's best interest, and making truthful statements about investments, and their compensation. The Labor Department released the proposal in April 2015[1] (our past article detailing the Department's proposal can be found below on page 4).

The Investment Company Institute and the Securities Industry and Financial Markets Association are among the organizations that oppose the Labor Department's proposal.[2]

Mr. Ketchum has stated that the Securities and Exchange Commission (the SEC) should formulate a unified standard, which would apply consistently to all investments, not only retirement savings.[3] SEC Chair Mary Jo White has similarly stated that she prefers a uniform fiduciary standard.

Mr. Ketchum asserted that the Labor Department's proposal has several drawbacks, including that it:

- Unduly emphasizes civil class action lawsuits and arbitration;
- Subjects covered firms to a problematic standard of proof, under which they would need to demonstrate that any higher compensation was directly related to the time and expertise necessary to provide advice on a product;

- Lacks enough guidance, for broker-dealers and judicial arbiters, about managing conflicts in firms' business models, other than suggesting a shift to asset-based fees or fee-neutral structures; and
- Threatens to cause firms to close their retirement account advisory businesses or constrain the clients they serve.

OCIE Launches Program to Evaluate Retirement Plan Sales Practices

The Securities and Exchange Commission (SEC) Office of Compliance Inspections and Examinations (OCIE) recently launched "Retirement-Targeted Industry Reviews and Examinations ("ReTIRE"), an effort by the SEC that will work to better protect retail investors' retirement funds. Accordingly, ReTIRE will include a targeted review of investment advisors' and broker-dealers' (collectively "firms") retirement planning sales practices.

Through the National Examination Program, OCIE will conduct examinations of SEC-registered investment advisers and broker-dealers under ReTIRE that will focus on certain higher-risk areas of firms' sales, investments, and oversight processes, with particular emphasis on select areas where retail investors saving for retirement "may be harmed."

OCIE intends to use data analytics, information from prior examinations, and examiner-driven due diligence to identify firms to examine under ReTIRE. OCIE will focus on the activities of investment advisory representatives and/or broker-dealer registered representatives. OCIE plans to test whether targeted firms have reasonable bases for recommendations, whether they are disclosing conflicts of interest, and whether proper supervision and compliance controls are in place, as well as the marketing of and disclosure related to products.

OCIE also will check for firms' consistency when selecting the type of account; performing due diligence on investment options; making initial investment recommendations; and providing ongoing account management. OCIE plans to review controls, oversight and supervisory policies and procedures and may focus on firms with operations in multiple and/or distant branches. OCIE will also review firms' sales and account selection practices in light of the fees charged, the services provided to investors, and the expenses of such services.

SEC Proposes Changes to Reporting and Disclosure Obligations for Investment Companies and Advisers

In May 2015, the Securities and Exchange Commission (SEC) proposed changes to the reporting and disclosure obligations of registered investment companies and registered investment advisers.[45] With this proposal, the SEC hopes to modernize and enhance data reporting. The main parts of the proposal include new Form N-PORT, new Form N-CEN, amendments to Regulation S-X, Web site availability of shareholder reports, and amendments to Form ADV.

Form N-PORT is a monthly form that would replace Form N-Q, the form that investment companies use to report portfolio information for their first and third fiscal quarters. Form N-PORT would require information about monthly portfolio holdings in a structured data format.

Form N-CEN is an annual form that would replace Form N-SAR, the semi-annual census reporting form. Information provided on Form N-CEN relates to, among other things, matters submitted to a vote of security holders, material legal procedings, service providers, and information specific to exchange-traded funds.

The proposed amendments to Regulation S-X would require standardized enhanced derivatives disclosures in investment companies' financial statements. The Regulation S-X amendments would also affect the parts of financial statements that concern securities lending and the valuation of portfolio securities.

Regarding shareholder reports provided on Web sites, proposed Rule 30e-3 of the Investment Company Act [or "1940 Act" or other defined term] would permit an investment company to satisfy requirements to transmit reports to shareholders by posting such reports and certain other information on the company's Web site.

The proposed amendments to Form ADV, the investment adviser registration and reporting form, would focus on the risk profile of investment advisers. The Form ADV amendments would, among other things, require information about the assets, borrowings and derivatives related to separately managed accounts, and additional information about the adviser's business, including branch office operations and the use of social media. Another proposed amendment is Investment Advisers Act Rule 204-2, which would require investment advisers to maintain records of the calculation of performance information that is distributed to any person.

SEC Charges Hedge Fund Executives and External Auditor for Improper Disclosure of Expense Allocations

The SEC announced that Alpha Titans LLC (Alpha Titans), as well as principal officer Timothy P. McCormack and general counsel Kelly D. Kaeser, misused assets of two affiliated private funds to pay more than $450,000 in office rent, employee salaries and benefits without obtaining the proper client consent and without making the proper disclosures. Simon Lesser, an outside auditor, was charged with professional misconduct for approving Alpha Titans' audit reports, which contained unqualified opinions that the funds' financial statements were presented fairly.

Marshall S. Sprung, co-chief of the SEC Enforcement Division's Asset Management Unit, said "Alpha Titans did not make the proper disclosures for clients to decipher that the funds were footing the bill for many of the firm's operational expenses." Mr. Sprung said "private fund managers must be fully transparent about the type and magnitude of expenses they allocate to the funds." The SEC announced the findings in late April following an investigation.

According to the SEC, Alpha Titans, Mr. McCormack, and Ms. Kaeser sent investors audited financial statements that failed to disclose nearly $3 million in expenses tied to transactions involving other entities controlled by the funds. Further, Mr. Lesser knew that the fund documents failed to disclose these expenditures and, yet, provided audit reports that indicated that the fund documents had adequately addressed related party disclosures in the funds' financial statements.

