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REGULATION

SEC Chair's Agenda Provides Glimpse of New Rules to Come

SEC Chair Mary Jo White recently offered a peek into new SEC rule proposals we can expect to see in the coming months. The sneak preview includes some eye openers from the Division of Investment Management (IM), like proposed rules requiring funds to adopt liquidity management programs and requiring large asset managers to conduct stress-testing. The insights were contained in the agenda of SEC rulemaking actions published on October 21, 2014 by the Office of Information and Regulatory Affairs of the President's Office of Management and Budget. Here are some of the items of particular interest:

Investment company use of derivatives. IM is considering recommending that the SEC propose new rules under the 1940 Act addressing funds' use of derivatives. It is not clear whether the proposal will address some of the more knotty issues, such as segregation of assets or how to define concentration or diversification when a fund uses derivatives.

Liquidity management programs for funds. IM is considering recommending that the SEC propose a new rule requiring open-end funds to adopt and implement liquidity management programs and that the SEC provide enhanced guidance related to required liquid assets in open-end funds.

Transition plans for investment advisers. IM is considering recommending that the SEC propose a new rule that would require registered investment advisers to create and maintain "transition plans." It is not clear what kind of "transitions" IM is referring to.

Stress-testing for large asset managers and large investment companies. IM is considering recommending that the SEC propose new requirements for stress-testing by large asset managers and large investment companies.

Exchange-traded funds. IM is considering recommending that the SEC re-propose exemptive rules to provide relief for index-based and actively managed exchange-traded funds (ETFs). Currently, new ETFs must obtain individual exemptive relief in order to operate.

Exchange-traded products. The Division of Trading and Markets is considering recommending that the SEC seek public input to evaluate the listing and trading of exchange-traded products (ETPs) in the marketplace.

The Results Are in: Investors Favor Additional Regulatory Protection

On November 6, 2014, FINRA released results from a survey of U.S. investors measuring the demand for additional regulatory protections for investors. The survey of 1,000 adults revealed that an overwhelming majority felt that it was important to protect investors and police the markets. Indeed, 74 percent polled would support *additional* regulatory protections to safeguard against broker-dealer misconduct, and 56 percent expressed support for additional protections even if it meant a minimal increase in costs. Interestingly, the results of the survey revealed that younger investors (ages 21 to 39) and investors at an investment level below $100,000, were more likely to support additional protections than their older and more heavily invested counterparts.

The additional protections referenced in the survey may point to areas of increased regulatory attention for FINRA. Specifically, the survey indicated that at least half of investors polled perceived the following nine protections as "highly important":

- Disciplining brokers who break the rules with fines, suspensions, or revocations of licenses;
- Detecting when brokers are making trades that benefit themselves and not the investor;
- Disclosing to the public all instances of rule breaking by firms or individual brokers;
- Detecting when firms are taking risks that potentially harm their investors and the financial system;
- Detecting when unsuitable securities are being sold to investors;
- Requiring brokers to register publicly and disclose their professional history, including past complaints or problems;
- Monitoring which products firms are selling to investors and when there is a sudden change or unusual product concentration;
- Conducting periodic on-site visits to verify that brokerage firms are following all rules and regulations; and
- Reviewing all brokerage firms' advertising to ensure compliance with rules.

SEC Declines to Approve Non-Transparent ETFs

The SEC gave a preliminary thumbs-down to non-transparent ETFs. In two separate notices, the SEC said that applications to allow actively managed ETFs to withhold daily disclosure of portfolio holdings did not "meet the standard for exemptive relief" under Section 6(c) of the 1940 Act, and took the unusual step of preliminarily denying the applications.

The ETF sponsors requesting the exemptive relief proposed to create actively managed ETFs that would not follow the universal practice of disclosing their portfolio holdings on a daily basis. Rather, the sponsors proposed a mechanism involving a "blind trust" for each authorized participant. The sponsors also proposed to give retail investors (but not institutional investors) an alternative "back-up redemption option" to enable them to redeem their shares directly from the ETF, rather than selling them on the open market, in the event of a significant deviation of the closing market price from the ETF's net asset value (NAV). Retail shareholders using this option would be subject to a redemption fee of up to two percent. The sponsors also proposed to publish an intraday indicative value (IIV) for the actively managed ETFs, which is an approximation of an ETF's NAV. The applicants suggested that the IIV, to be published every 15 seconds, would be a way to minimize discounts and premiums.

