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IN THIS ISSUE

Regulatory Updates

CFTC Adopts "Substituted Compliance" Approach for Registered Investment Companies that are Commodity Pools Page 1

SEC's Final Rules on General Solicitation and Bad Actor Disqualification for Investment Advisers and Broker-Dealers Change Regulatory Landscape Page 1

Division of Investment Management: Private Fund Custodians Need Not Maintain Private Stock Certificates Page 2

NY Fed to Establish an Overnight Fixed-Rate Reverse Repo Facility Available to Money Market Funds and Others Page 2

SEC to Focus on Private Fund Adviser Compliance Procedures in Rule 506(c) Offerings Page 3

Affiliated ETFs Mergers Possible Without SEC Order Page 3

SEC/FINRA/CFTC Urge Firms to Bolster Business Continuity Plans Page 4

FINRA Raises Concerns About Advertising "Free" and "No-Fee" Services Page 4

Delayed Effectiveness of Large Trader Reporting for Certain Broker-Dealers Page 4

OFR Report: Asset Managers Potentially Threaten Financial Stability Page 4

Federal Regulators Tighten Proposals to Require "Securitizers" to Retain Credit Risk Page 5

PCAOB Report Criticizes Broker-Dealer Audit Deficiencies Page 5

Enforcement + Litigation

SEC Charges Adviser with Misleading Fund Board About Trading Capabilities Page 5

Federal Court Questions Whether "Classic Theory" of Insider Trading Applies to Mutual Fund Shares Page 6

SEC Sanctions Portfolio Manager for Misleading CCO Page 6

SEC Sanctions Adviser for Pushing Class A Shares when Investors Qualified to Buy Institutional Class Shares Page 6

Court Tosses ETF Securities Lending Fee Case Page 7

SEC Sanctions Non-U.S. Bank for Failure to Register as a Broker-Dealer or Investment Advisers when Existing Clients Relocated to the United States Page 7

FINRA Enforcement Action Stresses Procedures for Due Diligence on Private Placements of Investment Funds Page 8

FINRA Sweep of Firms' Compliance with Prospectus Delivery Requirements Page 8

Second Circuit Upholds Dismissal of Case Alleging Disclosure Violations by Leveraged ETFs Page 9

Tidbits

Page 9

MORRISON
FOERSTER

REGULATORY UPDATES

CFTC Adopts "Substituted Compliance" Approach for Registered Investment Companies that are Commodity Pools

In mid-August, the CFTC adopted final rules implementing a "substituted compliance" approach for disclosure and compliance obligations of registered investment companies (RICs) that are also commodity pools. Rather than requiring that RICs comply with the sometimes inconsistent disclosure, compliance and financial reporting regulations of the SEC and the CFTC, the CFTC said that compliance with applicable SEC regulations, with minor adjustments, would be adequate.

The new rules reflect a departure from the harmonization rules proposed last year by the CFTC when it adopted changes to Rule 4.5 that exclude from the definition of a commodity pool operator (CPO) only those CPOs of RICs that invest a *de minimis* amount of their assets in commodity interests other than for bona fide hedging purposes. Public comments received on the harmonization proposal raised concerns that it did not go far enough and that the burden on RICs to comply with two regulatory schemes would be significant without providing shareholders with any meaningful benefit. The CFTC determined that compliance with the SEC regulations would provide market participants with meaningful disclosure with regard to fees and risks and provide the CFTC with information necessary to its oversight of CPOs.

Under the substituted compliance regime, in the event that the CPO of a RIC fails to comply with SEC disclosure, compliance and financial reporting regulations, it would also be in violation of its obligations under applicable CFTC regulation and, presumably, subject to enforcement action by both regulators. More detailed information regarding the final rules can be found in our client alert.

SEC's Final Rules on General Solicitation and Bad Actor Disqualification for Investment Advisers and Broker-Dealers Change Regulatory Landscape

Amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act relaxing prohibitions against general solicitation in certain private offerings of securities and new bad actor disqualification provisions for all private placements under Rule 506, which became effective on September 23, 2013, have dramatically changed the regulatory landscape for private offerings.

The new rules not only significantly affect issuers; they likely will have a large impact on broker-dealers and investment advisers as well. Registered broker-dealers often act as intermediaries that facilitate Rule 506 offerings, while investment advisers organize and sponsor pooled investment funds that conduct Rule 506 offerings in an issuer capacity.