Alpha Titans, Mr. McCormack, Ms. Kaeser and Mr. Lesser agreed to settle the SEC's complaint without admitting or denying the charges. The firm and Mr. McCormack agreed to pay a penalty of $200,000, a disgorgement of $469,522 and prejudgment interest of $28,928. Mr. McCormack and Ms. Kaeser agreed to be barred from the securities industry for one year, and Ms. Kaeser agreed to a one-year suspension from practicing on behalf of any client regulated by the SEC. Alpha Titans will no longer solicit new investments and is forbidden from accepting new clients as it winds down operations. Mr. Lesser agreed to pay a $75,000 penalty and was suspended from practicing as an accountant for any SEC-regulated entity for at least three years.

The SEC's charges against Alpha Titans and its principals and the penalties imposed in the ensuing settlement procedures indicate that the SEC is focused on ensuring that hedge funds produce fund documents that clearly, accurately and thoroughly disclose the types and amounts of expenses to be charged to the fund or its investors. Further, the SEC is monitoring wherein fund managers allocate expenses and use fund assets strictly in accordance with the relevant provisions in the fund documents. Finally, the SEC appears to be looking to outside auditors to play an important role in this regard. Accordingly, outside auditors should be diligent in reviewing expense allocations and the use of fund assets to determine compliance with fund documents.

Department of Labor Proposes New Regulations on Fiduciary Advice

The U. S. Department of Labor (DOL) has reissued long-awaited proposed regulations describing the circumstances in which a person who provides investment advice in connection with a retirement plan or individual retirement arrangement (IRA) acts as a fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code. If adopted as proposed, the proposed regulations (referred to as the "investment advice fiduciary rules") will significantly alter the landscape for how employee benefit plans, their fiduciaries and participants, and IRA holders receive investment advice. The DOL initially proposed a version of the controversial investment advice fiduciary rules in October 2010, but later withdrew the initial proposal due to concerns raised by the business community and lawmakers from both parties.

The new investment advice fiduciary rules broadly define a fiduciary to include any individual who provides investment advice for a fee for consideration in making a retirement investment decision to an ERISA-covered plan, a plan fiduciary, a plan participant or beneficiary, or an IRA holder. The proposed rules encompass:

- Recommendations as to: (i) the advisability of buying, selling or holding investments; and (ii) the management of investments, including the management of assets to be distributed from a plan or IRA;
- Recommendations as to the advisability of taking a distribution of assets from a plan, and the investment of those distributed assets;
- Appraisals and fairness opinions regarding investments in connection with specific transactions (other than appraisals and fairness opinions for a collective investment fund, a pooled separate account or employer securities held in an employee stock ownership plan (ESOP));
- Recommendations of a person who will receive a fee for any of the functions described above.

In conjunction with the proposed regulations, the DOL issued a proposed new series of prohibited transaction exemptions and amendments to existing prohibited transaction exemptions. A new exemption likely to receive the most attention is referred to as the "Best Interest Contract" exemption. It provides relief for compensation received by investment advice fiduciaries as a result of the purchase, sale, or holding by a plan or IRA of certain investments. Among other conditions, the exemption requires the investment advice fiduciary to adhere to basic standards of impartial conduct, which include:

- Giving advice that is in the client's best interest;
- Avoiding misleading statements; and
- Receiving no more than reasonable compensation.

The basic standards of impartial conduct set forth in the new proposed exemption reflect the conduct of many advisers in dealing with their clients, and standards that already apply under ERISA to advisers that work with employee benefit plans sponsored by employers. However, by making the standards a condition of the Best Interest Contract exemption, the DOL is extending the standards of impartial conduct to IRA advisers, many of whom have not historically been subject to formal regulation.

The Best Interest Contract exemption also requires that an investment advice fiduciary enter into a contract with the client that acknowledges the adviser's fiduciary status. The contract cannot include provisions limiting the liability of the investment advice fiduciary in the event of a violation of the contract's terms. An investment advice fiduciary who breaches this contract could be subject to a private cause of action for breach of contract, which is especially important for IRA providers, as IRA owners do not currently have a cause of action against investment advisers for breach of fiduciary duties under ERISA. The proposed exemption permits the contract to require that individual disputes be resolved through arbitration, and prohibits any limitation on the right of a plan, participant, or IRA owner to bring or participate in a class action lawsuit to resolve disputes.

The proposed regulations have a 75-day comment period, and we expect that several hundred comments will be submitted.

SEC Staff Publishes Money Market Fund Reform FAQs

In April 2015, the staff of the SEC's Division of Investment Management published guidance in two separate releases (the Releases) to follow up on the money market fund reforms the SEC adopted in July 2014 (the 2014 MMF Release). The first of the two Releases (the MMF FAQs) discusses interpretive questions that came out of the 2014 MMF Release.[6] The second Release (the Valuation FAQs) discusses the valuation guidance for all mutual funds contained in the 2014 MMF Release.[7]

The MMF FAQs address several topics, including:

- Issues related to reorganizations designed to allow a fund to comply with the Rule 2a-7 amendments;
- Issues related to qualifying as a retail money market fund, including the practice in which sponsors of retail money market funds provide seed capital to launch money market funds;
- Stress testing of U.S. Treasury money market funds not being needed, as long as the fund board determines that the types of events covered by the tests are not relevant for the fund;
- Floating net asset value (NAV) money market fund shares coming within the meaning of the term "cash items" for purposes of the statutory definition of "investment company;" and
- Other topics, including website disclosure, statements in sales literature about maintaining a stable NAV, compliance dates, fees and gates, government money market funds, diversification, and asset-backed securities.

