Ballard Spahr LLP

INVESTMENT MANAGEMENT

Recent Investment Management Developments

July 2016

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.

SEC Enforcement Action against Private Equity Fund Adviser

On June 1, 2016, the SEC announced that a private equity fund adviser and its principal owner agreed to pay more than $3.1 million to settle SEC charges that, among other things, they acted as an unregistered broker and acted contrary to governing documents of funds they served.[1] The charges were against Blackstreet Capital Management, LLC (Blackstreet) and its principal owner, Murry N. Gunty (the Respondents). The Respondents agreed to the settlement without admitting or denying the SEC's allegations.

Acting as Unregistered Broker

The SEC found that Blackstreet performed in-house brokerage services for compensation rather than using investment banks or broker-dealers to handle the acquisition and disposition of portfolio companies for a pair of private equity funds that the Respondents advised. Blackstreet disclosed to its funds and their investors that Blackstreet would provide brokerage services in exchange for a fee, yet Blackstreet never registered as a broker-dealer.

Conflicted Transactions, Actions Contrary to Fund's Governing Documents

The SEC found that the Respondents engaged in conflicted transactions and inadequately disclosed fees and expenses.

According to the SEC, Blackstreet charged fees to portfolio companies in one fund for providing operating partner oversight, but the fund's limited partnership agreement (LPA) did not disclose that Blackstreet received such fees, thus creating an undisclosed conflict of interest. The SEC found that Blackstreet used fund assets to pay for unauthorized political and charitable contributions as well as entertainment expenses. According to the SEC, Blackstreet also engaged in a conflicted transaction when it acquired a departing employee's shares in one fund's portfolio companies without disclosing its financial interests or obtaining consent to the acquisition.[2]

The SEC also alleged that Gunty acquired fund interests from certain limited partners through an entity he controlled. According to the SEC, Gunty then directed the fund's general partner (which he also controlled) to waive Gunty's obligation to satisfy future capital calls associated with the investments. The SEC's order stated that these acquisitions and subsequent waivers were against the terms of the fund's LPA, and that Blackstreet's failure to disclose these waivers to fund investors made the LPA materially misleading.

Violations and Sanctions

The SEC's order finds that Blackstreet violated Section 15(a) of the Securities Exchange Act of 1934 (regarding broker registration requirements), and Sections 206(2) (anti-fraud provision) and 206(4) (anti-fraud provision, and prohibition of material misstatements and omissions by investment advisers) of the Investment Advisers Act of 1940 (Advisers Act). The SEC also found that Blackstreet violated a rule promulgated under the Advisers Act (Rule 206(4)-7) requiring investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

In addition to imposing cease and desist orders, the SEC's order requires the Respondents to disgorge about $2.3 million, including about $505,000 to be distributed to affected clients. The Respondents must also pay about $284,000 in interest and a $500,000 penalty.

SEC Issues Guidance on Business Continuity Planning for Registered Investment Companies

The Securities and Exchange Commission's (SEC or Commission) Division of Investment Management recently issued a guidance update (Guidance) addressing business continuity plans (BCPs).[3] In the Guidance, the Division's Staff (the Staff) underscores the importance of mitigating operational risks related to significant business disruptions, particularly through proper business continuity planning for registered investment companies (Funds).

Funds are required to adopt and implement written compliance policies and procedures reasonably designed to prevent violation of the federal securities laws pursuant to Rule 38a-1 of the Investment Company Act of 1940.[4] Because the SEC believes that business continuity planning is critical to a Fund's (or any business entity's) ability to continue operations during, and to recover from, a significant business disruption, the SEC has taken numerous steps to address business continuity practices in the financial services industry and the ability of market participants to continue operations during times of crisis.[5]

With regard to Fund compliance, the Staff believes that Funds should consider how to mitigate exposures through compliance policies and procedures that address business continuity planning and potential disruptions in services that could affect a Fund's ability to continue operations. In addition, the Staff suggests that Funds should consider conducting thorough initial and ongoing due diligence of those third parties, including due diligence of their service providers' business continuity and disaster recovery plans.

The Guidance enumerates a couple of notable practices for business continuity planning, including that (1) BCPs cover facilities, technology/systems, and employees as well as dependencies on critical services provided by other third-party service providers; (2) a broad cross-section of employees from key functional areas are involved in the BCP program; (3) the Fund's Chief Compliance Officer (CCO) participates in the Fund's third-party service provider oversight process; (4) BCP presentations are provided to Fund board of directors on an annual basis; (5) some form of BCP testing occurs at least annually; and (6) business continuity outages are monitored by the CCO and other pertinent Fund staff and reported to the Fund board as warranted.

In addition, in the Staff's view, a Fund's BCP should contemplate arrangements with critical service providers, and consider the following lessons learned from past business continuity events and the SEC's outreach efforts when formulating Funds' BCPs as they relate to critical service providers:

- Backup Processes and Contingency Plans
- Monitoring Incidents and Communications Protocols
- Understanding the Interrelationship of Critical Service Provider BCPs
- Contemplating Various Scenarios

In sum, the Staff believes that Funds will be better prepared to deal with business continuity events, if and when they occur, if Funds consider the robustness of their BCPs as well as those of their critical third-party service providers. The Staff also believes such planning will assist Funds and Fund complexes in mitigating the impact of significant business disruptions on operations and in servicing investors, as well as in complying with federal securities laws throughout business continuity events.

FINRA Proposes Amendments to Rules Governing Communications with the Public

The Financial Industry Regulatory Authority (FINRA) recently filed with the Securities and Exchange Commission (SEC or Commission) proposed amendments to certain aspects of the FINRA rules governing member firms' communications with the public.[6] The proposed rules would revise the filing requirements of FINRA Rule 2210 (Communications with the Public) and FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools) and the content and disclosure requirements in FINRA Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings).[7] This article addresses the impact of the proposed rule revisions, if adopted, on mutual funds.

I. Investment Company Shareholder Reports

FINRA Rule 2210 currently requires members to file the management's discussion of fund performance (MDFP) portion of a registered investment company shareholder report if the report is distributed or made available to prospective investors.[8] FINRA proposes to exclude the MDFP from the FINRA filing requirements by adding an express exclusion for annual or semi-annual reports that have been filed with the SEC in compliance with applicable requirements.[9]

II. Offering Documents Concerning Unregistered Securities

According to FINRA Rule 2210(c)(7)(F), "prospectuses, preliminary prospectuses, fund profiles, offering circulars and similar documents that have been filed with the SEC or any state, or that is exempt from such registration," are exempt from the filing requirements of Rule 2210 (c)(1) through (c)(4).[10] To avoid any confusion concerning the phrase "exempt from such registration," FINRA proposes to amend Rule 2210(c)(7)(F) to exclude from filing, among other things, "similar offering documents concerning securities offerings that are exempt from <u>SEC or state</u> registration requirements."

III. Backup Material for Investment Company Performance Rankings and Comparisons

Under existing FINRA rules, a member that files a retail communication for a registered investment company that contains a fund performance ranking or performance comparison must include a copy of the ranking or comparison used in the retail communication with its filing.[11] FINRA proposes to eliminate the requirement to file ranking and comparison backup material and instead expressly to require members to maintain backup materials as part of their records.[12]

IV. Generic Investment Company Communications

FINRA Rule 2210(c)(3)(A) requires members to file, within 10 business days of first use, retail communications "concerning" registered investment companies. FINRA proposes to revise this filing requirement to cover only retail communications that promote a specific registered investment company or family of registered investment.

V. Bond Mutual Fund Volatility Ratings

FINRA Rule 2213 requires members to file retail communications that include bond mutual fund volatility ratings to be accompanied or preceded by the bond fund's prospectus at least 10 business days prior to first use, and withhold them from publication or circulation until any changes specified by FINRA have been made.[13] The proposed rules would no longer require a retail communication that includes a bond fund volatility rating to be accompanied or preceded by a prospectus for the fund, and would permit members to file these communications within 10 business days of first use rather than prior to use. In particular, the proposed rules would eliminate the requirements: (1) that all disclosures be contained in a separate Disclosure Statement; (2) to disclose all current bond mutual fund volatility ratings that have been issued with respect to the fund; (3) to explain the reason for any change in the current rating from the most recent prior rating; (4) to describe the criteria and methodologies used to determine the rating; (5) to include a statement that not all bond funds have volatility ratings; and (6) to include a statement that the portfolio may have changed since the date of the rating.

MSRB Rule G-37 Amendments on Political Contributions and Related Issues Are Deemed Approved

Earlier this year, the Securities and Exchange Commission (SEC) was deemed to have approved[14] the Municipal Securities Rulemaking Board's (MSRB) amendments to MSRB Rule G-37 on political contributions and prohibitions on municipal securities business, and MSRB Rules G-8, G-9 (required records and preservation period, respectively) and Forms G-37 and G-37x (required reporting to the MSRB).

