Investment Services Regulatory Update

December 3, 2012

NEW RULES, PROPOSED RULES AND GUIDANCE

Treasury Issues Determination Exempting Foreign Exchange Swaps and Foreign Exchange Forwards from the Definition of "Swap"

On November 16, 2012, the Department of the Treasury issued a written determination exempting foreign exchange swaps and foreign exchange forwards from the definition of "swap," in accordance with the applicable provisions of the Commodity Exchange Act ("CEA"). In making its determination that foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the CEA, Treasury noted the distinctive characteristics of these instruments and its belief that requiring central clearing and trading under the CEA of these instruments would potentially introduce operational risks and challenges to the current settlement process. Treasury noted that its authority to issue a determination is limited to foreign exchange swaps and foreign exchange forwards and therefore that its determination does not extend to other foreign exchange derivatives.

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.

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.

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.

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