Although the 2014 MMF Release pointed out that fund boards may not delegate their responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security, the Valuation FAQs state that the 2014 MMF Release "was not intended to change the general nature of the board's responsibility" in this regard. The Valuation FAQs clarify that a fund board may appoint others to provide assistance in determining fair value, and a fund board may "may delegate to its appointee, subject to adequate oversight, specific responsibilities" to assist it in implementing valuation policies and procedures.

SEC Announces Whistleblower Awards to Compliance Professionals

The SEC announced on April 22, 2015, that it will award between $1.4 million and $1.6 million to a whistleblower who provided information to the SEC in an enforcement action against the whistleblower's employer.[8] Notably, the award recipient is a compliance professional. The award is the SEC's second such payment to an employee with internal audit or compliance responsibilities. The SEC announced the previous award—more than $300,000—in August 2014. In both situations, the SEC noted that the whistleblowers reported misconduct to the SEC after the company became aware of the misconduct and failed to take action. Andrew Ceresney, Director of the SEC's Division of Enforcement, noted that "when investors or the market could suffer substantial financial harm, our rules permit compliance officers to receive an award for reporting misconduct to the SEC." These awards are of concern to many companies because compliance professionals, by the nature of their jobs, have access to sensitive information.[9]

SEC Names a New Director of the Division of Investment Management

The SEC announced that David Grim has been named Director of the Division of Investment Management. Mr. Grim has been the division's acting director since February, following the departure of former director Norm Champ. Mr. Grim originally joined the SEC in September 1995 as a staff attorney in the division's Office of Investment Company Regulation, the SEC said in a news release. In January 1998, he moved to the division's Office of Chief Counsel and was named Assistant Chief Counsel in September 2007. Mr. Grim was appointed as deputy director of the division in January 2013, with responsibility for overseeing all aspects of its disclosure review, rulemaking, guidance, and risk monitoring functions.

OCIE Announces 2015 Priorities

The SEC's Office of Compliance, Inspections and Examinations (OCIE) recently announced its selected list of 2015 examination priorities for investment advisers, broker-dealers, and transfer agents.[10] These priorities generally address high-risk practices and products affecting market participants on both individual and national scales. They are grouped into three primary areas:

1) *Protecting Retail Investors and Investors Saving for Retirement*. OCIE is concerned that trends in retail investment resulting from the current low interest rate environment could present heightened risks for the average investor, as many in the financial services industry are resorting to traditionally alternative or institutional forms of investment to generate higher yields. Additionally, in response to the increase in importance of personal investment accounts for retirement purposes, financial services firms are expanding their products and services to help investors plan for retirement. To investigate the risks created by these growing trends, OCIE plans various examination initiatives, including:

    a. *"Alternative" Investment Companies*. Where firms offer alternative investments and strategies, OCIE will assess their products and services by focusing on three areas: leverage liquidity and valuation policies and practices; factors relevant to the adequacy of the funds' internal controls, including staffing, funding, and empowerment of boards, compliance personnel, and back officers; and the manner in which such funds are marketed to investors.

    b. *Fixed Income Investment Companies*. Expecting that the current interest rate environment will not last, OCIE will be reviewing whether mutual funds with high exposure to interest rate increases have implemented the compliance policies and procedures necessary to provide accurate disclosures, and that their investments and liquidity profiles are consistent with those disclosures.

2) *Assessing Market-Wide Risks*. OCIE plans to use the following initiatives, among others, to assess the potential for systemic risks to the market:

a. *Large Firm Monitoring*. Together with the Division of Trading and Markets and the Division of Investment Management, OCIE will monitor large U.S. broker-dealers and asset managers to assess risks at individual firms to maintain early awareness of potential industry-wide developments.

b. *Cybersecurity*. Following 2014's initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and control, OCIE will expand this initiative to include transfer agents.

3) *Using Data Analytics To Identify Signals of Potential Illegal Activity*. OCIE has developed and become more proficient in using data analytics to identify and target firms that appear to be engaged in potentially fraudulent or otherwise illegal activities. In 2015, OCIE will use these capabilities to address activities such as recidivist representatives, microcap fraud, excessive trading, and anti-money laundering noncompliance.

4) *Other Initiatives*. In addition to the areas described above, OCIE also expects to address other priorities, including:

a. *Proxy Services*. OCIE will select certain proxy advisory service firms and examine how they make recommendations on proxy voting, how they address potential conflicts of interest, and how well investment advisers comply with their fiduciary duties concerning voting proxies on behalf of their clients.

b. *Never-Before-Examined Investment Companies*. OCIE will conduct focused, risk-based examinations of selected registered investment company complexes that have yet to be examined.

SEC Broadly Interprets Janus on Enforcement Actions

The SEC has issued an opinion[11] essentially exempting its enforcement actions from the holding of the U.S. Supreme Court's decisions in *Janus Capital Group v. First Derivative Traders*.[12] In *Janus*, the Supreme Court ruled that, concerning the antifraud provisions of Rule 10b-5 under the Securities Exchange Act of 1934[13] and Section 17(a) of the Securities Act of 1933,[14] primary liability for misrepresentations and omissions lies with the person who has the ultimate authority over the statement or omission, including its content and whether and how to communicate it.[15] In its opinion, the SEC interpreted *Janus* to mean that, because of the breadth of certain provisions within Rule 10b-5 and Section 17 and the limited holding of *Janus*, the Supreme Court's decision does not limit the SEC's ability to bring charges under Rule 10b-5.[16]

