Ballard Spahr LLP

INVESTMENT MANAGEMENT

Recent Investment Management Developments

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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 Issues Guidance on Mutual Fund Fee Structure

The Securities and Exchange Commission's (SEC) Division of Investment Management recently issued a guidance update addressing disclosure issues and certain procedural requirements with offering variations in mutual funds sales loads and new funds share classes.[1] In the guidance, the Division's staff also discusses certain administrative procedures that will assist in streamlining the review of disclosure filings.

The guidance was issued as a result of a Department of Labor rule and certain exemptions intended to address conflicts of interest in retirement advice. The initial compliance date is April 10, 2017 (For more information about the DOL's fiduciary rule, please see the article on page 17 of this Update).[2] Since the rule's adoption, representatives of funds have been considering a variety of issues related to the rule's implementation, including contemplating certain changes to funds' fee structures that would, in certain instances, level the compensation provided to a financial intermediary for the sale of funds shares by that intermediary and facilitate intermediaries' compliance with the rule. Some funds are considering streamlined sales load structures to simplify costs for investors and to help address operational and compliance challenges that can exist for intermediaries that sell shares of multiple funds. The guidance discusses the requirements under the applicable federal securities laws with respect to funds that wish to use certain fee structures.

Variations in Sales Loads

A fund may sell shares at prices that reflect scheduled variations in, or elimination of, sales loads as long as each sales load variation is disclosed in the prospectus. Rule 22d-1 under the Investment Company Act of 1940 and item 12(a)(2) of Form N-1A require that each variation be applied uniformly to particular "classes" of investors or transactions and disclosed in the prospectus with specificity.

For funds that are considering new variations to sales loads that would apply uniformly to investors that purchase fund shares through a single intermediary (or category of multiple intermediaries), item 12(a)(2) of Form N-1A requires that the prospectus. Under this approach, investors who purchase through a designated intermediary would be a "class" under item 12(a)(2). Therefore, the disclosure should specifically identify each intermediary whose investors receive a sales load variation. This information must be presented in a clear, concise, and understandable manner, and should include tables, schedules, and charts where doing so would facilitate understanding. In addition, the narrative explanation to the fund fee table must alert investors to the existence of sales load discounts or waivers and provide a cross-reference to the section and page of the prospectus and statement of additional information that describes these arrangements.

To add disclosure about sales load variations, a fund will need to file the amendment to its registration statement under Rule 485(a) under the Securities Act of 1933. The staff encourages funds to seek selective review of the filing as described below, if only certain disclosures about the fund are changing, such as adding sales load variations. In addition, if sales load variation disclosures will be substantially identical across multiple funds within a fund complex, the staff suggests that the funds consider whether it is appropriate to request relief under Rule 485(b)(1)(vii) under the Securities Act (Template Filing Relief) as described below.

Administrative Procedures

Selective Review: The staff encourages registrants to request a selective review of a filing that contains disclosure that is not substantially different from the disclosure contained in one or more prior filings by the Fund or other Funds in the complex. Any such request should be made in the cover letter accompanying the filing and should include:

- a statement as to whether the disclosure in the filing has been reviewed by the staff in another context;
- a statement identifying prior filings that the registrant considers similar to, or intends as precedent for, the current filing;
- a summary of the material changes made in the current filing from the previous filings; and
- any specific areas that the registrant believes warrant particular attention.[3]

Template Filing Relief: In circumstances in which a fund complex makes substantially identical changes to multiple funds, it may be appropriate for the registrant to request Rule 485(b)(i) (vii) relief to avoid the need to file multiple Rule 485(a) filings. Instead, the registrant could file a single Rule 485(a) filing for staff review, together with a Template Filing Relief request for other funds with substantially identical disclosure. Any Rule 485(b) filing relying on Template Filing Relief should include a cover letter or an explanatory note in the filing explaining that it is relying on this relief.

SEC's Division of Investment Management Letter Regarding Brokers Setting Their Own Commissions for Selling "Clean Shares"

The Securities and Exchange Commission's (SEC) Division of Investment Management has issued a no-action letter stating that the restrictions of Section 22(d) of the Investment Company Act (the 1940 Act) do not apply to a broker when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in mutual fund shares that do not provide any form of distribution-related payment to the broker. This means that brokers can determine their own commissions to charge when selling mutual fund shares—provided that such shares do not have any front-end load, deferred sales charge, or other asset-based fee that compensates financial intermediaries (including brokers) for sales or distribution activities. These types of mutual fund shares, which do not have built-in fees that ultimately provide compensation to the brokers who sell them, are called clean shares.

