INVESTMENT MANAGEMENT LEGAL + REGULATORY UPDATE

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REGULATION

SEC Begins to Scrutinize Registrants' Cybersecurity Practices

In a Risk Alert published on April 15, 2014, the SEC announced plans to examine the cybersecurity practices of over 50 registered broker-dealers and investment advisers. The SEC's Risk Alert closely followed the March 26 Cybersecurity Roundtable at which Chair Mary Jo White underscored the importance of cybersecurity to market security and customer data protection. At the Roundtable, Chair White emphasized the "compelling need for stronger partnerships between the government and private sector" to address cyber threats.

The Risk Alert detailed the types of questions the SEC may ask registrants in these exams about including cybersecurity governance, risks associated with remote customer access and risks associated with vendors and third parties. The sample questions ask whether companies have discovered malware in their systems, suffered a network breach or found that computers used by customers and vendors to remotely access networks have been compromised since January 2013.

The scope and detail of the sample questions reflect the SEC's commitment to assessing and encouraging cybersecurity readiness. In the past, the SEC has actively enforced Rule 30 of its Regulation S-P (Privacy of Consumer Financial Information), the so-called Safeguards Rule, in the cybersecurity area. The SEC has imposed fines ranging from $100,000 to $275,000 for such deficiencies as the failure of a firm to have policies and procedures adequately designed to protect customer records and information, distribution of insufficient written materials regarding safeguarding customer information and failure to implement adequate controls to safeguard customer information.

FINRA has also been active in the area of cybersecurity, as discussed in our previous client alert. However, increased attention in the wake of several recent highly publicized intrusions likely heralds additional enforcement actions and more serious scrutiny of companies' preparedness to respond to the growing threat presented by cyber hackers.

For more information see our full client alert.

SEC Staff Sets Boundaries for Adviser Testimonials in Social Media

A recent Division of Investment Management guidance update established some ground rules on how the "testimonial rule" applies when advisers use social media communications.

Rule 206(4)-1(a)(1) under the Advisers Act prohibits registered investment advisers from publishing any advertisement that refers to "any testimonial of any kind concerning the investment adviser" or concerning any service rendered by the investment adviser. The guidance update notes that "whether public commentary on a social media site is a testimonial depends upon all of the facts and circumstances relating to the statement."

The guidance update introduces the concept of an "independent social media site," which refers to a third-party social media site that predominately hosts user opinions, beliefs, findings or experiences about service providers. An investment adviser's own social media profile or account that is used for business purposes is not an independent social media site.

An investment adviser may not invite clients to post public commentary on its own website, but the adviser may publish the same public commentary on its own site if the commentary comes from an independent social media site. In doing so, the investment adviser may not edit, revise, sort or otherwise change the commentary in a manner that emphasizes favorable commentary or de-emphasizes unfavorable commentary.

Click here to read our client alert, which contains more analysis on the new social media guidance.

Chair White: SEC to Tackle High-Frequency Trading Risks and Dark Pools

In a speech on June 5, 2014, SEC Chair Mary Jo White said that she has asked the SEC's staff to develop a recommendation for an anti-disruptive trading rule. The rule would apply to active proprietary traders in short time periods when liquidity is most vulnerable and the risk of price disruption caused by aggressive short-term trading strategies is highest.

The Chair asked the staff to recommend rules designed to clarify the status of unregistered proprietary traders to subject them to the rules for dealers, and to eliminate an exception from FINRA membership requirements for dealers that trade in off-exchange venues.

The Chair said that the SEC will focus on the efforts of the exchanges and FINRA to minimize consolidated data latency through new rules to keep up with fast-paced changes in a technology-driven market. For example, the SEC would ask the exchanges and FINRA to consider requiring a "time stamp" in the consolidated data feeds. The time stamp would indicate, for example, when a trading venue processed the display of an order or execution of a trade.

