Investment Services Regulatory Update

November 1, 2012

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Proposes Extending Temporary Rule Regarding Adviser Principal Trades

On October 9, 2012, the SEC proposed an amendment to Rule 206(3)-3T to extend the Rule's expiration date by two years until December 31, 2014. The temporary Rule provides an alternative method for investment advisers who are also broker-dealers to comply with Section 206(3) of the Advisers Act, which requires an adviser to obtain client consent prior to engaging in a principal transaction with the client. Rule 206(3)-3T was initially adopted on September 24, 2007 in response to a federal appeals court decision that vacated Rule 202(a)(11)-1 of the Advisers Act, which allowed registered broker-dealers to offer fee-based accounts without being regulated as investment advisers. On December 28, 2010, the SEC extended Rule 206(3)-3T until December 31, 2012. Pursuant to Rule 206(3)-3T, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides written prospective disclosure regarding the conflicts arising from principal trades; (3) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; (4) provides the client with an annual report on all principal transactions with that client; and (5) sends confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC proposed no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension was necessary to provide sufficient protection to advisory clients while the SEC analyzes the findings and recommendations from its study of the standards of care applicable to broker-dealers and investment advisers as required by Section 913 of the Dodd-Frank Act and also as it obtains data and economic analysis related to standards of conduct and enhanced regulatory harmonization of broker-dealers and investment advisers.

Comments on the proposal are due by November 13, 2012.

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.

OTHER NEWS

IDC Issues White Paper on Board Oversight of Exchange-Traded Funds

In October 2012, the Independent Directors Council issued a white paper providing a general overview of exchange-traded funds (ETFs) structured as open-end funds and discussing various topics directors may wish to consider in connection with their oversight of ETFs. The white paper states that ETF directors oversee the management and operations of ETFs under the same regulatory framework as other registered open-end funds, but ETFs themselves may be subject to additional requirements imposed by the exchange on which the ETF is listed or pursuant to SEC exemptive relief received by the ETF. The paper highlighted the following six topics and related information that directors may wish to consider in connection with their oversight of existing ETFs or in contemplation of approving new ETFs:

The Exemptive Process for ETFs. In order to operate, ETFs require exemptive relief from certain provisions of the 1940 Act to allow them to create and redeem creation units at net asset value only with authorized participants, while also allowing their shares to trade in the secondary market at negotiated prices. Directors may want to consider the time required to obtain such relief, the type of exemptive relief sought, the conditions to the exemptive relief, the processes employed to ensure compliance with such conditions and whether the exemptive relief imposes any specific responsibilities on the directors.

ETF Design and Investment Objective. Directors should consider whether the ETF is an index-based ETF or an actively-managed ETF. For index-based ETFs, directors may consider how the index was selected and the due diligence performed on the index provider, whether the ETF will seek to replicate the index or use a representative sampling technique and what regulatory limitations may be imposed on the ETF, such as diversification requirements, all of which may cause the ETF not to track its index as closely as it would without such techniques or restrictions. For actively-managed ETFs, directors may consider anticipated portfolio turnover and processes employed to minimize trading ahead of the ETF.

Additionally, directors should consider whether authorized participants will be able to purchase and redeem creation units in-kind, for cash or both. Generally, because of the use of in-kind transactions and secondary market trading, many boards decide not to adopt a policy to detect and deter frequent trading and market timing of ETF shares. If creation units may be purchased or redeemed in cash, though, a board may determine to adopt such a policy.

ETF Contractual Relationships. In addition to typical fund service providers, ETFs also work with exchanges and index providers. With respect to the ETF's primary listing exchange, directors may consider the costs of listing on such exchange, applicable listing standards and any responsibilities imposed on the directors, information about the designated market maker and, if listing on a foreign exchange, any additional responsibilities and potential liabilities of directors under the laws of that jurisdiction. As to index providers, directors may consider the terms of the licensing agreement, including costs, exclusivity and duration, as well as contingency plans if the adviser is unable to renew the license.

Trading of ETF Shares. Directors may wish to receive regular reports as to premiums and discounts, bid-ask spreads, tracking error, correlation and trading volume. For any persistent trading issues, directors should consider whether there are any steps that should be taken to address the issues.

Portfolio Management and Trading of Underlying Securities. For index-based ETFs, directors should review and monitor tracking error and the causes of such tracking error and the effectiveness of any sampling strategy. Additionally, if ETFs have investment objectives similar to other funds in the fund complex, directors should consider the policies in place to address potential conflicts of interest between the funds.

Disclosure. ETF disclosure is similar to that for other funds, with a few exceptions, including that ETFs must disclose (1) that their shares are traded on an exchange and may not be purchased or redeemed from the ETF except in creation units by authorized participants, (2) that ETF shares may trade at a premium or discount to net asset value and the number of days ETF shares traded at a premium or discount, and (3) their portfolio holdings or creation basket composition daily. Directors also should review the adequacy of the ETF's disclosure in regards to causes of tracking error, use of

derivatives and securities lending. Directors may also consider the process for ensuring that marketing and web materials are consistent with the ETF's registration statement.

The white paper is available at: http://www.ici.org/idc/pubs/white_papers.

Professional Organizations Issue Guidance to Audit Committees Regarding Evaluation of External Auditors

In October 2012, a group of seven professional organizations, including the Independent Directors Council and the Mutual Fund Directors Forum, issued a report setting forth an evaluation tool for audit committees to use in assessing a company's external auditor. The report notes that audit committees have direct responsibility for overseeing a company's financial reporting process and controls and for hiring and overseeing a company's external auditor, and states that, as a part of this responsibility, audit committees should annually evaluate their external auditors in order to make an informed recommendation to the board as to whether it should retain the auditor. The report provides guidelines and recommendations for audit committees to follow when conducting evaluations of external audit firms. The report states that such evaluations should include an assessment of the following areas:

- the quality of services and sufficiency of resources provided by the audit firm, the auditor's engagement team and the engagement partner;

- the communication and interaction between the audit committee and the auditor, including the frequency, completeness and openness of such communication; and

- the independence, objectivity and professional skepticism of the auditor as it relates to the auditor's ability to evaluate and challenge, when necessary, the methods, assumptions and disclosures used by management in its financial reporting.

The report provides sample questions for audit committees to use in assessing each of the above elements. In addition, the report encourages audit committees to obtain observations from management, internal audit staff and other employees of the company that have substantial contact with the external auditors. A sample survey for obtaining input on the external auditor from company personnel is included in the report. The report also includes relevant requirements and standards related to prohibited non-audit services and an overview of auditor communications with audit committees.

The report is available at:
http://www.mfdf.org/director_resources/resource/AuditorEvaluation/.

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.