Recent Investment Management Developments

March 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.

OCIE Announces 2015 Priorities

The SEC's Office of Compliance, Inspections and Examinations (OCIE) recently announced its selected list of 2015 examination priorities for investment advisers, broker-dealers, and transfer agents.[1] These priorities generally address high-risk practices and products affecting market participants on both individual and national scales. They are grouped into three primary areas:

1) *Protecting Retail Investors and Investors Saving for Retirement*. OCIE is concerned that trends in retail investment resulting from the current low interest rate environment could present heightened risks for the average investor, as many in the financial services industry are resorting to traditionally alternative or institutional forms of investment to generate higher yields. Additionally, in response to the increase in importance of personal investment accounts for retirement purposes, financial services firms are expanding their products and services to help investors plan for retirement. To investigate the risks created by these growing trends, OCIE plans various examination initiatives, including:

   a. *"Alternative" Investment Companies*. Where firms offer alternative investments and strategies, OCIE will assess their products and services by focusing on three areas: leverage liquidity and valuation policies and practices; factors relevant to the adequacy of the funds' internal controls, including staffing, funding, and empowerment of boards, compliance personnel, and back officers; and the manner in which such funds are marketed to investors.

   b. *Fixed Income Investment Companies*. Expecting that the current interest rate environment will not last, OCIE will be reviewing whether mutual funds with high exposure to interest rate increases have implemented the compliance policies and

procedures necessary to provide accurate disclosures, and that their investments and liquidity profiles are consistent with those disclosures.

2) *Assessing Market-Wide Risks*. OCIE plans to use the following initiatives, among others, to assess the potential for systemic risks to the market:

   a. *Large Firm Monitoring*. Together with the Division of Trading and Markets and the Division of Investment Management, OCIE will monitor large U.S. broker-dealers and asset managers to assess risks at individual firms to maintain early awareness of potential industry-wide developments.

   b. *Cybersecurity*. Following 2014's initiative to examine broker-dealers' and investment advisers' cybersecurity compliance and control, OCIE will expand this initiative to include transfer agents.

3) *Using Data Analytics To Identify Signals of Potential Illegal Activity*. OCIE has developed and become more proficient in using data analytics to identify and target firms that appear to be engaged in potentially fraudulent or otherwise illegal activities. In 2015, OCIE will use these capabilities to address activities such as recidivist representatives, microcap fraud, excessive trading, and anti-money laundering noncompliance.

4) *Other Initiatives*. In addition to the areas described above, OCIE also expects to address other priorities, including:

   a. *Proxy Services*. OCIE will select certain proxy advisory service firms and examine how they make recommendations on proxy voting, how they address potential conflicts of interest, and how well investment advisers comply with their fiduciary duties concerning voting proxies on behalf of their clients.

   b. *Never-Before-Examined Investment Companies*. OCIE will conduct focused, risk-based examinations of selected registered investment company complexes that have yet to be examined.

SEC Broadly Interprets Janus on Enforcement Actions

The SEC has issued an opinion[2] essentially exempting its enforcement actions from the holding of the U.S. Supreme Court's decisions in *Janus Capital Group v. First Derivative Traders*.[3] In *Janus*, the Supreme Court ruled that, concerning the antifraud provisions of Rule 10b-5 under the Securities Exchange Act of 1934[4] and Section 17(a) of the Securities Act of 1933,[5] 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.[6] 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.[7]

The opinion addressed an enforcement action brought by the SEC's Division of Enforcement against two employees of an unregistered fixed-income fund.[8] 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.[9] 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.[10]

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).[11] 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.[12] 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).[13] The SEC concluded that the ruling in *Janus* does not, in fact, limit its ability to bring charges under Rule 10b-5 at all.[14] 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.[15]

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;[16] 17(a)(2) applies whenever a party obtains money or property by means of an untrue statement;[17] 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.[18]

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.[19] 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.[20] 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.[21] 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.[22] 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.[23] 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.[24]
- 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.[25]

SEC's Focus in 2015

On December 11, 2014, Mary Jo White, Chair of the Securities and Exchange Commission (SEC), gave a speech at The New York Times DealBook Opportunities for Tomorrow Conference[26] wherein she highlighted the SEC's priorities for 2015 related to industry risks arising from the portfolio composition and operations of investment advisers and funds. These priorities include:

1) *Enhancing Data Reporting.* Funds and investment advisers currently report significant information about their portfolios and operations to the SEC. However, in her speech, Chair White noted a desire to expand and update the existing reporting and disclosure requirements for both funds and investment advisers. The goal would be to improve the data and information the SEC uses to draw conclusions about risks in the asset management industry and to develop appropriate regulatory responses. In particular, Chair White emphasized SEC staff recommendations to enhance the reporting and disclosure of: (1) basic census information, (2) a fund's investments in derivatives, (3) the liquidity and valuation of a fund's holdings, and (4) a fund's securities lending practices.

2) *Enhancing Controls on Risks Related to Portfolio Composition.* To enhance existing controls on risks related to portfolio composition, SEC staff is focusing on liquidity management and the use of derivatives in mutual funds and Exchange Traded Funds (ETFs). SEC staff is considering whether to require mutual funds and ETFs to adopt broad risk management programs to address the risks related to their liquidity and derivatives use.

Simultaneously, SEC staff is reviewing proposals for specific requirements, such as updated liquidity standards, disclosure of

liquidity risks, or measures to appropriately limit the leverage created by a fund's use of derivatives.

3) *Improving Transition Planning and Stress Testing*. To better mitigate operational risk, funds and investment advisers must take steps to ensure they have a plan for transitioning their clients' assets when circumstances warrant. Correspondingly, SEC staff is developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business.

In addition, SEC staff is considering ways to implement new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act.[27]

In her concluding remarks, Chair White stated the SEC will look to investors and market participants to provide input to help implement SEC staff proposals into workable regulations for funds and investment advisers. Consequently, to ensure that any final regulations reflect a blend of best practices and investor safeguards, funds, investment advisers and other industry participants are well-advised to become acquainted with the proposals and involved in the conversation with SEC staff as soon as practicable.

Zehrer v. Harbor Capital Advisers, Inc.: Excessive Fee Litigation

In *Zehrer v. Harbor Capital Advisors, Inc.*, No. 14-C-789, 2014 WL 6478054 (N.D. Ill. Nov. 18, 2014), a shareholder of the Harbor International Fund alleged the fees paid to the fund's investment manager and advisor were improper and excessive and constituted a breach of the advisor's fiduciary duty under Investment Company Act Section 36(b). In response to a motion to dismiss, the U.S. District Court for the Northern District of Illinois found that the complaint adequately pleaded a plausible claim that the advisor breached its fiduciary duty by retaining fees that were disproportionate to the services rendered.