The amendments will become effective on August 17, 2016.[15] Once effective, amended Rule G-37 will extend the core standards under Rule G-37 to municipal advisors, their political contributions and the provision of municipal advisory business. The amendments are designed to address potential "pay-to-play" practices by municipal advisors consistently with the MSRB's existing regulation of dealers. The amendments to Rule G-37 will:

- prohibit a municipal advisor from engaging in municipal advisory business with a municipal entity for two years, subject to exceptions, following the making of a contribution to certain officials of the municipal entity by the municipal advisor, a municipal advisor professional (MAP) of the municipal advisor, or a political action committee (PAC) controlled by the municipal advisor or a MAP of the municipal advisor (a "ban on municipal advisory business");[16]
- prohibit municipal advisors and MAPs from soliciting contributions, or coordinating contributions, to certain officials of a municipal entity with which the municipal advisor is engaging, or seeking to engage, in municipal advisory business;
- require a nexus that links the influence that may be exercised by an official of a municipal entity—the influence in the awarding of business to the municipal advisor (or the dealer, municipal advisor or investment adviser clients of a defined municipal advisor third-party solicitor)—and the contributions received by the official;
- prohibit municipal advisors and certain MAPs from soliciting payments, or coordinating payments, to political parties of states and localities with which the municipal advisor is engaging in, or seeking to engage in, municipal advisory business;
- prohibit municipal advisors and MAPs from committing indirect violations of amended Rule G-37;

- require quarterly disclosures to the MSRB of certain contributions and related information;
- provide for certain exemptions from a ban on municipal advisory business; and
- extend applicable interpretive guidance under Rule G-37 to municipal advisors.

In addition, related amendments to Rule G-8 will add a new paragraph to impose the same recordkeeping requirements related to political contributions by municipal advisors and their associated persons that apply to dealers and their associated persons.[17] Amended Rule G-9 will require municipal advisors to preserve for six years the records required by amended Rule G-8.[18] Forms G-37 and G-37x will be amended to permit both dealers and municipal advisors to make the disclosures required under the amended rule on such forms, and, for dealer-municipal advisors, to make the required disclosures on a single form.[19]

FinCEN Finalizes Beneficial Ownership Identification Rules

[Please see our related article regarding AML requirements for investment advisers on page 23.]

As part of the U.S. Treasury Department's ongoing efforts to prevent bad actors from using U.S. companies to conceal money laundering, tax evasion, and other illicit financial activities, the Financial Crimes Enforcement Network (FinCEN) has issued a final rule to strengthen the customer due diligence (CDD) efforts of "covered financial institutions." [20] The CDD rule, issued May 11, 2016, requires covered financial institutions, including banks, federally insured credit unions, broker-dealers, mutual funds, futures commission merchants, and introducing brokers in commodities, to identify the natural persons that own and control legal entity customers—the entities' "beneficial owners." Covered financial institutions have until May 11, 2018, to comply with the CDD rule.

The rule imposes several new obligations on covered financial institutions with respect to their "legal entity customers." These include corporations, limited liability companies (LLCs), general partnerships, and other entities created by filing a public document or formed under the laws of a foreign jurisdiction. Certain types of entities are excluded from the definition of "legal entity customer," including financial institutions, investment advisers, and other entities registered with the Securities and Exchange Commission, insurance companies, and foreign governmental entities that engage only in governmental, noncommercial activities.

For each such customer that opens an account, including an existing customer opening a new account, the covered financial institution must identify the customer's "beneficial owners." The CDD adopts a two-part definition of "beneficial owner," with an ownership prong and a control prong. Under this approach, each covered financial institution must identify:

- each individual who owns 25 percent or more of the equity interests in the legal entity customer; and
- at least one individual who exercises significant managerial control over the customer.

The covered financial institution must verify the identity of each beneficial owner identified by the customer. Importantly, the covered financial institution is entitled to rely on the customer's certification regarding each individual's *status* as a beneficial owner. However, using the same procedures employed in its Customer Identification Program, the covered financial institution must obtain personally identifying information about each beneficial owner. This information must be documented and maintained by the covered financial institution. The CDD Notice of Proposed Rulemaking contemplated requiring the use of a standard certification form. However, the final rule makes use of the form, a copy of which is attached to the rule, optional and permits the covered financial institution to obtain and record the necessary information "by any other means that satisfy" its verification and identification obligations.

In response to industry concerns that the beneficial ownership identification obligation would require covered financial institutions to continually monitor the allocation of its customers' equity interests and the composition of its management team to update its beneficial ownership information, FinCEN made clear that the CDD rule does not require covered financial institutions to continuously update each customer's beneficial ownership information. Rather, the CDD calls for a "snapshot" of the customer's beneficial owners at the time of account creation. However, FinCEN does expect covered financial institutions to update beneficial ownership information when it detects relevant information about the customer during the course of regular monitoring.

In addition to the CDD rule, the Treasury Department also issued a Notice of Proposed Rulemaking (NPR) on May 10, 2016,[21] aimed at identifying the beneficial owners of foreign-owned single member LLCs. The NPR would impose additional reporting and recordkeeping requirements on these entities, by treating them as domestic corporations separate from their owners "for the limited purposes of the reporting and record maintenance requirements" imposed by the Internal Revenue Code. Under the proposed approach, each LLC would be required to:

- Obtain entity identification numbers from the Internal Revenue Service (IRS), which requires identification of a responsible party—a natural person;
- Annually file IRS Form 5472, an informational return identifying "reportable transactions" that the LLC engaged in with respect to any related parties, such as the entity's foreign owner; and
- Maintain supporting books and records.

SEC Issues Guidance Addressing Fund Disclosure Reflecting Risks Related to Current Market Conditions

The Division of Investment Management of the U. S. Securities and Exchange Commission (SEC) issued a guidance update[22] (the Update) in order to "foster investor protection by reminding mutual funds, exchange traded funds, and other registered investment companies of the importance to investors of full and accurate information about fund risks, including risks that arise as a result of changing market conditions." In the Update, the staff notes that it believes that funds should review risk disclosures on an ongoing basis and assess whether they remain adequate in light of current conditions.

The guidance states that clear and accurate disclosure of the risks of investing in funds is important to informed investment decisions and, therefore, to investor protection, and the staff has provided guidance on various aspects of risk disclosure on a number of occasions.[23] The Update is intended to address what the SEC staff views as another important aspect of fund risk disclosure, namely, the changes in risks that a fund may be subject to as a result of changes in market conditions.
According to the Update, funds should consider taking the following steps on an ongoing basis should in order to ensure that risk disclosures to investors remain adequate in changing market conditions:

- Monitor market conditions and their impact on fund risks;
- Assess whether fund risks have been adequately communicated to investors in light of current market conditions; and
- Communicate with investors.

To illustrate the types of disclosures that a fund may wish to consider, the Update provides two examples of where changing market conditions might necessitate updated risk disclosure. The first example was disclosures by fixed income funds regarding interest rate risk, liquidity risk, and duration risk. The second example is funds investing in debt securities issued by the Commonwealth of Puerto Rico and its agencies and instrumentalities. In each case, the staff has observed disclosures that highlight current conditions in a manner that they believe can make risk disclosure timelier, more meaningful, and more complete. The SEC staff has observed prospectuses, shareholder reports, and fund websites where such disclosures are included.

DOL Finalized Conflict of Interest Rule

The U.S. Department of Labor (DOL) published its long-awaited conflict of interest final rules (the Final Rules) revising the standards for becoming a fiduciary to retirement plans under the Employee Retirement Income Security Act of 1974 (ERISA), and to individual retirement accounts (IRAs) under the Internal Revenue Code of 1986 (the Code). The Final Rules, published April 8, 2016, were based on a proposal by DOL made in April 20, 2015 (the Proposed Rule). The DOL also adopted certain other exemptions, including the Best Interest Contract Exemption (BIC Exemption), a class exemption for allowing principal transactions in certain debt securities, and amendments to existing exemptions allowing fiduciaries to receive compensation in connection with certain securities transactions.

The Final Rule

DOL received an enormous amount of feedback on the Proposed Rule from the financial services and employee benefits industries. In response to the feedback the DOL incorporated the following revisions into the Final Rule:

- Clarifying the standard for determining whether a person has made a "recommendation" covered by the final rule
- Clarifying that marketing oneself or one's service without making an investment recommendation is not fiduciary investment advice
- Removing appraisals from the rule and reserving them for a separate rulemaking project
- Allowing asset allocation models and interactive materials to identify specific investment products or alternatives for ERISA and other plans (but not IRAs) without being considered fiduciary investment advice, subject to conditions
- Providing an expanded seller's exception for recommendations to independent fiduciaries of plans or IRAs with financial expertise and plan fiduciaries with at least $50 million in assets under management;
- Clarifying the difference between "education" and "advice"

The BIC Exemption

In conjunction with the final rule, as noted above, the DOL also finalized series of prohibited transaction exemptions (PTEs), one of which is the BIC Exemption. The DOL adopted the BIC exemption with the following revisions:

- Eliminating the limited asset list
- Expanding its coverage to include advice provided to sponsors of small 401(k) plans
- Eliminating the contract requirement for ERISA plans and participants
- Not requiring contract execution prior to advisers' recommendations
- Specially allowing for the required contract terms to be incorporated in account-opening documents
- Providing a negative consent process for existing clients to avoid having to get new signatures from those clients
- Simplifying execution of the contract by requiring the financial institution to execute the contract rather than also requiring each individual adviser to sign
- Clarifying how a financial institution that limits its offerings to proprietary products can satisfy the best interest standard
- Streamlining compliance for fiduciaries that recommend a rollover from a plan to an IRA or moving from a commission-based account or moving from one IRA to another and will receive only level fees
- Eliminating most of the proposed data collection requirements and some of the more detailed proposed disclosure requirements
- Requiring the most detailed disclosures envisioned by the BIC exemption to be made available only upon request

- Providing a mechanism to correct good faith violations of the disclosure conditions without losing the benefit of the exemption

The final rule is effective June 7, 2016 and the compliance date is April 10, 2017. However, certain requirements (including the written contract requirement) will have a compliance date of January 1, 2018.

