Ballard Spahr LLP

INVESTMENT MANAGEMENT

Recent Investment Management Developments

December 2015

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

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

Schwab Investments' (Schwab) petition to the U.S. Supreme Court for review of an April 2015 decision of the Ninth Circuit Court of Appeals (the Ninth Circuit), which allowed common-law claims to proceed against Schwab related to its management of the Schwab Total Bond Market Fund (the Fund), was denied by the U.S. Supreme Court on October 5, 2015.[1] On that same day, the U.S. District Court for the Northern District of California (District Court) issued an opinion deciding on a motion to dismiss filed by Schwab.[2]

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

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

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

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

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

The impact of the Ninth Circuit decision may be of limited impact, however, as the District Court's October decision upon remand found Northstar's breach of contract claims to be precluded by SLUSA. The breach of fiduciary claims against Schwab and the Trustees were not dismissed, but the District Court did not consider whether SLUSA precluded these claims, as it held that Schwab and the Trustees were precluded from asserting a SLUSA defense on procedural grounds. In addition, in November 2015, a similar case against PIMCO Funds also was dismissed, by the U.S. District Court for the Central District of California, based on similar grounds.[3]

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

SEC Settles First "Distribution-in Guise" Case

The Securities and Exchange Commission (SEC) reached a settlement on September 21, 2015, with First Eagle Investment Management (First Eagle) and its affiliate FEF Distributor, LLC (the Distributor) which were charged with improperly causing the First Eagle Funds (the Funds) to use Fund assets to pay for services intended to market the Funds and distribute the Funds' shares outside of a plan of distribution adopted under Rule 12b-1 of the Investment Company Act of 1940 (the 1940 Act).

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

The SEC alleged that the fees paid pursuant to the Dealer Agreement and the Marketing Agreement were included in the amounts that were reported to the Fund's board of directors as sub-transfer agency costs, and, as a result, were paid out of the Fund's assets outside of its Rule 12b-1 Plan.[1] Furthermore, the Funds' prospectus disclosure regarding distribution expenses stated that "FEF Distributors or its affiliates bear distribution expenses to the extent

they are not covered by payments under the Rule 12-b plans." Therefore, SEC alleged that First Eagle and the Distributor violated Section 206(2) of the Advisers Act[2], Section 12(b) of the Investment Company Act and Rule 12b-1[3], and Section 34(b) of the Invest Company Act[4]. Without admitting or denying the charges, First Eagle and the Distributor agreed to pay nearly $40 million to the affected shareholders.

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

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

In September 2015, the Securities and Exchange Commission (SEC) proposed a new rule and amendments to its existing rules and forms that are intended to promote effective liquidity risk management throughout the mutual fund industry.[4] The new rule and amendments, if adopted, are expected to enhance the liquidity risk management by reducing the risk that funds will be unable to meet redemption obligations and mitigating dilution of the interests of fund shareholders in accordance with section 22(e) and Rule 22c-1 under the Investment Company Act of 1940.

Proposed Rule 22e-4

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

A. Program Requirements

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

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

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

- Convertible to cash within one business day.
- Convertible to cash within two to three business days.
- Convertible to cash within four to seven calendar days.
- Convertible to cash within eight to 15 calendar days.

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

- Convertible to cash within 16-30 calendar days.

- Convertible to cash in more than 30 calendar days.

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

- Existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants

- Frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange)

- Volatility of trading prices for the asset

- Bid-ask spreads for the asset

- Whether the asset has a relatively standardized and simple structure

- For fixed income securities, maturity and date of issue

- Restrictions on trading of the asset and limitations on transfer of the asset

- The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding. Analysis of position size should consider the extent to which the timing of disposing of the position could create any market value impact, and

- Relationship of the asset to another portfolio asset

C. Assessing and Managing a Fund's Liquidity Risk

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

- Short-term and long-term cash flow projections, taking into account the following considerations:
    - Size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods
    - The fund's redemption policies
    - The fund's shareholder ownership concentration
    - The fund's distribution channels, and
    - The degree of certainty associated with the fund's short-term and long-term cash flow projections

- The fund's investment strategy and liquidity of portfolio assets

- Use of borrowings and derivatives for investment purposes, and

- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

This list is not meant to be exhaustive. In assessing its liquidity risk, a fund may take into account considerations in addition to the factors set forth in proposed rule 22e-4(b)(2)(iii). Proposed Rule 22e-4(b)(2)(iv) would require a fund to manage its liquidity risk based on this assessment, including: requiring the fund to determine (and periodically review) a

minimum percentage of the fund's net assets that must be invested in three-day liquid assets (the fund's "three-day liquid asset minimum[5]"); prohibiting a fund from acquiring any less liquid asset if the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets; and prohibiting a fund from acquiring any 15 percent standard asset[6] if the fund would have invested more than 15 percent of its net assets in 15 percent standard assets.