In preliminarily denying the proposals, the SEC said that the proposed structure, even combined with enhanced prospectus disclosure, "falls short of providing a suitable alternative to the arbitrage activity in ETF shares that is critical to helping keep the market price of current ETF shares at or close to the NAV per share of the ETF."

Among other things, the SEC said that even dissemination of the IIV every 15 seconds is inadequate for purposes of making efficient markets and "could result in poor execution." Moreover, the SEC cited lack of meaningful standards for IIV methodologies and a lack of accountability for responsibility to ensure the accuracy of IIV calculations. The SEC also cited other issues with the reliability of the IIV, including tracking errors and inaccuracies during periods of market stress.

The SEC had other issues with the proposed frequency of portfolio reporting as well. It said that a "back-up redemption option," which would allow retail investors to redeem shares at the current day-end NAV under certain conditions and with the payment of a redemption fee, "does not remedy the defects" of the proposal. The SEC said that it believed the lack of sufficient information about the portfolio could result in potential disruption of orderly trading and a lack of market confidence.

Is the idea of a non-transparent ETF dead? The SEC said that the applicants could request a hearing to argue their case and overcome the SEC's carefully explained objections to the proposed ETFs. In the absence of a request for a hearing, however, the SEC will deny the applications. It seems likely that, at least for now, the SEC considers non-transparent ETFs not ready for prime time.

SEC Gives the Nod to Exchange-Traded Mutual Funds

Barely two weeks after it signaled thumbs-down on two requests to approve non-transparent ETFs, the

SEC published a notice of application that would allow the applicant to create exchange-traded mutual funds (ETMFs), novel structures that are a hybrid between mutual funds and traditional ETFs.

ETMFs feature characteristics of both ETFs and traditional mutual funds. Like ETFs, ETMFs would list and trade on a national securities exchange; directly issue and redeem shares only in "creation units," impose fees on creation units issued and redeemed to authorized participants to offset costs, and primarily use in-kind transfers of securities when issuing and redeeming creation units. Like mutual funds, ETMFs would sell and redeem their shares at prices linked to the funds' NAV and would maintain confidentiality of current portfolio positions.

ETMF shares would trade on an exchange at the next-determined NAV, plus or minus any premium or discount quoted by market makers. The premium or discount would be based on market factors, including the balance of supply and demand for shares, share inventory positions, and volume. Investors would lock in the premium or discount at the time of trade, but the actual transaction price would be based on the ETMF's actual NAV determined as of the close of business. Thus, investors won't know the NAV at the time they place an order, but the levels of premium and discount would be fully transparent.

For more details on this relief, see our related blog post.

SEC's Champ: Staff to Focus on Alt Fund Risk Disclosures

In a recent speech, Norm Champ, the Director of IM, called for alt funds (and all funds that use alternative strategies) to assess the accuracy and completeness of their prospectus disclosure, including whether the disclosure is presented in an understandable manner using plain English.

Champ's comments may be a harbinger of enforcement investigations and proceedings to come, as the Office of Compliance Inspections and Examinations (OCIE) drills down on valuation, liquidity, and leverage—areas that present heightened risks for alt fund investors.

In his October 29 speech, rather than addressing potential substantive regulation of these areas, Champ focused on risk disclosure. Acknowledging that concise risk disclosures are more difficult to draft when funds use complex investment strategies, he nonetheless emphasized the importance of ensuring that disclosure gives the "average investor" information needed to make informed investment decisions. This push for concise disclosure arises in the context of concerns that "there could be a disconnect" between the strategies and risks that alt funds disclose versus the strategies that these funds actually employ.

It seems likely that the staff will compare how funds disclose risks to how those funds actually manage their portfolios, and try to identify anomalies. This approach, in turn, will increase pressure on fund directors, who must "assess on an ongoing basis" whether (i) fund disclosures are consistent with what funds are actually doing, (ii) the disclosures reflect the fund's overall risks, and (iii) the average investor can understand those disclosures.