SEC's Chair White Speaks on Role of Fund Boards

Mary Jo White, Chair of the Securities and Exchange Commission (SEC), spoke about the role of mutual fund directors, particularly independent directors, in light of recent developments in the fund industry. She made her remarks to a group gathered at a conference of the Mutual Fund Directors Forum on March 29, 2016.

Chair White addressed the historical evolution of the role of independent directors of mutual funds, and then focused on the role of fund directors in assessing more recent risks in the industry. She also discussed recent SEC enforcement actions against fund directors.

Evolving Role of Independent Fund Directors

Chair White noted that the Investment Company Act of 1940 (as amended, the 1940 Act) established a corporate governance framework in which the boards of mutual funds, which often lack any employees of their own, provide an independent check on the management of the funds' investment advisers. Since 1940, Chair White observed, courts, Congress, and the SEC have articulated additional and specific responsibilities that fund directors bear.

Role of Independent Fund Directors in 2016 – Risk Assessments

Regarding the role of independent directors in light of today's environment, Chair White cited two specific events as examples of emerging risks that fund boards should keep in mind:

- BNY Mellon: In August 2015, a glitch in software used by Bank of New York Mellon resulted in the custodian bank being unable to provide daily calculations of net asset values for several fund families. The incident lasted several days. To Chair White, this episode illustrates an operational risk that fund boards should consider. In addressing risks related to service providers, she noted that board should inquire into whether "fund management [has] considered the backup systems and redundancies of the critical service providers that value the fund, keep track of fund holdings and transactions, and strike NAVs." She also noted that funds boards should look at whether "fund management also considered specific alternate systems or work-arounds that may be necessary to continue operations or manage through potential business disruptions."

- Third Avenue: In December 2015, the Third Avenue Focused Credit Fund, which concentrated its investments in high-yield and distressed debt, suspended redemptions and liquidated as a result of insufficient liquidity in the face of increased redemption requests. Chair White observed that, when addressing potential liquidity issues, boards should ask questions that will enable them to understand whether the funds' investments are appropriately aligned with their anticipated liquidity needs and redemption obligations. She noted that relevant considerations include "the quality of the information that management provides to the board on liquidity, the frequency with which management reports to the board on liquidity, and how management of the funds monitors and manages liquidity risk."

Besides operational and liquidity risks, Chair White mentioned other risks that fund boards should be evaluating, including cybersecurity, derivatives, liquidity, trading, pricing, and fund distribution. She reminded the audience that fund directors should consider whether their current fund boards have members with the necessary skills, experience, and expertise.

Chair White observed that the proper role of a fund board is to provide oversight of critical fund functions, but *not* day-to-day management. She acknowledged that determining an appropriate dividing line between oversight and day-to-day management is a challenge. The SEC, she noted, is facing this challenge as it considers rule proposals related to enhanced reporting for investment advisers and mutual funds; liquidity risk management reforms; and the use of derivatives by funds. Yet another area of responsibility for fund boards, which has been the subject of recent SEC staff guidance, is understanding the overall distribution process (including the marketing and sales of fund shares) to inform the board's judgment about whether certain fees represent payments for distribution, which should be paid pursuant to a Rule 12b-1 plan.

<u>Enforcement</u>

Chair White noted two recent enforcement actions brought against fund directors, in the first of which eight fund directors, including independent directors, were found to have caused funds to violate Rule 38a-1 under the 1940 Act, which requires funds to adopt, and boards to approve, policies and procedures related to fair valuation, and in the second, four fund directors, including independent directors, were found to have failed to satisfy their obligations under Section 15(c) of the 1940 Act to properly request and evaluate information reasonably necessary for the board to approve the terms of an investment advisory contract.

Chair White noted that the failures that gave rise to these enforcement actions were basic ones, and that most fund directors, who "exercise their responsibilities effectively, performing their oversight role with diligence and skill… should not fear enforcement, as judgments that directors make in good faith based on responsibly performing their duties will not be second guessed."

SEC, FINRA Release 2016 Examination Priorities

The Financial Industry Regulatory Authority (FINRA) and the U. S. Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) published their examination priorities for 2016. [24] Both OCIE and FINRA are increasing their examination focus on protection of retail investors, market risks posed by technology, anti-money laundering (AML) compliance, and issues related to liquidity.

The annual publication of these examination priorities provides securities industry participants a useful window into the thinking of FINRA and the SEC staff as to the most important risks facing the industry. Market participants should take the opportunity to review their policies, procedures and operations in the indicated areas, to ensure that the identified risks have been addressed.

<u>OCIE 2016 Examination Priorities</u>

OCIE's examination priorities focus on the same three policy priorities as did the 2015 priorities—protecting retail investors and investors saving for retirement; assessing market-wide risks; and using data analytics to identify signals of potential illegal activity. Each of the policy priorities is discussed below.

Protecting Retail Investors and Investors Saving for Retirement

OCIE noted that the theme of protecting retail and retirement investors has been a priority for the past few years, and that it is likely to remain so for the foreseeable future. OCIE specifically identified the following examination initiatives that are related to this theme.

> <u>ReTIRE</u>. In June 2015, OCIE launched this multi-year examination initiative, focusing on

SEC-registered investment advisers and broker-dealers and the services they offer to investors with retirement accounts for issues related to recommendations made to investors, conflicts of interest, supervision and compliance controls, and marketing and disclosure practices.

Exchange-Traded Funds (ETFs). OCIE is planning to examine ETFs for compliance with applicable exemptive relief granted under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 and with other regulatory requirements, as well as review how the ETF units (as distinct from the shares that trade on an exchange) are created and redeemed. These examinations also will focus on sales strategies, trading practices, and disclosures involving ETFs, including excessive portfolio concentration, primary and secondary market trading risks, adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs.

Branch Offices. OCIE plans to continue to examine SEC-registered broker-dealers' and investment advisers' supervision of their associated persons in branch offices, including using data analytics to identify associated persons in branches that appear to be engaged in potentially inappropriate trading.

Fee Selection and Reverse Churning. OCIE plans to continue to examine SEC-registered investment advisers and dually-registered investment adviser/broker-dealers that offer retail investors a variety of fee arrangements (e.g., asset-based fees, hourly fees, wrap fees, commissions). The focus of these examinations will be on recommendations of account types and whether the recommendations are in the best interest of the retail investor at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such arrangements.

Variable Annuities. OCIE stated that it is aware that variable annuities have become a part of the retirement and investment plans of many investors. These examinations will assess the suitability of sales of variable annuities to investors (e.g., exchange recommendations and product classes), as well as the adequacy of disclosure and the supervision of such sales.

Public Pension Advisers. OCIE plans to examine advisers to municipalities and other government entities, focusing on pay-to-play and certain other key risk areas related to advisers to public pensions, including identification of undisclosed gifts and entertainment.

Assessing Market-Wide Risks

OCIE noted in the 2016 priorities that the SEC's mission is not limited to protecting investors and facilitating capital formation, but also includes maintaining "fair, orderly, and efficient markets." OCIE noted the following examination initiatives in this connection.

Cybersecurity. In September 2015, OCIE launched its second initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and controls. This initiative continues in 2016.

Regulation Systems Compliance and Integrity (SCI). OCIE plans to examine certain self-regulatory organizations, alternative trading systems, plan processor, and clearing agencies to evaluate whether they have established, maintained, and enforced written policies and procedures reasonably designed to ensure the capacity, integrity, resiliency, availability, and security of their SCI systems.

Liquidity Controls. Due to the changes in fixed-income markets over the past several years, OCIE plans to examine advisers to mutual funds, ETFs, and private funds that have exposure to potentially illiquid fixed-income securities. OCIE also intends to examine registered broker-dealers that have become new or expanding liquidity providers in the marketplace.

Clearing Agencies. OCIE plans to continue to conduct annual examinations of clearing agencies designated systemically important, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Areas for review will be determined through a risk-based approach in collaboration with the Division of Trading and Markets and other regulators, as applicable.

Using Data Analytics to Identify Signals of Potential Illegal Activity

Recidivist Representatives and their Employers. OCIE plans to continue to use its analytic capabilities to identify individuals with a track record of misconduct and examine the firms that employ them. For example, they will assess the compliance oversight and controls of investment advisers that have employed such individuals after they have been disciplined or barred from a broker-dealer.

Anti-Money Laundering. OCIE plans to continue to examine broker-dealers' AML programs, using its analytic capabilities to focus on firms that have not filed the number of suspicious activity reports (SARs) that would be consistent with their business models or have filed incomplete or late SARs. OCIE also will continue to assess AML programs with a particular emphasis on the adequacy of the independent testing obligation, to ensure that these programs are robust and are targeted to each firm's specific business model, and the extent to which firms consider and adapt, as appropriate, their programs to current money laundering and terrorist financing risks.