Attorney Advertising

The rules will affect investment advisers and broker-dealers – directly or indirectly – in several ways:

- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons will constitute disqualifying events under the "bad actor" rule.
- The scope of the bad actor rule will be expanded by using the term "investment manager" rather than "investment adviser." This is meant to ensure that control persons of pooled funds that deal in instruments other than securities, such as commodities, real estate and certain derivatives, are covered persons and subject to disqualification under the bad actor rule. This revision recognized that, unlike operating companies making Rule 506 offerings, most pooled investment funds engaging in Rule 506 offerings function through their investment managers and their personnel and have few, if any, employees.
- An issuer may rely on Rule 506's exemption, even if there is a disqualification as to a covered person, if the issuer can demonstrate that it did not know and, in the exercise of reasonable care, it could not have known about the disqualification at the time of the sale of securities.
- Existing FINRA rules governing offering-related communications take on greater significance with the wider availability of general solicitation in private placements. In addition, broker-dealers and investment advisers participating in offerings in conjunction with issuers relying on the new general solicitation rule will continue to be subject to FINRA or SEC rules generally prohibiting false or untrue statements.
- An issuer may verify that its investors are accredited by, among other things, obtaining written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant that such person or entity has taken reasonable steps within the prior three months to verify that the purchaser is an accredited investor and has determined that such purchaser is an accredited investor. The rationale behind this provision is that these third parties are all subject to various other regulatory, licensing and examination requirements.
- Broker-dealers and investment companies qualify as accredited investors under the general solicitation rule.

These rules and related rules recently proposed by the SEC are addressed in several client alerts, all of which can be accessed from this post on our new blog, the BD/IA Regulator.

Division of Investment Management: Private Fund Custodians Need Not Maintain Private Stock Certificates

In a recent IM Guidance Update, the SEC's Division of Investment Management said that it would not object if registered investment advisers to certain private funds do not maintain "private stock certificates" with a qualified custodian under certain circumstances.

The Guidance Update responds to inquiries about whether Rule 206(4)-2 under the Investment Advisers Act (the "Custody Rule") requires registered advisers to audited private funds to maintain privately issued, non-transferable stock certificates with a qualified custodian. The staff said that, although private stock certificates do not technically meet the definition of "privately offered securities" in the Custody Rule, they are similar in all material respects. Moreover, the staff said that maintaining private stock certificates at a qualified custodian does not provide additional protection to fund investors, because auditors perform substantive procedures to verify fund investments (including privately issued securities) regardless of whether the private stock certificates are held at a qualified custodian.

Under the new guidance, registered investment advisers to private funds will no longer be required to custody private stock certificates with a qualified custodian if:

- the client is a pooled investment vehicle that is subject to an annual audit as set forth in Rule 206(4)-2(b)(4);
- the private stock certificate can only be used to effect a transfer, or to otherwise facilitate a change in beneficial ownership, of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer;
- ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client;
- the private stock certificate contains a legend restricting transfer; and
- the private stock certificate is appropriately safeguarded by the RIA and can be replaced upon loss or destruction.

NY Fed to Establish an Overnight Fixed-Rate Reverse Repo Facility Available to Money Market Funds and Others

The New York Fed quietly announced it is testing a "new tool" that would provide a lifeline for yield-starved money market funds.

In a recent speech at Fordham University, William C. Dudley, president and chief executive officer of the New York Fed, said the Fed was developing a fixed-rate, full allotment overnight reverse repo facility. The Fed proposes to open this facility to money market funds and other financial institutions, not just to primary

dealers through which it historically has conducted its open market operations.

That is, the Fed would offer a fixed interest rate to repo counterparties, including banks, dealers, money market funds and some government sponsored entities, on money that they lend to the Fed.

The Fed terms these transactions "reverse repos," or reverse repurchase agreements. Under this definition, the Fed sells an overnight security to a money market fund (or other counterparty), which in turn pays a purchase price. The following day, the Fed repays the loan (and gets its securities back). The repayment amount is higher than the purchase price: the difference is, in effect, an interest payment. The transaction is the economic equivalent of an overnight collateralized loan of cash to the Fed. (The Fed characterized these transactions from its own perspective. From a money market fund's perspective, these transactions would be "repos.")

The Fed also terms the facility "full allotment." That is, the facility would have no cap on the amount of funds accepted from any of its counterparties at the posted overnight interest rate.

The reverse repo program effectively would establish a floor on money market rates, thereby improving the Fed's control over short-term interest rates. This is because by offering what is essentially a risk-free investment, a counterparty would be unwilling to lend money to a borrower for a smaller return, especially when the loan would involve some degree of risk.

Dudley made it clear what the program is not: "The testing and development of the facility is not being undertaken to facilitate or expedite exit from our large balance sheet and should not be considered to be an element of the exit process," he said. In addition to setting a floor on money market rates, the program is designed "to improve the implementation of monetary policy even when the balance sheet is large. Even if our balance sheet increases significantly further and stays very large for many years, it will be useful to have this facility available to improve monetary policy control."