According to the complaint, Harbor Capital Advisors retained a substantial portion of the investment management fees it charged the fund, but delegated almost all of the investment management responsibilities to a sub-advisor, Northern Cross LLC. For example, the complaint alleged that the fund paid Harbor Capital more than $225 million in investment management fees in fiscal year 2012, but that Harbor Capital paid Northern Cross just under $125 million for sub-advisory services. As a result, the complaint alleged, Harbor Capital retained more than $100 million even though it did little or no work for the fund.

Harbor Capital filed a motion to dismiss, arguing in part that the plaintiff failed to allege facts that create an inference that Harbor Capital charged excessive fees and thereby breached its fiduciary duty. The court denied the motion on November 18, 2014. In its memorandum opinion, the court held that the plaintiff pleaded adequate facts for the court to conclude that Harbor Capital's fee was so "disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." (*Jones v. Harris Associates L.P.*, 559 U.S. 335, 346 (2010)). The court also ruled that Harbor Capital's argument that it retained "significant responsibility for the Fund's management," and therefore earned its fee, was better suited for summary judgment.

Although an allegation of excessive fees alone is normally not grounds for inferring that a breach of fiduciary duties has occurred, the court's denial of the advisor's motion to dismiss in *Zehrer* suggests that excessive fees may remain a viable theory for alleging that an advisor has breached its fiduciary duties to a fund, at least in the context of a motion to dismiss.

MSRB Adopts Municipal Advisory Supervision Rule, Proposes Amending Current MSRB Rules G-37, G-20, and G-3 to include Municipal Advisors, and Implements a New Fee for Municipal Advisors

During 2014, the Municipal Securities Rulemaking Board (MSRB) adopted its dedicated municipal advisor rule, requiring the implementation of a supervisory system for municipal advisors. Furthermore, the MSRB has continued to propose rules and rule amendments to implement a regulatory structure for municipal advisors. These proposals have included restricting political contributions, adopting a professional qualification examination requirement, extending gift rules to municipal advisors, and expanding existing books and records requirements. The MSRB also implemented a new fee for municipal advisors.

In October 2014, the U.S. Securities and Exchange Commission (SEC) approved the adoption of MSRB Rule G-44, the first dedicated MSRB rule for municipal advisors, which relates to the supervisory and compliance obligations of municipal advisors. Rule G-44 requires implementation of a reasonably designed supervisory system, as well as the designation of a chief compliance officer ("CCO"). These changes take effect on April 23, 2015, except for Rule G- 44(d), relating to annual certification, which takes effect on April 23, 2016. Rule G-44 requires that municipal advisors:

- Establish, implement, and maintain a system to supervise their municipal advisory activities and those of their associates, which system is reasonably designed to achieve compliance with all applicable securities laws and regulations, including MSRB rules;

- Implement processes to establish, maintain, review, test, and modify written compliance policies and supervisory procedures;

- Designate one individual as their CCO to serve as a primary advisor to the municipal advisor on the overall compliance scheme (CCO can be a firm employee or a person external to the firm); and

- Have the firm's chief executive officer(s) (or equivalent officer(s)) annually certify in writing that the municipal advisor has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable rules.

In conjunction with the approval of Rule G-44, the SEC also approved amendments to MSRB Rule G-8, relating to books and records to be made by brokers, dealers, and municipal securities dealers, and MSRB Rule G-9, on preservation of records. These amendments address the books and records that must be made and preserved by municipal advisors required to register with the SEC, including records related to supervisory and compliance obligations.

Also in October 2014, the MSRB requested comment on draft amendments to MSRB Rule G-20 on gifts, gratuities and non-cash compensation given or permitted to be given by brokers, dealers, and municipal securities dealers. The proposed changes would apply rule G-20, and related record-keeping requirements contained in Rules G-8 and G-9, to municipal advisors, and codify existing MSRB and (FINRA) interpretive guidance into rule form. Under the proposed change, Rule G-20, which applies to the activities of dealers, would extend certain restrictions to municipal advisors and associated persons, including:

- A prohibition of gifts or gratuities in excess of $100 per person per year in relation to the municipal securities activities of the recipient's employer;

- The exclusion from the $100 limit of "normal business dealings"; and

- The exclusion from the $100 limit of contracts of employment and contracts for compensation for services.

In August 2014, the MSRB requested comment on amendments to MSRB Rule G-37, which, if adopted, would extend the rule's coverage to municipal advisors. The amendments "are designed to address potential 'pay-to-play' practices by municipal advisors, consistently with the MSRB's existing regulation of dealers."

In April 2014, the MSRB filed a new rule with the SEC, A-11, which establishes an annual municipal advisor professional fee of $300 for each Form MA-I filed with the SEC. The rule became effective immediately upon filing.

In March 2014, the MSRB proposed amending Rule G-3 to create new "registration classifications" for municipal advisor representatives and principals under the rule, and to require municipal advisors to pass a professional qualification examination to continue to act in those capacities. The proposed amendments would not allow current municipal advisors to be "grandfathered" out of the examination requirement, but would allow a one-year grace period for job incumbents to complete the examination requirement.

Mutual Fund Insider Trading Case Remanded

In July 2013, the Seventh Circuit Court of Appeals examined for the first time, but left unresolved, the question of whether the misappropriation theory of insider trading may be used to impose Section 10(b) liability regarding the redemption of mutual fund shares. The SEC brought claims alleging insider trading and other securities law violations against Jilaine Bauer, the general counsel and chief compliance officer of Heartland Advisors, Inc. (Heartland), an investment advisor and broker-dealer in Milwaukee. The Seventh Circuit acknowledged that the action was one of a few instances in which the SEC had brought insider trading claims in connection with a mutual fund redemption, and remanded the case so the district court could rule on whether the misappropriation theory of insider trading applied.

Heartland managed the portfolios for Heartland Group, Inc., an open-end management investment company, and also underwrote and distributed shares of its mutual funds, which included municipal bond funds. Beginning in 1999 and continuing through the time Bauer redeemed her shares, the funds experienced substantial net redemptions, and bonds in the funds' portfolio defaulted or were at risk of default. In the midst of the redemption and credit problems, a fund manager tendered his resignation. In August 2000, Ms. Bauer imposed trading restrictions on all Heartland personnel who were aware of the impending resignation. In late September 2000, she lifted the trading ban. A few days later, Ms. Bauer redeemed all of her shares in the funds for approximately $45,000. The funds' net asset values continued to decline, and the funds entered receivership five months later. In December 2003, the SEC filed suit against Heartland, Ms. Bauer, and several other Heartland executives. All the defendants except Ms. Bauer entered into settlement agreements with the SEC. On May 25, 2011, the district court granted summary judgment to the SEC on the insider trading charges against Ms. Bauer. The decision was premised on two factors: the parties' stipulation that Ms. Bauer was an insider who possessed nonpublic information at the time she sold her shares, and the district court's findings that there were no genuine issues of material fact that the information she possessed was material and that she acted with scienter. Ms. Bauer appealed.