Microcap Fraud. OCIE plans to continue to examine the operations of broker-dealers and transfer agents for activities that indicate they may be engaged in, or aiding and abetting, pump-and-dump schemes or market manipulation. OCIE also will review whether broker-dealers are complying with their obligations under the federal securities laws when publishing quotes for or trading securities in the over-the-counter markets.

Excessive Trading. OCIE plans to continue to analyze data, including data obtained from clearing brokers, to identify and examine firms and their registered representatives that appear to be engaged in excessive or otherwise potentially inappropriate trading.

Product Promotion. OCIE also will focus on detecting the promotion of new, complex, and high-risk products and related sales practice issues to identify potential suitability issues and potential breaches of fiduciary obligations.

FINRA 2016 Examination Priorities

FINRA also will be maintaining its focus on the protection of retail investors in its examination program for 2016. FINRA indicated that its primary areas of focus are firm culture, conflicts and ethics; supervision, risk management and controls; and capital funding.

Firm Culture, Conflicts and Ethics

FINRA has focused on firm culture and conflicts of interests in a variety of contexts over the last few years. This remains a focus of the examination program for 2016. FINRA identified five primary

FINRA plans to assess five "indicators" of a firm's culture:

- Whether control functions are valued within the organization
- Whether policy or control breaches are tolerated
- Whether the organization proactively seeks to identify risk and compliance events
- Whether supervisors are effective role models of firm culture
- Whether sub-cultures (e.g., at a branch office, a trading desk, or an investment banking department) that may not conform to overall corporate culture are identified and addressed.

Supervision, Risk Management and Controls

FINRA stated its intention to focus four areas where they have observed repeated concerns that affect firms' business conduct and the integrity of the markets. Those areas are management of conflicts of interest, technology, outsourcing, and anti-money laundering.

Regarding the management of conflicts of interest, FINRA expects to complete its 2015 sweep examination of member firms regarding their compensation practices. FINRA expects to publish the results as they relate to the compensation of registered representatives, and firms' approaches to mitigating conflicts of interest that arise through the sale of proprietary or affiliated products, or products for which a firm receives third-party payments (e.g., revenue sharing).

FINRA also noted that firms' technology systems and controls would be an area of continued focus, given that technology failures can create the potential for significant customer harm, as well as pose threats to market integrity. FINRA also noted that it will continue to focus on the design and implementation of AML controls at member firms.

Capital Funding

FINRA devotes substantial resources to monitoring firms financial stability on an on-going basis, and that in connection with its 2016 examination program, it plans to focus on firms' funding needs and liquidity, and that high-frequency trading firm would be a particular focus.

Other Areas of Focus

FINRA also noted additional areas of focus across a variety of topical areas that are in additional to the core themes discussed above. These topics include suitability and concentration; sales to seniors and vulnerable investors; sales charges and discounts, including in connection with 529 plans; securities offerings; outside business activities of registered representatives; financial and operational controls; and issues impacting market integrity.

Conclusion

Both the OCIE and FINRA examination priorities letters should be reviewed carefully by firms that are subject to the jurisdiction of these regulators. However, they should not be read as an exhaustive list of examination topics, as priorities could shift, or new issues could emerge during 2016.

SEC Seeks to Increase Investment Adviser Examinations

A senior official at the U. S. Securities and Exchange Commission (SEC) has announced that the SEC intends to increase the number of examinations that SEC-registered investment advisers that its staff conducts each year.[25] The SEC staff has been concerned for some time that the examination rate for investment advisers, which in 2015 was 10 percent, is too low.[26] By contrast, the examination rate for SEC-registered broker-dealers was just over 50 percent.[27]

The process to increase the examination rate is beginning with the reassignment of approximately

100 current staff members from examining broker-dealers to examining investment advisers. The transition process is expected to be completed by the end of 2016. The SEC also is still considering using third-party firms to conduct examinations of SEC-registered investment advisers, but no formal actions have been taken, and the assistant director of the SEC's Division of Investment Management stated that such a plan was unlikely to be adopted during 2016.

SEC Issues Guidance on Mutual Fund Distribution and Sub-Accounting Fees

The Securities and Exchange Commission's (SEC) Division of Investment Management (the staff) has issued a Guidance Update (the guidance)[28] outlining their views and recommendations that resulted from the "Distribution in Guise" sweep examination that recently was concluded (see our prior article on Page 8). The guidance focuses on the conflicts of interest that arise when mutual fund assets are used to pay for subaccounting[29] provided by financial intermediaries that also distribute the funds, if such payments are not made pursuant to a plan of distribution adopted pursuant to Rule 12b-1 under the 1940 Act (a Rule 12b-1 Plan), and the ways that investment advisers to funds and the funds' boards of directors can address these conflicts.

Payments by mutual funds for subaccounting services do not in and of themselves raise any conflict of interest issues, and generally are paid out of the mutual fund's assets. However, when these payments are made to intermediaries, the question arises as to whether some or all of the payments for subaccounting services are really payments for the distribution services of the intermediary. If they are for distribution services, and if the payments are not made pursuant to a Rule 12b-1 Plan, this presents a conflict of interest, as the sale of additional shares of a mutual fund primarily benefit the adviser, through a higher investment advisory fee, and not the shareholders of the mutual fund.

In the guidance the staff recommends that:

- Boards implement a process to evaluate whether a portion of subaccounting service fees is being used to pay directly or indirectly for distribution
- Advisers (and other relevant service providers) provide sufficient information to boards to allow them to make that determination
- Advisers and other relevant service providers should inform boards about any subaccounting servicing arrangements that are potentially distribution-related, so that the board can review these arrangements with "heightened attention"

These three recommendations are discussed in detail below.

Board Process

The guidance notes that in the staff's view, when an intermediary receives payments for subaccounting services, it raises a question as to the direct or indirect use of fund assets for distribution that the fund board should weigh in on. Therefore a process reasonably designed to assist the board in evaluating whether a portion of subaccounting service fees, is being used for distribution purposes, is strongly recommended. The guidance suggests that the same types of factors and analysis as described in the 1998 Letter[30] on mutual funds supermarket fees may serve as a useful framework even though some of these factors may not be relevant to sub-accounting fees.

The staff also noted that, in adapting the 1998 Letter to the consideration of sub-accounting fees, additional relevant information also likely would include, but would not be limited to:

- Information about the specific services provided under the mutual fund's sub-accounting agreements
- The amounts being paid
- If the adviser and other service providers are recommending any changes to the fee

structure or if any of the services provided have materially changed
- Whether any of the services could have direct or indirect distribution benefits
- How the adviser and other service providers ensure that the fees are reasonable
- How the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so).[31]

The guidance notes that some mutual fund boards also have established maximum allowable sub-accounting fees to be paid with fund assets. The staff recommends that if a board uses fee caps as part of this process, it should carefully evaluate any benchmark used in establishing the cap. In addition, the guidance mentions that many mutual funds did not have explicit policies and procedures as part of their rule 38a-1 compliance programs designed to prevent violations of rule 12b-1 and the adoption of such policies and procedures are recommended.

Information to be Provided to Boards regarding Distribution and Servicing Agreements

The guidance notes that Rule 12b-1(d) of the 1940 Act requires a board to request, and parties to agreements related to a 12b-1 plan to furnish, any information reasonably necessary to make an informed determination of whether such plan should be implemented or continued. In addition, advisers have a fiduciary duty to either eliminate relevant conflicts of interest, or to mitigate and to provide full and fair disclosure of the conflict. Therefore, the staff recommends that advisers and other relevant service providers provide boards with information sufficient for it to evaluate whether and to what extent sub-accounting payments may reduce or otherwise affect advisers' or their affiliates' revenue sharing obligations, or the level of fees paid under a rule 12b-1 plan. The staff noted that this information is likely to be relevant to the board's analysis of these payments.

Indicators that a Payment May Be for Distribution

The guidance lists certain activities and arrangements that may raise concerns that payments shareholder services may be, in part, for distribution. Those include:

- Distribution-related activity conditioned on the payment of sub-accounting fees
- Lack of a 12b-1 plan
- Tiered payment structures
- Lack of specificity or bundling of services
- Distribution benefits taken into account when negotiating the arrangement
- Large disparities in sub-accounting fees paid to intermediaries
- Sales data provided by intermediaries

Scope of Boards' Obligations

The staff recognizes that mutual fund boards are typically not involved in the day-to-day negotiation of agreements with intermediaries. Thus, the staff noted that mutual fund directors could receive and rely on the assistance of outside counsel, the fund's chief compliance officer, or personnel from the adviser or relevant service providers, as appropriate, to assist them in making these judgments.

SEC Charges Investment Advisory Firm with Fraud

The Securities and Exchange Commission (SEC) announced fraud charges against Atlantic Asset Management LLC (AAM), an investment advisory firm, alleging AAM didn't inform clients of a conflict of interest that would benefit the firm.[32]

According to the SEC's December 15, 2015, complaint, a company that partially owns AAM is also a parent company of a broker-dealer. The SEC alleged that AAM invested more than $43 million of its clients' funds in illiquid bonds without disclosing the conflict of interest created by the bond sales generating a private placement fee for the broker-dealer that is affiliated with AAM. These actions, the SEC alleged, constituted securities fraud.