SEC to Focus on Private Fund Adviser Compliance Procedures in Rule 506(c) Offerings

With general solicitation and general advertising now permitted in Rule 506(c) offerings, private fund advisers should review their policies and procedures to determine whether they are reasonably designed to prevent the use of fraudulent or misleading advertisements. Norm Champ, the Director of the SEC's Division of Investment Management, in remarks before the Practicing Law Institute in New York, said that hedge fund sponsors should also confirm that their practices for verifying accredited investor status meet the new requirements that apply to Rule 506(c) offerings.

In anticipation of the new rules, the SEC created an inter-Divisional group to review the new market for Rule 506(c) offerings, and the practices that will evolve from the new rules. Among other things, he said, the staff will focus on accredited investor verification practices, and develop risk characteristics regarding the types of issuers and market participants that use general solicitation.

Not surprisingly, Champ said that the staff will also focus on performance claims by private funds making Rule 506(c) offerings.

Champ said that the Financial Stability Oversight Council, or FSOC, will use information collected from Form PF to assess systemic risk, and that the SEC will use the information to support its own regulatory programs, examinations and investigations. He emphasized that the information the SEC collects will remain confidential.

Champ said that the Office of Compliance Inspections and Examinations, or OCIE, has established an "outreach" program for newly registered advisers to private funds that will focus on five key areas of risk:

- Marketing
- Portfolio management
- Conflicts of interest
- Safety of client assets
- Valuation

Champ also reminded advisers that insider trading continues to be a major area of focus for the Commission's enforcement staff, and that advisers should review their compliance policies and procedures to ensure that they can adequately detect and prevent insider trading.

While Champ's remarks provided no ground-breaking news, they are a helpful reminder to advisers that the SEC will be watching the development of Rule 506(c) offerings. Now is the opportune time for advisers to review those policies and procedures and whip them into shape before the next regulatory examination.

Affiliated ETFs Mergers Possible Without SEC Order

Can two affiliated ETFs rely on Rule 17a-8 to merge despite representations they made to obtain exemptive relief from the Commission? That's the question addressed in a recent Guidance Update from the Division of Investment Management.

Among the standard representations required by the SEC to grant exemptive relief necessary to operate an ETF is that each ETF will issue and redeem its shares solely in creation units through authorized participants in exchange for a previously published "basket" of instruments and/or cash. This seems to preclude ETFs from relying on Rule 17a-8, since under the Rule an acquired ETF would transfer substantially all of

its assets to an acquiring ETF in return for the acquiring ETF issuing interests (not necessarily in creation units) to the shareholder of the acquired ETFs. Authorized participants would not be part of the transaction at all.

The staff noted that exemptive orders granted to date do not contemplate the merger of affiliated ETFs, and therefore do not address the specifics of a merger relying on the Rule 17a-8 exemption. But, to rely on Rule 17a-8, the ETFs would have to comply with certain disclosure, registration, shareholder approval and other requirements designed to protect the merging ETFs and their shareholders. As a result, the staff would not recommend enforcement to the Commission if two affiliated ETFs proposed to merge in reliance on, and in compliance with, Rule 17a-8.

This relief is welcome, but narrow: other types of corporate reorganizations (including, for example, the conversion of an open-end fund into an ETF) might yield different results.

SEC/FINRA/CFTC Urge Firms to Bolster Business Continuity Plans

The Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and the Commodities Futures Trading Commission's (CFTC) issued a staff advisory on business continuity and disaster recovery planning. This advisory follows a joint review of the effects of Hurricane Sandy, which closed U.S. equity and options markets on October 29 and 30, 2012, and encourages firms to review and enhance their business continuity plans ("BCP") to improve responses to, and reduce recovery time after, significant large-scale events.

Subsequently, the SEC's Office of Compliance Inspections and Examinations issued a Risk Alert regarding business continuity and disaster recovery planning for investment advisers. The Risk Alert focuses on requirements specifically applicable to investment advisers, including Rule 206(4)-7 under the Investment Advisers Act, which requires investment advisers to adopt compliance policies and procedures reasonably designed to ensure compliance with federal securities laws. The staff said that such compliance programs "should include [business continuity plans] because an adviser's fiduciary obligation to its clients includes taking steps to protect clients' interests from risks resulting from the adviser's inability to provide advisory services after, for example, a natural disaster."

To read more specifics about the staff advisory, please see our client alert.

FINRA Raises Concerns About Advertising "Free" and "No-Fee" Services

FINRA raised concerns that broker-dealer advertisements offering "free" and "no-fee" services may be misleading.

FINRA Regulatory Notice 13-23 provides members with guidance regarding disclosure of fees in communications about retail brokerage accounts and Individual Retirement Accounts (IRAs).

