INVESTMENT MANAGEMENT LEGAL + REGULATORY UPDATE

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REGULATION

Department of Labor Issues Fiduciary Regulations Under ERISA

The Department of Labor (DOL) issued its long-anticipated final regulation (the "Regulation") defining who is a fiduciary as a result of giving investment advice to plans subject to ERISA, to participants or beneficiaries of these plans, or to IRAs.

The Regulation significantly expands the categories of persons considered fiduciaries from the regulation it replaced, which was issued in 1975, but generally relaxes many of the requirements contained in the 2015 Proposed Regulation, which immediately preceded the final Regulation.

For additional discussion and analysis, our Client Alert is available here.

SEC's White: Fund Directors Should Provide Oversight, Not Management; Consider "Emerging Problems of Tomorrow"

In a speech to the Mutual Fund Directors Forum (MFDF) on March 29, 2016, SEC Chair Mary Jo White acknowledged that regulators should not completely overload fund directors with additional responsibilities or confuse strong oversight with micromanagement of a fund.

The SEC must "be sensitive to where a director's oversight responsibility could cross the line into day-to-day-management," she said. Drawing an appropriate line is a challenge, she added, "one that the SEC is grappling with" as it considers proposed rules governing liquidity risk management and derivatives, among others, that are "designed to address the increasingly complex portfolios and operations of mutual funds and ETFs."

For additional discussion and analysis, our Client Alert is available here.

SEC Proposes Limits on Fund Use of Derivatives and Leverage

The SEC recently proposed rules that would limit the amount of leverage that mutual funds may obtain through

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derivatives. Rule 18f-4 would require funds to comply with an "exposure-based portfolio limit" or an "alternative risk-based portfolio limit." The proposals would also require funds and business development companies (BDCs) to manage the risks of investing in derivatives by clarifying requirements to segregate liquid assets to "cover" their potential exposure to derivatives. Finally, the proposal would require funds that make extensive use of derivatives or utilize "complex" derivatives to establish written derivatives risk policies and appoint a derivatives risk manager.

You can find additional analysis and initial impressions in our Client Alert, available here.

Derivatives Rule Proposal: More Work for Overburdened Fund Directors

The SEC's proposals to modernize its regulation of fund use of derivatives and leverage again increase the scope and complexity of the responsibilities of investment company fund directors.

For additional discussion, Jay Baris, in an article in *Fund Board Views*, describes what directors need to know about the SEC's proposals and how the proposals could affect them. The article is available here.

CFTC Announces Its Largest Whistleblower Award to Date

On April 4, 2016, the Commodity Futures Trading Commission (CFTC) announced by far its largest whistleblower award to date, agreeing to pay "more than $10 million" to a whistleblower who provided key information leading to a successful enforcement action.

In accordance with Section 748 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), which established the CFTC's whistleblower program, the CFTC has not publicly disclosed information that could reasonably be expected to reveal the whistleblower's identity. In addition to not identifying the whistleblower, the CFTC has specified neither the exact amount of the award nor the successful enforcement action for which the whistleblower provided information.

For additional discussion and analysis, our blog post is available here.

SEC Fines Broker-Dealer for Improper Research Report

In what the SEC indicated is its first action against a broker-dealer for violations of Section 5(b) of the Securities Act of 1933, as amended, by initiating research coverage while it was seeking, or had been invited, to participate in underwriting an offering for that issuer, the SEC recently entered into a settlement agreement with the broker-dealer.

According to the SEC, the issuer cancelled a proposed secondary stock offering for which the broker-dealer was planning to act as the lead underwriter. At that point, the issuer planned another offering, and the issuer invited the broker-dealer to participate as a co-manager. However, according to the SEC, the issuer made the broker-dealer's participation contingent upon the broker-dealer commencing research coverage—a "quid pro quo"—which the investment bank agreed to do. In commencing research coverage, the investment bank rated the stock a "buy," with a price target that was considerably higher than its then-current market price.

Under these circumstances, the SEC will typically view a research report about the subject company as an improper prospectus. While SEC Rule 139 includes a safe harbor from the definition of "prospectus" for research reports that satisfy the rule, this safe harbor excludes cases, such as this one, where the broker-dealer initiated coverage. Here, the SEC deemed the research report to be a prospectus, due to its potential to condition the market.

For additional discussion and analysis, our blog post is available here.