The SEC based its suit primarily on the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940. In a press release, Andrew M. Calamari, Director of the SEC's New York Regional Office, stated that AAM violated its duty to its clients by placing its own financial interests ahead of client interests, and that "AAM's clients should have been informed that the investments in illiquid bonds would financially benefit people with ownership control over AAM."

This suit by the SEC highlights the need for investment advisers to assess and disclose existing or potential conflicts of interest. Advisers with financial industry affiliations must be particularly aware of the potential for conflicts of interest, and the need to disclose such conflicts and potential conflicts to clients.

SEC Proposes Rule Regulating Derivatives

The Securities and Exchange Commission (SEC) in December proposed Rule 18f-4 under the Investment Company Act of 1940, as amended (the Act), to provide a comprehensive approach to the regulation of the use derivative instruments by mutual funds, closed-end funds, exchange-traded funds, and business development companies (collectively, Funds).

The proposed rule limits Funds' use of leverage through derivative transactions, requires that any Fund engaging in derivative transactions has adequate assets available to meet its obligations in connection with those transactions, and also require Funds to put risk management measures in place.[33] Derivative transactions are defined to include transactions in any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument") under which the Fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise.

The proposed rule also imposes requirements on Funds engaging in "financial commitment transactions," including reverse repurchase agreements, short sale borrowings, and any firm or standby commitment agreement. Additional reporting and disclosure requirements also would be added to proposed Form N-PORT and proposed Form N-CEN.

<u>Requirements for Derivatives</u>

Under the proposed rule, Funds may engage in derivative transactions only if the Fund:

- Complies with one of the two portfolio limitations
- Segregates and maintains certain qualifying assets, and
- Adopts a formal derivatives risk management program, if required, based on the Fund's use of derivatives.

Portfolio Limitations for Derivatives Transactions

Under the proposed rule, a Fund would be required to comply with one of two alternative portfolio limitations designed to limit the amount of leverage the Fund may obtain through derivatives and certain other transactions.

> <u>Exposure-Based Portfolio Limit</u>: Under the exposure-based portfolio limit, a Fund's aggregate exposure would be limited to 150 percent of the Fund's net assets. 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. The notional amount of any derivative transaction can be adjusted under certain circumstances.

Risk-Based Portfolio Limit*:* Only Funds in which the use of derivatives reduces the Fund's overall market risk may rely on this limit. Under the risk-based portfolio limit, a Fund's exposure would be limited 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 a 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.

Asset Segregation for Derivatives Transactions

Funds would be required to manage the risks associated with derivatives by segregating certain assets (generally cash and cash equivalents) equal to the sum of two amounts.

Mark-to-Market Coverage Amount*:* Funds would be required to segregate assets equal to the amount that the Fund would pay if the Fund exited the derivatives transaction at the time of the determination. This amount can be reduced by the amount of any variation margin the Fund has posted in connection with a transaction, and also by giving effect to any netting agreement in place between the parties.

Risk-Based Coverage Amount: Funds also would be required to segregate an additional risk-based coverage amount representing a reasonable estimate of the potential amount the Fund would pay if the Fund exited the derivatives transaction under stressed conditions. The Fund would be required to adopt policies governing the calculation of this amount, which policies must be approved by the board of directors (or similar body) of the Fund.

Derivatives Risk Management Program

Funds that engage in more than limited derivatives transactions (derivatives exposure exceeding 50 percent of the Fund's net assets) or that use any complex derivatives would be required to establish a formalized derivatives risk management program consisting of certain components (counterparty risk, leverage risk, liquidity risk, market risk, and operational risk), which would be administered by a designated derivatives risk manager. The Fund's board of directors would be required to approve and review the derivatives risk management program and approve the derivatives risk manager.

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.

Requirements for Financial Commitment Transactions

A Fund that enters into financial commitment transactions 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.

Disclosure and Reporting

Proposed Form N-PORT

The proposed revisions to Form N-PORT would require registered funds other than money market funds to provide portfolio-wide and position-level holdings data to the Commission on a monthly basis. The proposal would amend the form to require a Fund that is required to have a derivatives risk management program to disclose additional risk metrics related to its use of certain derivatives.

Proposed Form N-CEN

The proposed revisions to Form N-CEN would require registered funds to annually report certain census-type information to the Commission. The proposal would amend the form to require that a Fund disclose whether it relied on the proposed rule during the reporting period and the particular portfolio limitation applicable to the Fund.

Comment Period

The proposed rule is open for comment until March 28, 2016.

SEC Amends Money Market Rules, Removing References to Credit Ratings, Eliminating Exclusion from Issuer Diversification Provisions

The SEC adopted rule amendments to eliminate references to credit ratings in Rule 2a-7 and Form N-MFP under the Investment Company Act of 1940, as amended (the 1940 Act).[34] The SEC also amended issuer diversification provisions to eliminate an exclusion for securities subject to a guarantee issued by a non-controlled person.

Eligible Securities, Minimal Credit Risk Determinations

As amended, Rule 2a-7 provides that the determination of whether a security is an "eligible security"[35] will require a "single uniform minimal credit risk finding, based on the capacity of the issuer or guarantor of a security to meet its financial obligations." The SEC stated that eliminating references in Rule 2a-7 to ratings by nationally recognized statistical rating organizations (NRSROs) is not intended to change the current risk profile of money market funds, and that it also should not change fund boards' evaluation of minimal credit risk. To maintain similar risk profiles to those of current money market portfolios, revised Rule 2a-7 codifies general credit analysis factors that fund boards (or their delegates) must use to determine whether a security presents a "minimal credit risk."

The credit analysis factors include:

- Issuer's or guarantor's financial condition
- Issuer's or guarantor's sources of liquidity
- Issuer's or guarantor's ability to react to future market-wide and issuer- or guarantor-specific events, including the ability to repay debt in highly adverse situations, and
- Strength of the issuer's or guarantor's industry within the economy and relative to economic trends, and the issuer's or guarantor's competitive position within its industry.

The September 16, 2015, adopting release includes guidance on how each of these general factors could be evaluated. The SEC pointed out that the factors listed above and the guidance in the release are not exhaustive, and that other factors may be relevant, depending on the type of security being evaluated. Such evaluation should not be limited to the risk profile of a security in isolation. Rather, the evaluation should include consideration of the contribution of the security to the fund's aggregate credit risk. To that end, the SEC said such evaluation might include an examination of correlation of risk among securities held; credit risk associated with market-wide stresses; or specific security credit or liquidity disruptions.

The SEC noted that it appreciates concerns that eliminating the "floor" provided by NRSRO ratings could lead funds to take on additional credit risk in attempts to increase yield. To address this concern, the SEC codified the requirement to consider the factors listed above. The SEC stated that analyzing counter-party relationships, to the extent a fund has access to information needed to do so, should assist fund boards when making minimal credit risk determinations. However, the SEC declined to require such a consideration because the SEC staff has not identified this as a commonly used factor and is not aware of information suggesting many money market funds have the necessary information readily available.

Fund boards should consider necessary changes to their Rule 2a-7 policies and procedures to ensure that they are consistent not only with amended Rule 2a-7 but with the SEC's stated intent that the current risk profile of money market funds should not change. Money market funds and their boards should also consider whether other credit-related factors are relevant to their determinations about "minimal credit risk."

The amended rule also requires money market fund advisers to engage in "ongoing" monitoring of minimal credit risk determinations, which means "monitoring efforts should occur on a regular and frequent basis." The SEC stated that it understands that many funds currently monitor market changes and issuer-specific events on a daily basis.

Issuer Diversification

The amended rule eliminates an exclusion to the issuer diversification requirements for securities subject to guarantees issued by non-controlled persons. As a result of the elimination of this exclusion, a money market fund that invests in a security subject to a guarantee will need to comply with the following requirements:

- Securities subject to a guarantee (or demand feature) provided by any one guarantor may not exceed 10 percent of the fund's total assets, and
- Securities issued by any one issuer may not exceed 5 percent of the fund's total assets.

Compliance Date

Money market funds, their boards, and their advisers must comply with the amended rule by October 14, 2016. Consistent with their obligations under Rule 38a-1 under the 1940 Act, before that date, money market funds and their boards must adopt revised compliance policies "reasonably designed" to ensure compliance with the new credit quality and diversification obligations under Rule 2a-7.