FINRA noted that member firms' marketing campaigns regarding retail brokerage accounts and IRAs often emphasize that fees are not charged, and it is concerned that, although broker-dealers emphasize that they do not charge certain fees (for example, rollover fees), they charge other types of fees (for example, fees for opening, maintaining or closing accounts) that might not be disclosed. Failure to disclose fees that will – or may – be charged, particularly in the face of claims that they do not charge fees, may result in member communications that are not fair and balanced, and that could be misleading.

The Regulatory Notice also cautions that communications featuring prominent claims of "free accounts," with only a footnote disclosing other fees that may apply, may violate FINRA Rule 2210. FINRA reminded members that information may be placed in a footnote only if such diminutive disclosure would not inhibit an investor's understanding of the communication.

Delayed Effectiveness of Large Trader Reporting for Certain Broker-Dealers

The SEC's "large trader" rules that apply to clearing firms and certain other firms are effective in November. Thanks to a recent SEC release, however, some firms are getting a two-year compliance reprieve. These firms must develop the procedures and systems for reporting large trader activity within those two years.

The SEC originally established two phases for implementing broker-dealers' obligations. The recent release limits the scope of the obligations under the second phase of the rollout, and creates a third phase that delays the remaining obligations under the rule. The SEC's revised timetable resulted from a request by industry organizations that highlighted implementation challenges related to the recordkeeping and reporting requirements and, in particular, the requirement that broker-dealers obtain and report the execution times of large traders' transactions.

For more information, please see our client alert.

OFR Report: Asset Managers Potentially Threaten Financial Stability

Asset managers create vulnerabilities "that could pose, amplify, or transmit threats to financial stability," according to the Treasury Department's Office of Financial Research (OFR) in a September 2013 report.

The report, "Asset Management and Financial Stability" could significantly affect regulation of entities that oversee about $53 trillion in financial assets. The Financial Stability Oversight Council (FSOC) commissioned the report to help it determine whether and how it should impose prudential standards and supervision, as required by Section 113 of the Dodd-Frank Act. Translation:

FSOC may want to designate asset managers as SIFIs (systemically important financial institutions).

The report concludes that the diversity of investment management activities create vulnerabilities that could have implications for financial stability if they are not properly managed and if accompanied by use of leverage, liquidity transformation or funding mismatches. The risks to the financial system, the report said, include risk taking in separate accounts and reinvestment of cash collateral from securities lending.

The report summarizes the nature and scope of investment management in the U.S., and cites four key factors that make the industry vulnerable to shocks:

- "Reaching for yield" and herding behaviors;
- Redemption risk in collective investment vehicles;
- Leverage, which can amplify price movements and increase the potential for fire sales; and
- Firms as sources of risk.

It also identifies the key channels through which shocks can be transmitted and the impact that fire sales may have on funds and asset management firms, and presents data that purportedly support its claims. The report does not focus specifically on money market funds, and does not address in detail the risks posed by hedge funds, private equity funds and other private funds.

The report states that there are gaps in the data that, if available, could help the FSOC to further its analysis. This data includes information related to separately managed accounts, privately-held asset management firms, use of repurchase agreements and the investment of cash collateral from securities lending.

The report states that the asset management industry, while highly competitive, is also highly concentrated, with the top five mutual fund complexes managing nearly half ($6.6 trillion) of mutual fund assets.

It appears that the report will set the stage for the FSOC to expand its reach and justify SIFI designation of asset managers or funds themselves.

Federal Regulators Tighten Proposals to Require "Securitizers" to Retain Credit Risk

On August 28, 2013, the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Department of Housing and Urban Development, Federal Housing Finance Agency and the SEC approved a second notice of proposed rulemaking to implement Section 941 of the Dodd-Frank Act. Section 941 generally requires that "securitizers" retain at least 5% of the credit risk of any securitized assets.

The initial proposal, issued in April 2011, proposed general methods by which sponsors of asset-backed securities could satisfy the credit risk retention requirement. The reproposal updates these proposals to provide that a collateralized loan obligation (CLO) manager can use any combination of "vertical basis" (5 percent of the par value of each tranche issued by the CLO) and "horizontal basis" (5 percent of the par value of the CLO in a first-loss tranche) to satisfy the risk retention requirement. In addition, the 5 percent would be based on fair value, rather than par value.

The reproposal also introduces a separate risk retention option for open-market CLOs. An "open market CLO" is defined as a "CLO (1) whose assets consist of senior, secured syndicated loans acquired by such CLO directly from the sellers thereof in open market transactions . . . (2) that is managed by a CLO manager, and (3) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO." Under the reproposed rules, "senior, secured term loan tranches within a broader syndicated credit facility would be designated as 'CLO-eligible' at the time of origination if the lead arranger committed to retain 5 percent of each such CLO-eligible tranche, beginning on the closing date of the syndicated credit facility."

