INVESTMENT MANAGEMENT LEGAL+REGULATORY UPDATE

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REGULATION

Money Market Funds Stress-Testing Changes Imminent

The 2016 compliance dates for new rules included in the SEC's money market fund reforms are fast approaching. Among other things, the reforms include changes to stress-testing requirements, disclosure requirements, net asset value (NAV) calculations, and minimum liquidity thresholds.

In a recently published article, *Money Market Mutual Funds: Stress Testing and the New Regulatory Requirements*, professionals from NERA Economic Consulting offer practical insights into the implementation of the new stress-testing requirements.

The complete article is available here. For additional information, visit our BD/IA Regulator blog post here.

SEC Solicits Comments on Exchange-Traded Products

Citing significant growth in the size and scope of exchange-traded products (ETPs), on June 12, 2015, the SEC solicited comments to assist the staff's review of listing and trading "new, novel, or complex ETPs, including requests by ETPs for exemptive and no-action relief. . . ." While the SEC acknowledges its extensive experience with ETPs, it believes that engaging with the broader public and investment community will be beneficial to its continued oversight.

Of particular interest to the SEC are comments with respect to its oversight of ETPs under the Securities Exchange Act of 1934 ("Exchange Act"), including:

- views on the listing and trading of ETPs;
- the manner in which ETPs trade in the secondary market; and
- exemptive or no-action relief granted to ETPs under the Exchange Act.

The SEC is also interested in receiving comments on how broker-dealers:

- recommend and sell ETPs to investors; and
- fulfill their obligations to investors when recommending and selling ETPs, in light of FINRA's existing guidance regarding complex products and ETPs.

For additional information, visit our BD/IA Regulator blog post here. Comments are due by August 17, 2015.

MORRISON FOERSTER

SEC Proposes Heightened Data and Reporting Rules for Funds and Advisers, Ponders New Rules on Derivatives and Leverage

At an open meeting of the SEC, Chair Mary Jo White announced proposed enhancements to SEC reporting by investment companies and investment advisers.

Among other things, the SEC's proposed rules would:

- Require funds and ETFs to provide additional data related to investments in derivatives, securities lending activities, liquidity and pricing of portfolio investments. These requirements would be designed to help the SEC assess potential risks to investors.
- Require funds to disclose certain basic risk metrics to help the SEC and investors better understand exposure to potential changes in risk factors and asset prices.
- Require investment advisers to file new categories of information with respect to separately managed accounts and the derivatives they hold.
- Modernize how data are transmitted to shareholders by requiring funds to provide investors with shareholder reports and portfolio information on fund websites, while preserving the ability of investors to request hard copies.
- Subject fund financial statements to enhanced and standardized disclosure requirements for derivatives and securities lending.

The proposed rules would also require monthly reporting on Form N-PORT, which would require registered funds (other than money market funds) to report portfolio-wide and position-wide holdings data.

With respect to investment adviser registration, the SEC proposed to amend Form ADV to require additional information for the SEC and investors to better understand the risk profile of individual advisers and the industry as a whole.

In addition, the SEC noted that the staff is forming recommendations to enhance the management and disclosure of liquidity risk by mutual funds and ETFs and to "update liquidity standards" for mutual funds and ETFs.

Our Take

The SEC's efforts to require enhanced reporting, enhanced risk management, and transition planning should come as no surprise following statements from federal banking regulators and the Financial Stability Oversight Council (FSOC) that asset managers present systemic risks to the U.S. financial markets. We believe that the SEC, not the federal banking regulators, is best positioned to address these risks, and the SEC must take control of this debate.

A more complete analysis of the proposed rules can be found in our Client Alert, available here. The proposed rule is available here.

FINRA Is Apparently Holding Its CARDS

Broker-dealers appear to have succeeded, at least for now, in beating back FINRA's proposal to capture extensive amounts of data through electronic means.

For over a year, FINRA has been pushing its Comprehensive Automated Risk Data System (CARDS), which would require clearing firms (on behalf of introducing firms) and self-clearing firms to regularly submit to FINRA, in an automated, standardized format, specific information about their customers' accounts and the customer accounts of each member firm for which they clear. Richard Ketchum, FINRA Chairman and CEO, claims that CARDS would enhance FINRA's access to data and analytics, "help it evolve [its] risk-based surveillance and examination programs regarding sales activities" and enable it to "operate as an early warning system to more effectively identify potential fraudulent activity and customer sales practice abuse to guide examinations."