U.S. Court of Appeals for the District of Columbia Circuit Dismisses Challenges to SEC's Political Contribution Rule

The U.S. Court of Appeals for the District of Columbia Circuit recently dismissed a petition brought by the New York Republican State Committee and the Tennessee Republican Party (plaintiffs) requesting direct review of a four-year-old rule, promulgated under the Investment Advisers Act of 1940 (Investment Advisers Act), regulating campaign contributions by investment advisers (Political Contribution Rule).[36]

The case was originally brought in the District Court for the District of Columbia in August 2014, in which the plaintiffs sought an order declaring that the Political Contribution Rule, as applied to federal campaign contributions, exceeds the SEC's statutory authority, and violates the Administrative Procedure Act and the First Amendment. They also sought an order enjoining the SEC from enforcing the rule with respect to federal campaign contributions. The District Court dismissed the suit for lack of subject matter jurisdiction on the grounds that the courts of appeals had exclusive jurisdiction to hear challenges to rules under the Investment Advisers Act.[37]

The plaintiffs appealed the decision and concurrently filed a petition urging the Court of Appeals to grant their petition and exercise jurisdiction. First, they claimed that the Investment Advisers Act's review provision does not apply to their challenge because the text of the provision contemplates only review of the SEC's orders and says nothing of its rules. In the alternative, the plaintiffs argued that the Court of Appeals should grant their petition for review even though it was not timely filed. In this connection, they contended that the law governing where and when they were supposed to file was so unclear that they were justified in filing late. Finally, they maintained that the statute's 60-day period for mounting challenges to rules is unlawfully short.

The Court of Appeals dismissed the case, holding that absent countervailing indicia of congressional intent, statutory provisions for direct review of orders encompassed challenges to rules.[38] The Court of Appeals held that if the plaintiffs were uncertain about where and when to file their suit, the Court of Appeals' precedent gave precise instructions about what to do. The proper course for the plaintiffs to protect their rights was to file a petition with the Court of Appeals within 60 days of the rule's issuance. Third, the plaintiffs' final argument, that Congress cannot place a 60-day limit on access to pre-enforcement relief, was similarly foreclosed as "a limitations period is only too short if 'the time allowed [to file a claim] is manifestly so insufficient that the statute becomes a denial of justice.' *Wilson v. Iseminger*, 185 U.S. 55, 63 (1902)."

Therefore, the Court of Appeals held that it had exclusive jurisdiction to hear challenges to rules promulgated under the Investment Advisers Act and such challenges must be brought in this court within 60 days of promulgation of the rule, and there were no grounds for an exception in this case. It therefore affirmed the District Court's decision and dismissed the petition as time-barred.

Supreme Court Denies Schwab's Petition for Review of Ninth Circuit Court of Appeals Decision; District Court Issues Decision upon Remand

Schwab Investments' (Schwab) petition to the U.S. Supreme Court for review of an April 2015 decision of the Ninth Circuit Court of Appeals (the Ninth Circuit), which allowed common law claims to proceed against Schwab related to its management of the Schwab Total Bond Market Fund (the Fund), was denied by the U.S. Supreme Court on October 5, 2015.[39] On that same day, the U.S. District Court for the Northern District of California (District Court) issued an opinion deciding on a motion to dismiss filed by Schwab.[40]

The Ninth Circuit's decision in *Northstar Financial Advisors, Inc., v. Schwab Investments* ruled in favor of Northstar Financial Advisors (Northstar), which sued Schwab, its trustees, and the investment advisor, Charles Schwab Investment Management Inc., on behalf of shareholders of the Fund, alleging the Fund had deviated from its fundamental investment strategy of managing the Fund to track a bond index maintained by Lehman Brothers Holdings Inc. According to the complaint, Schwab invested 37 percent of the Fund's assets in CMOs even though the fund's investment objectives prohibited investing more than 25 percent of its assets in any given industry. Schwab petitioned to have the Ninth Circuit reconsider its decision, but in April 2015, the Court of Appeals refused to rehear the case en banc. Accordingly, Schwab's only remaining avenue for review was to seek certiorari from the Supreme Court.

Northstar's final amended complaint, upon which the Ninth Circuit ruled, stated eight claims for breaches of fiduciary duty and two breach of contract claims. Ultimately, the Ninth Circuit found that the fund documents at issue in the case created a contract with shareholders and held that Schwab had breached that contract by investing heavily in CMOs from 2007 to 2009. The Ninth Circuit also ruled that shareholders could bring these claims directly against the Fund on the basis of specific state laws, or on common law principles. The case was remanded to the District Court, with a direction to consider whether the state law claims were precluded by Securities Litigation Uniform Standards Act of 1998 (SLUSA).

In its petition for certiorari from the Supreme Court, Schwab indicated that the Ninth Circuit's decision in this case "threatens to expand significantly" the lawsuits brought against mutual funds. The Investment Company Institute (ICI) also filed an amicus brief supporting Schwab's position and arguing that the ruling would have widespread adverse effects on funds and their shareholders. The basis for both Schwab and ICI's concern was that the Court of Appeals' decision creates a new cause of action (a breach of contract claim) for shareholders of mutual funds who believe that the mutual fund has deviated from its investment policy.

The impact of the Ninth Circuit decision may be of limited impact, however, as the District Court's

October decision upon remand found Northstar's breach of contract claims to be precluded by SLUSA. The breach of fiduciary claims against Schwab and the Trustees were not dismissed, but the District Court did not consider whether SLUSA precluded these claims, as it held that Schwab and the Trustees were precluded from asserting a SLUSA defense on procedural grounds. In addition, in November 2015, a similar case against PIMCO Funds also was dismissed, by the U.S. District Court for the Central District of California, based on similar grounds.[41]

SEC Settles First "Distribution-in Guise" Case

The SEC reached a settlement in September 2015, with First Eagle Investment Management (First Eagle) and its affiliate FEF Distributor, LLC (the Distributor) which were charged with improperly causing the First Eagle Funds (the Funds) to use Fund assets to pay for services intended to market the Funds and distribute the Funds' shares outside of a plan of distribution adopted under Rule 12b-1 of the Investment Company Act of 1940 (the 1940 Act).

According to the complaint, the Distributor entered into a Selected Dealer Agreement (Dealer Agreement) and a Correspondent Marketing Program Participation Agreement (Marketing Agreement) with two intermediaries in 2006 and 2007 respectively. The Dealer Agreement stated in its opening paragraph that the Distributor "[has] invited [Intermediary One] to become a selected dealer to *distribute shares* of the [Funds]." (The Distributor also had separately entered into a Financial Services Agreement with Intermediary One in which Intermediary One agreed to provide a variety of sub-transfer agency services that are typically paid for out of fund assets.) The Marketing Agreement stated that Intermediary Two will "(i) provide e-mail distribution lists of correspondent broker-dealers that have requested 'sales and marketing concepts' from Intermediary Two; (ii) [and] market the Funds on its internal websites; (iii) invite the Funds to participate in special marketing promotions and offerings to correspondent broker-dealers;…"

The SEC alleged that the fees paid pursuant to the Dealer Agreement and the Marketing Agreement were included in the amounts that were reported to the Fund's board of directors as sub-transfer agency costs, and, as a result, were paid out of the Fund's assets outside of its Rule 12b-1 Plan.[42] Furthermore, the Funds' prospectus disclosure regarding distribution expenses stated that "FEF Distributors or its affiliates bear distribution expenses to the extent they are not covered by payments under the Rule 12-b plans." Therefore, SEC alleged that First Eagle and the Distributor violated Section 206(2) of the Advisers Act[43], Section 12(b) of the Investment Company Act and Rule 12b-1[44], and Section 34(b) of the Invest Company Act[45]. Without admitting or denying the charges, First Eagle and the Distributor agreed to pay nearly $40 million to the affected shareholders.

This is the first case arising out of the Distribution-in Guise Initiative, the stated goal of which is to ensure that mutual fund assets are not used to pay distribution-related expenses outside of a Rule 12b-1 Plan adopted by the mutual fund's board of directors.

SEC Proposes Rules to Establish Liquidity Risk Management Programs and Adopt Swing Pricing

In September 2015, the SEC proposed a new rule and amendments to its existing rules and forms that are intended to promote effective liquidity risk management throughout the mutual fund industry.[46] The new rule and amendments, if adopted, are expected to enhance the liquidity risk management by reducing the risk that funds will be unable to meet redemption obligations and mitigating dilution of the interests of fund shareholders in accordance with section 22(e) and Rule 22c-1 under the Investment Company Act of 1940.

Proposed Rule 22e-4

The SEC is proposing new Rule 22e-4, which would require each registered open-end fund, including open-end exchange-traded funds (ETFs) but not including money market funds, to establish a liquidity risk management program that is designed to assess and manage the fund's liquidity risk. Under the proposed rule, liquidity risk would be defined as the risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value.

A. Program Requirements

According to proposed Rule 22e-4, a fund's liquidity risk management program must include the following required program elements: classification, and ongoing review of the classification, of the liquidity of each of the fund's positions in a portfolio asset (or portions of a position in a particular asset); assessment and periodic review of the fund's liquidity risk; and management of the fund's liquidity risk, including the investment of a set minimum portion of net assets in assets that the fund believes are convertible to cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale.

B. Classifying the Liquidity of a Fund's Portfolio Positions

In classifying and reviewing the liquidity of portfolio positions, proposed Rule 22e-4 would require a fund to consider the number of days within which a fund's position in a portfolio asset (or portions of a position in a particular asset) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale. Based on its determination of the number of days within which the fund could convert its position in an asset to cash under this standard, the fund would be required to classify each of its positions in a portfolio asset into one of six liquidity categories:

- Convertible to cash within one business day.
- Convertible to cash within two to three business days.
- Convertible to cash within four to seven calendar days.
- Convertible to cash within eight to 15 calendar days.
- Convertible to cash within 16-30 calendar days.
- Convertible to cash in more than 30 calendar days.

