Investment Services Regulatory Update

March 1, 2013

New Rules, Proposed Rules and Guidance

SEC Staff Provides Guidance on Health Care Tax and After-Tax Return Calculations

On February 22, 2013, the SEC staff issued guidance on whether the 3.8% tax on net investment income (the "3.8% tax") imposed on certain taxpayers under the Health Care and Education Reconciliation Act of 2010 should be included in determining the highest individual marginal federal income tax rate used to calculate after-tax return pursuant to Form N-1A. The staff stated that because investors subject to the highest marginal rate on taxable income are also subject to the 3.8% tax, registrants should include the 3.8% tax in after-tax return calculations. According to the staff, in calculating after-tax return, registrants should use 43.4% as the highest individual marginal federal income tax rate on ordinary income, which is the highest current marginal rate (39.6%) plus 3.8%. The staff also stated that registrants should include the 3.8% tax in their calculations of tax on qualified dividend income and long-term capital gains or any tax benefit resulting from capital losses as required by Form N-1A (i.e., the highest individual federal long-term capital gains tax rate would be 23.8%, which is the current maximum long-term capital gains rate (20%) plus 3.8%).

SEC Amends Rule Regarding Obligations to Lost Securityholders and Unresponsive Payees

On January 16, 2013, the SEC adopted amendments to Rule 17Ad-17 under the Exchange Act in order to require brokers and dealers to search for "lost securityholders." Section 929W of the Dodd-Frank Act added sub-section 17A(g) to the Exchange Act which directs the SEC to extend the requirements of Rule 17Ad-17 beyond only recordkeeping transfer agents. Amended Rule 17Ad-17 requires broker-dealers to comply with the Rule to the same extent currently required of transfer agents. For purposes of the amended Rule, a "lost securityholder" generally is a securityholder to whom correspondence has been sent to the address on file with the transfer agent or broker-dealer that has been returned as undeliverable, and for whom no information has been received regarding the securityholder's new address.

Amended Rule 17Ad-17 requires broker-dealers, like transfer agents, to exercise reasonable care to ascertain the correct address of a lost securityholder. To exercise the required reasonable care, two database searches must be conducted either by taxpayer identification number or by name. The first search must be conducted between three and twelve months after such securityholder becomes a lost securityholder. The second search must be conducted between six and twelve months after the first search. This is the same procedure currently required of transfer agents.

Amended Rule 17Ad-17 also requires a paying agent (which may include a transfer agent, broker-dealer or investment adviser, among others) to provide a written notification to "unresponsive payees." A securityholder is considered an "unresponsive payee" if a check has been sent to the securityholder, and the check is not negotiated before the earlier of the next regularly scheduled check or six months from the date the not-yet-negotiated check was sent. The notification must state that the securityholder has been sent a check that has not yet been negotiated. Generally this notification must be sent no later than seven months after sending the not-yet-negotiated check. However, this notification requirement does not apply to any check for less than $25, and amended Rule 17Ad-17 makes it clear that the notification requirement has no effect on state escheatment laws.

The amendments to Rule 17Ad-17 become effective on March 25, 2013, and the compliance date is January 23, 2014.

SEC Extends Temporary Rule Regarding Adviser Principal Trades

On December 20, 2012, the SEC adopted 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 made 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

SEC Staff Releases 2013 Examination Priorities

On February 21, 2013, the SEC staff released its examination priorities for 2013. The examination priorities address the entire market, including investment advisers, investment companies and broker-dealers, and are meant to communicate areas that the staff perceives to have heightened risk. The staff disclosed several market-wide examination initiatives, including fraud detection and prevention, corporate governance and enterprise risk management, conflicts of interest and technology, along with examination priorities specific to investment advisers, investment companies and broker-dealers.

For investment advisers and investment companies, the staff identified the following ongoing risks and new and emerging issues as examination priorities for 2013:

- **Ongoing Risks**
    - *Safety of Assets*. Examinations will continue to include asset verifications to confirm the safety of client assets and compliance with custody requirements.
    - *Conflicts of Interest Related to Compensation Arrangements*. Examinations will seek to identify undisclosed compensation arrangements and related conflicts of interest.

- *Conflicts of Interest Related to Allocation of Investment Opportunities*. Examinations will seek to confirm that investment advisers have controls in place to monitor side-by-side management of accounts that pay performance-based fees with those that do not.

- *Marketing/Performance*. Examinations will focus on the accuracy of advertised performance and, where applicable, changes in advertising related to the JOBS Act.