Chair White also took aim at dark venues and alternative trading systems (ATS). Transparency, she said, is the hallmark of the U.S. securities markets, and that "I am concerned by the lack of it in these dark venues."

She asked the SEC's staff to recommend how to expand information about ATS operations it receives and to consider "whether the current regulatory model for exchanges and other trading venues makes sense for today's markets."

Presence Exams Focus Staff Attention on Private Equity Fund Fees

In a recent speech, Andrew Bowden, Director of the SEC's Office of Compliance Inspections and Examinations (OCIE), "spread sunshine" on private equity industry practices gathered through so-called "presence exams" of newly registered private fund advisers.

The goal of the presence exams, he said, is to help these advisers spot potential issues before they find themselves in regulatory hot water. But the "sunshine" may feel more like a giant spotlight on private fund advisers, with some storm clouds rolling in on the horizon.

Bowden's remarks sounded some familiar themes. Key among them: transparency and clear disclosure are the surest way to mitigate conflicts of interest. The private equity business model, however, presents unique risks that firms should address.

For example, he said, private equity funds generally use client funds to obtain a controlling interest in private companies. The relative paucity of disclosure and transparency of these investments, however, can present private fund advisers with conflicts that advisers of registered funds do not face.

Fees and Expenses. One area of significant focus for OCIE is how private equity advisers collect fees and allocate expenses. Bowden said that in more than 50% of the presence exams conducted to date, OCIE has identified what it believes are "violations of law or material weaknesses in controls" related to how private equity advisers handle fees and expenses.

Shifting fees. Bowden said that OCIE has concerns about arrangements that shift fees or expenses from the adviser to the investor, but which are not fully disclosed to investors and therefore may be unexpected. These include, for example:

- *The use of consultants or "Operating Partners."* Operating Partners provide portfolio companies with consulting services that they could not otherwise afford. OCIE's concern is that these independent consultants "look and act just like other adviser employees," but "it is the investors who are unknowingly footing the bill for these resources," on top of management fees paid to the adviser.

- *Shifting fees without disclosure.* OCIE identified a trend of advisers shifting expenses from themselves to their clients well into a fund's life without adequate disclosure. For example, service providers originally characterized as the adviser's employees may reappear later as "consultants" paid by the fund.

- *Shifting administration expenses.* OCIE identified a practice of advisers using "process automation" to shift expenses to fund shareholders without adequate disclosure. For example, by having the funds pay for automated reporting systems, the advisers avoid the cost of preparing reports that their own employees prepared in the past.

Hidden fees. In addition to shifting fees, Bowden said that OCIE is concerned that private equity funds and their advisers are charging hidden fees without adequate disclosure. These fees include:

- *Accelerated monitoring fees.* Advisers commonly charge "monitoring fees" to portfolio companies for providing board and other advisory services during a portfolio company's holding period. OCIE found, however, that some advisers have their portfolio companies sign monitoring agreements that obligate them to pay monitoring fees for 10 years or more, although the typical holding period lasts about five years. Some of these arrangements, he said, run past the term of a fund, and exit strategies employed by a fund may trigger large accelerated payments.

- *Undisclosed administration fees.* OCIE identified a practice of advisers charging undisclosed administrative fees not originally contemplated by a limited partnership agreement.

- *Exceeding expense limits.* OCIE cited a trend of exceeding transaction fee limits set in a limited partnership agreement, or charging transaction fees not contemplated by limited partnership agreements as another troubling hidden-fee practice.

- *Affiliated service providers.* OCIE observed a practice of advisers requiring funds to enter into arrangements with related parties that provide services of "questionable value" to the fund.

Marketing and Valuation. Another ongoing and familiar concern relates to marketing and valuation. Bowden said that OCIE observed that some private equity advisers use valuation methodologies that are not consistent with disclosures to investors.