In the face of extensive comments and criticism from the industry, including the Securities Industry and Financial Markets Association (SIFMA) and small broker-dealers, Ketchum announced before the House Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services that FINRA "will not move ahead with the present form of the proposal and will not move forward with an amended version until we conclude that the concerns raised in the comments have been addressed."

For additional information, visit our BD/IA Regulator blog post here.

SEC Issues Cybersecurity Guidance for Registered Investment Advisers and Registered Funds

The SEC's Division of Investment Management issued guidance highlighting the importance of cybersecurity and discussing measures that registered investment companies (funds) and registered investment advisers (advisers) should consider when addressing cybersecurity risk. The latest guidance reflects the staff's continuing focus on cybersecurity as a key compliance issue (see our related report on the SEC's cybersecurity sweep exam here).

Other regulators, including FINRA and certain state regulators, have also recently highlighted the importance of this issue for their members and registrants (see our related posts here and here).

As the staff noted, the nature of cybersecurity threats is "rapidly changing." While that makes the implementation of effective compliance policies challenging, the SEC has made clear that it will continue to examine firms' cybersecurity policies and procedures and their ability to mitigate the impact of a cyber-attack.

The guidance highlights a number of measures that funds and advisers may wish to consider when developing cybersecurity policies. The staff stressed that its suggestions are not comprehensive and that registrants should consider the nature of their businesses and operations to ensure that policies adequately protect fund investors and advisory clients.

Our Take

Cybersecurity can affect almost every facet of a firm's business and its relationship with its shareholders, clients, and service providers. As the staff pointed out, cybersecurity touches not only on technology-related matters (e.g., data protection and identity theft) but also broader issues, including business continuity plans and potential disruptions in shareholder services. In short, this is not only a "compliance" issue, it's a business issue. Accordingly, funds and investment advisers should comprehensively review their cybersecurity policies and related compliance policies and consider implementing a crisis response program that would be utilized in the case of a cybersecurity breach.

A more complete analysis can be found in our Client Alert, available here.

Additional information on cybersecurity issues can be found on our BD/IA Regulator blog, available here, and in our Client Alert, available here.

No-Action Relief Granted for Three-Tier Fund Structure

The SEC's Division of Investment Management said that it will not recommend enforcement proceedings against an investment adviser that structures a three-tier fund allowing certain funds to invest in a "Central Fund" established to create operational efficiencies.

Under the proposed structure, the investment adviser will establish a fund of funds that invests in shares of other funds in the same complex that, in turn, invest assets in a Central Fund. Ordinarily, this arrangement would violate the anti-pyramiding provisions of Section 12(d)(1) and 17(a) of the 1940 Act, which were designed to prevent potential abuses of control, fee layering, and investor confusion.

The staff said that it would not recommend an enforcement action if certain conditions and requirements were met.

A more complete analysis can be found on our BD/IA Regulator blog, available here.

SEC Division of Investment Management Cautions Advisers on Acceptance of Gifts and Entertainment

According to guidance recently published by the SEC's Division of Investment Management, fund compliance policies and procedures should address the receipt of gifts or entertainment by fund advisory personnel.

Section 17(e)(1) of the 1940 Act generally prohibits first-tier or second-tier affiliates of a registered fund, acting as agent, from accepting from any source any compensation (other than regular salary or wages from the registered fund) for the purchase or sale of any property to or for the registered fund, except in the course of the person's business as an underwriter or broker. The staff noted that fund advisory personnel are second-tier affiliates of a fund and that they generally act as agents of a fund. Thus, for example, fund portfolio managers who accept gifts or entertainment from a broker-dealer in connection with the purchase or sale of a fund's portfolio securities would violate Section 17(e)(1).

The staff guidance states that funds' compliance policies should address compliance with Section 17(e)(1), and we note that there is no *de minimis* exception to the Section's coverage.

A more complete analysis can be found on our BD/IA Regulator blog post here. Also, see an article by Jay Baris that appeared in *Fund Directions*, which can be found here.