The opinion addressed an enforcement action brought by the SEC's Division of Enforcement against two employees of an unregistered fixed-income fund.[17] The two employees, a senior product manager and chief investment officer, were charged with misleading investors about the risk profile and extent of subprime mortgages held by the fund between 2006 and 2007, as well as the effect of certain asset sales.[18] Both employees were initially cleared in 2011, with the administrative law judge holding that *Janus* precluded charges being brought against either party, as neither of them had "ultimate authority" over the statements.[19]

On appeal, the SEC reasoned that while *Janus* does limit liability for a misleading statement under Rule 10b-5(b), it does not similarly restrict Rules 10b-5(a) or (c).[20] Those provisions allow for primary liability to be applied to anyone who, with scienter, or intent to deceive, uses any manipulative device or engages in any manipulative act in selling or buying securities.[21] Therefore, even if *Janus* did apply to the SEC's use of Rule 10b-5(b), the agency would still be able to bring charges under Rule 10b-5(a) or (c).[22] The SEC concluded that the ruling in *Janus* does not, in fact, limit its ability to bring charges under Rule 10b-5 at all.[23] The SEC argues that this interpretation does not expand the narrow scope with which the Supreme Court limited the implied right of action, as the SEC does not have the same reliance requirements.[24]

The SEC also held that *Janus* does not apply to Section 17(a), which has no private right of action. Stating that Section 17(a) does not require manipulative or deceptive conduct to apply, the opinion read each section to apply in specific cases: 17(a)(1) applies to all scienter-based fraud;[25] 17(a)(2) applies whenever a party obtains money or property by means of an untrue statement;[26] and 17(a)(3) applies to the general effect on members of the investing public, while being limited to transactions, practices, and courses of business.[27]

The SEC found that the senior product engineer had violated all three sections of 10b-5 and Section 17(a)(1) by approving and using presentation materials, including a PowerPoint presentation, that misrepresented his firm's investment in asset-backed securities by as much as 45 percent.[28] The chief investment officer was found to have only violated Section 17(a)(3) when he negligently approved client letters containing false statements about the fund's risk profile and advice from the investment adviser that was inconsistent with the views of others within the firm.[29] The SEC suspended the respondents for one year from association with any investment adviser or investment company, and assessed penalties of $65,000 and $6,500, respectively.[30] The matter is currently on appeal.

SEC Staff Releases Results of Cybersecurity Examination Sweep

On February 3, 2015, OCIE released a summary of its findings from a set of examinations it conducted on registered broker-dealers and investment advisers in 2013 and 2014.[31] The examinations focused on how firms representing a cross-section of the industry handle risks related to cybersecurity, and how vulnerable they are to cyber-attacks.

In the examinations, OCIE staff collected information related to, among other things, firms' policies and practices on identifying cybersecurity risks (including those arising from vendors and remote access); establishing cybersecurity governance; protecting firm networks and information; and detecting unauthorized activity. OCIE staff also collected information about firms' experiences with cyberattacks.

The following are some of the observations OCIE offered based on the examinations:

- The vast majority of firms have adopted written information security policies, and most of them conduct audits of compliance with these policies.
  - Business continuity plans often address cybersecurity attacks, and provide for the mitigation and response to cyber incidents.
  - Written policies and procedures generally do not address how firms determine whether they are responsible for client losses resulting from cyber incidents, and very few firms offer security guarantees to protect clients.
  - Many firms use published standards to model their information security measures—for example, firms use standards from the National Institute of Standards and Technology and the International Organization for Standardization.
- The vast majority of firms conduct periodic assessments to identify cybersecurity threats and potential business consequences. However, fewer firms require such risk assessments from vendors with access to the firms' networks.
- Most of the firms reported that they had experienced some kind of cyber-related incident. In particular, a quarter of the broker-dealers that had losses related to fraudulent e-mails noted that the losses resulted from

employees not following the firms' identity authentication procedures.

OCIE staff is still reviewing information from these examinations, and cybersecurity will continue to be a focus of OCIE in 2015. In addition to the SEC, the Financial Industry Regulatory Authority, the regulatory organization for broker-dealers, has identified cybersecurity as a top examination priority.[32] Further SEC guidance about how firms can address cyber risks and incidents is probably forthcoming. In the meantime, OCIE's reported findings highlight a number of items that firms may want to consider in evaluating their current level of preparedness. In doing so, firms can:

- Review OCIE's sample cybersecurity document request for an idea of what an OCIE examination would cover.[33]
- Perform periodic risk assessments to identify internal and external risks (included risks associated with, among other things, vendors or other third parties, devices, connections, software, and sign-on capabilities).
- Update firm policies and procedures, including the firm's business continuity plan, based on findings of risk assessments.
- Test and adjust technical controls.
- Ensure proper training takes place, and document details of when and with whom the training was conducted.
- Participate in information sharing opportunities with industry peers. For example, the Securities Industry and Financial Markets Association encourages its members to join the Financial Services Information Sharing and Analysis Center, which enables firms to receive notifications and information designed to help protect systems and assets.[34]

SEC's Focus in 2015

On December 11, 2014, Mary Jo White, Chair of the Securities and Exchange Commission (SEC), gave a speech at The New York Times DealBook Opportunities for Tomorrow Conference[35] wherein she highlighted the SEC's priorities for 2015 related to industry risks arising from the portfolio composition and operations of investment advisers and funds. These priorities include:

1) *Enhancing Data Reporting*. Funds and investment advisers currently report significant information about their portfolios and operations to the SEC. However, in her speech, Chair White noted a desire to expand and update the existing reporting and disclosure requirements for both funds and investment advisers. The goal would be to improve the data and information the SEC uses to draw conclusions about risks in the asset management industry and to develop appropriate regulatory responses. In particular, Chair White emphasized SEC staff recommendations to enhance the reporting and disclosure of: (1) basic census information, (2) a fund's investments in derivatives, (3) the liquidity and valuation of a fund's holdings, and (4) a fund's securities lending practices.