Bowden noted that OCIE examiners do not seek to second-guess fair value assessments, but rather want to ensure that advisers use valuation processes that align with what they promise to investors. He said that examiners are looking for, among other things:

- cherry-picking comparables or adding back inappropriate items into EBITDA without a rational reason or disclosure to investors; and
- changing a valuation methodology from period to period without disclosure to investors.

Marketing materials are also coming under the microscope — in particular, those that advertise performance using projections instead of actual valuations and situations when key team members resign or announce a reduced role soon after fundraising is complete.

There is work to be done to bring private equity advisers' controls and disclosures in line with regulatory requirements and investor expectations, according to Bowden. In short, it is not sufficient to just comply with the letter of the law; firms must also treat clients and investors "fairly, equitably, and in accordance with [their] status as fiduciaries."

Securities Regulators Seek Information on Order Routing

Apparently attempting to understand how broker-dealers provide best execution in the face of incentives to trade on certain exchanges, the SEC and FINRA are asking broker-dealers for extensive transaction information regarding how they route trades to exchanges. This data will enable the regulators to monitor how firms (that have an incentive to trade with the exchange offering the highest rebates) handle potential conflicts of interest with customers (who seek best execution).

The regulators' requests appear to grow out of an academic paper recently published by several academics at the Indiana University and University of Notre Dame business schools.

The authors of the academic paper point out that every U.S. stock exchange today either charges fees or pays rebates on orders based, in part, on whether they are market orders. Exchanges charge fees on market orders that take liquidity out of the marketplace and pay rebates on limit orders that supply liquidity to the market. Exchanges earn revenue on the difference between the fees and the rebates. The paper concludes that broker-dealers might route customer limit orders to the exchange that pays them the highest rebates, but that might not necessarily provide best execution on the trades.

According to an article in the IU Bloomington Newsroom, the authors presented their academic paper to several broker-dealers, the SEC and FINRA, and the paper then leaked out to the broader industry. FINRA apparently viewed the paper's revelations as significant, since it sent out a broad request for routing data from 50 firms, according to the article. It's not clear whether FINRA is calling this a "sweep." FINRA typically posts on its website its "Targeted Examination Letters," except when it doesn't; this may be one time it doesn't.

Now we have learned that the SEC is making similar requests, using its inspection powers under Section 17(a) of the Exchange Act and issuing subpoenas. Larger firms should anticipate that one or both of the securities regulators will be seeking their data, and we suggest that those firms that receive these invitations to provide data remain cognizant that there are many firms that were invited to the same party. We cannot predict where the regulators will take this inquiry, but firms that drawn into it will only benefit from having as much information as possible.

FINRA Makes Dark Pool Data Publicly Available

In an effort to increase market transparency and enhance investor confidence, FINRA now provides data indicating the activity levels in each alternative trading system, including all market facilities commonly called "dark pools." FINRA's goal, announced on June 2, 2014, is to "shed light on the securities that are traded in each 'dark pool,' which occurs away from traditional stock exchanges." The information is available through FINRA's website.

Commissioner Gallagher Slams FSOC's "Misguided Debate" over SIFI Status for Advisers

SEC Commissioner Daniel Gallagher wrote a comment letter to the SEC criticizing the Office of Financial Research (OFR) *Asset Management and Financial Stability Report* (the "OFR Report") as "fundamentally flawed."

The Commissioner's May 15, 2014 letter noted that as an SEC commissioner, he has "no statutory standing whatsoever" in FSOC's "misguided debate over whether to designate asset managers as systemically important financial institutions (SIFIs)" and that he chose to submit his own views. The letter joined other commenters on the OFR Report that have "sharply criticized the absence of empirical data underlying the generalizations advanced by the report and the flawed methodology used to analyze systemic risk."

The Commissioner did not mince words. He characterized FSOC's SIFI designation process as "pure – and dangerous – folly" and explained that attempts by FSOC and the Financial Stability Board to apply bank regulatory principles to capital markets regulation is a "fatally misguided approach, the regulatory equivalent of trying to jam a square peg into a round hole."