Section 10(b) of the Exchange Act prohibits fraud in connection with the purchase or sale of a security. To prove a violation of Section 10(b), the SEC had to establish that Ms. Bauer made a material misrepresentation or a material omission as to which she had a duty to speak, did so with scienter, and did so in the purchase or sale of securities. Two general theories explain how insider trading violates Section 10(b). Under the "classical theory," when a corporate insider trades in the securities of his or her corporation on the basis of material, nonpublic information, the relationship of trust between the shareholders and the insiders has been breached. Under the "misappropriation theory," a corporate outsider misappropriates confidential information for securities trading purposes in breach of a duty owed

to the source of the information, and the disclosure obligation "runs to the source of the information." The outsider entrusted with confidential information must either refrain from trading or disclose to the principal that he plans to trade. The misappropriation theory is "designed to protect the integrity of the security markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to the corporation's shareholders."

The Seventh Circuit articulated that the threshold issue is whether, and to what extent, insider trading theories apply to mutual fund redemptions—a question that had never been directly addressed in federal court. The SEC argued on appeal that Ms. Bauer's conduct fit the misappropriation theory of insider trading; however, then agency never presented the misappropriation theory to the district court. Rather, it relied on the classical theory. The Seventh Circuit remanded on several grounds, and also expressed skepticism as to the application of the misappropriation theory, stating "the misappropriation theory may overlook certain structural realities of a mutual fund. For example, the Commission might unravel for the district court how an officer at a mutual fund investment advisor can be fairly considered a corporate 'outsider' given the investment advisor's deeply entwined role as sponsor and external manager of the fund."

UPDATE: Following remand from the Seventh Circuit, Ms. Bauer filed a motion for summary judgment with respect to the SEC's misappropriation theory, which the district court granted, dismissing the remainder of the SEC's insider trading case. The district court noted that the SEC never raised a misappropriation theory with the court, and thus the court deemed that theory to be waived. Furthermore, the court stated that it was unwilling to extend the misappropriation theory of insider trading to this case where "no precedent supports the extension of this theory" to Ms. Bauer, and the SEC had not developed a "sound application of the misappropriation theory" or explained to the court how someone in Ms. Bauer's position as an officer at a mutual fund investment advisor can fairly be considered a corporate "outsider" given the investment advisor's "deeply entwined role as sponsor and external manager of the fund."

SEC Announces First-of-Its-Kind Whistleblower Award To an Audit and Compliance Professional

On August 29, 2014, the Securities and Exchange Commission (SEC) announced[28] that it was rewarding an audit and compliance professional with a whistleblower award of more than $300,000 for reporting company wrongdoing to the SEC after the company failed to take action. This is the first whistleblower award granted to an employee who performs an audit and compliance function. The employee first reported the problem internally, but contacted the SEC when the company failed to take action within 120 days of the internal report. The information provided by the employee directly led to a successful SEC enforcement action against the company.

Under Section 21F of the Securities Exchange Act of 1934, the whistleblower program rewards individuals who voluntarily report high-quality, original information about a company's wrongdoing to the SEC. In March 2014, the Supreme Court extended whistleblower protections afforded to employees of a company under section 1514A of the Sarbanes-Oxley Act of 2002 to employees of investment advisers that contract to manage mutual funds.[29] Mutual funds rarely have employees of their own and are instead usually managed by investment advisers. The extension of whistleblower protections was necessary to protect the employees of investment advisers "who are often the only firsthand witnesses" to violations of the securities laws by mutual funds.[30]

In order to merit an award, the information reported must result in an SEC enforcement action that imposes sanctions exceeding $1 million. For audit and compliance professionals, the whistleblower must first report the information internally to give the company a chance to address the issue before going

to the SEC. Awards can range from 10 to 30 percent of the money collected from an enforcement action. In this case, the award of more than $300,000 represents 20 percent of the money collected by the SEC as a result of the enforcement action against the company. This award serves as a strong reminder that companies should take prompt action to address internal reports of potential violations of federal securities laws.

SEC Issues No-Action Letter To Allow for Amendment of a Sub-Advisory Agreement without Shareholder Approval

On July 28, 2014, the SEC's Division of Investment Management issued a no action letter[31] stating that it would not recommend enforcement action under Section 15(a) of the Investment Advisers Act of 1940 if an investment adviser and a sub-adviser revised their sub-advisory agreement to reallocate the advisory fee paid by the advised fund without obtaining the approval of the fund's shareholders. The SEC staff's decision relied upon representations that the change in the allocation of the fee arrangement will not increase the total amount of advisory fee paid by the fund, and the level and nature of services provided by the advisers to the fund also will not change.

The facts underlying the no-action letter are as follows: RiverNorth Capital Management, LLC (RNCM) serves as investment adviser to the RiverNorth/DoubleLine Strategic Income Fund (the Fund). DoubleLine Capital, LP (DoubleLine) serves as the Fund's sub-adviser pursuant to a sub-advisory agreement between RNCM and DoubleLine. Under the sub-advisory agreement, a portion of the Fund's assets are allocated and managed by DoubleLine, and the rest of the Fund's assets are managed by RNCM. DoubleLine's fee is calculated by subtracting a pro rata portion of the Fund's operating expenses from the gross assets managed by DoubleLine. However, RNCM proposed to amend the sub-advisory agreement to eliminate DoubleLine's payment of a pro rata portion of the Fund's operating expenses and allow DoubleLine to be compensated based solely upon gross assets managed. This change would result in a slight increase in the advisory fee earned by DoubleLine. Likewise, it would result in a slight decrease in the fee earned by RNCM, as the entirety of the Fund's operating expenses would be paid from RNCM's portion of the Fund's assets. However, the overall amount of advisory fee paid by the Fund would not change. Because the overall fee to the Fund and its shareholders will remain consistent under the amendment, and because the amendment will not reduce or modify the nature or level of service provided in any way, SEC staff decided not to recommend enforcement action against any of the parties if the sub-advisory agreement was amended as proposed without shareholder approval.

SEC Works on Rules To Address Risks Posed by Asset Management Industry

In September 2014, it was reported that the Securities and Exchange Commission (SEC) is weighing new rules to enhance oversight of registered funds, private funds, and investment advisers.[32] The aim would be to provide insight into whether the asset management industry presents risks to the financial system. The new requirements would mandate that investment advisory firms provide regulators more information about portfolio holdings, and that the firms conduct stress tests. Such tests would be focused on whether funds have sufficient liquid assets to sustain large-scale redemptions if market shocks were to occur.