The Division issued the Letter to The Capital Group Companies, Inc., the investment adviser to the American Funds. The Department of Labor's fiduciary rule (the DOL Rule) prompted the Capital Group to request the letter from the Division. The DOL Rule, which generally goes into effect in April 2017, expands the circumstances in which financial intermediaries are treated as fiduciaries to ERISA plans and individual retirement accounts, and are therefore precluded from receiving compensation that varies with investment choices made or from recommending proprietary investment products absent an exemption. The DOL Rule aims to address, among other things, conflicts of interest in the sales of mutual fund shares by eliminating financial incentives that could cause a broker to recommend one investment product over another. A broker seeking to comply with the DOL Rule while selling mutual fund shares may therefore want to use arrangements where the broker receives payments in connection with such sales only from the investor and not from third parties.

According to the letter, the SEC staff would permit a separate, external commission set by the broker selling mutual fund shares under certain conditions. In the absence of the clarity provided by the letter, such a practice might arguably violate Section 22(d) of the 1940 Act, which prohibits fund sales except at "a current public offering price described in the prospectus." Now, with brokers having the ability to set their own commissions for selling clean shares, investors will likely pay different total prices for clean shares issued by the same fund, depending on the particular broker that a given investor uses, as well as the commission schedule of that broker's firm. In this regard, clean shares will be on "equal footing" with other securities that brokers sell on commission, such as shares of stock issued by operating companies.

SEC and FINRA Examination Priorities for 2017

The Securities and Exchange Commission (SEC) has announced its Office of Compliance Inspections and Examinations (OCIE) priorities for 2017. The Financial Industry Regulatory Authority (FINRA) has also published its examination priorities for 2017.

OCIE's and FINRA's annual lists of priorities provide participants in the securities industry a useful view into the thinking of the SEC staff and FINRA as to the most important risks facing the industry and investors. Firms should take the opportunity to review their compliance and supervisory programs to ensure they have addressed the risks identified by these regulatory authorities.

OCIE 2017 Examination Priorities

OCIE's 2017 examination priorities are organized around three thematic areas: matters of importance to retail investors, risks related to elderly and retiring investors, and market-wide risks. The retail-investor and market-wide-risks thematic areas are carried over from the 2016 thematic areas, whereas the specific thematic area relating to elderly and retiring investors reflects greater prominence given to this area by OCIE for 2017. OCIE's examinations cover a number of types of registered entities, including broker-dealers, investment advisers, transfer agents, and municipal advisors. OCIE will concentrate its examinations on registrants' compliance programs. The areas of focus that OCIE has identified for 2017 are in many ways similar to those OCIE identified for 2016. However, there are some new and newly expanded areas of emphasis which are noted below (e.g., robo-advisers, money market funds, and FINRA oversight).

Retail Investors

A new addition to the retail-investor thematic area for 2017 is the focus on electronic investment advice (including so-called robo-advisers). Robo-advice includes platforms that interact with investors online as well as other models that combine automation with persons who provide financial advice. OCIE will look at compliance programs, marketing practices, the formulation of investment recommendations (including those generated by algorithms), and data protection measures. The 2017 priorities also show an expanded focus on wrap fee programs in which an investor is charged a single bundled fee for advisory and brokerage services, and share class selection. Other topics carried over from last year, and which fall under the retail-investor thematic area, include exchange traded funds, advisers that have never been examined by OCIE, and recidivist financial advisers and their employers. OCIE additionally will continue its focus on multi-branch advisers (see the discussion below in this Update regarding the Multi-Branch Adviser Initiative). OCIE specifically pointed out in its 2017 priorities that it will continue reviewing conflicts of interest and other factors that may affect registrants' recommendations to invest or remain invested in particular share classes of mutual funds. The 2017 examination priorities give greater prominence to this area than the 2016 examination priorities did.

Senior Investors and Retirement Investments

OCIE noted in its 2017 examination priorities that it will devote increased attention to issues affecting senior investors and investors saving for retirement. This includes a continuation of its multi-year ReTIRE initiative, which focuses on investment advisers and broker-dealers that serve investors with retirement accounts. OCIE will also continue to examine public pension advisers, and will be reviewing practices relating to pay-to-play and gifts and entertainment.

Market-Wide Risks

A new priority for 2017 that OCIE specifically identified, in the context of market-wide risks, is money market funds. OCIE will examine money market funds for compliance with amendments to rules governing money market funds, which became effective in October 2016. Another newly specified area is payment for order flow. OCIE will examine certain broker-dealers to assess how they are complying with their duty of best-execution when routing customer orders. Yet another new area of focus is enhanced oversight by OCIE of FINRA, including assessing the quality of FINRA's examinations of individual broker-dealers.