PCAOB Report Criticizes Broker-Dealer Audit Deficiencies

For two years, the Public Company Accounting Oversight Board (PCAOB) has been reviewing the work of auditors of broker-dealers, with a view to assessing their work and enabling the PCAOB to develop a permanent program for inspection of broker-dealer audits. In mid-August, the PCAOB issued its second progress report on this program. PCAOB's criticisms of the auditors that it regulates will most likely cause the auditors to beef up their audits in the areas criticized, and broker-dealers are bound to feel the effects in future audits. Broker-dealers should review the second report, the most significant findings of which are summarized in our client alert.

ENFORCEMENT + LITIGATION

SEC Charges Adviser with Misleading Fund Board About Trading Capabilities

The SEC recently charged a registered investment adviser and its principal with misleading a mutual fund's board about the adviser's portfolio management trading capabilities. The SEC said the adviser misled the board at two meetings when the board considered and approved the investment advisory contract between the fund and the adviser. The SEC also claimed that, based on these misrepresentations, the fund misrepresented its investment strategy in its registration statement.

Section 15(c) of the 1940 Act requires the board of directors of a mutual fund annually to evaluate and approve the fund's advisory agreement. Section 15(c) also requires an investment adviser to provide the board with such information as may reasonably be necessary to evaluate the contract. Here, the adviser claimed it employed algorithmic high speed currency trading but, according to the SEC, the adviser did not possess any algorithms or computer models capable of the currency trading described to the board. Rather, the SEC said, at the time the fund commenced operations, an individual trader controlled currency trading using a technical, rules-based analysis and "her own intuition."

The SEC claims that the adviser responded to a written request from the board's legal counsel with a PowerPoint presentation describing "a currency arbitrage overlay" involving an algorithmic trading program. Based on this representation and an in-person presentation, the SEC said, the board approved the fund's contract with the adviser and the proposed fee structure for the adviser's services.

Pending a change of control of the adviser, the adviser made a second submission to the board, containing essentially the same claims about its trading capacities, the SEC said. The adviser also used the second submission to justify a fee increase because the fund's investment strategy "required more work to implement" than originally anticipated. The board approved a new contract between the fund and the adviser with the proposed higher fees.

Based on information provided by the adviser, the board also approved allegedly inaccurate prospectus disclosure. The prospectus disclosure that the adviser's principal reviewed claimed that "[u]sing high frequency market data, the adviser has created models of the [foreign exchange] market that it believes are able to analyze the price formation process of exchange rates in real-time."

The SEC charged that the adviser and its principal violated Section 15(c) of the 1940 Act and Section 34(b) of the 1940 Act, which makes it unlawful for any person to make an untrue statement of a material fact in a fund's registration statement or to omit to state in the prospectus a fact necessary in order to prevent the statements, in light of the circumstances, from being materially misleading. The SEC also charged that the respondents violated the anti-fraud provisions of the Investment Advisers Act.

Federal Court Questions Whether "Classic Theory" of Insider Trading Applies to Mutual Fund Shares

A federal court of appeals recently held out the possibility that insider trading prohibitions – at least under the classic theory – do not apply to mutual fund redemptions.

The U.S. Court of Appeals for the Seventh Circuit recently reversed and remanded a summary judgment granted to the SEC in a case alleging that a mutual fund's CCO improperly redeemed fund shares while in possession of material non-public information. The court directed the district court to address the novel issue of whether Section 10(b) of the Securities Exchange Act of 1934 applies to insider trading in mutual fund shares.

A key consideration in any insider-trading case is whether the non-public information is material. In this case, the issue may turn on the level of public information that was available to shareholders. Mutual funds, their service providers and their boards should therefore consider not only their own disclosure obligations, but also other information available to the public when considering whether their risk disclosure is adequate.

Additional information about the case is available in our client alert.

SEC Sanctions Portfolio Manager for Misleading CCO

In August, the SEC brought its first action for misleading and obstructing the work of a CCO. The SEC found that a portfolio manager deliberately altered documents and misled the firm's CCO in an attempt to hide his violations of the adviser's code of ethics.

Rule 17j-1(d) under the 1940 Act requires that employees of an adviser with access to a fund's portfolio must timely submit reports regarding their personal trading in securities held or to be acquired by the fund. Registered investment advisers must adopt a code of ethics including policies for compliance with Rule 17j-1. In this case, the adviser's code of ethics required that portfolio managers pre-clear their personal securities trades.

The SEC said that the portfolio manager failed to pre-clear or report hundreds of personal securities transactions, including transactions in securities held in certain funds managed by the adviser. The SEC also said that the portfolio manager submitted false quarterly and annual reports, falsely certified his annual compliance with the firm's code of ethics and took active steps to conceal his trading. The SEC sanctioned the portfolio manager for violations of Rule 17j-1. The portfolio manager was also sanctioned for violations of Rule 38a-1(c), which prohibits an officer, director or employee of a fund or its adviser from taking any action to manipulate or mislead a fund's CCO.