2) *Enhancing Controls on Risks Related to Portfolio Composition*. To enhance existing controls on risks related to portfolio composition, SEC staff is focusing on liquidity management and the use of derivatives in mutual funds and Exchange Traded Funds (ETFs). SEC staff is considering whether to require mutual funds and ETFs to adopt broad risk management programs to address the risks related to their liquidity and derivatives use.

Simultaneously, SEC staff is reviewing proposals for specific requirements, such as updated liquidity standards, disclosure of liquidity risks, or measures to appropriately limit the leverage created by a fund's use of derivatives.

3) *Improving Transition Planning and Stress Testing*. To better mitigate operational risk,

funds and investment advisers must take steps to ensure they have a plan for transitioning their clients' assets when circumstances warrant. Correspondingly, SEC staff is developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business.

In addition, SEC staff is considering ways to implement new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act.[36]

In her concluding remarks, Chair White stated the SEC will look to investors and market participants to provide input to help implement SEC staff proposals into workable regulations for funds and investment advisers. Consequently, to ensure that any final regulations reflect a blend of best practices and investor safeguards, funds, investment advisers and other industry participants are well-advised to become acquainted with the proposals and involved in the conversation with SEC staff as soon as practicable.

MSRB Adopts Municipal Advisory Supervision Rule, Proposes Amending Current MSRB Rules G-37, G-20, and G-3 to include Municipal Advisors, and Implements a New Fee for Municipal Advisors

During 2014, the Municipal Securities Rulemaking Board (MSRB) adopted its dedicated municipal advisor rule, requiring the implementation of a supervisory system for municipal advisors. Furthermore, the MSRB has continued to propose rules and rule amendments to implement a regulatory structure for municipal advisors. These proposals have included restricting political contributions, adopting a professional qualification examination requirement, extending gift rules to municipal advisors, and expanding existing books and records requirements. The MSRB also implemented a new fee for municipal advisors.

In October 2014, the U.S. Securities and Exchange Commission (SEC) approved the adoption of MSRB Rule G-44, the first dedicated MSRB rule for municipal advisors, which relates to the supervisory and compliance obligations of municipal advisors. Rule G-44 requires implementation of a reasonably designed supervisory system, as well as the designation of a chief compliance officer ("CCO"). These changes take effect on April 23, 2015, except for Rule G- 44(d), relating to annual certification, which takes effect on April 23, 2016. Rule G-44 requires that municipal advisors:

- Establish, implement, and maintain a system to supervise their municipal advisory activities and those of their associates, which system is reasonably designed to achieve compliance with all applicable securities laws and regulations, including MSRB rules;

- Implement processes to establish, maintain, review, test, and modify written compliance policies and supervisory procedures;

- Designate one individual as their CCO to serve as a primary advisor to the municipal advisor on the overall compliance scheme (CCO can be a firm employee or a person external to the firm); and

- Have the firm's chief executive officer(s) (or equivalent officer(s)) annually certify in writing that the municipal advisor has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable rules.

In conjunction with the approval of Rule G-44, the SEC also approved amendments to MSRB Rule G-8, relating to books and records to be made by brokers, dealers, and municipal securities dealers, and MSRB Rule G-9, on preservation of records. These amendments address the books and records that must be made and preserved by municipal advisors required to register with the SEC, including records related to supervisory and compliance obligations.

Also in October 2014, the MSRB requested comment on draft amendments to MSRB Rule G-20 on gifts, gratuities and non-cash compensation given or permitted to be given by brokers, dealers, and municipal securities dealers. The proposed changes would apply rule G-20, and related record-keeping requirements contained in Rules G-8 and G-9, to municipal advisors, and codify existing MSRB and (FINRA) interpretive guidance into rule form. Under the proposed change, Rule G-20, which applies to the activities of dealers, would extend certain restrictions to municipal advisors and associated persons, including:

- A prohibition of gifts or gratuities in excess of $100 per person per year in relation to the municipal securities activities of the recipient's employer;

- The exclusion from the $100 limit of "normal business dealings"; and

- The exclusion from the $100 limit of contracts of employment and contracts for compensation for services.

In August 2014, the MSRB requested comment on amendments to MSRB Rule G-37, which, if adopted, would extend the rule's coverage to municipal advisors. The amendments "are designed to address potential 'pay-to-play' practices by municipal advisors, consistently with the MSRB's existing regulation of dealers."

In April 2014, the MSRB filed a new rule with the SEC, A-11, which establishes an annual municipal advisor professional fee of $300 for each Form MA-I filed with the SEC. The rule became effective immediately upon filing.

In March 2014, the MSRB proposed amending Rule G-3 to create new "registration classifications" for municipal advisor representatives and principals under the rule, and to require municipal advisors to pass a professional qualification examination to continue to act in those capacities. The proposed amendments would not allow current municipal advisors to be "grandfathered" out of the examination requirement, but would allow a one-year grace period for job incumbents to complete the examination requirement.

SEC Issues No-Action Letter To Allow for Amendment of a Sub-Advisory Agreement without Shareholder Approval

On July 28, 2014, the SEC's Division of Investment Management issued a no action letter[37] stating that it would not recommend enforcement action under Section 15(a) of the Investment Advisers Act of 1940 if an investment adviser and a sub-adviser revised their sub-advisory agreement to reallocate the advisory fee paid by the advised fund without obtaining the approval of the fund's shareholders. The SEC staff's decision relied upon representations that the change in the allocation of the fee arrangement will not increase the total amount of advisory fee paid by the fund, and the level and nature of services provided by the advisers to the fund also will not change.