Additional information about Champ's remarks can be found here.

SEC Staff Finds that Broker-Dealers Still Are Not Conducting Adequate Section 5 Reviews

Based on what it learned in a sweep examination, the staff of the SEC clarified broker-dealers' obligations when engaging in transactions in unregistered securities. The SEC's core focus in these areas is curbing and preventing activities that undermine, or threaten to undermine, well-functioning markets, including fraud, manipulation, and money laundering.

The staff published FAQs, which addressed broker-dealers' obligations when seeking to rely on the exemption in Section 4(a)(4) of the Securities Act of 1933 ("Securities Act") to conduct a "reasonable inquiry" into the facts surrounding a proposed unregistered sale of securities before selling the securities, in order to form reasonable grounds for believing that a selling customer's part of the transaction is exempt from Section 5 of the Securities Act. The FAQs provide non-exhaustive factors that the SEC may consider to be part of this inquiry, and address a broker-dealer's obligations in specific situations.

An accompanying Risk Alert summarizes the SEC staff's examinations of 22 broker-dealers identified as being frequently involved in the sale of the securities of microcap companies. Specifically, the examinations assessed the firms' compliance with obligations to (1) perform a "reasonable inquiry" in connection with customers' unregistered sales of securities when the firms relied on the Section 4(a)(4) exemption, and (2) file suspicious activity reports (SARs), as required under the Bank Secrecy Act and the Securities Exchange Act of 1934, in response to "red flags" related to such sales.

As evidenced by the FAQs and Risk Alert, the SEC and FINRA are highly focused on Section 5 compliance and related issues of anti-money laundering compliance and microcap manipulation. Please review our feature in *Law360* for more detail about the SEC's findings and for our suggestions to broker-dealers in light of the regulators' enhanced focus on this area.

Referral Fees and Commission Sharing—When May Broker-Dealers Share Their Fees with Non-Brokers?

FINRA recently filed proposed rule changes with the SEC addressing when broker-dealers may pay referral

fees or otherwise share compensation with persons who are not registered as broker-dealers. The proposed rule changes are subject to the SEC's approval. If approved, new Rule 2040 and related conforming changes to other FINRA rules will go into effect 45 to 90 days after publication in the Federal Register. For a summary of the proposed rule please review our recent blog post.

IM Chief Accountant's Office Weighs in on the Presentation of Consolidated Financials

IM's Chief Accountant's office recently issued a Guidance Update setting forth its views on the presentation of consolidated financial statements by regulated investment companies (RICs) and business development companies (BDCs).

The Guidance notes that RICs that are feeder funds may have a "controlling financial interest in another entity" for purposes of Regulation S-X, since the feeder fund holds nothing but the securities of the master fund, which could constitute a controlling financial interest in the master fund. Similarly, a RIC that is a fund of funds may have a controlling financial interest in underlying funds in the same fund complex.

In the feeder fund context, the SEC staff said that it generally takes the position that the most meaningful presentation of financial information is unconsolidated, subject to several requirements outlined in the Guidance. The staff noted that a feeder fund is typically one of several investors in the master fund, and the unconsolidated financials and related disclosure provide a meaningful and transparent presentation of the financial position and results of operations of the feeder fund.

In the case of a fund of funds, the staff also believes that an unconsolidated presentation of financials is more meaningful, particularly since the level of its interest in any particular underlying fund can fluctuate between controlling and non-controlling.

In contrast, many BDCs establish wholly owned subsidiaries in order to facilitate investment in certain portfolio companies. In general, these subsidiaries are designed to act as an "extension of the BDC's investment operations and to facilitate the execution of the BDC's investment strategy." Thus, the staff believes that the financial statements of these subsidiaries should be consolidated with those of the BDC as a means of providing investors with the most meaningful presentation of the BDC's financial position.