Other Initiatives

In its 2017 examination priorities, OCIE noted that it will be examining municipal advisors to assess their compliance with recently adopted SEC and Municipal Securities Rulemaking Board rules. A newly noted focus area for private fund advisers in 2017 is the controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts. Another newly noted focus area for transfer agents is specifically examining transfer agents that service microcap issuers in an effort to detect issuers that may be engaging in unregistered, non-exempt offerings of securities.

<u>FINRA 2016 Examination Priorities</u>

FINRA will be focusing on, among other areas, high-risk brokers, sales practices such as excessive trading of long-term products, financial risks such as liquidity risk, and operational risks such as cybersecurity. In 2017, FINRA plans to commence electronic, off-site reviews to supplement on-site examinations of member firms. These reviews will involve specific information requests, and responses will be analyzed off-site.

High-risk and Recidivist Brokers

FINRA will devote attention to looking at whether firms establish appropriate supervisory and compliance controls for high-risk and recidivist brokers. FINRA has established an examination unit to examine brokers who may pose a high risk to investors. The unit will scrutinize compliance with requirements related to suitability, know-your-customer, outside business activities, private securities transactions, and commissions and fees. FINRA will review firms' procedures for hiring statutorily disqualified brokers. FINRA will continue to look at firms' branch office inspection programs, including how such programs cover account activity and reporting, as well as advertising and customer communications.

Sales Practices

FINRA will assess firms' controls to protect senior investors from fraud and improper advice, including through the recommendation of microcap stocks. FINRA will be evaluating the suitability of recommendations to customers, and controls firms use to monitor recommendations that could cause excess concentration in customers' accounts. FINRA will look at firms' capacity to detect short-term trading of long-term products, such as mutual funds and variable annuities. Firms' procedures pertaining to representatives' outside business activities and private securities transactions are another area that FINRA will evaluate. FINRA will review firms' compliance with their supervisory and record-retention obligations with respect to social media.

Financial Risks

Liquidity risk management—evaluating firms' stress testing and funding contingency plans—is another area to be scrutinized. FINRA will assess firms' risk management practices, considering areas such as readiness, communication plans, risk metrics, and triggers. FINRA also will review firms' implementation of the obligations established in the first phase of its June 2016 amendments to FINRA Rule 4210. These amendments established margin requirements for covered agency transactions.

Operational Risks

FINRA will assess firms' programs to mitigate cybersecurity threats. Such assessments will include looking at methods for preventing data loss, and how data flows through firms and vendors. FINRA notes that it has seen poor controls related to the use of passwords, encryption of data, portable storage devices, patches and virus protection, and physical security. FINRA also noted that firms have failed to fulfill obligations under Securities Exchange Act of 1934 (the Exchange Act) Rule 17a-4(f), which requires firms to preserve certain records in a non-rewriteable, non-erasable format (also known as WORM format). Other risks FINRA will be concentrating on include controls and supervision to protect customer assets pursuant to Exchange Act Rule 15c3-3, SEC Regulation SHO, and firms' anti-money laundering programs. FINRA will be looking at whether firms have correctly registered as municipal advisors, where applicable.

Market Integrity

Detecting and deterring manipulation will continue to be a priority for FINRA. For example, FINRA is working on enhancing its ability to detect large groups of market participants engaging in manipulation. FINRA will engage in monitoring to look for market participants who are trading in a potentially manipulative manner by using aggressive and dominant trading on one side of the market to benefit a position on the other side of the market. FINRA stated that firms should consider how advances in technology affect how they make decisions about customer orders, and that firms should provide accurate disclosures about payments for order flow. FINRA also will expand its Audit Trail Reporting Early Remediation Initiative, which alerts firms to potential equity audit trail issues. FINRA will review compliance with the data requirements of the Tick Size Pilot Program and its quoting and trading restrictions. Priorities in trading examinations will include reviewing disclosures to customers by alternative trading systems, and whether floor brokers and upstairs firms are handling manual options orders consistent with best execution obligations. Lastly, FINRA noted that it will continue to enhance the manipulation-based surveillance patterns in its fixed-income surveillance program, and it will prioritize developing a data integrity program to monitor the accuracy of data submitted in connection with reporting requirements for transactions in U.S. Treasury securities, as required by the Trade Reporting and Compliance Engine (TRACE).

<u>Conclusion</u>

Both the OCIE and FINRA examination priorities should be reviewed carefully by firms that are subject to the jurisdiction of these regulators. However, such publications should not be read as an exhaustive list of examination topics. Priorities could shift, or new issues could emerge during 2017. For example, one reason for such a shift is the potential leadership change at the SEC in connection with the incoming presidential administration and the nomination of Jay Clayton for the position of Chair of the SEC (see the discussion below in this Update regarding the Pending SEC Leadership Change).