SEC's Division of Investment Management Issues Guidance on Fund Risk Disclosure

On March 9, 2016, the SEC's Division of Investment Management issued a Guidance Update reminding funds and other registered investment companies of the importance of including risks in their disclosure documents that arise because of changing market conditions. In particular, the staff noted, funds should review their risk disclosures on an ongoing basis to consider whether these disclosures remain adequate in light of current market conditions.

The staff offered the following steps to review on an ongoing basis to help funds maintain "robust" risk disclosures:

- Monitoring market conditions and their impact on fund risks;
- Assessing whether funds' risks have been adequately communicated to investors in light of current market conditions; and
- Maintaining communication with investors.

We note that many advisers and fund service providers undertake the above steps each day as part of the day-to-day management of funds.

The staff also noted particular market conditions that may change how risks associated with fixed income funds are disclosed and communicated to investors. The staff noted that, based upon its observations of fund prospectuses, shareholder reports, and fund websites, these risks include:

- Interest rate risk, including the risk that interest rates rise, which in turn may result in a decline in the value of the fixed income investments held by the fund;
- Liquidity risk, including the risk that, with increasing interest rates, periods of volatility and increased redemptions may occur, including reductions in dealer market-making capacity;
- Duration risk, including the risk that longer-term fixed income investments may be more sensitive to interest rate changes; and
- Puerto Rican debt, including the risk that Puerto Rico defaults on its debt.

This is not an exhaustive list but, instead, should serve as guidance and examples of recent market conditions that could impact a fund.

FINRA Reports on "Robo-Advisors"

In response to the emerging growth and use of so-called "robo-advisors," including coverage in the media, FINRA recently released a report relating to these digital investment tools.

FINRA issued the report to remind broker-dealers of their obligations under FINRA rules in connection with these tools. The report is also designed to share practices related to digital investment advice that FINRA believes are effective, including technology management, portfolio development, and conflicts of interest mitigation. The report also identifies practices that FINRA believes firms should consider and potentially adopt.

The FINRA Report on Digital Investment Advice is available here.

FINRA Proposes Crowdfunding Rules

FINRA recently filed a proposed rule change with the SEC in order to adopt the final rules relating to Title III crowdfunding "funding portals."

The final FINRA rules seem to align closely with the proposed rules, with some notable changes. For example, FINRA is not requiring a fidelity bond, nor is it requiring that funding portals implement an anti-money laundering program.

The Funding Portal Rules are comprised of seven rules: 100, 110, 200, 300, 800, 900, and 1200. In addition, FINRA is adopting Rule 4518 that will apply to broker-dealer members.

The Division of Trading and Markets also must adopt rules relating to funding portals and broker-dealer intermediaries in crowdfunded offerings.

For additional discussion and analysis, our Client Alert from 2013, which discusses the proposed rules, is available here.

FINRA and T+2: The Rule Roll-Out Begins

As the U.S. financial markets commence their move towards a T+2 settlement period, FINRA has introduced a proposed set of rule changes designed to support this change. The current timetable contemplates that the changes would be finalized in the third quarter of 2017, and FINRA is attempting to effect its rule revisions in accordance with that schedule. FINRA will continue to review its rules to verify that impacted rules for securities settlement are identified and considered for amendment as needed. FINRA is requesting comments as to its proposals, including as to whether it has identified all of the relevant rules that would require amendments.

Of course, the necessary amendments to the SEC's Rule 15c6-1, relating to the settlement cycle for securities in the secondary market, would be part of a separate SEC rulemaking process.

FINRA Approves Price Disclosure Proposal for Debt Securities

On February 26, 2016, FINRA issued a press release announcing that its Board of Governors approved a proposal to amend Rule 2232 relating to customer confirmations. The proposed amendments would require member firms to disclose on retail customer confirmations the "mark-up" or "mark-down" for many types of transactions in corporate and agency debt securities.

For additional discussion and analysis, our *Structured Thoughts* article is available here.

The proposal is now subject to SEC review and approval before becoming final.

