Investment Services Regulatory Update

October 1, 2012

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Proposes Rules to Implement JOBS Act Provisions for Elimination of Prohibitions Against General Solicitation in Private Offerings

On August 29, 2012, the SEC proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act in order to implement Section 201(a) of the Jumpstart Our Business Startups Act ("JOBS Act"). Section 201(a)(1) of the JOBS Act directed the SEC to eliminate the prohibition against general solicitation in security offerings made under Rule 506 provided that all purchasers of the securities are accredited investors. Section 201(a)(2) of the JOBS Act directed the SEC to revise Rule 144A(d)(1) to provide that securities to be sold pursuant to Rule 144A may be offered through a general solicitation so long as the final purchasers are qualified institutional buyers ("QIBs").

The SEC has proposed new Rule 506(c), which would permit general solicitation in security offerings made under Rule 506 provided that: (1) the issuer takes reasonable steps to verify that purchasers are accredited investors, (2) each purchaser qualifies or the issuer reasonably believes that each purchaser qualifies as an accredited investor at the time of the sale of securities, and (3) all terms and conditions of Rule 501 and Rules 502(a) and (d) are satisfied. The SEC did not propose specific verification methods to be used by issuers, but recommended that issuers consider the following factors when determining the reasonableness of the steps taken to verify that a purchaser is an accredited investor: (a) the nature of the purchaser and type of accredited investor that the purchaser claims to be, (b) the amount and type of information that the issuer has about the purchaser, and (c) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as the minimum investment amount. For privately offered funds, including hedge funds, venture capital funds and private equity funds, the SEC stated that conducting a general solicitation pursuant to proposed Rule 506(c) would not cause an offering to be deemed a public offering for purposes of relying on the exclusions from the definition of investment company set forth in Sections 3(c)(1) and 3(c)(7) of the 1940 Act.

Comments on the proposal are due by October 5, 2012.

SEC and CFTC Adopt Further Definitions of Swap and Related Terms

On July 18, 2012, the SEC and CFTC adopted joint rules further defining the term "swap" and other related terms as required by the Dodd-Frank Act as part of the new regulatory framework for swaps. The rules provide clarification of the types of agreements, contracts and transactions that are considered "swaps," which are regulated by the CFTC, and those that are considered "security-based swaps," which are regulated by the SEC. The rules also address "mixed swaps," which are regulated by both the SEC and CFTC, as well as "security-based swap agreements," which are regulated by the CFTC but over which the SEC has anti-fraud authority. The rules

become effective on October 12, 2012. The adoption of the rules or their effectiveness also trigger the effective or compliance dates of certain other SEC and CFTC rules that reference the final swap definitions, including amended CFTC Rule 4.5 regarding the registration and compliance obligations of commodity pool operators and commodity trading advisors.

CFTC Extends Compliance Date for CPO and CTA Registration

On July 13, 2012, the CFTC's Division of Swap Dealer and Intermediary Oversight granted no-action relief exempting certain commodity pool operators (CPOs) and commodity trading advisors (CTAs) from CFTC registration through December 31, 2012. Pursuant to the no-action letter, eligible advisers and sponsors of new registered investment companies and certain privately offered pools launched after July 13, 2012 will not be required to register as CPOs or CTAs under amended CFTC Rule 4.5 or Rule 4.13(a)(4) until December 31, 2012. In order to rely on the no-action relief, eligible advisers and sponsors must maintain compliance with the substantive provisions of the letter (which parallel the provisions of former Rules 4.5 and 4.13(a)(4)) and file a claim with the CFTC prior to engaging in business that would otherwise require registration.

OTHER NEWS

Mutual Fund Directors Forum Issues Practical Guidance for Fund Directors on Oversight of Proxy Voting

In September 2012, the Mutual Fund Directors Forum issued a report providing an overview of proxy voting practices in the fund industry and offering guidance to fund boards regarding the implementation and oversight of the proxy voting process. According to the report, boards should consider the following matters in developing a proxy voting process for the funds they oversee:

- what voting responsibilities, if any, to delegate to another party, such as the fund adviser or a third party proxy service firm;
- whether and how fund investment professionals should be involved in the proxy voting process;
- the process for overriding a proxy voting guideline, including the information to be considered in approving an override and who should be involved in the decision-making process;
- whether different funds in the same complex should be allowed to vote differently on the same matter (i.e., split voting);
- how and when funds should engage with portfolio companies on proxy votes;
- how to identify and address conflicts of interest that may arise in the proxy voting process; and

- for funds that engage in securities lending, how to handle proxy voting for loaned securities.

After setting the proxy voting process, boards are required to oversee the process on an ongoing basis as part of their fiduciary duties. In fulfilling their oversight responsibilities, the report suggests that boards should consider the following matters:

- whether the proxy voting process should be overseen by the whole board or delegated to a separate board committee;

- how often the board should review the proxy voting process (which should be at least annually); and

- what information and reports the board should receive regarding the proxy voting process, including reports regarding conflicts of interest, proxy voting overrides and votes against management.