Multi-Branch Adviser Initiative

The Office of Compliance Inspections and Examinations (OCIE) has published a [Risk Alert]() in which it stated that OCIE intends to focus on investment advisers that provide advisory services from multiple locations. Such examinations will focus on evaluating the design and effectiveness of advisers' compliance programs with respect to their oversight of advisory services provided at remote locations. This is a continuation of an initiative that OCIE had included in its 2016 examination priorities. In the course of such exams, OCIE will be looking at risks presented in the branch office model regarding the provision of advisory services to clients, such as the identification of potential conflicts of interest, and the level of autonomy supervised persons have in providing advice.

Pending SEC Leadership Change

President-elect Donald Trump has announced that he nominated Jay Clayton to serve as Chair of the Securities and Exchange Commission (SEC), subject to confirmation by the U.S. Senate. Mr. Clayton is a partner at Sullivan & Cromwell. His practice has included representing Wall Street firms as well as other large companies in mergers and acquisitions and capital markets activities. If confirmed, Mr. Clayton will succeed the outgoing Chair Mary Jo White. Unlike Chair White, a former prosecutor, Mr. Clayton has dedicated a substantial portion of his career to representing financial firms. Some commenters have observed that this potential change in leadership portends a shift in the SEC's priorities—away from what some have described as particularly "zealous" enforcement activities under the leadership of Chair White.[4]

Summary of IRS Proposed Regulations Providing Guidance On The Tax Qualification Of Mutual Funds

On September 27, 2016, the Internal Revenue Service (IRS) issued proposed regulations (Proposed Regulations) that provide guidance relating to the gross income and asset diversification tests used to determine whether a mutual fund qualifies as a regulated investment company (RIC) for federal income tax purposes.[5] The IRS simultaneously announced that it no longer will issue rulings on whether a financial instrument constitutes a security for certain purposes applicable to RICs.[6] The Proposed Regulations, if adopted in their current form, would have a significant effect on RICs that hold investments in controlled foreign corporations[7] (CFCs) or passive foreign investment companies[8] (PFICs). Because of their situs outside the United States, CFCs and PFICs are subject to special Internal Revenue Code provisions designed to prevent deferral of federal income tax.

The Proposed Regulations address two issues that have caused ambiguity and confusion in the last decade: (1) what constitutes a "security" for purposes of determining RIC qualification under Section 851[9]; and (2) whether the income required to be included in taxable income (Deemed Income Inclusion) of a RIC from a CFC under Section 951(a)(1)(A)(i) or from a QEF under Section 1293(a)[10] will be counted for purposes of the gross income test and the asset diversification test under Section 851.

An article discussing the above summary appeared in Ballard Spahr's Tax Truths: Volume 1, Issue 2 – December 2016. [Click here]() to read the full article.

Director of OCIE Speaks at the National Society of Compliance Professionals 2016 National Conference

Calling the Office of Compliance Inspections and Examinations (OCIE) the eyes and ears of the Securities and Exchange Commission, OCIE Director Marc Wyatt discussed the National Exam Program (NEP) and the office's function, mission, and impact in keynote remarks at the National Society of Compliance Professionals 2016 National Conference.

Mr. Wyatt noted that OCIE has examination responsibility for more than 28,000 registrants, including more than 12,000 investment advisers, approximately 11,000 mutual funds and exchange-traded funds, more than 4,000 broker-dealers, 650 municipal advisers, 400 transfer agents, 18 national securities exchanges, the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board, the Securities Investor Protection Corporation, the PCAOB, and eight active clearing agencies.

He also noted that recent legislative changes enacted in the Dodd-Frank Act and the JOBS Acts have further expanded OCIE's responsibilities to include examinations of, among others, major security-based swap participants, securities-based swap execution facilities, and crowdfunding portals.

In Fiscal Year 2016, OCIE completed more than 2,400 examinations across all its program areas. Mr. Wyatt noted that this is a more than a 20 percent increase over 2015, which was itself a six-year high. Over the past year in particular, Mr. Wyatt believed OCIE had evolved as an office to more optimally allocate their valuable resources, by bolstering staffing in the investment adviser/investment company examination program by roughly 20 percent; enhancing focus on FINRA; and investing in technology and data analytics.

Further, Mr. Wyatt emphasized that he measured the impact and success of an examination, and OCIE's influence and impact as a whole, using the four pillars of OCIE's mission—improve compliance, prevent fraud, monitor risk, and inform policy. He also noted that OCIE must strike the right balance among these metrics.