In addition, the factors that a fund must consider in making these classifications include:

- Existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants
- Frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange)
- Volatility of trading prices for the asset
- Bid-ask spreads for the asset
- Whether the asset has a relatively standardized and simple structure
- For fixed income securities, maturity and date of issue
- Restrictions on trading of the asset and limitations on transfer of the asset
- The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding. Analysis of position size should consider the extent to which the timing of disposing of the position could create any market value impact, and
- Relationship of the asset to another portfolio asset

C. Assessing and Managing a Fund's Liquidity Risk

The proposed rule would require each fund to take the following factors into account, as applicable, in assessing the fund's liquidity risk:

- Short-term and long-term cash flow projections, taking into account the following considerations:
    - Size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods
    - The fund's redemption policies
    - The fund's shareholder ownership concentration
    - The fund's distribution channels, and
    - The degree of certainty associated with the fund's short-term and long-term cash flow projections
- The fund's investment strategy and liquidity of portfolio assets
- Use of borrowings and derivatives for investment purposes, and
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

This list is not meant to be exhaustive. In assessing its liquidity risk, a fund may take into account considerations in addition to the factors set forth in proposed rule 22e-4(b)(2)(iii). Proposed Rule 22e-4(b)(2)(iv) would require a fund to manage its liquidity risk based on this assessment, including: requiring the fund to determine (and periodically review) a minimum percentage of the fund's net assets that must be invested in three-day liquid assets (the fund's "three-day liquid asset minimum[47]"); prohibiting a fund from acquiring any less liquid asset if the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets; and prohibiting a fund from acquiring any 15 percent standard asset[48] if the fund would have invested more than 15 percent of its net assets in 15 percent standard assets.

D. Board Approval and Designation of Program Administrative Responsibilities

Under proposed Rule 22e-4(b)(3)(i), each fund would obtain initial approval of its written liquidity risk management program from the fund's board of directors, including a majority of independent directors. Proposed Rule 22e-4(b)(3)(iii) would expressly require a fund to designate the fund's investment adviser or officers (which may not be solely portfolio managers of the fund) responsible for administering the fund's liquidity risk management program, which designation must be approved by the fund's board of directors.

E. Record Keeping Requirements

Proposed Rule 22e-4(b)(3)(i) would require that each fund maintain a written copy of the policies and procedures adopted as part of its liquidity risk management program for five years, in an easily accessible place.

Amendments to Rule 22c-1

The SEC is proposing amendments to Rule 22c-1 to permit certain mutual funds (but not ETFs or money market funds), under certain circumstances, to use "swing pricing," the process of adjusting the Net Asset Value (NAV) of a fund's shares to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity, and amendments to Rule 31a-2 to require funds to preserve certain records related to swing pricing. Funds would be able to adopt swing pricing policies and procedures in their discretion (although, once these policies and procedures are adopted, a fund would be required to adjust its NAV when net purchases or net redemptions cross the swing threshold, unless the fund's board approves a change to the fund's swing threshold).

Disclosure and Reporting Requirements

With respect to reporting and disclosure, the SEC is proposing two amendments to Form N-1A regarding the disclosure of fund policies concerning the redemption of fund shares, and the use of swing pricing. The SEC is also proposing amendments to proposed Form N-PORT and proposed Form N-CEN that would require disclosure of certain information regarding the liquidity of a fund's holdings and the fund's liquidity risk management practices.

Compliance Dates

- *Liquidity Risk Management Program.* The SEC expects to provide for a tiered set of compliance dates based on asset size for proposed Rule 22e-4. For larger entities—namely, funds that together with other investment companies in the same "group of related investment companies" have net assets of $1 billion or more as of the end of the most recent fiscal year—the proposed compliance date is 18 months after the effective date to comply with proposed Rule 22e-4. For smaller entities (*i.e.*, funds that together with other investment companies in the same "group of related investment companies" have net assets of less than $1 billion as of the end of the most recent fiscal year), the SEC is proposing an extra 12 months (or 30 months after the effective date) to comply with proposed Rule 22e-4.

- *Swing Pricing.* Funds that choose to adopt swing pricing would be able to rely on the rule after the effective date as soon as the fund could comply with proposed Rule 22c-1(a)(3) and other requirements related to recordkeeping, financial reporting and prospectus disclosure.

- *Amendments to Form N-1A.* The SEC expects to require compliance with the proposed amendments for all initial registration statements on Form N-1A, and all post-effective amendments that are annual updates to effective registration statements on Form N-1A, which are filed six months or more after the effective date.

- *Amendments to Form N-PORT.* The effective dates for the amendments for Form N-Port are similar to the tiered compliance dates for the liquidity classification requirements for fund liquidity risk management programs under proposed Rule 22e-4 (discussed above). As such, the compliance dates would be based on asset size for the proposed amendments to proposed Form N-PORT. The SEC is proposing a compliance date of 18 months after the effective date for larger entities and an extra 12 months (or 30 months after the effective date) for smaller entities.

- *Amendments to Form N-CEN.* The proposed compliance date for these amendments is 18 months after the effective date to comply with the new reporting requirements.

Proposed Anti-Money Laundering Rules Applicable to Investment Advisers

The Financial Crimes Enforcement Network (FinCEN) recently issued proposed anti-money laundering (AML) rules (the Proposed Rules) that would apply to any investment adviser registered or required to be registered as an investment adviser with the Securities and Exchange Commission (the SEC).[49] This would include investment advisers to certain hedge funds, private equity funds, and other private funds.

If adopted as proposed, the Proposed Rules would require covered investment advisers to establish AML programs, report suspicious activity to FinCEN, and comply with certain other reporting and recordkeeping requirements. The Proposed Rules would subject investment advisers to recordkeeping requirements under the Bank Secrecy Act (the BSA) by including investment advisers in the definition of "financial institution" in the regulations that implement the BSA.

FinCEN described the Proposed Rules as addressing vulnerabilities in the U.S. financial system. It noted that money launderers might be attracted to investment advisers if they are not required to establish AML policies or suspicious activity reporting programs. Financial institutions that are already regulated under the BSA include mutual funds, broker-dealers, banks, and insurance companies.

Required AML Program

The Proposed Rules would require each covered investment adviser to develop and implement a written AML program. The AML program would need to be approved by the investment adviser's board of directors (or, if there is no such board, the persons performing functions similar to those of a board). In accordance with its AML program, the investment adviser would have to establish and implement policies, procedures and internal controls "reasonably designed" to prevent money laundering or the financing of terrorist activities, and to achieve and monitor compliance with the BSA. The design of the AML program would need to be based on the investment adviser's assessment of the money laundering or terrorist financing risks associated with the investment adviser's business. The investment adviser would have to test the AML program for compliance. The investment adviser would need to designate a person or persons as responsible for implementing and monitoring the AML program. The investment adviser would be required to provide for ongoing training for appropriate persons with respect to the AML program. Where an AML program already covers an investment adviser, such as when the investment adviser is dually registered with the SEC as an investment adviser and a broker-dealer or is affiliated with an entity required to establish an AML program, the investment adviser would not need to implement multiple or separate programs as long as the program covers all of the entity's activities and businesses that are subject to the BSA. Investment advisers could contractually delegate appropriate portions of its AML program to third-party service providers, such as broker-dealers, custodians, and transfer agents.

Required Suspicious Activity Reports

The Proposed Rules would require covered investment advisers to report suspicious transactions or attempted transactions by filing a suspicious activity report (SAR). The type of suspicious transactions that must be reported on a SAR are ones that did or would involve or aggregate at least $5,000.

Other Reporting and Recordkeeping Requirements

The Proposed Rules would impose on covered investment advisers the BSA regulatory requirements generally applicable to financial institutions. One such requirement is the obligation to file Currency Transaction Reports (CTRs). A CTR is required for a transaction that involves a transfer of more than $10,000 in currency by, through or to the investment adviser. This CTR requirement would supersede investment advisers' current obligation to file reports on Form 8300 for the receipt of more than $10,000 in cash and negotiable instruments. The Proposed Rules would also impose on applicable investment advisers the requirements of the "Recordkeeping and Travel Rules." The Recordkeeping and Travel Rules pertain to creating and retaining records for the transmittals of funds, and transmitting information about these transactions to other financial institutions in the payment chain. In this sense, the transaction information "travels" with the transmitted funds.

Compliance Dates, Enforcement

An investment adviser covered by the Proposed Rules would need to develop and implement an AML program by the date that is six months from the effective date of the final rule. The Proposed Rules would delegate to the SEC FinCEN's authority to examine compliance with these rules. FinCEN has the authority to impose civil penalties for violations of the BSA and its regulations.

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[50]

The Investment Company Institute and the Securities Industry and Financial Markets Association are among the organizations that oppose the Labor Department's proposal.[51]

Mr. Ketchum has stated that the SEC should formulate a unified standard, which would apply consistently to all investments, not only retirement savings.[52] 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 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 advisers' 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.

[1] In *re Blackstreet Capital Management, LLC and Murry N. Gunty*, File No. 3-17267, Exchange Act Release No. 77,959, Investment Advisers Act Release No. 4411 (June 1, 2016), *available at* https://www.sec.gov/litigation/admin/2016/34-77959.pdf.