The facts underlying the no-action letter are as follows: RiverNorth Capital Management, LLC (RNCM) serves as investment adviser to the RiverNorth/DoubleLine Strategic Income Fund (the Fund). DoubleLine Capital, LP (DoubleLine) serves as the Fund's sub-adviser pursuant to a sub-advisory agreement between RNCM and DoubleLine. Under the sub-advisory agreement, a portion of the Fund's assets are allocated and managed by DoubleLine, and the rest of the Fund's assets are managed by RNCM. DoubleLine's fee is calculated by subtracting a pro rata portion of the Fund's operating expenses from the gross assets managed by DoubleLine. However, RNCM proposed to amend the sub-advisory agreement to eliminate DoubleLine's payment of a pro rata portion of the Fund's operating expenses and allow DoubleLine to be compensated based solely upon gross assets managed. This change would result in a slight increase in the advisory fee earned by DoubleLine. Likewise, it would result in a slight decrease in the fee earned by RNCM, as the entirety of the Fund's operating expenses would be paid from

RNCM's portion of the Fund's assets. However, the overall amount of advisory fee paid by the Fund would not change. Because the overall fee to the Fund and its shareholders will remain consistent under the amendment, and because the amendment will not reduce or modify the nature or level of service provided in any way, SEC staff decided not to recommend enforcement action against any of the parties if the sub-advisory agreement was amended as proposed without shareholder approval.

SEC Works on Rules To Address Risks Posed by Asset Management Industry

In September 2014, it was reported that the Securities and Exchange Commission (SEC) is weighing new rules to enhance oversight of registered funds, private funds, and investment advisers.[38] The aim would be to provide insight into whether the asset management industry presents risks to the financial system. The new requirements would mandate that investment advisory firms provide regulators more information about portfolio holdings, and that the firms conduct stress tests. Such tests would be focused on whether funds have sufficient liquid assets to sustain large-scale redemptions if market shocks were to occur.

Though the SEC and its staff have not yet arrived at a formal proposed rule, the potential rules would likely resemble requirements imposed after the worst of the financial crisis on large financial institutions to address risks that regulators believed these institutions posed to the economy. In particular, the practice by some mutual funds of using derivatives and other strategies employed by hedge funds is attracting the SEC's attention.

SEC Scrutinizes Annual Advisory Agreement Renewal Process

In July 2014, the SEC settled the previously reported proceeding involving Chariot Advisors and its former owner, Elliott Shifman, regarding charges of violating and aiding and abetting the violation of Section 15(c) of the 1940 Act.[39]

The SEC found that, in communications during the 15(c) process for a proposed fund, Chariot Advisors lied to the board of The Northern Lights Funds about Chariot's ability to run an algorithmic currency trading strategy. The SEC found that in PowerPoint presentations, in other written submissions, and during in-person presentations before the board, Mr. Shifman stated that Chariot Advisors would use algorithmic currency trading for the fund. According to the SEC's findings, however, Chariot Advisors did not possess any algorithms for conducting currency trading.

The SEC order points out that the ability to conduct currency trading for the Chariot Fund was particularly significant because the fund was just being formed and, in the absence of an operating history by which to judge performance, the Northern Lights board focused on Chariot Advisors' reliance on models in evaluating the advisory contract. The implementation of the currency trading strategy was also important, the SEC order notes, because Mr. Shifman had indicated that the S&P 500 Index would be an appropriate benchmark for the Chariot Fund's performance. As a result of the conduct described above, the SEC found that Chariot Advisors violated Section 15(c), and Mr. Shifman caused this violation.

This matter arose out of an initiative by the Asset Management Unit of the Enforcement Division of the SEC to scrutinize the 15(c) process. A fund board should take note that, in *In the Matter of Chariot Advisors, LLC,* the SEC examined the various disclosures made to the board during the 15(c) process.

Chariot Advisors is at least the fourth enforcement case the SEC's specialized asset management unit has brought as part of its compliance sweep regarding the requirement that fund boards evaluate their agreements with investment advisers. The proceeding also follows a 2013 investigation involving the Northern Lights Funds in which gatekeepers of the Northern Lights Fund Trust and the Northern Lights Variable Trust settled allegations that they caused false or misleading disclosures about what they considered in approving or renewing investment advisory contracts.

As a result of the *Chariot Advisors* proceeding, Mr. Shifman was suspended from association with virtually any entity in the securities industry for 12 months and ordered to pay a $50,000 fine.

Although the proceeding did not directly implicate the fund board, the action underscores the SEC's continuing intent to scrutinize the entire 15(c) process and, by implication, warns fund boards to be diligent in their adherence to their 15(c) duties.

EU Court of Justice Ruling May Allow U.S. Funds To Obtain Tax Refunds

The Court of Justice of the European Union (EU) ruled in April 2014 that a non-EU investment fund may be able to obtain the same tax exemption available to funds established in an EU member state.[40] The case arose in Poland, where domestic and EU investment funds are exempt from tax, but non-EU funds are subject to tax on the dividend income they receive. A U.S. mutual fund sought a tax refund, arguing that the disparate treatment was in violation of a provision of the Treaty on the Functioning of the European Union (TFEU), which prohibits restrictions on the movement of capital between member states and third countries.

The Court of Justice ruled that the TFEU prohibits the enactment of tax laws of a member state that make dividends payable to a non-EU investment fund ineligible for the applicable tax emption if the member state and nonmember state are bound by an obligation of mutual administrative assistance which enables the national tax authorities to verify information transmitted by the investment fund. The Court of Justice referred the case back to the Polish court for a determination whether the U.S. – Poland tax treaty meets this standard. The principles of the ruling, which apply across the EU, not just to Poland, could lead to large refunds for U.S. funds.