Improve Compliance

Mr. Wyatt stated that improving compliance has an impact on each of the other pillars. He said that OCIE can help improve compliance by providing registrants with information so they can assess their own compliance programs based on their unique business model and undertake steps to develop solutions which address any potential gaps. For example, for the last four years, OCIE has published an annual public statement of examination priorities to inform investors and registrants about areas that the staff believes present heightened risk.[11] He also noted that OCIE publishes Risk Alerts with descriptions of some of its larger upcoming initiatives such as the Supervision Initiative[12] and exams focusing on cybersecurity.[13]

In addition to publications, OCIE regularly hosts outreach events, and OCIE staff members speak at numerous industry-focused events such as the Conference. In 2016, he noted OCIE conducted more than 150 outreach conferences with the industry and securities regulators, both regionally and nationally, and OCIE staff appeared at roughly 150 events in order to promote transparent communications and coordination among industry participants and regulators.

Prevent Fraud

Mr. Wyatt noted that one metric of the role OCIE plays in preventing fraud is the number of examinations OCIE refers to the Commission's Enforcement Division. This number has typically hovered around 10 percent. In 2016, OCIE's examinations have resulted in several notable enforcement actions. OCIE had a big impact with respect to wrap fee accounts, or those accounts where a single fee typically covers all of the management, brokerage, and administrative expenses for the account. The Commission settled three cases, which were referred from OCIE, involving transaction costs paid by wrap fee account advisory clients. Specifically, these cases related to the practice of "trading away," or using a broker other than the sponsoring broker to execute trades in which a commission is charged, in addition to the wrap fee, to the client. OCIE has also helped to shed light on the practices of two of the largest operators of dark pools. Beyond referrals to Enforcement, Mr. Wyatt said he believed that OCIE exams also are successful when registrants proactively address compliance issues revealed in the course of an exam and take steps to remedy those issues.

Monitor Risk

Given OCIE's role as the "eyes and ears" of the Commission, Mr. Wyatt said he wanted to ensure OCIE optimally employs the intelligence and data which it gathered in the course of its exams to inventory emerging risk in the industry. Every exam gives the NEP an opportunity to gain unique insight into the markets. This risk identification and inventory process ensures emerging business practices or innovative products and services are identified, monitored, and, if necessary, are addressed in an effective manner. He noted that OCIE also regularly coordinates efforts and utilizes data produced by the Risk and Examinations Office in the Division of Investment Management and the Division of Economic and Risk Analysis, and shares information about examination trends, findings, and industry observations with other SEC offices in order to identify mutual areas of interest and concern.

Inform Policy

OCIE strives to use its perspective to provide support to the rule-making process and inform other guidance issued by the Commission, and its divisions, and offices, Mr. Wyatt said. He also noted that OCIE is an active participant in Commission-wide working groups, where it provides substantial input into the rule-making process, and that OCIE exams also may directly inform guidance provided by the Commission's rulemaking divisions.

SEC Announces Record Enforcement Results for FY 2016

The Securities and Exchanges Commission (SEC) has announced the enforcement results for its 2016 fiscal year.[14] During 2016, the SEC filed 868 enforcement actions alleging financial reporting-related misconduct by companies and their executives and misconduct by registrants and gatekeepers. This is a record for enforcement actions in a single year.

The 2016 enforcement actions included a single-year record of 160 cases involving investment advisers or investment companies. The agency also reached new highs for Foreign Corrupt Practices Act (FCPA) related enforcement actions (21) and in money distributed to whistleblowers ($57 million) in a single year. The SEC brought many other actions in 2016 spanning the entire spectrum of the marketplace, including:

- Combating financial fraud and enhancing issuer disclosure;
- Holding gatekeepers accountable;
- Ensuring fairness among market participants;
- Rooting out insider trading schemes through innovative uses of data and analytics;
- Uncovering misconduct by investment advisers and investment companies;
- Fighting market manipulation and microcap fraud;
- Halting international and affinity-based investment frauds;
- Policing the public finance markets;
- Cracking down on misconduct involving complex financial instruments;
- Combating foreign corrupt practices;
- Standing up for whistleblowers;
- Demanding admissions in important cases enhancing public accountability;
- Successful litigation; and
- Winning five U.S. District Court jury or bench trials in FY 2016.[15]

The table below compares the SEC enforcement results of FY 2014, 2015, and 2016:[16]

Enforcement Results: Fiscal Years 2014-2016

Fiscal Year	2014	2015	2016
Independent or Standalone Enforcement Actions	413	507	548
Follow-on APs	232	168	195
Delinquent Filings	110	132	125
Total Actions	**755**	**807**	**868**
Disgorgement and Penalties Ordered	**$4.16 billion**	**$4.19 billion**	**Over $4 billion**

Investment Adviser AXA Wins Excessive Fee Trial

A federal judge in New Jersey has ruled in favor of AXA Equitable Life Insurance Company (AXA Equitable) and its wholly owned subsidiary, AXA Equitable Funds Management Group, LLC (FMG and together with AXA Equitable, AXA) after five years of litigation regarding investment advisory fees.[17]

The lawsuit was brought under Section 36(b) of the Investment Company Act of 1940 (1940 Act). Section 36(b) allows the Securities and Exchange Commission or a fund shareholder (on behalf of the fund) to bring an action against an investment adviser of the fund (or any affiliated person) for an alleged breach of such adviser's fiduciary duty to the fund concerning the compensation for services paid by such fund to such adviser. Most "excessive fee" cases are brought under Section 36(b) of the 1940 Act, but other cases have alleged state law claims for breach of fiduciary duty.