[2] The SEC's order does not specify the party from whom Blackstreet failed to obtain consent. It seems likely, however, that the SEC's order is referring to the fund that owned the portfolio companies. Blackstreet was under a duty to disclose the proposed acquisition to the fund because Blackstreet was the fund's manager, thus making the proposed acquisition a conflicted transaction. The portfolio companies themselves may also have been entitled to consent. Under share purchase agreements, the portfolio companies had exclusive rights to repurchase the employee's shares at fair market value in the event of the employee's departure or termination. *See* page 6 of the SEC's order for the discussion of this topic.

[3] *See* https://www.sec.gov/investment/im-guidance-2016-04.pdf.

[4] *See* 17 CFR 270.38a-1(a)(1).

[5] *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] ("Compliance Program Adopting Release"). In 2003, the Commission also adopted rule 206(4)-7 under the Advisers Act, which makes it unlawful for a registered investment adviser to provide investment advice unless the adviser has adopted and implemented written policies and procedures that are reasonably designed to prevent violation by the adviser and its supervised persons of the Advisers Act and the rules thereunder. *See* 17 CFR 275.206(4)-7(a). In addition, the Commission proposed a new rule under the Advisers Act that would require SEC-registered investment advisers to adopt and implement business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser's operations and that also address certain components. *See* Adviser Business Continuity and Transition Plans, Advisers Act Rel. No. 4439 (June 28, 2016).

[6] *See* SR-FINRA-2016-018, *available at* https://www.finra.org/industry/rule-filings/sr-finra-2016-018.

[7] The SEC approved amendments to FINRA Rule 2210 (Communications with the Public) to require each of a member firm's websites to include a readily apparent reference and hyperlink to BrokerCheck on (1) the initial Web page that the firm intends to be viewed by retail investors, and (2) any other Web page that includes a professional profile of one or more registered persons who conduct business with retail investors. The rule amendments became effective June 6, 2016. *See* Regulatory Notice 15-50, *available at* http://www.finra.org/industry/notices/15-50.

[8] *See, e.g.*, Notice to Members 99-79 (September 1999) ("[m]embers are not required to file shareholder reports with [FINRA] if they are only sent to current fund shareholders. However, if a member uses a shareholder report as sales material with prospective investors, the member must file the management's discussion of fund performance (MDFP) portion of the report (as well as any supplemental sales material attached to or distributed with the report) with the Department.").

[9] *See* proposed amendments to FINRA Rule 2210(c)(7)(F). To the extent that a member distributes or attaches registered investment company sales material along with the fund's shareholder report, such material would remain subject to filing under Rule 2210.

[10] *See* FINRA Rule 2210(c)(7)(F).

[11] *See* FINRA Rule 2210(c)(3)(A).

[12] *See* proposed amendments to FINRA Rules 2210(b)(4)(A)(vi) and 2210(c)(3)(A).

[13] *See* FINRA Rules 2210(c)(2)(C) and 2213(b) and (c).

[14] Section 19(b)(2)(D) of the Security Exchange Act of 1934 (the Exchange Act) provides, in pertinent part, that "[a] proposed rule change shall be deemed to have been approved by the Commission, if (i) the Commission does not approve or disapprove the proposed rule change or begin proceedings under subparagraph (B) within the period described in subparagraph (A)," and Section 19(b)(2)(A) of the Exchange Act describes, unless extended, a 45-day period following the Commission's publication of the notice of a proposed rule change. 15 U.S.C. 78s(b)(2)(A) & (D).

[15] *See* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/~/media/CA9BEF27FD0A4C118EAA9A4875C87D52.ashx.

[16] The amendments to Rule G-37 include a number of new terms, which are defined in amended Rule G-37(g), *available at* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/~/media/CA9BEF27FD0A4C118EAA9A4875C87D52.ashx.

[17] *See* http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/~/media/CA9BEF27FD0A4C118EAA9A4875C87D52.ashx.

[18] *Id.*

[19] *Id.*

[20] *See* https://www.federalregister.gov/articles/2016/05/11/2016-10567/customer-due-diligence-requirements-for-financial-institutions.

[21] *See* https://www.federalregister.gov/articles/2016/05/10/2016-10852/treatment-of-certain-domestic-entities-disregarded-as-separate-from-their-owners-as-corporations-for.

[22] Fund Disclosure Reflecting Risks Related to Current Market Conditions, IM Guidance Update No. 2016-02 (March 2016).

[23] For example, the staff has highlighted the importance of providing a concise summary of principal investment risks, rather than a long, complex, and detailed description of those risks, in the summary section of the prospectus. *See* Guidance Regarding Mutual Fund Enhanced Disclosure, IM Guidance Update 2014-08 at 2-3 (June 2014).

[24] FINRA Regulatory and Examination Priorities Letter (January 5, 2016); OCIE Examination Priorities for 2016(January 11, 2016).

[25] Cameron Finch, SEC to Boost Adviser Exams Via Third Party Exams, Staff Moves, *Bloomberg BNA's Securities Regulation & Law Report*, 48 SRLR 401, February 29, 2016.

[26] U.S. Securities and Exchange Commission Fiscal Year 2015 Agency Financial Report at Page 51, *available at* https://www.sec.gov/about/secpar/secafr2015.pdf.

[27] *Id*.

[28] The guidance was issued by SEC in January 2016, No. 2016-01. See https://www.sec.gov/investment/im-guidance-2016-01.pdf

29 The guidance defines "sub-accounting fees" as fees paid to financial intermediaries characterized as non-distribution related sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees.

30 See Letter from Douglas Scheidt to Craig S. Tyle on October 30, 1998 at https://www.sec.gov/divisions/investment/noaction/1998/ici103098.pdf

31 See Page 4 of the guidance.

[32] Complaint, *SEC v. Atlantic Asset Management, LLC* (S.D. N.Y. Dec. 15, 2015), *available at* https://www.sec.gov/litigation/complaints/2015/comp-pr2015-280.pdf; Press Release, SEC, *SEC Announces Fraud Charges Against Investment Adviser* (Dec. 15, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-280.html

[33] The ability of Funds to borrow money or otherwise issue "senior securities" is limited under Section 18 of the Investment Company Act. Certain derivatives transactions (*e.g.,* forwards, futures, swaps and written options), as well as financial commitment transactions (*e.g.*, reverse repurchase agreements, short sale borrowings, or firm or standby commitment agreements or similar agreements) impose on a Fund an obligation to pay money or deliver assets to the Fund's counterparty, which implicates Section 18. The proposed derivatives framework would be an exemptive rule under Section 18.

[34] *See Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*, Investment Company Act Release No. 31,828 (September 16, 2015), *available at* http://www.sec.gov/rules/final/2015/ic-31828.pdf.

[35] Under current Rule 2a-7, a money market fund must limit its investments to securities that are both "eligible securities" and have been determined by the fund's board to pose minimal credit risks to the fund.

[36] *See No. 1:14-cv-01345*.

[37] *See New York Republican State Comm. v. SEC*, 70 F. Supp. 3d 362, 364 (D.D.C. 2014).

[38] *See Investment Company Institute v. Board of Governors of the Federal Reserve System*, 551 F.2d 1270, 1278 (D.C. Cir. 1977).

[39] *See Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 779 F.3d 1036, 2015 U.S. App. LEXIS 3670 (9th Cir. 2015), *as amended by* 2015 U.S. App. LEXIS 7027 (9th Cir. 2015).

[40] *See* No. 08-CV-04119-LHK, 2015 U.S. Dist. LEXIS 135847 (N.D. Cal. Oct. 5, 2015).

[41] *See Hampton v. Pac. Inv. Mgmt. Co.*, No. SACV 15-00131-CJC(JCGx), 2015 U.S. Dist. LEXIS 157491 (C.D. Cal. Nov. 2, 2015).

[42] *See In the Matter of First Eagle Investment Management, LLC and FEF Distributors, LLC*, SEC Administrative Proceeding Release Number: IA-4199.

[43] Section 206(2) of the Advisers Act makes it "unlawful for any investment adviser ... directly or indirectly to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

[44] Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder make it unlawful for any registered open-end investment management company to "engage directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company" unless such financing is made pursuant to a written plan that meets the requirements of Investment Company Act Rule 12b-1(b).

[45] Section 34(b) of the Investment Company Act makes it unlawful for any person "to make any untrue statement of a material fact in any registration statement . . . filed or transmitted pursuant to [the Investment Company Act]" or "to omit to state therein any fact necessary in order to prevent the statements made therein, in light of the circumstances under which they were made, from being materially misleading."

[46] *See SEC Release No. 33-9922*

[47] Three-Day Liquid Asset Minimum is the percentage of the fund's net assets that must be invested in three-day liquid.

[48] A "15 percent standard asset" is any funds asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.

[49] *Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers*, 80 FR 52680 (Sept. 1, 2015); Press Release, Financial Crimes Enforcement Network, *FinCEN Proposes AML Regulations for Investment Advisers* (Aug. 25, 2015) *available at* http://www.fincen.gov/news_room/nr/html/20150825.html.

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

[51] *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).

[52] Joe Morris, *FINRACEO Knocks DOL's Fiduciary Standard*, Ignites (May 28, 2015).