Though the SEC and its staff have not yet arrived at a formal proposed rule, the potential rules would likely resemble requirements imposed after the worst of the financial crisis on large financial institutions to address risks that regulators believed these institutions posed to the economy. In particular, the practice by some mutual funds of using derivatives and other strategies employed by hedge funds is attracting the SEC's attention.

SEC Pay-To-Play Rules

On June 20, 2014, the SEC brought its first case under the "pay-to-play" rules against a Philadelphia-area private equity firm, TL Ventures, Inc. (TL Ventures).[33] TL Ventures agreed to pay nearly

$300,000 in disgorgement and penalty fees to settle the case.

The SEC's pay-to-play rules were adopted in 2010 to prohibit investment advisers from providing compensatory advisory services, either directly to a government client or through pooled investment vehicles, for two years following a campaign contribution by the firm or certain firm agents to political candidates or officials in a position to influence the selection or retention of advisers to manage public pension funds or other government client assets.[34] The rules do not require that an adviser intend to influence the government official to award the adviser business. Further, the rules broadly define a political "contribution" as including any gift, subscription, loan, advance, deposit of money, or anything of value.

In 2011, a TL Ventures executive made a $2,500 contribution to a campaign of a candidate for Mayor of Philadelphia and a $2,000 contribution to the Governor of Pennsylvania. Both are officials covered by the pay-to-play rules — the Mayor appoints three of the nine City of Philadelphia Board of Pensions and Retirement (the Retirement Board) members, and the Governor appoints six of the 11 Pennsylvania State Employees' Retirement System (SERS) members. The contributions triggered a two-year ban on business under SEC Rule 206(4)-5 prohibiting TL Ventures' advisory services to those government entities. At the time, TL Ventures was still receiving advisory fees from SERS and Retirement Board, each of which had been invested in one of TL Ventures funds since 1999 and 2000, respectively.

To settle the SEC's charges, TL Ventures, without admitting or denying any wrongdoing, agreed to cease and desist from future violations of the law, and further agreed to pay disgorgement of $256,697, prejudgment interest of $3,197, and a civil penalty of $35,000 to the SEC. Additionally, the company agreed to be censured and to cease and desist from committing or causing any violations of the provisions referenced in the settlement order.

In its press release announcing the enforcement action, the chief of the SEC's Municipal Securities and Public Pensions Unit stated: "Public pension funds are increasingly investing in alternative investment vehicles such as hedge funds and private equity funds. When dealing with public pension fund clients, advisers to those kinds of investment vehicles should be mindful of the restrictions that can arise from political contributions."

SEC Scrutinizes Annual Advisory Agreement Renewal Process

In July 2014, the SEC settled the previously reported proceeding involving Chariot Advisors and its former owner, Elliott Shifman, regarding charges of violating and aiding and abetting the violation of Section 15(c) of the 1940 Act.[35]

The SEC found that, in communications during the 15(c) process for a proposed fund, Chariot Advisors lied to the board of The Northern Lights Funds about Chariot's ability to run an algorithmic currency trading strategy. The SEC found that in PowerPoint presentations, in other written submissions, and during in-person presentations before the board, Mr. Shifman stated that Chariot Advisors would use algorithmic currency trading for the fund. According to the SEC's findings, however, Chariot Advisors did not possess any algorithms for conducting currency trading.

The SEC order points out that the ability to conduct currency trading for the Chariot Fund was particularly significant because the fund was just being formed and, in the absence of an operating history by which to judge performance, the Northern Lights board focused on Chariot Advisors' reliance on models in evaluating the advisory contract. The implementation of the currency trading strategy was also important, the SEC order notes, because Mr. Shifman had indicated that the S&P 500 Index would be an appropriate benchmark for the Chariot Fund's performance. As a result of the conduct described above, the SEC found that Chariot Advisors violated Section 15(c), and Mr. Shifman caused this violation.

This matter arose out of an initiative by the Asset Management Unit of the Enforcement Division of the SEC to scrutinize the 15(c) process. A fund board should take note that, in *In the Matter of Chariot Advisors, LLC,* the SEC examined the various disclosures made to the board during the 15(c) process.

Chariot Advisors is at least the fourth enforcement case the SEC's specialized asset management unit has brought as part of its compliance sweep regarding the requirement that fund boards evaluate their agreements with investment advisers. The proceeding also follows a 2013 investigation involving the Northern Lights Funds in which gatekeepers of the Northern Lights Fund Trust and the Northern Lights Variable Trust settled allegations that they caused false or misleading disclosures about what they considered in approving or renewing investment advisory contracts.

As a result of the *Chariot Advisors* proceeding, Mr. Shifman was suspended from association with virtually any entity in the securities industry for 12 months and ordered to pay a $50,000 fine.

Although the proceeding did not directly implicate the fund board, the action underscores the SEC's continuing intent to scrutinize the entire 15(c) process and, by implication, warns fund boards to be diligent in their adherence to their 15(c) duties.

Supreme Court Allows Anti-Retaliation Suits by Fund Service Providers' Employees

The U.S. Supreme Court has ruled that the anti-retaliation provision of the Sarbanes-Oxley Act of 2002[36] (Sarbanes-Oxley) protects employees of investment advisers and other service providers to mutual funds, and other public companies that engage in whistleblowing.[37] In prior decisions, lower courts had reached differing conclusions. The case came from the U.S. Court of Appeals for the First Circuit, which had ruled that the applicable provision protects only employees of the public company (or mutual fund) itself. The Supreme Court decision allows employees of contractors and subcontractors to public companies to seek reinstatement and compensation if they are discharged or discriminated against for providing information concerning shareholder fraud, certain criminal frauds, or violations of SEC rules to federal regulatory or law enforcement agencies or through internal channels.

Sarbanes-Oxley provides that no public company, or any officer, employee, contractor, subcontractor, or agent of such company, may retaliate against "an employee." Courts had been divided on whether the "employee" must be an employee of the public company, or could be an employee of the contractor or subcontractor.

The Court concluded that the statutory text, purposes, and history show that the provision covers employees of private contractors and subcontractors, just as it covers employees of the public company—in this case, a mutual fund served by them. The Court was unpersuaded by the argument that mutual funds and investment advisers are separately regulated under the Investment Company Act of 1940 (1940 Act) and observed that, because mutual funds had no employees of their own, Sarbanes-Oxley would offer no protection for whistleblowing about operations of the funds if the appellee's legal position were sustained.