The report is available at:
http://www.mfdf.org/images/uploads/newsroom/Oversight_of_Proxy_Voting.pdf.

PCAOB Adopts Standard on Auditor Communications with Audit Committees

On August 15, 2012 the PCAOB adopted Auditing Standard No. 16 (AS 16), *Communications with Audit Committees*, replacing and expanding the PCAOB's interim auditing standards AU sec. 380, *Communication with Audit Committees*, and AU sec. 310, *Appointment of the Independent Auditor*. AS 16 specifies the communications an auditor must make to audit committees and encourages "effective two-way communication between the auditor and the audit committee." The new standard requires, among other things:

- *Engagement.* Auditors must establish an understanding of the terms of the audit engagement with the audit committee. The terms of the engagement must be recorded in an engagement letter executed on behalf of the company with the audit committee's acknowledgement and agreement.

- *Communications*. AS 16 retains many of the communications requirements in AU sec. 380 and also incorporates new communications requirements to provide the audit committee with additional information. Pursuant to AS 16, auditors are required to communicate:

    - certain matters regarding the company's accounting policies, practices and estimates;

    - the auditor's evaluation of the quality of the company's financial reporting;

    - information related to significant unusual transactions;

- the auditor's views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters;

- an overview of the overall audit strategy, including timing of the audit, significant risks identified by the auditor and significant changes to the planned audit strategy or identified risks;

- information about the nature and extent of specialized skill or knowledge needed in the audit;

- the basis for the auditor's determination that he or she can serve as principal auditor if significant parts of the audit will be performed by other auditors;

- concerns regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective;

- difficult or contentious matters for which the auditor consulted outside of the engagement team;

- the auditor's evaluation of going concern;

- departure from the auditor's standard report; and

- other significant matters, including complaints or concerns regarding accounting or auditing matters that come to the auditor's attention during the audit.

- *Timing*. Auditors must make the required communications to the audit committee before the auditor issues its audit report.

- *Inquiries*. Auditors must make additional inquiries of the audit committee to address whether the audit committee is aware of matters relevant to the audit, including violations or possible violations of laws or regulations.

If approved by the SEC, AS 16 will be effective for audits of fiscal years beginning on or after December 15, 2012.

PCAOB Issues Guidance on Inspection Process

On August 1, 2012, the PCAOB issued guidance regarding the PCAOB's audit firm inspection process. The guidance is intended to assist audit committees in understanding the PCAOB's inspections of audit firms and in gathering information from their auditors about those inspections. The release provides an overview of the PCAOB inspection process and explains the types of findings contained in an inspection report. Part I findings are made public by the PCAOB and describe audit deficiencies where inspection staff found that the auditor failed to gather sufficient audit evidence to support an audit opinion. Part II findings describe deficiencies found in the audit firm's overall system of quality control that lead the PCAOB to doubt that the system provides reasonable assurance that professional standards are met. Part II findings may not be made public by the PCAOB unless the PCAOB determines that an audit firm failed to remediate the findings within twelve months of the issuance of the PCAOB's inspection report; however, the audit firm may voluntarily release the Part II findings contained in its inspection report.

The release identifies the following possible questions that an audit committee may wish to ask an audit firm about a PCAOB inspection:

- Was the company's audit selected for PCAOB inspection?
- Did the PCAOB identify deficiencies in other audits that involved auditing or accounting issues similar to issues presented in the company's audit?
- What were the audit firm's responses to the PCAOB findings?
    - The PCAOB cautions that in considering an audit firm's responses to inspection findings certain responses "should be viewed with skepticism." These responses include those that might minimize the significance of a PCAOB finding, such as that there was "just a documentation problem" or "a difference in professional judgment."
- What topics were included in Part II findings?
    - The PCAOB notes that audit firms may be reluctant to share the details of Part II findings, in which case an audit committee may want to ask for certain generic information about Part II findings, including (1) what changes the audit firm is making to address the findings, (2) whether the PCAOB has provided any initial indications that the audit firm's remediation efforts may not be sufficient and (3) what final determinations the PCAOB has made about the audit firm's remediation efforts.

The PCAOB release is available at:
http://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf.