NASAA Adopts Model Act on the Prevention of Financial Exploitation of Vulnerable Adults

On January 22, 2016, the North American Securities Administrators Association (NASAA) adopted a model act entitled "An Act to Protect Vulnerable Adults from Financial Exploitation." This act seeks to facilitate coordination among securities regulators, broker-dealers, and adult protective services agencies in dealing with the financial exploitation of seniors and other vulnerable

adults. The model act reflects the collective views of the NASAA membership, which consists of 67 state, provincial, and territorial securities administrators from the 50 states, D.C., Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico; however, the model act has no legal authority and is only meant to serve as a guidepost to individual jurisdictions. State legislatures or regulators (with or without modifications) may adopt the model act, and it has both permissive and mandatory components.

The Basics of the Model Act

If adopted by a state legislature, the model act would require a state-registered broker-dealer or a "qualified individual" (as defined in the model act) with a reasonable belief that financial exploitation of an eligible adult is occurring or may occur to notify adult protective services and the commissioner of securities in that jurisdiction (collectively, the "Agencies"). Optionally, the broker-dealer or other qualified individual could also notify any contact person previously designated by the eligible adult (unless the person is suspected of foul play). Additionally, if a disbursement is requested from the account, the broker-dealer, after an initial review of the facts, *may* place a temporary hold on disbursements from the account.

For a more detailed review of the provisions of the model act, see our blog post, available here.

FINRA Reminds Members of Obligations in Offerings Subject to a Contingency

On February 8, 2016, FINRA released Regulatory Notice 16-08 relating to the contingency offering requirements of Rules 10b-9 and 15c2-4 under the Exchange Act. The Notice arises from FINRA's review of various private placement offering documents in connection with Rule 5123's filing requirement for certain offerings. FINRA observed that broker-dealers have not always complied with the regulatory requirements applicable to contingency offerings. Accordingly, the Notice is designed to remind broker-dealers of their obligations under these rules.

For additional discussion and analysis, our Client Alert is available here.

FINRA Proposes Rule to Reduce the Regulatory Burdens on Boutique Investment Banks

FINRA recently filed with the SEC a proposed rule which would reduce the regulatory burden for broker-dealers that limit their activities to M&A and certain corporate financing transactions. The proposed rule would create a new category of broker-dealers called "Capital Acquisition Brokers" or "CABs." On March 17, 2016, the SEC published an order instituting proceedings to determine whether to approve the proposed rule. The SEC has requested written comments, which are due by April 13, 2016.

Purpose of Proposal

The rule was developed based upon FINRA's earlier release seeking comment on a proposal to create a new category of broker-dealers that limit their business activities to corporate financing. *See* FINRA Regulatory Notice 14-009 (February 2014). As FINRA observed at that time, there are a number of broker-dealers that limit their business to advising companies on M&A transactions, raising funds through private placements, and evaluating strategic alternatives. While these firms must generally be registered as broker-dealers because they often receive transaction-based compensation, they do not handle customer funds or securities, do not manage customer accounts, and do not engage in market-making or proprietary trading. As a result, some of the requirements set forth in FINRA's rules are not relevant to their business operations.

Limited Activities

In order to qualify as a CAB, a firm must limit its activities to the following:

- Advising issuers, including private funds, concerning public or private securities offerings;
- Assisting on the preparation of offering materials;
- Acting as a placement agent in the sale of unregistered securities to institutional investors (as defined in the FINRA rules) and qualified purchasers (as defined in the 1940 Act) through an exempt offering;
- Advising a company regarding an M&A or restructuring transaction;
- Providing fairness opinions;
- Effecting the sale of securities in an M&A transaction involving the transfer of control of a privately held company;
- Providing negotiation, structuring, valuation, or other support for a capital raising or M&A transaction; and
- Advising on the selection of investment bankers.

Importantly, broker-dealers that act as underwriters or selected dealers in registered public offerings could not qualify as CABs. However, broker-dealers that limit their activities to advisory services in connection with public offerings could qualify as CABs.

Firms that limit their business activities as set forth above and that voluntarily elect to be treated as a CAB would be subject to a separate set of rules for CABs and reduced regulatory requirements.

For additional discussion and analysis, our blog post is available here.

FINRA's Securities Helpline for Seniors™ Provides Guidance to Broker-Dealers

Last spring, FINRA launched its Securities Helpline for Seniors™ (the "Helpline"), which seeks to enhance investor protection by serving as a resource to seniors making investment decisions. Recently, FINRA reported that, since its launch, the Helpline has fielded over 2,500 calls.

Since the Helpline launched, FINRA has used the information gathered from these calls to assist seniors, detect fraud, and identify ways that broker-dealer firms can guard against exploitation of seniors within their own organizations.