EU Court of Justice Ruling May Allow U.S. Funds To Obtain Tax Refunds

The Court of Justice of the European Union (EU) ruled in April 2014 that a non-EU investment fund may be able to obtain the same tax exemption available to funds established in an EU member state.[38] The case arose in Poland, where domestic and EU investment funds are exempt from tax, but non-EU funds are subject to tax on the dividend income they receive. A U.S. mutual fund sought a tax refund, arguing that the disparate treatment was in violation of a provision of the Treaty on the Functioning of the European Union (TFEU), which prohibits restrictions on the movement of capital between member states and third countries.

The Court of Justice ruled that the TFEU prohibits the enactment of tax laws of a member state that make dividends payable to a non-EU investment fund ineligible for the applicable tax emption if the member state and nonmember state are bound by an obligation of mutual administrative assistance which enables the national tax authorities to verify information transmitted by the investment fund. The Court of Justice referred the case back to the Polish court for a determination whether the U.S. – Poland tax treaty meets this standard. The principles of the ruling, which apply across the EU, not just to Poland, could lead to large refunds for U.S. funds.

SEC, Other Regulators Pursue Puerto Rico Bond Inquiries

In the third quarter of 2013, the SEC canvassed several mutual fund companies, asking for information about their funds' exposure to municipal bonds issued by the Commonwealth of Puerto Rico, the trading of Puerto Rico debt among accounts and funds, and communications with shareholders about Puerto Rico.[39] The SEC sent these requests while the island's credit ratings verged on "junk" status.

In February 2014, Puerto Rico lost its investment-grade credit ratings. Yet, in March 2014, a $3.5 billion sale of Puerto Rico high-yield bonds was oversubscribed.[40] Mutual funds that typically do not focus on municipal bonds were among the buyers of Puerto Rico's high-yield bonds.[41] The demand for these bonds may have signaled an improvement in investor sentiment about higher-yield municipal bonds. The demand may have also been the result of the lack of yield across the financial markets.

Just a week after Puerto Rico's $3.5 billion bond sale, the Financial Industry Regulatory Authority (FINRA) announced that it was examining trading in the island's bond issue.[42] FINRA's examination arose from concerns that these bonds were being sold to individual investors, based on the relatively small amounts in which some market participants were completing trades in the bonds.[43]

In May 2014, plaintiffs in the Southern District of New York sought class-action status for their suit, against UBS AG and Popular, Inc. (the parent of Banco Popular), concerning failed investments in closed-end mutual funds that invested in Puerto Rico bonds.[44] According to the plaintiffs, UBS and Popular underwrote Puerto Rico bonds, served as investment advisers to the funds buying the bonds, and earned commissions from investors who bought shares of the funds through the bank's retail brokerage units. The plaintiffs also alleged that UBS used leverage in the funds, and encouraged investors to borrow $500 million to further their investments in the funds.[45]

The U.S. Treasury Department has formed a new unit to monitor the municipal bond market. [46] Puerto Rico's fiscal difficulties in particular have been drawing attention of regulators because a default by Puerto Rico on its bonds could have significant implications for the rest of the municipal bond market. Approximately three-fourths of municipal bond funds own debt issued by Puerto Rico.[47]

Investment Adviser Charged with Breaching Fiduciary Duties and Misleading Investors

In April 2014, the SEC charged Total Wealth Management, Inc., as well as its chief executive officer, chief compliance officer, and another employee, with violations of the securities laws.[48] The SEC alleged that Total Wealth and its CEO and owner, Jacob Keith Cooper, created a conflict of interest by paying themselves undisclosed "revenue sharing fees" derived from investments they recommended to investors and misrepresented the extent of the due diligence they had conducted on investments they recommended. The SEC also alleged that Total Wealth's chief compliance officer, Nathan McNamee, and Total Wealth representative Douglas David Shoemaker breached fiduciary duties they owed to clients, and defrauded clients, by not disclosing relevant conflicts of interest and by concealing the revenue-sharing fees. The SEC described these fees as "kickbacks."[49] Each of Messrs. Cooper, McNamee, and Shoemaker allegedly created an entity to receive the revenue-sharing fees and to hide the fact that they were the ultimate recipients of

these payments. As described in the SEC's order, the revenue-sharing fees were not apparent to investors, and Total Wealth paid these fees to the controlled entities for "consulting" work, even though the other entities provided no consulting services. The alleged misconduct occurred in connection with investments in unregistered funds in the Altus family of funds. Total Wealth was also the owner and managing member of Altus Management, the general partner of the Altus funds.

The SEC charged, among other things:

- Total Wealth and Messrs. Cooper, McNamee and Shoemaker with violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder, and Section 207 of the Advisers Act, all of which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities

- Total Wealth and Mr. Cooper with breaching fiduciary duties in violation of Sections 206(1), 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 promulgated thereunder

The remedial actions that the SEC may seek could include financial penalties, disgorgement, and cease-and-desist orders.

SEC Fines One Adviser and Charges Another Defendant over Social Media Misuse, Issues Guidance on the "Testimonial Rule"

The SEC settled a claim in January 2014 against Mark Grimaldi of Navigator Money Management over allegedly misleading tweets about the firm's performance record.[50] The SEC charged the investment adviser with having made false statements and having "cherry-picked" information in a misleading fashion in an effort to attract new clients using Twitter. The regulator's message: social media statements are no different from any other statements and carry the same risks and restrictions. Mr. Grimaldi paid a $100,000 fine.

On April 8, 2014, the SEC announced that it had brought fraud charges against a Honolulu resident, Keiko Karamura, who had engaged in two separate schemes that ultimately defrauded investors out of more than $200,000.[51]

Initially, Ms. Karamura set up a fake hedge fund and posted about it through social media websites such as Twitter. Her posts included account statements that belonged to a different hedge fund. All investments that were made towards Ms. Karamura's fabricated hedge fund inured to her benefit. In another alleged scheme, Ms. Karamura used social media websites to boast about investment experience that she did not actually possess and induced investors to pay for her investment advice services.

In March 2014, perhaps motivated by the aforementioned cases, the SEC issued guidance[52] regarding whether the publication of comments made about investment advisers on social media sites would violate Rule 206(4)-1(a)(1) (the "testimonial rule"[53]) or Rule 206(4)-1(a)(5), each promulgated under the Advisers Act (collectively, the Rules).

Section 206(4) and the Rules govern fraudulent communications by registered investment advisers (RIAs). The new SEC guidance instructs RIAs to apply the spirit of this section and the Rules to their social media communications. This guidance provides that:

- Publishing clients' experiences on the RIA's own website, or on the RIA's social media site, is prohibited as a testimonial.