Coming Soon: Regulations for Uniform Fiduciary Standard

In testimony before the House Committee on Financial Services on March 24, 2015, SEC Chair Mary Jo White said that she supports a uniform fiduciary standard of conduct for broker-dealers and investment advisers that provide personalized securities advice to retail customers. She detailed plans for rules concerning enhanced risk monitoring and regulatory safeguards for asset managers.

Chair White testified that she asked the SEC staff to develop rulemaking recommendations for the SEC to consider, taking into account the SEC staff recommendations contained in a 2011 report to Congress on this issue, and the views of other interested persons. She cited three challenges that the SEC faces in adopting rules:

- *How to define the standard*. Chair White said she favors a principles-based approach rooted in fiduciary duty applicable to investment advisers.
- *How to provide clear guidance on what the standard would require*. This guidance would address how current business practices can or cannot continue under the new standard.
- *How to provide meaningful application, examination, and consistent enforcement of a new uniform standard*. Central to this challenge, she explained, is extending examination coverage for registered advisers.

Separately, Chair White said that the Division of Investment Management established a new risk and examinations office (REO). She said that REO is developing recommendations for the SEC to “modernize and enhance data reporting for both funds and advisers” (see our summary above).

Chair White said that the Division of Investment Management is also considering whether the SEC should require enhanced risk management programs for mutual funds and exchange-traded funds (ETFs), to address risks related to liquidity and use of derivatives, and to enhance the SEC’s oversight of these activities (see our summary of the resulting request for comment above).

Chair White also addressed other issues on the SEC’s agenda, including issuer disclosure and capital formation, trading and markets, economic analysis, risk assessment and data analytics and enforcement.

A more complete analysis can be found on our BD/IA Regulator blog, available here.

ENFORCEMENT + LITIGATION

SEC Sanctions Independent Trustees for Deficient Advisory Contract Review

In a cease-and-desist order entered on June 17, 2015, the SEC found that a fund adviser, two independent trustees, and an inside trustee willfully violated Section 15(c) of the 1940 Act by failing to satisfy specific requirements for approving a fund’s investment advisory agreement.

The SEC also found that the funds’ administrator caused one of the funds to violate Section 30(e) of the 1940 Act and Rule 30e-1, by omitting from the fund’s shareholder reports disclosure related to the trustees’ evaluation of the advisory and sub-advisory agreements under Section 15(c).

Section 15(c) of the 1940 Act imposes a duty on the board of a registered investment company to request and evaluate—and a duty on the adviser to furnish—such information as may reasonably be necessary for

SPOTLIGHT ON BDCS

House Holds Hearings on Bill to Ease BDC Restrictions

The Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Financial Services Committee heard testimony on June 16, 2015 in support of proposed bills that would, among other things, increase the flexibility of business development companies (BDCs) to use leverage and expand the pool of accredited investors.

Among other things, the Bill would:

- Increase the ability of BDCs to leverage their investments.
- Allow BDCs to issue multiple classes of preferred shares and eliminate the requirement that preferred shareholders must have board representation.
- Modernize the securities offering and communications framework for BDCs to bring them into parity with corporate issuers that file on Forms S-1 and S-3.
- Eliminate a prohibition for BDCs to own investment advisers.
- Expand the bucket for investment in securities that are not “eligible portfolio companies.”

A more complete analysis of the proposed Bill can be found in our Client Alert, available here. The testimony and the Bill are available here and here.

the directors to evaluate the terms of an advisory contract. Item 27(d)(6) of Form N-1A further requires that, if a fund's board approved any investment advisory contract during the fund's most recent fiscal half-year, the next shareholder report must contain a discussion, in reasonable detail, concerning "the material factors and the conclusions with respect thereto that formed the basis for the board's approval."

Our Take

This case appears to be a "message" case; that is, a clear reminder that the annual review of a fund's advisory contract is one of the central responsibilities of a fund board, and demonstrates that the SEC will dive deep into the weeds to review the adequacy of that contract-review process.

A more complete analysis can be found in our Client Alert, available here.

OCIE Launches Sweep Examination of BD/IA Retirement Investments

The SEC's Office of Compliance Inspections and Examinations (OCIE) is launching a sweep examination that will target the retirement-based savings activities of broker-dealers and investment advisers.