At the end of 2015, FINRA published a report highlighting effective firm practices identified to address the concerns raised through the Helpline. These practices are as follows:

- Obtain the contact information, upon account opening, of a trusted person to reach out to for concerns about the senior's account.
- Avoid conflicts of interest by limiting a registered representative's ability to occupy a position of trust, such as serving as a power of attorney or trustee, for his or her client.
- Establish someone within the firm who focuses on, and serves as the contact person for, senior investor issues.
- Train staff to identify potential client incapacity or elder abuse and to report these problems.
- Publish client-focused educational materials to inform senior investors and help protect them from possible scams.
- Keep your firm up to date on senior issues by joining industry groups focused on combating elder abuse and by hosting or attending symposiums discussing these issues.
- Exercise caution in terminating relationships with aged clients.
- Implement policies and procedures among employees of the firm for handling instances of diminished mental capacity.
- Understand and carefully explain to clients the tax consequences of transferring assets from qualified accounts.
- Ensure paperwork regarding distribution of account assets upon death accurately reflects the current wishes of the client.

Although they are not necessarily current rule requirements, the practices identified in FINRA's report represent helpful guidance as to items that broker-dealers may wish to consider implementing as a "best practice." And, of course, several of these practices may become the "law of the land," as discussed in our summary of FINRA's recently proposed Rules 4512 and 2165, which is available here.

SEC Staff Publishes Guidance on Fund Distribution and Sub-accounting Fees: Emphasis on Process and Fully Informed Directors

The SEC's Division of Investment Management recently published a Guidance Update that addressed the issue of how mutual funds, their investment advisers, and independent fund directors should evaluate arrangements involving mutual fund distribution and fees paid for services related to sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees (referred to as "sub-accounting fees" by the Division's staff).

The guidance urges fund boards to establish a robust process for evaluating and approving sub-accounting arrangements and to ensure that funds establish compliance policies and procedures for reviewing and identifying any payments that are made for distribution-related services and that are not paid by a Rule 12b-1 distribution plan.

In the guidance, the staff hones in on the issue of whether payments of fees to intermediaries that are not characterized as distribution fees raise questions of whether some or all of those fees "are being used to pay for activities that are primarily intended to result in the sale of mutual fund shares." This is commonly referred to as "distribution in guise."

For additional discussion and analysis, our Client Alert is available here.

SEC Agenda for 2016: Tighten Rules on Leverage for Funds; Stress Testing and Third-Party Compliance Reviews for Advisers

In recent testimony before the House Committee on Financial Services, SEC Chair Mary Jo White described what the SEC has in store for the investment management industry.

Chair White said that, in addition to recent rule proposals concerning liquidity risk management and disclosure enhancements, the SEC

staff is working on additional initiatives "aimed at helping to ensure that the SEC's regulatory program is fully addressing the increasingly complex portfolio composition and operations of the asset management industry." These initiatives include:

- *Use of Derivatives by Investment Companies*. In December, the SEC proposed new requirements related to the use of derivatives by registered funds, including measures to appropriately limit the leverage these instruments may create and to enhance risk management programs for such activities.

- *Transition Plans for Investment Advisers*. The SEC staff is developing recommendations that the SEC proposes requiring investment advisers registered with the SEC to create and maintain transition plans to prepare for a major disruption in their business.

- *Stress Testing for Large Investment Advisers and Large Investment Companies*. The staff is also considering recommending that the SEC propose new requirements for stress testing by large investment advisers and large investment companies. Such rules would implement, in part, requirements under section 165(i) of the Dodd-Frank Act.

- *Third-Party Compliance Reviews*. At the Chair's direction, the staff is also preparing a recommendation to the SEC for proposed rules that would mandate third-party compliance reviews for registered investment advisers. The reviews would not replace examinations conducted by the SEC's Office of Compliance Inspections and Examinations but would be designed to improve overall compliance by registered investment advisers.

More recently, in remarks at the ICI's annual mutual fund conference, David Grim, the Director of the SEC's Division of Investment Management, confirmed that the Division's staff is developing proposed rules to address transition planning and stress testing. He also emphasized that investment companies and investment advisers cannot lose sight of the importance of oversight and due diligence of third-party service providers, including how those service providers might operate during significant business disruptions.