Investment Adviser Charged with Breaching Fiduciary Duties and Misleading Investors

In April 2014, the SEC charged Total Wealth Management, Inc., as well as its chief executive officer, chief compliance officer, and another employee, with violations of the securities laws.[41] The SEC alleged that Total Wealth and its CEO and owner, Jacob Keith Cooper, created a conflict of interest by paying themselves undisclosed "revenue sharing fees" derived from investments they recommended to investors and misrepresented the extent of the due diligence they had conducted on investments they recommended. The SEC also alleged that Total Wealth's chief compliance officer, Nathan McNamee, and Total Wealth representative Douglas David Shoemaker breached fiduciary duties they owed to clients, and defrauded clients, by not disclosing relevant conflicts of interest and by concealing the revenue-sharing fees. The SEC described these fees as "kickbacks."[42] Each of Messrs. Cooper, McNamee, and Shoemaker allegedly created an entity to receive the revenue-sharing fees and to hide the fact that they were the ultimate recipients of these payments. As described in the SEC's order, the revenue-sharing fees were not apparent to investors, and Total Wealth paid these fees to the controlled entities for "consulting" work, even though the other entities provided no consulting services. The alleged misconduct occurred in connection with investments in unregistered funds in the Altus family of funds. Total Wealth was also the owner and managing member of Altus Management, the general partner of the Altus funds.

The SEC charged, among other things:

- Total Wealth and Messrs. Cooper, McNamee and Shoemaker with violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder, and Section 207 of the Advisers Act, all of which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities

- Total Wealth and Mr. Cooper with breaching fiduciary duties in violation of Sections 206(1), 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 promulgated thereunder

The remedial actions that the SEC may seek could include financial penalties, disgorgement, and cease-and-desist orders.

Trend: Advisers Attacked for Overcharges on Subadvised Funds

In the first quarter of 2014, mutual fund shareholders continued to use Section 36(b) of the 1940 Act to sue certain investment advisers that subcontract advisory functions to a subadviser. Section 36(b) imposes a fiduciary duty on an investment adviser related to compensation received from funds. Under Section 36(b), shareholders have a right to recover excessive fees on behalf of the fund.

In March 2014, a plaintiff filed a complaint on behalf of the BlackRock Global Allocation Fund against BlackRock Advisors, the principal investment adviser to the fund.[43] In February 2014, other plaintiffs filed a complaint, also on behalf of the fund, against BlackRock Advisors, as well as against a former subadviser and the current subadviser, both of which are BlackRock affiliates.[44] The plaintiff in the March complaint alleged that, in 2013, the principal BlackRock adviser retained almost 43 percent of investment management fees, despite doing little work for the fund. The plaintiffs in the February 2014 complaint alleged that the fund was potentially paying more than twice what BlackRock charged other funds for subadvisory services outside of the BlackRock fund complex. The plaintiffs in both complaints also allege that adviser did not sufficiently share economies of scale with the fund by reducing fees as the fund grew. Additionally, the plaintiffs allege that fund's board failed to protect the fund and its shareholder, and did not independently and conscientiously negotiate arm's-length fees with the adviser.

Similar to the plaintiffs in these two suits against BlackRock, shareholders in February 2014 sued Harbor Capital Advisors over amounts being paid in relation to advisory fees paid by the Harbor International Fund.[45] The plaintiff alleged that the subadviser, Northern Cross, was doing substantially all of the work, but that Harbor Capital Advisors was nonetheless retaining about $100.5 million out of the more than $225 million the fund paid in investment management fees in 2012.

Despite the rise in suits alleging that advisers are receiving excessive fees from subadvised funds, the plaintiffs will have to overcome a high bar to prevail on their claims. They will have to prove that the defendant investment adviser charged a fee that is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[46]

SEC Focuses Independent Fund Trustees on Audit Quality

In February 2014, Paul Beswick, the SEC's chief accountant, urged fund audit committees to focus on audit quality rather than price. According to Mr. Beswick, "[I]f the audit committee is solely fee hunting and if there was a subsequent audit failure, beyond the obvious problems for the auditor and the company, this may raise questions about the diligence of the members of the audit committee in fulfilling their responsibilities." [47]

Mr. Beswick voiced his concerns immediately after the Public Company Accounting Oversight Board issued a report that was critical of the adequacy of current auditor reviews.[48] The report noted that the audits were generally deficient because the audit committees and other designated company reviewers were failing to assess independent audits properly. As a result, the report concluded that "[o]bservations from the Board's 2012 inspections indicated that audit deficiencies and the related deficiencies in engagement quality reviews continued to be high."

Mr. Beswick made his comments at the Practicing Law Institute's "SEC Speaks in 2014" Conference. One of the major focal points of the conference was how to improve the quality of independent auditor reports of public companies. The conference leaders concluded that audit committees are in the position to improve the process by performing adequate and meaningful reviews of their companies' independent audit reports.

1 The text of the Labor Department's proposed rule and related materials are available at http://www.dol.gov/ebsa/regs/conflictsofinterest.html

2 *See* Edward Hayes, *ICI Backs SIFMA's DOL Alternative*, Wolters Kluwer Financial Services, US Financial Services News (Jun. 19, 2015) (noting that the Financial Services Roundtable has produced its own alternative to the Labor Department's proposal).