SEC Sanctions Adviser for Pushing Class A Shares when Investors Qualified to Buy Institutional Class Shares

On October 2, 2013, the SEC sanctioned an investment adviser and its owner for failing to seek best execution and breaching their fiduciary duty in selecting mutual fund share classes for three advisory clients. The case is one of several arising out of the SEC staff's investigation into governance and disclosure practices related to a "turnkey" mutual fund trust. It underscores, once again, the regulator's continued focus on the operations of fund complexes that utilize this type of structure.

According to the SEC's order instituting settled administrative proceedings, the investment adviser was the adviser to a registered fund-of-funds and two private funds ("Funds"). The SEC found that, in violation of its fiduciary duty under Section 206(2) of the Investment Advisers Act, the adviser arranged for the Funds to purchase "Class A shares" that paid ongoing Rule 12b-1 distribution fees to a broker-dealer affiliate of the adviser, even though the Funds were eligible to purchase lower-cost institutional class shares. The SEC found that the adviser's actions violated Section 206(4) of the Advisers Act, as well as Rule 206(4)-8, because they were inconsistent with the disclosure in the Funds' offering documents. The order also found that the adviser violated certain antifraud provisions of the federal securities laws, including Section 34(b) of the Investment Company Act of 1940 and Section 17(a)(2) of the Securities Act of 1933.

The affiliated broker-dealer was also found to have charged commissions exceeding usual and customary brokerage commissions for the execution of transactions in ETF shares held by the fund-of-funds, in violation of Section 17(e)(2)(A) of the 1940 Act. The SEC said that the procedures adopted by the fund-of-funds' board were not reasonably designed to ensure that the commissions charged were reasonable and fair because they did not require any investigation into commissions actually charged by other broker-dealers for similar transactions.

As a result of the adviser's actions, the Funds unnecessarily paid approximately $2.5 million in Rule 12b-1 fees to the affiliated broker-dealer over a 10-year period. In June 2010, following discussions with the SEC staff, the adviser refunded approximately $1.8 million in Rule 12b-1 fees to the fund-of-funds.

Without admitting or denying the charges, the investment adviser agreed to disgorge an additional $685,000 in Rule 12b-1 fees. In addition, the adviser and its principal agreed to pay $267,000 in interest and $100,000 in penalties, and consented to censures and cease-and-desist orders.

Court Tosses ETF Securities Lending Fee Case

A federal district court in Tennessee dismissed a case brought by two union pension funds claiming that securities lending fees paid by an ETF to its adviser's affiliate violated the adviser's fiduciary duty under Section 36(b) of the 1940 Act.

The defendants argued that the SEC issued an order exempting the adviser from the prohibitions of Section 17(a) of the 1940 Act, and thus payments to an affiliated securities lending agent were appropriate.

The SEC's order required the ETFs to follow specific procedures to ensure that fees paid to the securities lending agent were fair and reasonable in light of the usual and customary charges imposed by others for services of the same nature and quality.

Section 36(b) of the 1940 Act "imposes a fiduciary duty on investment advisors with respect to compensation and grants shareholders an express private right of action to seek relief from breaches of fiduciary duty resulting in excessive compensation." Like many sections of the 1940 Act, however, Section 36(b) includes exceptions to the general rule. One such exception, Section 36(b)(4), provides that Section 36(b) "shall not apply to compensation or payments made in connection with transactions subject to [Section 17 of the 1940 Act], or rules, regulations, or orders thereunder."

The court said that, because the SEC had expressly granted the ETFs an exemptive order ***under*** Section 17(b) of the 1940 Act, "[b]y the plain text of Section 36(b)(4), the [...] Order removes the transaction at issue from scope of Section 36(b)." In addition, the court noted that "Section 36(b)(4) of the [1940] Act makes it clear that rights and remedies under section 17 and section 36(b) are intended to be mutually exclusive."

The court also quickly dismissed the plaintiffs' claims under Section 47(b) and Section 36(a) of the 1940 Act, finding no private right of action under either section.

The court dismissed the case without prejudice, and the plaintiffs have until September 17, 2013, to file a motion for leave to amend the complaint. Given the very clear language used by the court, however, it may be unlikely that the plaintiffs will be able to resurrect the Section 36(b) claim with new facts. It remains to be seen if the plaintiffs can develop a new, and actionable, theory.

SEC Sanctions Non-U.S. Bank for Failure to Register as a Broker-Dealer or Investment Advisers when Existing Clients Relocated to the United States

The SEC recently reminded non-U.S. broker-dealers and advisers with clients that relocate to the U.S. that they may be required to register under the U.S. securities laws. On July 31, 2013, the SEC sanctioned a Netherlands-based bank for failure to register as an investment adviser under the Investment Advisers Act or as a broker-dealer under the Securities Exchange Act, without qualifying for an exception or exemption from such registration requirements.