D. Board Approval and Designation of Program Administrative Responsibilities

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

E. Record Keeping Requirements

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

Amendments to Rule 22c-1

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

Disclosure and Reporting Requirements

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

Compliance Dates

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

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

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

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

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

Proposed Anti-Money Laundering Rules Applicable to Investment Advisers

The Financial Crimes Enforcement Network (FinCEN) recently issued proposed anti-money laundering (AML) rules (the Proposed Rules) that would apply to any investment adviser registered or required to be registered as an investment adviser with the Securities and Exchange Commission (the SEC).[7] This would include investment advisers to certain hedge funds, private equity funds, and other private funds.

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

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

Required AML Program

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

appropriate portions of its AML program to third-party service providers, such as broker-dealers, custodians, and transfer agents.

Required Suspicious Activity Reports

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

Other Reporting and Recordkeeping Requirements

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

Compliance Dates, Enforcement

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

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

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

The Labor Department's proposal would require retirement investment advisers and their firms to acknowledge formally a fiduciary status and enter into a contract with their customers to commit to the standard. Acting in accordance with the standard would include giving advice that is in the customer's best interest, and making truthful statements about investments, and their compensation. The Labor Department released the proposal in April 2015[8] (our past article detailing the Department's proposal can be found on page 6).

The Investment Company Institute and the Securities Industry and Financial Markets Association are among the organizations that oppose the Labor Department's proposal.[9]

Mr. Ketchum has stated that the Securities and Exchange Commission (the SEC) should formulate a unified standard, which would apply consistently to all investments, not only retirement savings.[10] SEC Chair Mary Jo White has similarly stated that she prefers a uniform fiduciary standard.

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

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

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

OCIE Launches Program to Evaluate Retirement Plan Sales Practices

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

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

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

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

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

In May 2015, the Securities and Exchange Commission (SEC) proposed changes to the reporting and disclosure obligations of registered investment companies and registered investment advisers.[11],[12] With this proposal, the SEC hopes to modernize and enhance data reporting. The main parts of the proposal include new Form N-PORT, new Form N-CEN, amendments to Regulation S-X, website availability of shareholder reports, and amendments to Form ADV.

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

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

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

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

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

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

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

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

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

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

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

Department of Labor Proposes New Regulations on Fiduciary Advice

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

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

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

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

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

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

The Best Interest Contract exemption also requires that an investment advice fiduciary enter into a contract with the client that acknowledges the adviser's fiduciary status. The contract cannot include

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

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

SEC Staff Publishes Money Market Fund Reform FAQs

In April 2015, the staff of the SEC's Division of Investment Management published guidance in two separate releases (the Releases) to follow up on the money market fund reforms the SEC adopted in July 2014 (the 2014 MMF Release). The first of the two Releases (the MMF FAQs) discusses interpretive questions that came out of the 2014 MMF Release.[13] The second Release (the Valuation FAQs) discusses the valuation guidance for all mutual funds contained in the 2014 MMF Release.[14]

The MMF FAQs address several topics, including:

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

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

SEC Announces Whistleblower Awards to Compliance Professionals

The SEC announced on April 22, 2015, that it will award between $1.4 million and $1.6 million to a whistleblower who provided information to the SEC in an enforcement action against the whistleblower's

employer.[15] Notably, the award recipient is a compliance professional. The award is the SEC's second such payment to an employee with internal audit or compliance responsibilities. The SEC announced the previous award—more than $300,000—in August 2014. In both situations, the SEC noted that the whistleblowers reported misconduct to the SEC after the company became aware of the misconduct and failed to take action. Andrew Ceresney, Director of the SEC's Division of Enforcement, noted that "when investors or the market could suffer substantial financial harm, our rules permit compliance officers to receive an award for reporting misconduct to the SEC." These awards are of concern to many companies because compliance professionals, by the nature of their jobs, have access to sensitive information.[16]

SEC Broadly Interprets *Janus* on Enforcement Actions

The SEC has issued an opinion[17] essentially exempting its enforcement actions from the holding of the U.S. Supreme Court's decisions in *Janus Capital Group v. First Derivative Traders*.[18] In *Janus*, the Supreme Court ruled that, concerning the antifraud provisions of Rule 10b-5 under the Securities Exchange Act of 1934[19] and Section 17(a) of the Securities Act of 1933,[20] primary liability for misrepresentations and omissions lies with the person who has the ultimate authority over the statement or omission, including its content and whether and how to communicate it.[21] In its opinion, the SEC interpreted *Janus* to mean that, because of the breadth of certain provisions within Rule 10b-5 and Section 17 and the limited holding of *Janus*, the Supreme Court's decision does not limit the SEC's ability to bring charges under Rule 10b-5.[22]