The plaintiffs alleged in their complaint that AXA charged excessive investment management fees to certain AXA Funds that were operated under the "manager of managers" model. The basis of this claim was that AXA retained a large portion of the fee that was charged to the fund, and remitted only a small portion of the fees to a group of sub-advisors that were providing the actual investment advice. The court concluded that the plaintiffs failed to meet their burden to demonstrate that AXA breached its fiduciary duty in violation of Section 36(b) or to show any actual damages.

In reaching its conclusion, the court rejected the plaintiffs' effort to focus exclusively on the contractual language of the investment management and sub-advisory agreements. Instead, the court concluded, based on substantial credible testimony that "[T]here were duties and responsibilities beyond the contracts" that AXA performed. The court further held that as the sponsor of the funds, AXA bore significant enterprise risk, including litigation and reputational risks, and operational and business risks, among other risks. Based on the foregoing, the court held that AXA was entitled to retain a portion of the fees charged to investors.

The AXA case is the first excessive fee case to proceed to trial since the U.S. Supreme Court decided *Jones v. Harris Associates, L.P.*, 130 S. Ct. 1418 (2010), which embraced the legal standard applied in the *Gartenberg*[18] case. In *Jones*, the Supreme Court ruled that "[T]o face liability under §36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[19] While the decision discusses the evidence presented at trial relating to the factors enumerated in *Gartenberg*, it does not significantly focus on the liability standard quoted above. Many other excessive fee cases have been filed since the 2010 decision in *Jones* and most of them are still pending.

SEC Charges Hedge Fund Manager and Advisory Firm with Insider Trading

The Securities and Exchange Commission (SEC) recently filed a complaint against a hedge fund manager and his investment advisory firm in federal district court in Philadelphia, alleging insider trading based on material nonpublic information that he learned in confidence from a corporate executive. The complaint is another sign of the SEC's continuing focus on potential insider trading cases.

In 2010, the manager, through his personal holdings and the holdings of clients of the firm, was one of Atlas Pipeline Partners, L.P.'s (APL) largest shareholders. According to the SEC's complaint, during the summer of 2010, APL negotiated to sell a substantial company asset. The manager was alleged to use his status as a significant APL shareholder to gain access to an APL executive and to obtain information about APL's impending sale of the asset. When the sale was announced, APL shares soared 31 percent and the manager earned about $4 million by buying securities in APL before the sale, according to the SEC complaint. Approximately 17 months after the sale of the asset, the firm received a subpoena regarding trading in APL securities. According to the complaint, the manager contacted the APL executive and attempted to fabricate a story in case the manager and the APL executive were questioned about this trading.

In addition to the insider trading, the SEC also alleged that the manager repeatedly violated federal securities laws by failing to timely report information about holdings and transactions in securities of publicly traded companies that he beneficially owned.

"We allege that [the manager], who as a large APL shareholder obtained access to confidential corporate information, and abused that access by trading on this information," Andrew Ceresney, head of SEC's division of enforcement, said in a statement. The manager denies all of the SEC's charges.

The Securities and Exchange Commission Adopts Amendments to Form ADV and Investment Adviser Act Rules

The Securities and Exchange Commission (SEC) adopted amendments to Form ADV and Investment Advisers Act of 1940 rules.[20] These amendments are designed to provide additional information regarding advisers, including information about their separately managed account (SMA) business, incorporate a method for private fund adviser entities operating a single advisory business to register using a single Form ADV, and clarify certain Form ADV items and instructions. The SEC also adopted amendments to the Advisers Act books and records rule and technical amendments to several Advisers Act rules to remove transitional provisions that are no longer necessary.

I. Amendments to Form ADV

A. Separately Managed Accounts

Under the amended Form ADV, advisers will be required to provide certain aggregate information about SMAs that they advise. For the purposes of these new reporting requirements, the SEC considers advisory accounts other than those that are pooled investment vehicles (*i.e.*, registered investment companies, business development companies and pooled investment vehicles that are not registered (including, but not limited to, private funds)) to be SMAs. The information required to be reported includes the type of assets held in SMAs, the use of borrowing and derivatives in SMAs, any custodian that accounts for at least 10 percent of SMA regulatory assets under management (RAUM), and the amount of the adviser's RAUM attributable to SMAs held at the custodian.