Our take. These initiatives indicate that the SEC, carefully watching the Financial Stability Oversight Council in its rearview mirror, continues to focus on assessing and monitoring systemic risk. These initiatives may limit current fund practices and strategies and increase compliance costs.

ENFORCEMENT + LITIGATION

"Tell Us About Your Culture" – FINRA Commences Sweep

In its annual exam priorities letter, FINRA announced that it would examine the "compliance culture" at member firms.

In furtherance of that goal, in February 2016, FINRA issued a "sweep letter" to members, requesting information designed to inform FINRA about how member firms establish, communicate, and implement cultural values.

In announcing the sweep, FINRA stated:

> A culture that consistently places ethical considerations and client interests at the center of business decisions helps protect investors and the integrity of the markets. Conversely, failures in these areas can impose significant harm on investors and the markets as well as firms themselves.

FINRA plans to meet with executives from across a recipient firm's business, including compliance, legal, and risk management staff, to discuss cultural values. In preparation for these meetings, FINRA requested explanations and materials relating to a variety of matters that FINRA believes relate to firm culture.

FINRA states that its goal is to better understand industry practices and determine whether member firms are taking reasonable steps to properly establish and implement their cultural values. Knowing firm practices in this area, and the challenges firms face, will help FINRA develop potential guidance for the industry and determine other steps that could be taken.

Culture, it seems to us, is an ill-defined concept that is difficult to mandate, so it will be interesting to see what conclusions FINRA draws from this sweep. Ultimately, the issues that appear to be driving this sweep are long-standing concerns about the duties that broker-dealers owe their customers and how compensation and management systems impact dealings with customers. In the meantime, recipient firms should take the time to ensure that executives across the firm can speak knowledgeably about what the culture is—including the compliance culture—and why it makes sense for that firm.

SEC Sanctions Alt Fund Asset Manager for Fee Overcharges and Misleading Investors

The SEC recently settled proceedings against an asset manager for material misstatements made in the offer and sale of units of a publicly registered managed futures fund. The SEC found that the manager disclosed that it charged the fund management fees based on the net asset value of each of the fund's series when, in fact, the management fees were calculated based on the notional trading value (including leverage) of the assets in each series.

The manager is registered as an investment adviser with the SEC and as a commodity pool operator with the Commodities Futures Trading Commission. The SEC's jurisdiction over the manager primarily stems from its registration as an investment adviser, although the SEC also found that the investment adviser caused the fund to violate the fund's reporting obligations (under the Securities Exchange Act of 1934) related to the fund's securities registered under the Securities Act of 1933. The fund is a commodity pool and is not a registered fund under the Investment Company Act of 1940.

According to the SEC, the adviser calculated its management fees in a manner inconsistent with the method described in the fund's registration statements and periodic reports. It also deviated from the disclosed valuation methodology for some of the fund's holdings.

To settle the proceedings, the adviser agreed to refund investors approximately $5.4 million in excessive fees collected, plus $600,000 in prejudgment interest accrued. In addition, the adviser agreed to pay a $400,000 civil penalty.

This case reinforces the need to ensure that funds carefully review their disclosure documents and ensure that internal policies and procedures are consistent with their stated disclosure.

For a more detailed review of the findings of this proceeding, see our blog post here.

OCIE Publishes Exam Priorities for 2016

The National Exam Program of the SEC's Office of Compliance Inspections and Examinations (OCIE) recently published its examination priorities for 2016. The letter is organized around three key thematic areas of focus:

Protecting Retail Investors—Including Those Saving for Retirement

OCIE will continue to focus attention on retail investors, specifically those saving for retirement. OCIE identified several areas of particular interest and specific initiatives related to retirement savings and the broader retail marketplace.

Market-wide Risks

In order to maintain fair, orderly, and efficient markets, OCIE announced that it will examine structural risks and trends that involve multiple firms or entire industries, including, among others:

- Broker-dealers' and investment advisers' cybersecurity compliance and controls, including testing and assessments of firms' implementation of procedures and controls;
- Systems compliance and integrity (SCI) entities to evaluate the establishment, maintenance, and enforcement of policies and procedures; and
- Advisers to mutual funds, ETFs, and private funds and their liquidity controls and procedures, including registered broker-dealers that have become new or expanding liquidity providers in the marketplace.

Using Data Analytics to Identify Signals of Potential Illegal Activity

Much like 2015, OCIE intends to continue to develop and use its enhanced data analytics to identify firms that appear to be engaged in fraudulent or other illegal activity.