- Social media sites that include a listing of contacts or "friends" will generally not be considered a testimonial or endorsement of the RIA, unless the RIA attempts to infer that such friends have experienced favorable results as clients.

- Directing clients to social media services owned or operated by the RIA is not deemed to be soliciting testimonials from clients.

- Communications by third-party websites or content producers who are independent, i.e., have "no material connection" to the RIA, are not prohibited testimonials.

RIAs likely will have to conduct additional monitoring and adopt new policies and procedures to ensure compliance with the updated guidance. They must weigh their obligation to comply with these conditions against the benefit of using social media commentary in advertisements.

Trend: Advisers Attacked for Overcharges on Subadvised Funds

In the first quarter of 2014, mutual fund shareholders continued to use Section 36(b) of the 1940 Act to sue certain investment advisers that subcontract advisory functions to a subadviser. Section 36(b) imposes a fiduciary duty on an investment adviser related to compensation received from funds. Under Section 36(b), shareholders have a right to recover excessive fees on behalf of the fund.

In March 2014, a plaintiff filed a complaint on behalf of the BlackRock Global Allocation Fund against BlackRock Advisors, the principal investment adviser to the fund.[54] In February 2014, other plaintiffs filed a complaint, also on behalf of the fund, against BlackRock Advisors, as well as against a former subadviser and the current subadviser, both of which are BlackRock affiliates.[55] The plaintiff in the March complaint alleged that, in 2013, the principal BlackRock adviser retained almost 43 percent of investment management fees, despite doing little work for the fund. The plaintiffs in the February 2014 complaint alleged that the fund was potentially paying more than twice what BlackRock charged other funds for subadvisory services outside of the BlackRock fund complex. The plaintiffs in both complaints also allege that adviser did not sufficiently share economies of scale with the fund by reducing fees as the fund grew. Additionally, the plaintiffs allege that fund's board failed to protect the fund and its shareholder, and did not independently and conscientiously negotiate arm's-length fees with the adviser.

Similar to the plaintiffs in these two suits against BlackRock, shareholders in February 2014 sued Harbor Capital Advisors over amounts being paid in relation to advisory fees paid by the Harbor International Fund.[56] The plaintiff alleged that the subadviser, Northern Cross, was doing substantially all of the work, but that Harbor Capital Advisors was nonetheless retaining about $100.5 million out of the more than $225 million the fund paid in investment management fees in 2012.

Despite the rise in suits alleging that advisers are receiving excessive fees from subadvised funds, the plaintiffs will have to overcome a high bar to prevail on their claims. They will have to prove that the defendant investment adviser charged a fee that is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[57]

Following *Janus Capital Group* Holding, Second Circuit Declines To Find Rule 10b-5 Liability

In *Fezzani v. Bear, Stearns & Co. Inc.*,[58] the Second Circuit held that a defendant was not liable, in a private claim for damages, for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated under that section, even though the defendant had facilitated the alleged fraud. The court came to this conclusion because the plaintiff did not allege that the defendant communicated the artificial price information to the would-be buyers. The court found this fact relevant in light of, among other precedents, the U.S. Supreme Court's 2011 decision in *Janus Capital Group Inc. v. First Derivative Traders*. In *Janus,* the Supreme Court held that defendant cannot be held primarily liable in a Rule 10b-5(b) private securities action for "making" a misleading statement or omission unless the defendant had ultimate authority over the statement's content and whether and how to communicate it.[59] The Second Circuit's decision in

Fezzani is one of a number of decisions by courts that, applying the *Janus* decision, declined to impose liability on third parties who did not actually make allegedly misleading statements.

SEC's Champ Outlines Investment Management Staff Priorities

Norm Champ, the Director of the Division of Investment Management of the SEC, identified the following priorities of the SEC's Investment Management Staff in a speech to industry professionals in March 2014:

1. Complete the pending money market fund proposal.
2. Complete analyzing comments on the proposed rule regarding general solicitation and advertising.
3. Revise Form N-SAR (and related securities holdings disclosure).
4. Reform variable annuity disclosures.
5. Reform disclosures on target date funds.
6. Complete congressional mandates relating to the deletion of credit ratings references.
7. Review distribution fees and practices after consultation with the Office of Compliance, Inspections, and Examinations.
8. Propose a rule for investment advisers' obligations to report on "say-on-pay" votes.

SEC Focuses Independent Fund Trustees on Audit Quality

In February 2014, Paul Beswick, the SEC's chief accountant, urged fund audit committees to focus on audit quality rather than price. According to Mr. Beswick, "[I]f the audit committee is solely fee hunting and if there was a subsequent audit failure, beyond the obvious problems for the auditor and the company, this may raise questions about the diligence of the members of the audit committee in fulfilling their responsibilities." [60]

Mr. Beswick voiced his concerns immediately after the Public Company Accounting Oversight Board issued a report that was critical of the adequacy of current auditor reviews.[61] The report noted that the audits were generally deficient because the audit committees and other designated company reviewers were failing to assess independent audits properly. As a result, the report concluded that "[o]bservations from the Board's 2012 inspections indicated that audit deficiencies and the related deficiencies in engagement quality reviews continued to be high."

Mr. Beswick made his comments at the Practicing Law Institute's "SEC Speaks in 2014" Conference. One of the major focal points of the conference was how to improve the quality of independent auditor reports of public companies. The conference leaders concluded that audit committees are in the position to improve the process by performing adequate and meaningful reviews of their companies' independent audit reports.

SEC's Guidance on Unbundling of Proxy Proposals

Rule 14a-4(a)(3) promulgated under the Exchange Act concerns the "unbundling" of separate matters that are submitted to a shareholder vote by a company or any other person soliciting proxy authority. In January 2014, the staff of the SEC Division of Corporation Finance issued three Compliance and Disclosure Interpretations providing guidance on the unbundling of proxy proposals. In each of these interpretations, the SEC staff furnished examples under which the staff believes it is permissible for a registrant to combine multiple matters into a single proposal.

Multiple matters that are so "inextricably intertwined" that they effectively constitute a single matter need not be unbundled. The first interpretation discussed when a registrant's management has negotiated concessions from holders of a series of its preferred stock to reduce the stock's dividend rate in exchange for an extension of the

maturity date. The SEC staff stated that the proposal need not be unbundled because it involved multiple matters so "inextricably intertwined" as to effectively constitute a single matter. The SEC staff viewed the matters relating to the terms of the preferred stock as being inextricably intertwined because each of the proposed provisions related to a basic financial term of the same series of capital stock and was the sole consideration for the countervailing provision.