LITIGATION AND ENFORCEMENT ACTIONS

Federal Court Vacates and Remands the CFTC's Position Limits Rule

On September 28, 2012, the U.S. District Court for the District of Columbia vacated and remanded back to the CFTC, the CFTC's Position Limits Rule, which was set to take effect on October 12, 2012. The CFTC adopted the rule in November 2011 pursuant to the provisions of Dodd-Frank in an effort to place restrictions on speculative trading by setting position limits on derivatives tied to 28 physical commodities such as energy products like oil. Previously adopted restrictions, such as position limits covering agricultural commodities, will stay in effect. The court granted a motion for summary judgment in favor of the plaintiffs, the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association, finding that the CFTC did not make a showing that it found position limits were "necessary" and "appropriate" to "diminish, eliminate, or prevent" the burden of excessive speculation on interstate commerce as described in Section 6a(a)(1) of the Commodity Exchange Act. The court further went on to state that Dodd-Frank "clearly" and "unambiguously" required the CFTC to conclude that the position limits were necessary before imposing them. The CFTC must now decide whether to redraft the Position Limits Rule or seek an appeal. In its decision, the court declined to opine on the aggregation provisions of the Position Limits Rule. Because the entire rule will be vacated, the CFTC may modify and finalize aggregation rules on remand.

SEC Settles Charges Against Adviser for Failing to Disclose Revenue Sharing Payments and Other Conflicts of Interest

On September 6, 2012, the SEC settled charges against Focus Point Solutions, Inc. (FP), a registered investment adviser and provider of custodial support and "turn-key" asset management services, together with its related adviser, The H Group, Inc. and their principal, Christopher Keil Hicks with violating federal securities laws for failure to disclose material conflicts of interest in three areas of their advisory business. The SEC alleged that FP willfully violated Sections 206(2) and 207 of the Advisers Act by failing to disclose to the approximately 60 investment advisers that engaged FP to provide, among other things, proprietary asset allocation models and investment recommendations, that a registered broker-dealer agreed to pay FP a certain percentage of every dollar that FP's clients invested in certain "no transaction fee" mutual funds (NTF funds) offered by the broker and that FP had an incentive to recommend NTF funds over other investments that would not generate revenue for FP. The SEC also alleged that FP willfully violated Section 15 of the 1940 Act by misleading the trustees of Northern Lights Fund Trust, with respect to the Generations Multi-Strategy Fund, for which FP was seeking approval to become the sub-adviser, by representing that it did not expect to receive payments or benefits from the fund other than the fee paid pursuant to the sub-advisory agreement. However, according to the SEC, the fund's primary adviser, a firm under common control with FP and The H Group, agreed to pay FP approximately 15 basis points, separate and apart from the sub-advisory fee. The SEC's order further alleges that Mr. Hicks willfully aided and abetted each of FP's violations. The SEC's order states that the vast majority of the fund's

shareholders were clients of The H Group, which had recommended the fund to many of its clients. Finally, the SEC alleged that The H Group willfully violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-6 thereunder by voting client proxies in favor of the proposal to approve FP as the fund's sub-adviser, despite its related adviser having a financial interest in the outcome of the vote and a requirement under The H Group's proxy voting policy that, in circumstances involving a conflict of interest, the proxies be referred to the investors themselves to vote on the proposal.

As a result of the SEC's findings, FP agreed to disgorge $900,000 in ill-gotten gains, pay a $100,000 penalty and hire an independent consultant to conduct comprehensive compliance reviews of the firm. The H Group and Mr. Hicks each agreed to pay a $50,000 penalty. The two firms and Mr. Hicks also agreed to a censure and to cease and desist from committing or causing any violations and any future violations of the foregoing provisions.

SEC Charges Former Adviser to NASCAR Mutual Fund with Securities Law Violations

On August 10, 2012, the SEC charged David W. Dube and his investment advisory firm, Peak Wealth Opportunities LLC, with various violations of the federal securities laws in connection with the firm's service as investment adviser to StockCar Stocks Mutual Fund, Inc. The order initiating administrative and cease-and-desist proceedings against Mr. Dube and Peak Wealth alleged that Mr. Dube and Peak Wealth failed to: (1) provide the fund's board with information necessary for the board to evaluate the nature, quality and costs of Peak Wealth's services in connection with the board's review of the fund's advisory agreement; (2) file annual amended Forms ADV and make, keep and furnish true, accurate and current books and records for Peak Wealth's advisory business, including financial statements, bank records, trial balances and income and expense statements; and (3) withdraw its SEC registration as a registered investment adviser following the board's termination of Peak Wealth's advisory contract with the fund, which was the firm's sole client. The SEC's order stated that, despite repeated requests from the board in March and May 2010, Peak Wealth failed to provide the board with any requested documents for purposes of the board's review of the advisory agreement. As a result, in June 2010, the board terminated Peak Wealth's advisory agreement with the fund and voted to liquidate and deregister the fund. The SEC's order also stated that Peak Wealth failed to produce financial records in response to eight different requests for financial records from SEC examination staff during an examination of Peak Wealth and the fund in 2010. Finally, according to the SEC's order, Peak Wealth neither filed a Form ADV-W (after it became ineligible for SEC registration following the termination of the advisory agreement with the fund) nor annually amended Form ADV for its fiscal years ended September 30, 2009, 2010 and 2011.

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This Regulatory Update is only a summary of recent information and should not be construed as legal advice.