It looks like the SIFI debate, misguided or not, is likely to continue unabated for some time.

SEC Cautions Investors about Marijuana-Related Investments

In a May 16, 2014 investor alert, the SEC cautioned investors about potential risks involving investments in marijuana-related companies.

The SEC noted an increase in fraudsters seeking to exploit the latest growth industry – in this case, marijuana – to lure investors with the promise of high returns. The SEC reminded investors that while some states have legalized the operations of certain marijuana-related companies, federal law still makes it illegal to manufacture, distribute or dispense marijuana. The SEC reported that it suspended trading in several marijuana-related companies because of questions regarding the accuracy of publicly available information about these companies' operations.

SPOTLIGHT ON BDCs

Congressional Report May Kill BDC Reform Bill

A congressionally mandated budget report may ring the death knell for proposed legislation that would increase the leverage limit for business development companies (BDCs).

The April 10, 2014 report by the Congressional Budget Office (CBO) estimates that the Small Business Credit Availability Act, H.R. 1800, if enacted, would cost taxpayers $354 million over the next 10 years.

H.R. 1800, introduced in April 2013, would:

- Reduce the asset coverage requirements that apply to BDCs from 200 percent to 150 percent;
- Allow BDCs to invest in shares of investment advisers to BDCs;
- Eliminate certain protections for holders of preferred stock issued by BDCs; and
- Amend certain SEC rules and forms to allow BDCs to use streamlined securities offerings provisions that are available to other public companies.

Click here for our summary of H.R. 1800 and the prospects for its enactment.

The loss of federal tax revenues would result from the differences in taxation of income to individuals. BDCs pass through income to their shareholders, so the income they generate is typically subject only to individual income tax. In contrast, taxable income from "C" corporations is subject to taxation at the corporate level and at the individual tax level. The report estimates that by shifting income from C corporations to BDCs, enacting the legislation would reduce federal tax revenues by $350 million between 2014 and 2024.

The Statutory Pay-As-You-Go Act of 2010 established budget reporting and enforcement procedures for legislation affecting direct federal spending or federal tax revenues. The CBO report could block the legislation, unless its sponsors propose alternatives that would make the bill revenue neutral.

Best Practices for Independent Directors of BDCs

Click here to read our client alert on "Best Practices for Independent Directors of Business Development Companies," which originally appeared in the June 2014 edition of *Fund Directions*.

House Committee Passes JOBS Act Related Bills

The House Financial Services Committee passed several bills designed to promote capital formation, including a bill that would eliminate duplicative regulation of advisers to Small Business Investment Companies (SBICs). You can find our blog entry summarizing these bills and other developments affecting capital markets on our **mofojumpstarter** blog by clicking here.

ENFORCEMENT + LITIGATION

SEC Charges Dark Pool Operator with Improper Use of Trading Information

On June 6, 2014, the SEC announced that it has charged a New York based brokerage firm that operates a dark pool alternative trading system with improperly using subscribers' confidential trading information in marketing its services. The firm agreed to a censure and paid a $2 million fine.

Appeals Court Tosses District Court Decision to Reject SEC Settlement Deal

The United States Court of Appeals for the Second Circuit, in a much anticipated opinion, overturned a 2011 decision written by Judge Jed S. Rakoff to reject an SEC settlement with Citigroup.

Judge Rakoff's controversial decision criticized the SEC for settling an enforcement case without requiring an admission of guilt. Soon after the decision, the SEC signaled that it would require admissions of guilt when settling certain cases, setting off fears of an increase in litigation as firms facing enforcement charges no longer have an incentive to settle without admitting or denying guilt.

Andrew Ceresney, the SEC's Director of the Division of Enforcement, quickly praised the Second Circuit's June 2, 2014 opinion, stating that it reaffirmed "the significant deference accorded to the SEC in determining whether to settle with parties and on what terms."