The multi-year Retirement-Targeted Industry Reviews and Examinations (ReTIRE) Initiative, to be run by OCIE's National Examination Program, will focus on higher risk areas of sales, investment, and oversight processes, with an emphasis on potential harm to retail investors.

Specifically, the ReTIRE examination initiative will focus on, among other things:

- Whether broker-dealers and advisers have a reasonable basis for investment recommendations for retirement-related advice and products;
- How advisers and broker-dealers manage and disclose conflicts of interest to their clients;
- Adequacy of supervision of compliance controls, especially across multiple offices and among representatives with outside business activities; and
- Adequacy of brochures, sales materials, and disclosures to retail investors.

One of OCIE's stated goals is to encourage advisers and broker-dealers to "reflect upon their own practices, policies and procedures" and to promote improvements in supervision, oversight, and compliance programs. In anticipation of OCIE's sweep program, broker-dealers and advisers should review their compliance policies and procedures relating to retirement products to ensure that they pass muster.

The Risk Alert is available here.

FINRA's Revised Sanction Guidelines: Higher, Tougher, Fairer?

FINRA's newly revised Sanction Guidelines signal that the upward trend in sanctions against broker-dealers is likely to continue.

The Sanction Guidelines, which establish the range of sanctions that FINRA may impose in formal disciplinary proceedings, affect several specific types of violations, as well as the principles behind levying sanctions and the overall levels of monetary sanctions. The Guidelines are also meant to catch up to the sanctions that FINRA actually is levying; as FINRA stated, in revising the guidelines, it is seeking to "harmonize the Sanction Guidelines with the current state of the cases in this area."

FINRA also amended the Sanction Guidelines to increase sanctions for fraud and suitability violations and to emphasize that FINRA's disciplinary sanctions should be more than a mere cost of doing business, but rather serious enough to achieve deterrence.

Our Take

The credibility of FINRA's enforcement program depends on members believing that they are being treated fairly. That is, when violations are found following a hearing or agreed to in a settlement, the sanctions should be consistent with established precedent and with the treatment of other similar firms found to engage in similar violations. It has been observed of late that sanctions sought in litigated or settled cases do not always meet those criteria and that the precedent cited by FINRA staff to support those fines does not always meet that standard of consistency.

If the revised Sanction Guidelines provide more predictability and a greater sense of fairness, they will benefit both the brokerage industry and FINRA's reputation as the industry's regulator. Notwithstanding the potential significant increases in sanctions resulting from these revisions, a focus on strong guidance and consistency is welcome.

For a more complete analysis about this, see our Client Alert, available here.

Administrative Proceedings vs. Federal Court: The SEC Provides Limited Transparency into Its Choice of Forum

Recently issued guidance from the SEC's Division of Enforcement made public its "approach" to selecting a forum, which was intended to outline the facts and circumstances it considers in determining whether to bring a litigated enforcement action in federal district court or in its own administrative proceedings. The guidance, however, ultimately provides the Division with virtually complete discretion in choosing the playing field that will be most advantageous to its case and to its view of the "proper development of the law."

For the past two years, the SEC has come under heavy fire, both inside and outside the Commission, for its increasing use of its own administrative proceedings, rather than federal courts, as the preferred forum for bringing its enforcement actions.

The SEC's use of administrative proceedings has not gone unchallenged. Respondents in several administrative actions have brought suit against the agency, arguing that the administrative process is unconstitutional and deprives the SEC's targets of substantial due process rights. Judge Rakoff of the Southern District of New York has expressed his doubts about the appropriateness of the expanded use of administrative proceedings, stating that he worried about the balanced growth of the securities laws if those laws are interpreted in a "non-judicial" forum. Andrew Ceresney, the Director of the Division of Enforcement, has mounted a spirited defense of the use of administrative proceedings, arguing that they are fair and unbiased and that the federal securities laws should, indeed, be interpreted by the experts at the SEC.

Despite its best arguments, and now its attempt to provide some transparency into its decisions, the Division is likely to continue to be scrutinized for its ever-increasing use of administrative proceedings against non-regulated entities. And with the open-ended nature of the guidance, there is little to prevent the Division from choosing whatever forum it finds most advantageous.

A complete analysis of this issue can be found in our Client Alert, available here.