The SEC said that the bank and some of its retail and private banking affiliates located outside of the U.S. "regularly solicited, effected transactions in securities with and for, and, for compensation, provided investment advice to, persons in the United States." In many cases, the services were provided to existing foreign brokerage clients who relocated to the U.S. on a permanent basis. The SEC said that the bank did not maintain procedures sufficient to prevent its retail and private banking affiliates from providing such services to U.S. persons. Moreover, the SEC said that the bank did not maintain adequate training

programs to ensure that its personnel knew that continuing to provide such services to clients that relocated to the U.S. on a non-temporary basis constituted a violation of U.S. securities laws.

The SEC said that the bank became aware of the conduct at issue in 2004, but failed to adequately address it. The bank did not self-report the issues until 2008.

The bank agreed to conduct a thorough review of its commercial and merchant bank investment accounts, as well as commercial investment accounts within its retail and private banking affiliates, to determine if any of these accounts are held by U.S. persons. The bank was ordered to disgorge fees earned on the accounts already identified, plus pre-judgment interest, and to pay a civil money penalty of $2 million.

FINRA Enforcement Action Stresses Procedures for Due Diligence on Private Placements of Investment Funds

In a recent formal disciplinary proceeding, FINRA reaffirmed member firms' obligations to maintain adequate procedures for conducting due diligence on private placements, including the review of sales materials, and systems for monitoring suitability. In this case, an unaffiliated broker-dealer sold private placements of investment funds under Regulation D of the Securities Act of 1933 ("Reg D"). The firm assigned responsibility for conducting due diligence on private placements, and for approving private placements for sale, to a vice president who was also responsible for reviewing third-party due diligence reports, formulating recommendations for private placements and monitoring the suitability of purchases of such private placements.

In 2004, the vice president approved the private placement of an investment fund that was operated by the son of a registered representative of the firm. Over the course of the next three years, the firm allegedly ignored red flags regarding the fund's holdings and did not reevaluate the appropriateness of retaining the fund on the firm's approved list. FINRA charged that the vice president also approved a second private investment fund operated by the same sponsor without considering issues raised about the first fund or reviewing third-party due diligence reports regarding the new fund.

FINRA found that the firm had inadequate procedures for due diligence on private placements and that checks and balances on the vice president's activities were also inadequate since he was simultaneously recommending private placements and reviewing the suitability of those recommendations.

FINRA found that the firm's written supervisory procedures related to sales materials were inadequate. The firm allowed representatives to use sales materials created by fund sponsors, subject to pre-approval by the firm's compliance department, but relied solely on its registered representatives to forward any sales materials to the compliance department for review. FINRA said that the broker-dealer lacked a procedure to track the private placement materials received by registered representatives or to ensure that they were not passed on to customers prior to compliance review.

FINRA reminded member firms that they have a duty to conduct a reasonable investigation concerning securities offered under Reg D – including private funds – and the issuer's representations about such securities. Failure to comply with this duty can constitute a violation of the anti-fraud provisions of the federal securities laws.

As we move into a new era of general solicitation for private placements, FINRA member firms should carefully consider their obligations under FINRA rules and the anti-fraud provisions of the federal securities laws and ensure that their supervisory procedures are updated to address their due diligence obligations and their oversight of sales materials provided to their customers. For more information, see our recent client alert.

FINRA Sweep of Firms' Compliance with Prospectus Delivery Requirements

FINRA recently engaged in a "stealth sweep" of firms' untimely deliveries of mutual fund and ETF prospectuses resulting in formal disciplinary proceedings against twelve firms since 2011, and a total of over $5 million in fines. FINRA has not, however, posted the "Targeted Examination Letter" that initiated the sweep, has not issued any guidance about the sweep's findings beyond the press release that announced the first of the eight disciplinary proceedings, nor done anything else to publicize the results and lessons of this initiative to the broker-dealer community.

In its enforcement actions, FINRA sanctioned the firms for failures to provide prospectuses within three business days of trade date, as required by Rule 15c6-1, and to establish policies to monitor and ensure timely delivery. FINRA found that each firm had delivered between 2,500 and 934,074 prospectuses late for review periods of between one year and two-and-a-half years. Tellingly, FINRA found deficiencies in firms using third-party service providers to deliver the prospectuses as well as firms that deliver the prospectuses using their own representatives.

Many broker-dealers contract with third-party service providers to mail prospectuses to new customers. The firms cited by FINRA failed to supply the service provider with enough copies of their prospectuses to ensure that there was always a copy available to mail when needed. Those firms also failed to take advantage of the service provider's print-on-demand service, pursuant to which the service provider can print a copy of a prospectus when there is no copy available. FINRA also cited the failure to adequately obtain and review reports from the service provider regarding the timeliness of prospectus delivery and a failure to respond to the deficiencies

highlighted in those reports, as evidence that the firms were not fulfilling their obligation to establish a system that would ensure timely prospectus delivery.