But Ceresney's statement may be a tacit admission that Judge Rakoff's overturned decision may already have irrevocably achieved its purpose: the SEC will "continue to seek admissions in appropriate cases." At least the choice of whether to obtain an admission of guilt will belong to the SEC, not the federal courts.

SEC Fines Broker-Dealer/ Investment Adviser for Breakpoint Violations

In a case reminiscent of the "breakpoint" enforcement actions brought 10 years ago by securities regulators, the SEC recently found that a dually registered investment adviser and broker-dealer overcharged clients because it improperly calculated advisory fees.

The SEC's settlement order found that the firm offered breakpoint discounts designed to reduce advisory fees payable by clients who increased their assets in certain investment programs. In particular, the SEC said that the firm permitted clients to aggregate balances in certain related family accounts in order to achieve advisory fee breakpoints or discounts. The firm allegedly informed clients in account-opening documents about the opportunity to aggregate certain account balances to qualify for breakpoint discounts in the advisory fee. Starting in 2009, however, the firm allegedly failed to process all client aggregation requests. In addition, the SEC said, the firm had conflicting policies on whether representatives were required to pass on to clients the savings from breakpoint discounts.

According to the SEC, its examiners first identified this deficiency during a routine examination of a branch office. The staff notified the firm of its failures in 2010, and the firm provided refunds to affected clients. The firm failed, however, to undertake the SEC's recommended firm-wide review of all client accounts.

In a subsequent firm-wide examination, the SEC found that the firm was still failing to aggregate certain related accounts, and that the problem went beyond any one specific branch office. In fact, the SEC found the failures occurred because of inadequate policies and procedures at the firm's headquarters. For example, the procedures did not clearly delineate which of the two teams responsible for opening new accounts was required to review new account forms for account aggregation purposes. As a result, the SEC said, the firm failed to review many new account forms for aggregation purposes and to appropriately link accounts together to apply breakpoints in the billing process. The firm also allegedly had conflicting branch office policies on whether representatives were required to provide breakpoint discounts to advisory clients.

This enforcement action is reminiscent of the 2004 enforcement actions brought by the SEC and the NASD against 15 prominent firms for failure to deliver mutual fund breakpoint discounts. The SEC's actions at that time were intended to send a message that broker-dealers had to exercise due care to provide breakpoint discounts to mutual fund investors consistent with the promises made to customers.

This enforcement action highlights two important issues for investment advisers. First, advisers must charge advisory fees consistent with their disclosures and stated policies. Second, and equally important, firms must ensure that they have procedures in place to take appropriate remedial steps when SEC examiners identify a deficiency in an exam. As demonstrated here, today's deficiency can be tomorrow's enforcement action if the deficiency is not remedied before the SEC's next visit.

The firm agreed to settle the enforcement action without admitting or denying the findings.

TIDBITS

- On June 3, 2014, the SEC awarded two whistleblowers $875,000 for aiding an SEC investigation.

- On May 29, 2014, the SEC named Stephanie Avakian as Deputy Director of Enforcement. Before accepting this post, Ms. Avakian was a partner in a large New York law firm where she was vice chair of the firm's securities practice. Ms. Avakian was previously a branch chief in the Division of Enforcement's New York regional office.

- On May 15, 2014, the SEC announced that Chief Accountant Paul Beswick would be leaving the agency. Mr. Beswick has agreed to serve in a transitional capacity until his successor is identified.

- On May 2, 2014, the SEC announced that Chief Economist and Division of Economic and Risk Analysis Director Craig Lewis would be leaving the agency. Dr. Lewis will be returning to his position as the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management.

- On April 27, 2014, the SEC proposed new rules covering recordkeeping, reporting and notification requirements for security-based swap dealers and major security-based swap participants. The rules would also establish additional recordkeeping requirements for broker-dealers to account for their security-based swap activities. The proposing release can be accessed here.

- On April 3, 2014, the SEC reopened the period for public comment on proposed rule amendments related to marketing materials for target date retirement funds. The request for additional comments can be accessed here.

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