In addition to the themes described above, OCIE expects to examine:

- Newly registered municipal advisers to assess compliance with the recently adopted SEC and Municipal Securities Rulemaking Board rules.
- Private placements (including Regulation D and EB-5 Program offerings) for due diligence, disclosure, and suitability legal requirements. Changes to relevant U.S. securities regulation offer a variety of new distribution possibilities; regulators have expressed some interest in determining whether these privately placed securities are being sold properly.
- Never-before-examined investment advisers and investment companies.
- Private fund advisers, with a focus on fees and expenses and the controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts.
- Transfer agents' safeguarding of security-holder funds, among others.

A more detailed review of OCIE's priorities can be found in our blog post, available here.

FINRA's 2016 Priorities Letter: Objective and Subjective Issues

FINRA recently published its agenda of key examination priorities. This year's 13-page Regulatory and Examination Priorities Letter sets forth both long-standing and new items for firms to evaluate in preparing for an examination. Not surprisingly, the letter is broad and covers a wide range of areas; we indicate below our recommendations for firms that are preparing for an exam. Each member firm should, however, carefully assess the priorities identified in the letter in the context of its own businesses.

For additional discussion and analysis, our Client Alert is available here.

SEC Sanctions Adviser, Executives and CCO for Custody Rule Violation – Again

The SEC recently sanctioned a registered investment adviser, its two owners, and a former chief compliance officer for violating the Advisers Act "custody rule" after previously settling similar charges and agreeing to "cease and desist" from future violations. Without admitting or denying the charges, the executives consented to the SEC's findings that they caused and willfully aided and abetted the violations.

The former CCO agreed to pay a $60,000 penalty; two principals of the adviser agreed to a $1 million penalty and a one-year ban from raising money from new or existing investors.

The custody rule is designed to protect investor assets. The rule requires, among other things, an adviser that has "custody" of client assets to ensure that the custodian sends quarterly account statements to clients and that an independent public accountant verifies the assets in client accounts each year. Advisers of pooled investment vehicles ("funds") that send investors audited financial statements within 120 days of a fund's fiscal year-end, however, are not required to obtain independent verification of portfolio assets or to satisfy the quarterly account statements' delivery requirement.

The SEC found that, for three fiscal years beginning in 2010, the adviser and its executives failed to timely distribute audited financial statements to investors in pooled investment vehicles managed by the adviser. This alleged failure violated Rule 206(4)-2, the so-called "custody rule" under the Advisers Act. Moreover, the SEC found that the advisers and the executives violated the cease and desist order relating to the previous violations.

The SEC found that, notwithstanding the prior settlement order, the adviser and its principals took no remedial action to ensure compliance with the custody rule. Moreover, the SEC found that the former CCO substantially assisted the adviser's violations of the custody rule.

The SEC said that although the adviser's compliance manual tasked the CCO with ensuring compliance with the custody rule, the CCO did not implement necessary policies or procedures to ensure such compliance. The SEC found that the former CCO "simply reminded people of the custody rule deadline without taking any more substantial action." The SEC also criticized the former CCO for failing to notify the SEC staff of the adviser's difficulties in meeting the custody rule deadlines.

The SEC suspended the CCO from serving as a chief compliance officer for one year.

Our take. This settlement comes after a series of speeches by SEC officials that the SEC was not targeting CCOs or second-guessing them. The order provides an example of the threshold of undesirable behavior that a CCO must cross to spur an enforcement proceeding. To be sure, in light of the SEC's public statements related to its concerns about recidivism, a repeat offense will likely catch the enforcement division's eye.

SEC Sanctions Adviser for Misstatements in Advertisements, Client Presentations, and Regulatory Filings

The SEC found that a registered investment adviser that operates as a "manager of managers" misstated a sub-adviser's investment performance in communications with its clients, potential clients, and the SEC. According to the SEC, these misstatements occurred despite warnings from FINRA that the use of back-tested investment performance in mutual fund advertisements was misleading and that concerns about the sub-adviser's track record were raised by other market participants.

The SEC found that the adviser published the inflated, hypothetical, and back-tested performance record of a sub-adviser in regulatory filings, mutual fund advertisements, and client presentations over a period of more than four years.