B. Additional Information Regarding Investment Advisers

The amendments to Form ADV also include several new questions, and amendments to certain existing questions regarding identifying information, an adviser's advisory business, and its affiliations. For example, under the amended rules, an adviser will be required to, among other things:

- provide all of its CIK Numbers if it has one or more such numbers assigned, regardless of public reporting company status; provide the total number of offices at which it conducts investment advisory business;
- provide information about its 25 largest offices in terms of number of employees;
- report whether its chief compliance officer is compensated or employed by any person other than the adviser (or a related person of the adviser) for providing chief compliance officer services to the adviser, and if so, to report the name and IRS Employer Identification Number (if any) of that other person.

C. Umbrella Registration

The amendments also allow umbrella registration[21] for certain advisers to private funds, which will simplify the registration process for these advisers, and provide additional and more consistent data about groups of private fund advisers that operate a single advisory business through multiple legal entities. The amendments set forth the following conditions for the application of umbrella registration:

- The filing adviser and each relying adviser advise only private funds and clients in SMAs that are qualified clients (as defined in rule 205-3 under the Advisers Act);
- The filing adviser has its principal office and place of business in the United States;
- Each relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control;
- The advisory activities of each relying adviser are subject to the Advisers Act and the rules thereunder; and
- The filing adviser and each relying adviser operate under a single code of ethics adopted in accordance with rule 204A-1 under the Advisers Act and a single set of written policies and procedures adopted and implemented in accordance with rule 206(4)-(7) under the Advisers Act and administered by a single chief compliance officer in accordance with that rule.

II. Amendments to Advisers Act Rules

A. Amendments to Books and Records Rules

Rule 204-2(a)(16) currently requires advisers that are registered or required to be registered with the SEC to maintain records supporting performance claims in communications that are distributed or circulated to ten or more persons. The amendments removed the 10 or more persons condition and replaced it with "any person." Accordingly, under the amended rule, advisers will be required to maintain the materials listed in rule 204-2(a)(16) that demonstrate the calculation of the performance or rate of return in any communication that the adviser circulates or distributes, directly or indirectly, to any person.

Rule 204-2(a)(7) currently requires advisers that are registered or required to be registered with the SEC to maintain certain categories of written communications received and copies of written communications sent by such advisers. Under the amended rule, advisers will be required to also maintain originals of all written communications received and copies of written communications sent by an investment adviser relating to the performance or rate of return of any or all managed accounts or securities recommendations.

B. Other Amendments to Advisers Act Rules

The final rules also amended Rule 203A-5, 202(a)(11)(G)-1(e), 203-1(e), 203-1(b), 204-1(c) and 204-3(g) of Advisers Act. These technical amendments removed transition provisions that were adopted in conjunction with previous rulemaking initiatives, but that are no longer necessary.

OCIE Issues Risk Alert on Conflicts of Interest Regarding Adviser Compensation for Certain Share Class Recommendations

The SEC's Office of Compliance Inspections and Examinations (OCIE) recently issued a Risk Alert announcing a new exam initiative that will focus on how investment advisers registered under the Investment Advisers Act of 1940 are addressing the conflicts of interest that arise when advisers receive compensation or other financial incentives for recommending mutual fund and 529 plan share classes that have substantial loads or distribution fees. The Alert states that "examples of conflicts of interest related to share class recommendations include situations where the adviser is also a broker-dealer or affiliated with a broker-dealer that receives fees from sales of certain share classes, and situations where the adviser recommends that clients purchase more expensive share classes of funds for which an affiliate of the adviser receives more fees."

The Alert states that the OCIE will conduct "focused, risk-based examinations of high-risk areas," including:

- Whether advisers are meeting their obligations under Section 206 of the Advisers Act by acting in the clients' best interests and seeking best execution when recommending or selecting mutual fund and 529 Plan investments to clients.
- Whether advisers are meeting their obligations to make full and fair disclosure of all material facts, including all material conflicts of interest that could affect the advisory relationship in this connection, by assessing the adequacy and effectiveness of advisers' disclosures regarding compensation for the sale of shares and related conflicts of interest.
- Whether advisers' written policies and procedures surrounding its selection of mutual fund and 529 plan share class investments in clients' accounts are adequate and effective.

OCIE notes that while the items listed above are the primary areas of focus for the initiative, examiners may review additional issues based on information obtained during the examinations.

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.[22] 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.[23]

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).[24] 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.[25] 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.[26]

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.[27] 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).[28] This article addresses the impact of the proposed rule revisions, if adopted, on mutual funds.