A single "material" matter may be presented with a number of "immaterial" matters. When a registrant's management intends to present an amended and restated charter to shareholders for approval at an annual meeting—and the proposed amendments would change the par value of the common stock, eliminate provisions relating to a series of preferred stock that is no longer outstanding and not subject to further issuance, and declassify the board of directors—the SEC staff has said that the multiple proposals need not be unbundled. The SEC staff would not ordinarily object to the bundling of any number of immaterial matters with a single material matter. While there is no bright-line test for determining materiality within the context of Rule 14a-4(a)(3), registrants should consider whether the given matter substantively affects shareholder rights.

Multiple amendments to equity incentive plan may be presented as one matter. Although the SEC staff generally will object to the bundling of multiple, material matters into a single proposal—provided that the individual matters would require shareholder approval under state law, the rules of a national securities exchange, or the registrant's organizational documents if presented on a stand-alone basis—the SEC staff will not object to the presentation of multiple changes to an equity incentive plan in a single proposal. This is the case even if the changes can be characterized as material in the context of the equity incentive plan and the rules of a national securities exchange would require shareholder approval of each of the changes if presented on a stand-alone basis.

SEC Warns of Fixed Income Fund Risk

In January 2014, the SEC's Division of Investment Management issued guidance to fund advisers and boards on the risks of changing fixed income market conditions.[62] The guidance warns of the importance of sound risk management and disclosure practices by fixed income mutual funds and exchange-traded funds (ETFs), particularly as the Federal Reserve Board implements the end of its regimen of "quantitative easing."

The staff guidance notes that markets buffeted bond mutual funds and ETFs in June 2013, when the 10-year Treasury note yield rose substantially. The staff believes that such volatility is likely to be a near permanent development as a result of structural changes in the fixed income marketplace, which has grown much faster than the size of primary dealers' inventories. The staff believes that the size of dealer inventories is a proxy for their appetite and capacity to make markets by committing their own capital, as principal, to market intermediation. The staff believes that a significant reduction in dealer market-making capacity has the potential to decrease liquidity and increase volatility in the fixed income markets.

The staff guidance recommends several steps that fixed income fund advisers may consider taking, and it also notes that fund boards may want to consider discussing with fund advisers the steps these advisers are taking in this area.

Although many commentators believe the staff's analysis to have merit, the release has also produced two criticisms. First, many commentators believe that the mid-2013 spike in open market interest rates resulted from a confluence of factors—not just a reduction in dealer bond inventories relative to market size. For example, interest rates were almost certainly affected by the 2013 brinkmanship over the U.S. government's debt ceiling, coupled with a three-week federal government shutdown, the expected reduction in open market bond purchases by the Federal Reserve, and the threatened U.S. government securities default in October. At the height of the default threat, credit default swaps on one-year

Treasuries had increased 50 basis points as compared to an increase on German bunds of only three basis points. Equity volatility increased as well.[63]

Second, some commentators have criticized the SEC for engaging in what is tantamount to rulemaking—establishing a *de facto* standard on disclosure without going through the traditional proposal and comment process. By doing so, detractors believe the SEC not only exceeded its authority, but also lost the substantial benefit of industry experience reflected in the comment process.

PCAOB Evaluating Significant Changes to Auditor's Report

In April 2014, the Public Company Accounting Oversight Board (PCAOB) held a public meeting to further the discussion and evaluation of its 2013 proposal[64] for significant changes to the auditor's report. The proposed standard would require the auditor to report a wider range of information specific to the particular audit and auditor. For example, the auditor would be required to communicate in a separate section of the audit report the "critical audit matters" (CAM) in the audit of the current period's financial statements based on the results of the audit or evidence obtained. CAM are those matters the auditor addressed during the audit of the financial statement that:

- Involved the most difficult, subjective, or complex auditor judgments
- Posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence
- Posed the most difficulty to the auditor in forming an opinion on the financial statements.

The proposed auditor reporting standard identifies factors the auditor should take into account in determining CAM, including:

- The severity of control deficiencies identified relevant to the matter, if any
- The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any

The auditor's report would identify the CAM; describe the considerations that led the auditor to determine that the matter is a CAM; and refer to the relevant financial statement accounts and disclosures that relate to the CAM, when applicable.

Other provisions of the proposal would require:

- A statement containing the year the auditor began serving consecutively as the company's auditor (apparently instead of requiring mandatory rotation of audit firms)
- A statement that the auditor is a public accounting firm registered with PCAOB (United States) and is required to be independent from the company in accordance with federal securities laws and the applicable rules and regulations of the SEC and the PCAOB
- Enhancements to existing language in the auditor's report related to the auditor's responsibilities for fraud and the notes to the financial statements.

Champ Reviews Changes to Regulatory Landscape for Hedge Funds

Norm Champ, the director of the SEC's Division of Investment Management, recently urged hedge fund advisers to review their policies and procedures carefully to ensure that they are reasonably designed to prevent fraudulent or misleading advertisements, particularly if the hedge fund sponsors intend to engage in general solicitation activity. Such advisers should also consider the requirements of the new rule. The staff plans to evaluate the range of accredited investor verification practices that issuers

and offering participants use to identify trends in the market, including potentially fraudulent behavior, according to Mr. Champ.

Final Volcker Rule Adopted

More than two years after it was originally proposed, the final Volcker Rule, implementing Section 13 of the Bank Holding Company Act (added by the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as Dodd-Frank),[65] was released in December 2013. The rule is attributed to former Federal Reserve Board Chairman Paul Volcker, and its principal idea is to prevent banks from taking undue risks while enjoying the benefits of the public subsidy conferred by insured deposits.

As required by Dodd-Frank, the Volcker Rule prohibits a "banking entity" from two broad categories of activities:

- Engaging in proprietary trading of financial instruments (i.e., the purchase or sale of securities, commodity contracts (including foreign exchange swaps and forwards), derivatives, or options) for its own "trading account" with the idea of profiting from short-term price movements

- Owning and sponsoring hedge funds and certain private equity funds (known as "covered funds")

The rule defines "banking entity" as:

- Any insured depository institution (i.e., a commercial bank or a thrift)

- Any company that controls an insured depository institution (i.e., a bank holding company or a savings and loan holding company)

- Any company that is treated as a bank holding company under the International Banking Act of 1978 (i.e., a company that is or controls a non-U.S. bank with branches or agencies in the United States)

- An affiliate or subsidiary of any of the above

In large part, the final rule is unchanged from the original proposal. However, although the proposed rule required banking entities to implement significant compliance programs, the final rule gives some relief to smaller institutions but expands the obligations of large institutions (typically those with $50 billion or more in total consolidated assets). Large institutions are subject to an expanded corporate governance and oversight requirement for boards of directors, CEOs, and senior management; this includes a requirement for an annual CEO certification.