The SEC also found that the adviser failed to adopt and implement written compliance policies reasonably designed to prevent

violations of the Advisers Act and related rules. In particular, although the adviser's policies addressed its obligations with respect to advertising performance of its client accounts, those policies did not address the accuracy of third-party-produced performance information or third-party marketing materials or provide a means of reporting and assessing concerns raised about the accuracy of statements in such marketing materials.

Notably, these issues arose although the adviser initially "expressed skepticism" about the sub-adviser's track record. The SEC said that the adviser continued to refer to the incorrect numbers despite several red flags. For example, the adviser allegedly was aware of warnings from other market participants to the adviser's wholesalers that the track record reflected back-tested results rather than performance of "live" assets. A data provider that attempted to recreate the advertised track record also raised concerns. The SEC found that, although the adviser raised questions with the sub-adviser about these concerns, the adviser failed to follow up on its own questions.

The adviser retained an independent compliance consultant to review its compliance policies and procedures and settled the SEC's charges without admitting or denying the findings. The adviser must disgorge fees of $13.4 million plus prejudgment interest of $1.1 million and incurred a civil money penalty of $2 million.

Our take. The SEC recognized that the adviser asked questions of the sub-adviser and its principal and, in certain instances, was misled. This, together with a decision to proactively retain a compliance consultant, probably helped to reduce the firm's penalty. Nevertheless, the adviser's failure to adequately follow up on its concerns—and to implement a compliance program tailored to its business as a manager of managers—resulted in a failure of its compliance infrastructure that the SEC found actionable. Advisers need to ensure that their compliance programs provide adequate oversight of service providers—including sub-advisers—and that the compliance program includes a means of verifying that concerns about compliance matters are raised and addressed appropriately.

For an additional discussion of recent SEC sanctions imposed on an adviser for material misstatements in advertisements and misrepresentation of investment performances, see our blog post.

SEC Sanctions Broker-Dealer and Affiliated Asset Manager for Breaching Information Barriers for Exchange-Traded Products

The SEC recently charged an investment adviser and a broker-dealer for failing to maintain and enforce polices to prevent misuse of material non-public information. Without admitting or denying the charges, the respondents agreed to pay more than $1 million to settle the charges, including disgorgement, penalties, and interest.

According to the SEC's order instituting administrative proceedings, the broker-dealer and the affiliated asset manager repeatedly shared information about their trading positions for an exchange-traded note (ETN) whose market price traded at a premium to its intraday indicative value after new issuances of the note were temporarily suspended. The SEC charged that, despite information barriers between the respondents that were in place, traders from both affiliates met to discuss issues relating to the ETN. This sharing of information, the SEC said, violated the information barriers and created an unfair advantage for the affiliated asset manager.

As a result of the trading of material non-public information, the asset manager profited from a market opportunity that it should not have received, according to the SEC.

Our take. This matter underscores the importance of creating and enforcing information barriers that separate trading and investment management functions. By sharing material non-public information across the barrier, affiliated firms risk a "blending" of information among affiliates, creating opportunities that other market participants did not have. The SEC focused on the fact that the affiliates simply did not enforce the written policies and procedures in place. The case serves as a not-so-subtle reminder that the SEC views prevention of insider trading as a compliance priority.

TIDBITS

- On Thursday, April 14, 2016, Citi hosted its Annual CCO Forum in Columbus, OH. The mission of the forum is to promote CCO peer interaction and dialogue. Partner Jay Baris spoke on derivatives.
- On March 10, 2016, the SEC named Anthony S. Kelly co-chief of the Enforcement Division's Asset Management Unit. Mr. Kelly joins Marshall Sprung as co-chief and succeeds Julie Riewe, who recently left the SEC.
- OCIE, the Division of Investment Management, and the Asset Management Unit of the Division of Enforcement will be hosting a compliance outreach program.

The program will be held on April 19 at the SEC's Washington, D.C. headquarters from 8:30 a.m. to 5:30 p.m. Eastern Time. In-person attendance is limited to 500; a live webcast will be available at www.sec.gov. Registration for Senior Officers is available here.

- According to a governance study published by the Investment Company Institute, mutual funds directors are getting older and wiser as they oversee a growing amount of assets and funds.
- For insight into the EU financial regulatory agenda, read our publication, available here.
- According to a recent SEC report, the number of private funds and private fund assets has grown significantly over the past two years. For additional insight, read our Client Alert, available here.

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