OCIE Targets Never-Before-Examined Investment Companies for Compliance Exams

The SEC's Office of Compliance Inspections and Examinations (OCIE), in a Risk Alert dated April 20, 2015, announced a program targeting investment companies that have never been examined for focused, risk-based compliance examinations. OCIE's "Never-Before Examined Investment Company" (NBE IC) Initiative, which is part of OCIE's National Examination Program, will focus on higher-risk areas of concern to the SEC.

The Risk Alert states that the NBE IC Initiative will focus on open-end funds, closed-end funds, and underlying insurance funds, particularly those complexes that launched one or more years ago. Key areas of focus include: Rule 38a-1 compliance programs, the annual contract review process under Section 15(c), advertising and distribution, and valuation and NAV calculation, among others.

OCIE effectively has delivered NBE ICs a syllabus for their upcoming exams. Registered funds that have not yet been examined by OCIE staff should carefully review the Alert and update their policies and procedures in anticipation of an imminent compliance exam.

A more complete analysis can be found on our BD/IA Regulator blog, available here.

Firm Sanctioned for Breach of Fiduciary Duty and Violation of the Compliance Rule

The SEC sanctioned a registered investment adviser for breaching its fiduciary duty by failing to disclose to its clients a conflict of interest created by a portfolio manager's outside business activity and personal investments. The SEC found that the firm violated, among other things, Rule 206(4)-7 under the Advisers Act, which requires registered investment advisers to adopt written compliance policies reasonably designed to ensure that the adviser does not violate the federal securities laws.

As a result of these violations, among others, the firm was fined $12 million, and its CCO was fined $60,000. In addition, the firm was required to retain an independent compliance consultant.

Our Take

In light of this action, firms should evaluate whether their compliance policies are, in fact, "reasonably designed" to ensure compliance with the federal securities laws. In particular, firms should ensure that they have adopted policies related to outside business activities by key employees and that such policies reflect how the firm will assess, mitigate, and monitor any conflicts of interest presented by outside business activities.

CCOs should also be cognizant that the SEC believes the obligation to design procedures for monitoring and assessing, on an ongoing basis, any identified conflicts of interest lies squarely on the shoulders of the CCO. Failure to do so may result in a CCO causing a firm to violate its obligations under the compliance rules. Once again, it appears the SEC is signaling that the role of the

CCO as gatekeeper is not one to be undertaken lightly.

A more complete analysis can be found on our BD/IA Regulator blog, available here.

TIDBITS

- On May 8, 2015, the SEC named David Grim as Director of the Division of Investment Management. Mr. Grim had been the Division's acting director since February 2015. Mr. Grim has been with the SEC for nearly 20 years, and was named Deputy Director of the Division in January 2013.

- On May 28, 2015, the SEC named Andrew J. ("Buddy") Donohue as the SEC's Chief of Staff, and he will be a senior adviser to the Chair on all policy, management, and regulatory issues. Mr. Donohue rejoins the SEC after working in the private sector. From May 2006 to November 2010, Mr. Donohue served as Director of the Division of Investment Management.

- In a recent webinar hosted by the Mutual Fund Directors Forum, MoFo counsel Kelley Howes discussed best practices for mutual fund directors reviewing adviser profitability in the context of approving investment advisory agreements under Section 15(c) of the 1940 Act. A transcript of the webinar is available here.

- In a recently published article, MoFo partner Jay Baris discusses the impetus and history of the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The article, *Still Spry at 75: Reflections on the Investment Company Act and Investment Advisers Act*, is available here.

- To help navigate the issues created by the use of social media, MoFo partners Jay Baris and David Lynn released the *Guide to Social Media and Securities Law*, which is available here.

- In a recently published article, *Pay-to-Play Rule—Practical Considerations for Investment Advisers*, MoFo counsel Kelley Howes offers background on the Rule 206(4)-5 (the "Pay-to-Play" Rule) and practical guidance that investment advisers may want to consider in developing and implementing compliance programs and policies. An abstract of the article is available here.

- Since the financial crisis, financial institutions have been required to address significant regulatory changes. The new regulatory framework in the United States and Europe has introduced a series of new terms. A brief glossary, prepared by MoFo attorneys, may serve as a helpful summary of frequently used terms. To see the full glossary, click here.

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