The opinion addressed an enforcement action brought by the SEC's Division of Enforcement against two employees of an unregistered fixed-income fund.[23] The two employees, a senior product manager and chief investment officer, were charged with misleading investors about the risk profile and extent of subprime mortgages held by the fund between 2006 and 2007, as well as the effect of certain asset sales.[24] Both employees were initially cleared in 2011, with the administrative law judge holding that *Janus* precluded charges being brought against either party, as neither of them had "ultimate authority" over the statements.[25]

On appeal, the SEC reasoned that while *Janus* does limit liability for a misleading statement under Rule 10b-5(b), it does not similarly restrict Rules 10b-5(a) or (c).[26] Those provisions allow for primary liability to be applied to anyone who, with scienter, or intent to deceive, uses any manipulative device or engages in any manipulative act in selling or buying securities.[27] Therefore, even if *Janus* did apply to the SEC's use of Rule 10b-5(b), the agency would still be able to bring charges under Rule 10b-5(a) or (c).[28] The SEC concluded that the ruling in *Janus* does not, in fact, limit its ability to bring charges under Rule 10b-5 at all.[29] The SEC argues that this interpretation does not expand the narrow scope with which the Supreme Court limited the implied right of action, as the SEC does not have the same reliance requirements.[30]

The SEC also held that *Janus* does not apply to Section 17(a), which has no private right of action. Stating that Section 17(a) does not require manipulative or deceptive conduct to apply, the opinion read each section to apply in specific cases: 17(a)(1) applies to all scienter-based fraud;[31] 17(a)(2) applies whenever a party obtains money or property by means of an untrue statement;[32] and 17(a)(3) applies to the general effect on members of the investing public, while being limited to transactions, practices, and courses of business.[33]

The SEC found that the senior product engineer had violated all three sections of 10b-5 and Section 17(a)(1) by approving and using presentation materials, including a PowerPoint presentation, that misrepresented his firm's investment in asset-backed securities by as much as 45 percent.[34] The chief investment officer was found to have only violated Section 17(a)(3) when he negligently approved client letters containing false statements about the fund's

risk profile and advice from the investment adviser that was inconsistent with the views of others within the firm.[35] The SEC suspended the respondents for one year from association with any investment adviser or investment company, and assessed penalties of $65,000 and $6,500, respectively.[36] The matter is currently on appeal.

SEC Staff Releases Results of Cybersecurity Examination Sweep

On February 3, 2015, OCIE released a summary of its findings from a set of examinations it conducted on registered broker-dealers and investment advisers in 2013 and 2014.[37] The examinations focused on how firms representing a cross-section of the industry handle risks related to cybersecurity, and how vulnerable they are to cyber-attacks.

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

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

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

OCIE staff is still reviewing information from these examinations, and cybersecurity will continue to be a focus of OCIE in 2015. In addition to the SEC, the Financial Industry Regulatory Authority, the regulatory organization for broker-dealers, has identified cybersecurity as a top examination priority.[38] Further SEC guidance about how firms can address cyber risks and incidents is probably forthcoming. In the meantime, OCIE's reported findings highlight a number of items that firms may want to consider in evaluating their current level of preparedness. In doing so, firms can:

- Review OCIE's sample cybersecurity document request for an idea of what an OCIE examination would cover.[39]
- Perform periodic risk assessments to identify internal and external risks (included risks associated with, among other things, vendors or other third parties, devices, connections, software, and sign-on capabilities).
- Update firm policies and procedures, including the firm's business continuity plan, based on findings of risk assessments.

- Test and adjust technical controls.
- Ensure proper training takes place, and document details of when and with whom the training was conducted.
- Participate in information sharing opportunities with industry peers. For example, the Securities Industry and Financial Markets Association encourages its members to join the Financial Services Information Sharing and Analysis Center, which enables firms to receive notifications and information designed to help protect systems and assets.[40]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[19] 17 C.F.R. § 240.10b-5.

[20] 15 U.S.C. § 77q(a)

[21] *Id*., at 2306.

[22] SEC Opinion at 18-19.

[23] *Id.*, at 2.

[24] *Id*., at 3.

[25] *Id*.

[26] *Id*., at 17-19.

[27] *Id.*, at 18.

[28] *Id.*

[29] SEC Opinion, at 19.

[30] *Id.*

[31] *Id.*, at 13.

[32] *Id.*

[33] *Id.*

[34] *Id*., at 8.

[35] SEC Opinion at 39.

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

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

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

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

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