III. 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.[29] 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.[30]

IV. 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).[31] 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."

V. 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.[32] 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.[33]

VI. 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.

VII. 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.[34] 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[35] 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.[36] 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");[37]
- 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.[38] Amended Rule G-9 will require municipal advisors to preserve for six years the records required by amended Rule G-8.[39] 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.[40]

FinCEN Finalizes Beneficial Ownership Identification Rules

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." [41] 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,[42] 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[43] (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.[44] 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.

Enforcement

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."

[1] *See* https://www.sec.gov/investment/im-guidance-2016-06.pdf.

[2] *See* https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2.

[3] *See* Revised Procedures for Processing Registration Statements, Post-Effective Amendments and Preliminary Proxy Materials Filed by Registered Investment Companies. Investment Co. Act Rel. No 13768 (Feb. 15, 1984).

[4] Footnote: See Dave Michaels & Liz Hoffman, SEC Pick Jay Clayton Is a 180 From Chairman Mary Jo White, Wall St.J. (Jan. 4, 2017).]

[5] REG-123600-16, *available at* https://www.gpo.gov/fdsys/pkg/FR-2016- 09-28/pdf/2016-23408.pdf.

[6] Rev. Proc. 2016-50, *available at* https://www.irs.gov/pub/irs-drop/rp- 16-50.pdf

[7] Code § 957(a). The term "controlled foreign corporation" means any foreign corporation if more than 50% of : (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (within the meaning of Code Section 958(a)), or is considered as owned by applying the rules of ownership of Code Section 958(b), by "United States shareholders" on any day during the taxable year of such foreign corporation. A "United States shareholder" is a United States person that owns 10% or more of the voting power of all classes of stock entitled to vote. Code § 951(b).

[8] Code § 1297. A PFIC is defined as a foreign corporation that meets at least one of the two tests: (1) 75% or more of its income is derived from passive sources, or (2) 50% or more of the average fair market value of the assets it held during the year are passive income-producing assets. The U.S. taxpayer-investor in a PFIC is taxed according to an onerous excess-distribution regime under Code § 1291 unless the taxpayer makes either of two elections: the mark-to-market election under Section 1296 or the election to be treated as a qualified electing fund (QEF) under Code § 1295.

[9] All "section" references are to the Internal Revenue Code of 1986 unless otherwise stated

[10] If a RIC elects to treat a PFIC in which it is a shareholder as a QEF under Section 1295, it must include in its income its share of the QEF's income and gains, whether or not such income is distributed form the QEF to the RIC. *See* Code § 1293(a).

[11] *See, e.g.*, OCIE "Examination Priorities for 2016," January 11, 2016, https://www.sec.gov/about/offices/ocie/national- examination-program-priorities-2016.pdf

[12] OCIE Risk Alert, "Examinations of Supervision Practices at Registered Investment Advisers," Sept. 12, 2016, https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-supervision-registered-investment-advisers.pdf

[13] *See, e.g.*, OCIE Risk Alert, "OCIE's 2015 Cybersecurity Examination Initiative," Sept. 15, 2015, *available at*: https://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf

[14] *See* https://www.sec.gov/news/pressrelease/2016-212.html

[15] *Id.*

16 *Id.*

17 Mary Ann Sivolella v. AXA Equitable Life Insurance Company and AXA Equitable Funds Management Group, LLC and Sanford et al. v. AXA Equitable Funds Management Group, LLC, No.:11-cv-04194 (D.N.J. August 25, 2016).

18 *Gartenberg v. Merrill Lynch Asset Management*, 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd* 694 F.2d 923 (2nd Cir. 1982), *cert. denied sub nom*

19 *Jones v. Harris Associates, L.P.*, 130 S. Ct. 1418 (2010).

20 *See* Release No. IA-4509 *at* https://www.sec.gov/rules/final/2016/ia-4509.pdf.

21 "Umbrella Registration" means: "A single registration by a filing adviser and one or more relying advisers who collectively conduct a single advisory business and that meet the conditions set forth in General Instruction 5." *See* Form ADV, Glossary. "Filing Adviser" means: "An investment adviser eligible to register with the SEC that files (and amends) a single umbrella registration on behalf of itself and each of its relying advisers." *See* Form ADV, Glossary. "Relying Adviser" means: "An investment adviser eligible to register with the SEC that relies on a filing adviser to file (and amend) a single umbrella registration on its behalf." *See* Form ADV, Glossary.

22 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.

23 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.

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

25 *See* 17 CFR 270.38a-1(a)(1).

26 *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).

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

[28] 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.

[29] *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.").

[30] *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.

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

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

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

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

[35] 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).

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

[37] 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.

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

[39] *Id.*

[40] *Id.*

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

[42] *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.

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

[44] 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).