The final rule extends the compliance date for most of its requirements until July 21, 2015.

[1] SEC, OCIE National Exam Program, Examination Priorities for 2015 (Jan. 13, 2015), available at http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

[2] *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").

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

[4] 17 C.F.R. § 240.10b-5.

[5] 15 U.S.C. § 77q(a)

[6] *Id.*, at 2306.

[7] SEC Opinion at 18-19.

[8] *Id.*, at 2.

[9] *Id.*, at 3.

[10] *Id.*

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

[12] *Id.*, at 18.

[13] *Id.*

[14] SEC Opinion, at 19.

[15] *Id.*

[16] *Id.*, at 13.

[17] *Id.*

[18] *Id.*

[19] *Id.*, at 8.

[20] SEC Opinion at 39.

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

[22] 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.

[23] 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.

[24] 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.

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

[26] Chair Mary Jo White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Address Before The New York Times DealBook Opportunities for Tomorrow Conference Held at One World Trade Center, New York, N.Y. (December 11, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#_ftnref1.

[27] The Dodd-Frank Act requires the Commission to establish methodologies for this stress testing of financial companies such as broker-dealers, registered investment companies and registered investment advisers with $10 billion or more in total consolidated assets—including baseline, adverse, and severely adverse scenarios—and to design a reporting regime for this stress testing, which must be reported to the Commission and the Federal Reserve Board. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, section 165(i)(2), 124 Stat. 1423 (2010) (codified at 12 USC 5365).

[28] Sec. & Exch. Comm'n, *SEC Announces $300,000 Whistleblower Award to Audit and Compliance Professional Who Reported Company's Wrongdoing* (Aug. 29, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542799812.

[29] *Lawson v. FMR LLC* (U.S., 2014).

[30] *Id.*

[31] RiverNorth Capital Management, LLC, SEC No-Action Letter (July 28, 2014), http://www.sec.gov/divisions/investment/noaction/2014/rivernorth-072814.htm.

[32] Andrew Ackerman, *SEC Preps Mutual Fund Rules*, Wall St. J., Sept. 7, 2014, http://online.wsj.com/articles/sec-preps-mutual-fund-rules-1410137113; Edward Hayes, *SEC Considers Mutual Fund Rules*, US Fin. Servs. News, Sept. 10, 2014.

[33] *In TL Ventures Inc.*, Investment Advisers Act Release No. 3895 (June 20, 2014).

[34] 17 C.F.R. 17.275.206(4)-5

[35] *In re Chariot Advisors, LLC*, Admin. Proc. No. 3-15433, Investment Company Act Release No. 31149 (July 3, 2014).

[36] 116 Stat. 745.

[37] *Lawson v. FMR LLC*, No. 12-3, slip op. (U.S. Mar. 4, 2014).

[38] *Emerging Markets Series of DFA Investment Trust Company v. Dyrektor Izby Skarbowej w Bydgoszczy* (C-190/12) (April 10, 2014).

[39] Andrew Ackerman & Kelly Nolan, *SEC Canvasses Fund Companies on Puerto Rico Debt*, Wall St. J., Oct. 24, 2013.

[40] Maureen Nevin Duffy, *Muni Bonds Pose Questions for Advisors*, Financial Advisor Magazine, May 2014, 73.

[41] Joe Morris, *Puerto Rico Beckons Beyond Muni Bond World*, Ignites, May 19, 2014, http://ignites.com/pc/891044/85254.

[42] Mike Cherney & Al Yoon, *FINRA Examining Trading in Puerto Rico Bonds*, Wall St. J., Mar. 21, 2014.

[43] *Id.*

[44] Matthias Rieker, *UBS, Popular Sued Over Losses in Puerto Rico Bond Funds*, Wall St. J., May 7, 2014.

[45] Joe Morris, *UBS Sued Over Puerto Rico Fund Losses*, Ignites, May 7, 2014, http://www.ignites.com/pc/883674/84114.

[46] Andrew Ackerman, *Treasury Turns Its Gaze to Municipal-Bond Market*, Wall St. J., Apr. 16, 2014.

[47] *Id.*

[48] *In re Total Wealth Management, Inc.*, File No. 3-15842 (Sec. & Exch. Comm'n Apr. 15, 2014), http://www.sec.gov/litigation/admin/2014/33-9575.pdf.

[49] Sec. & Exch. Comm'n, *SEC Charges San Diego-Based Investment Adviser* (Apr. 15, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541502917.

[50] Sec. & Exch. Comm'n, *SEC Charges N.Y.-Based Money Manager and Firm for Misleading Advertisements* (Jan. 30, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540701988.

[51] Sec. & Exch. Comm'n, *SEC Announces Charges Against Honolulu Woman Defrauding Investors Through Social Media* (Apr. 8, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541446454.

[52] *Guidance on the Testimonial Rule and Social Media*, IM Guidance Update 2014-4 (Mar. 2014), http://www.sec.gov/investment/im-guidance-2014-04.pdf.

[53] Rule 206(4)-1(a)(l) promulgated under the Advisers Act.

[54] Complaint, *Foote v. BlackRock Advisors, LLC*, 3:14-cv-01991 (D.N.J. filed Mar. 28, 2014).

[55] Complaint, *Clancy v. BlackRock Investment Management, LLC*, 3:14-cv-01165 (D.N.J. filed Feb. 21, 2014).

[56] Complaint, *Zehrer v. Harbor Capital Advisors, Inc.*, 1:14-cv-00789 (N.D. Ill. filed Feb. 4, 2014).

[57] *See Jones v. Harris Assocs., L.P.*, 559 U.S. 335, 345-46 (2010).

[58] 716 F.3d 18 (2d Cir. 2013).

[59] 131 S.Ct. at 2307.

[60] Paul Beswick, *Remarks at the AICPA 2013 Conference on Current SEC and PCAOB Developments* (Dec. 9, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370540488257.

[61] Pub. Co. Accounting Oversight Bd., *Observations Related to the Implementation of the Auditing Standard on Engagement Quality Review*, PCAOB Release No. 2013-011 (Dec. 6, 2013), *available at* http://pcaobus.org/Inspections/Documents/120613_EQR.pdf.

[62] *Risk Management in Changing Fixed Income Market Conditions*, IM Guidance Update 2014-1 (Jan. 2014), http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf.

[63] The CBOE VIX index of volatility almost doubled from the low teens in May to about 23 in late June. Although small by comparison to the spikes in volatility seen during the financial crisis and its aftermath, the increase was nonetheless substantial.

[64] Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments.

[65] Pub. L. No. 111-203, 124 Stat. 1376 (Dodd-Frank Act); 12 U.S.C. § 1851 (new Section 13 of Bank Holding Company Act).