3 Joe Morris, *Finra CEO Knocks DOL's Fiduciary Standard*, Ignites (May 28, 2015).

4 *Investment Company Reporting Modernization*, Securities Act Release No. 9776, Exchange Act Release No. 75,002, Investment Company Act Release No. 31,610 (May 20, 2015), available at https://www.sec.gov/rules/proposed/2015/33-9776.pdf

5 Press Release, SEC, *SEC Proposes Rules to Modernize and Enhance Information Reported by Investment Companies and Investment Advisers*, (May 20, 2015), available at http://www.sec.gov/news/pressrelease/2015-95.html

6 SEC Division of Investment Management, 2014 Money Market Fund Reform Frequently Asked Questions, http://www.sec.gov/divisions/investment/guidance/2014-money-market-fund-reform-frequently-asked-questions.shtml

7 SEC Division of Investment Management, Valuation Guidance Frequently Asked Questions, http://www.sec.gov/divisions/investment/guidance/valuation-guidance-frequently-asked-questions.shtml

8 Order Determining Whistleblower Award Claim, Exchange Act Release No. 74,781, File No. 2015-2 (Apr. 22, 2015), http://www.sec.gov/rules/other/2015/34-74781.pdf; Press Release, SEC, SEC Announces Million-Dollar Whistleblower Award to Compliance Officer (Apr. 22, 2015), http://www.sec.gov/news/pressrelease/2015-73.html

9 See Phyllis Diamond, Compliance Official Who Exposed Possible Misconduct Sees $1M WB Award, Sec. Reg. & L. Rep. (BNA) 846 (Apr. 27, 2015).

10 SEC, OCIE National Exam Program, Examination Priorities for 2015 (Jan. 13, 2015), available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

11 *John P. Flannery*, Release Nos. 33-9689, 34-73840, 1A-3981 (Dec. 15, 2014) available at, http://www.sec.gov/litigation/opinions/2014/33-9689.pdf (hereinafter "SEC Opinion").

12 *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011)(hereinafter "Janus").

13 17 C.F.R. § 240.10b-5.

14 15 U.S.C. § 77q(a)

15 *Id.*, at 2306.

16 SEC Opinion at 18-19.

17 *Id.*, at 2.

18 *Id.*, at 3.

19 *Id.*

20 *Id.*, at 17-19.

[21] *Id.*, at 18.

[22] *Id.*

[23] SEC Opinion, at 19.

[24] *Id.*

[25] *Id.*, at 13.

[26] *Id.*

[27] *Id.*

[28] *Id.*, at 8.

[29] SEC Opinion at 39.

[30] *Id.*, at 1-2.

[31] Office of Compliance Inspections and Examinations, SEC, Cybersecurity Examination Sweep Summary (Feb. 3, 2015), available at http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

[32] See Financial Industry Regulatory Authority, Report on Cybersecurity Practices (Feb. 2015), available at https://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602363.pdf.

[33] Office of Compliance Inspections and Examinations, SEC, OCIE Cybersecurity Initiative Appendix (Apr. 15, 2014), available at http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf.

[34] Edward Hayes, SIFMA, FINRA Join Forces on Cybersecurity, Wolters Kluwer Financial Services (Feb. 12, 2015).

[35] Chair Mary Jo White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Address Before The New York Times DealBook Opportunities for Tomorrow Conference Held at One World Trade Center, New York, N.Y. (December 11, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#_ftnref1.

[36] The Dodd-Frank Act requires the Commission to establish methodologies for this stress testing of financial companies such as broker-dealers, registered investment companies and registered investment advisers with $10 billion or more in total consolidated assets—including baseline, adverse, and severely adverse scenarios—and to design a reporting regime for this stress testing, which must be reported to the Commission and the Federal Reserve Board. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, section 165(i)(2), 124 Stat. 1423 (2010) (codified at 12 USC 5365).

[37] RiverNorth Capital Management, LLC, SEC No-Action Letter (July 28, 2014), http://www.sec.gov/divisions/investment/noaction/2014/rivernorth-072814.htm.

[38] Andrew Ackerman, *SEC Preps Mutual Fund Rules*, Wall St. J., Sept. 7, 2014, http://online.wsj.com/articles/sec-preps-mutual-fund-rules-1410137113; Edward Hayes, *SEC Considers Mutual Fund Rules*, US Fin. Servs. News, Sept. 10, 2014.

[39] *In re Chariot Advisors, LLC,* Admin. Proc. No. 3-15433, Investment Company Act Release No. 31149 (July 3, 2014).

[40] *Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy* (C-190/12) (April 10, 2014).

41 *In re Total Wealth Management, Inc.*, File No. 3-15842 (Sec. & Exch. Comm'n Apr. 15, 2014), http://www.sec.gov/litigation/admin/2014/33-9575.pdf.

42 Sec. & Exch. Comm'n, *SEC Charges San Diego-Based Investment Adviser* (Apr. 15, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541502917.

43 Complaint, *Foote v. BlackRock Advisors, LLC*, 3:14-cv-01991 (D.N.J. filed Mar. 28, 2014).

44 Complaint, *Clancy v. BlackRock Investment Management, LLC*, 3:14-cv-01165 (D.N.J. filed Feb. 21, 2014).

45 Complaint, *Zehrer v. Harbor Capital Advisors, Inc.*, 1:14-cv-00789 (N.D. Ill. filed Feb. 4, 2014).

46 *See Jones v. Harris Assocs., L.P.*, 559 U.S. 335, 345-46 (2010).

47 Paul Beswick, *Remarks at the AICPA 2013 Conference on Current SEC and PCAOB Developments* (Dec. 9, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370540488257.

48 Pub. Co. Accounting Oversight Bd., *Observations Related to the Implementation of the Auditing Standard on Engagement Quality Review*, PCAOB Release No. 2013-011 (Dec. 6, 2013), *available at* http://pcaobus.org/Inspections/Documents/120613_EQR.pdf.