For more about these cases, and a set of practical suggestions for complying with the prospectus delivery rule, please see our client alert.

Second Circuit Upholds Dismissal of Case Alleging Disclosure Violations by Leveraged ETFs

The U.S. Court of Appeals for the Second Circuit upheld the dismissal by a lower court of investors' claims that certain ETF prospectuses failed to adequately disclose the risk of significant losses over an extended period of time.

In a July 22, 2013 decision, the court dismissed claims that certain ProShares ETF prospectuses failed to warn about the possible magnitude and probability of loss in investments held for more than a day, even when investors correctly predicted the overall direction of the ETFs' underlying index.

The ProShares ETFs are designed to provide a return equal to a specified multiple of an index or other benchmark, or the inverse return of the index or benchmark, for a single day, as measured from one NAV calculation to the next. Due to the compounding of daily returns, the ETF's returns over periods other than one day likely will differ in amount and possibly direction from the target return for the same period. The compounding effect can be exacerbated when the ETF is "geared," or leveraged, to produce a multiple of the return.

In this case, during a period of unusual market volatility in 2006-2009, certain ultra-short ETFs experienced significant losses, even when the performance of the underlying index would indicate a potential gain. The plaintiffs claimed that they lost money after holding their ETF shares for more than one day and that ProShares violated Sections 11 and 15 of the Securities Act of 1933 because it failed to disclose the risks of holding the shares for longer than one day.

The court disagreed, stating "no reasonable investor could read these prospectuses without realizing that volatility, combined with leveraging, subjected that investment to a great risk of long-term loss as market volatility increased." The court also rejected the plaintiffs' claims that the prospectuses should disclose with specificity the level of risk under various market scenarios "ProShares cannot be expected to predict and disclose all possible negative results across any market scenario," the court said.

Notably, the court rejected the plaintiffs' argument that by including "corrective disclosure" after the lawsuit was filed to enhance risk disclosure, the ETFs effectively acknowledged that the original disclosure was defective: "We have previously noted that where the 'quality of [a] disclosure could have been improved[,] the advisability of revision does not render what was done deceptive or misleading.'"

Disclosure: Morrison & Foerster represents the independent trustees of ProShares.

TIDBITS

- As previously reported, the U.S. Supreme Court granted *certiorari* in a case that considers whether an employee of a privately-held contractor to a public company is protected from retaliation by the whistleblower provision of the Sarbanes-Oxley Act. Oral argument in that case has been set for November 12, 2013.
- The SEC recently awarded more than $14 million to a whistleblower for information leading to an SEC enforcement action that recovered substantial investor funds. In a recent speech, Stephen Cohen, the Associate Director of the SEC's Division of Enforcement, assured his audience that there are more whistleblower awards to come.
- Cohen's remarks to the Society of Corporate Compliance and Ethics also sought to reassure CCOs that the enforcement staff is their partner "in ensuring that integrity and professionalism are woven into the very fabric of corporate culture." We discuss Cohen's remarks on the BD/IA Regulator blog.
- In a recent speech to the Securities Enforcement Forum, SEC Chair Mary Jo White said that one of the goals of the SEC's enforcement program is to be everywhere, "pursuing all types of violations of our federal securities laws, big and small." We have some thoughts about that, which can be found in this recent blog post.
- Jane Jarcho was named head of the SEC's Investment Adviser/Investment Company (IA/IC) examination program. She has been the Acting National Associate Director of the IA/IC examination program since March and previously served as Associate Director of the IA/IC examination program in the SEC's Chicago regional office.
- Other SEC staff changes occurring over the last several months include changes to the Directors of the Boston, Salt Lake City and Philadelphia regional offices, the appointment of a new Chief Litigation Counsel, and the appointment of a new Deputy Chief Accountant.
- Two new SEC Commissioners were sworn in during August. Michael Pinowar was sworn in on August 15, 2013, replacing former Commissioner Troy Paredes. He was previously the chief Republican economist for the U.S. Senate Committee on Banking, Housing and Urban Affairs where he worked on various matters overseen by the SEC. Kara Stein was sworn in on August 9, 2013, replacing former Commissioner Elisse Walter. She was previously Legal Counsel and Senior Policy Advisor to Sen. Jack Reed, and Staff Director of the Senate Banking, Housing, and Urban Affairs Committee's Subcommittee on Securities, Insurance, and Investment.

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This memorandum summarizes recent legal and regulatory developments of interest. Because of the generality of this newsletter, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. The views expressed herein shall not be attributed to Morrison & Foerster, its attorneys or its clients.

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