ENFORCEMENT + LITIGATION

SEC Charges Broker-Dealer for Failure to Protect Against Insider Trading by Employees

The Securities and Exchange Commission for the first time brought charges against a broker-dealer for failure to adequately protect against insider trading by its employees. The charges stem from a broker's use of a customer's confidential information to purchase shares in a company being acquired by a private equity firm. (The SEC previously charged the broker with insider trading in a separate action.) The broker-dealer that employed the broker settled charges of violations of the securities laws for failing to adequately establish, maintain, and enforce policies and procedures reasonably designed to prevent insider trading by employees with access to confidential client information.

Since 1988, the federal securities laws have required broker-dealers to establish, maintain, and enforce written policies and procedures, consistent with the nature of their business, to prevent the misuse of material nonpublic information. The policies and procedures must be tailored to the specific circumstances of the business, and broker-dealers (and investment advisers) must not only adopt such procedures but also vigilantly review, update, and enforce them.

As the SEC's settlement order points out, broker-dealers obtain material nonpublic information (MNPI) in various ways, including through their investment banking business and research operations, or from their customers. These various channels of obtaining MNPI and the risks of potential misuse make monitoring of trading by the firm, its registered representatives, and its customers critical to complying with the supervision requirements.

In its settlement order, the SEC found that the broker-dealer failed to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of MNPI, specifically, any MNPI obtained from its customers and advisory clients. In 2010, the risk became reality when a registered representative of the firm used information from one of his customers before the information was publicly announced. The representative traded on the basis of that information and also tipped off others, including several customers of the broker-dealer.

The SEC found that the principal failure of the firm's procedures occurred when the compliance group reviewed the representative's trading after the public disclosure of the acquisition but did not share information about the trading with other compliance groups in the firm or with senior management.

The SEC faulted the firm's insider trading procedure that required a "look-back" review of trading in employee accounts and in customer and client accounts after announcements that significantly affect the market. Specifically, the firm's written guidance regarding the look-back review procedures was insufficient. Among other things, the firm did not provide appropriate guidance on actions to be

taken by employees with respect to:

- Parameters to be considered by the firm's control group regarding the daily identification of market-moving news stories to identify securities warranting a trading review, and the documentation of work performed on those trading reviews;
- Additional review to be conducted by the control group when it found "red flags" such as profits or losses avoided greater than $5,000, trading by an "insider," or trades in any accounts in the same branch as an insider;
- The procedure for performing personnel interviews upon identification of "red flags" and for escalating reviews of suspect trading to the control group manager when there was no "sufficient explanation for the basis of the trade" provided during the review; and
- The documentation of the look-back review performed on trading reviews, which made it nearly impossible for firm management to determine whether the firm's policies and procedures were followed when conducting the reviews.

The SEC also found that the firm's policies and procedures failed to address how to consider options trading as part of the look-back reviews.

For more information, click here.

TIDBITS

- The National Futures Association (NFA) recently reminded persons claiming an exemption or exclusion from registration as a Commodity Pool Operator under CFTC Regulation 4.5, 4.13(a)(1), 4.13(a)(2), 4.13(a)(3), or 4.13(a)(5), or an exemption from registration as a Commodity Trading Adviser under CFTC Regulation 4.14(a)(8), that they must annually affirm the applicable notice of exemption or exclusion within 60 days of the calendar-year-end. NFA noted that failure to affirm any of the above exemptions or exclusions by March 2, 2015 would be deemed to be a request to withdraw the exemption or exclusion, which would, therefore, result in the automatic withdrawal of the exemption or exclusion on March 2, 2015. Affirmations may be made online by accessing NFA's Exemption System.
- When the SEC adopted amendments to the money market fund rules earlier this fall it included new valuation guidance that could transform the way directors approach fair value of portfolio securities held by all funds, not just money market funds. In the release, the SEC reminded fund directors that they have a non-delegable statutory duty to determine the fair value of portfolio securities when market prices are not available. The SEC was clear: While directors may "appoint others" to "assist them in determining fair value," the responsibility to actually determine fair value lays at their feet. See our recent article for more information on this development.

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This memorandum summarizes recent legal and regulatory developments of interest. Because of the generality of this newsletter, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. The views expressed herein shall not be attributed to Morrison & Foerster, its attorneys, or its clients.

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