- *Fund Governance*. Examinations will assess the "tone at the top" as well as confirm that fund directors are conducting reasonable reviews of information provided in connection with contract approvals, oversight of service providers and valuation of fund assets.

- **New and Emerging Issues**

  - *Payments for Distribution in Guise/Oversight of Omnibus Relationships*. Examinations will focus on payments made by investment advisers and funds to distributors and intermediaries, including revenue sharing, sub-transfer agency, shareholder servicing and conference support payments. Examinations will review whether these payments comply with Rule 12b-1 under the 1940 Act or are instead payments for distribution and preferential treatment. Examinations also will review the disclosures made to fund boards regarding these payments and the board's oversight of such payments. The staff's focus in this area may result in increased pressure on the oversight of omnibus and accounting relationships. Firms should consider the cost appropriateness of the fees they are paying for sub-transfer agency and shareholder servicing costs, as well as make certain that the fees paid are for those services and not for marketing or revenue sharing.

  - *"Alternative" Investment Companies*. Examinations will focus on the growing use of alternative and hedge fund investment strategies by funds, including reviewing leverage, liquidity, valuation, governance, compliance and marketing issues as they relate to the use of such strategies.

  - *New Registrants*. Over a two-year period, the staff intends to examine a "substantial percentage" of investment advisers that have registered with the SEC for the first time as a result of changes made under the Dodd-Frank Act.

  - *Dual Registrants*. Coordinated joint examinations of dually registered broker-dealer and investment advisory firms and distinct broker-dealer and investment advisory businesses that share common financial professionals will be expanded.

For broker-dealers, the staff identified the following ongoing risks and new and emerging issues as examination priorities for 2013:

- **Ongoing Risks**

  - Examinations will continue to focus on identifying fraud in connection with sales practices, trading risk areas, clearing firms with multiple correspondents engaging in high frequency/high volume trading and anti-money laundering compliance.

- **New and Emerging Issues**

  - In addition to looking at dually-registered broker-dealers, the staff identified the Market Access Rule as a priority in 2013. Within this focus area, examinations will concentrate on master/sub-accounts, proprietary trading, supervision of technology systems and broker-dealers dually registered as futures commission merchants. Examinations also will focus on certain risks relating to ETFs, such as fails to deliver and compliance with Regulation SHO.

Funds Face Emerging Cyber Risks

With the increasing reliance on technology in the fund industry, cyber risk has emerged as an important new risk area for funds and boards to consider. Technology failures, including privacy breaches, computer viruses and system interruptions, can affect both funds and their shareholders. Such failures also may generate significant negative publicity for funds and their service providers. Similar to other risk exposures, boards may wish to understand the types and extent of cyber risks faced by the funds they oversee and the steps being taken by management and service providers to prevent or mitigate such risks. Boards also may want to consider the extent to which current insurance policies cover cyber-related losses and address any gaps in insurance coverage as circumstances warrant.

SEC Approves New PCAOB Standard on Auditor Communications with Audit Committees

On December 17, 2012, the SEC approved the PCAOB's proposed Auditing Standard No. 16 (AS 16), *Communications with Audit Committees*. AS 16, which was adopted by the PCAOB on August 15, 2012, supersedes 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." AS 16 is effective for audits of fiscal years beginning on or after December 15, 2012. 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.

Litigation and Enforcement Actions

Pension Funds File Suit Against BlackRock and iShares for Excessive Securities Lending Fees

On January 18, 2013, two union pension plans filed a derivative suit in the U.S. District Court for the Middle District of Tennessee against BlackRock Fund Advisors (BFA), BlackRock Institutional Trust Company, N.A. (BTC), iShares, Inc., iShares Trust and the directors and trustees, including the independent directors and trustees, of iShares, Inc. and iShares Trust, alleging a breach of the fiduciary duties imposed by Section 36 of the 1940 Act. The complaint alleges that BFA and BTC, the iShares funds' investment adviser and securities lending agent, respectively, charged "grossly excessive" fees in connection with the lending of the funds' securities, detracting from the funds' returns. According to the complaint, the fees were so disproportionately large that they bore no reasonable relationship to the value of the services rendered and could not have been the product of arm's length bargaining. Rather, the plaintiffs allege the excessive securities lending fees were the consequence of inadequate board oversight and conflicts of interest among the BlackRock affiliated parties. The plaintiffs seek recovery of the "wrongfully expropriated" securities lending revenue pursuant to Section 36(b) and rescission of the securities lending agreement pursuant to Section 47(b) of the 1940 Act.

According to the complaint, pursuant to a securities lending agreement, the funds agreed to pay BTC a fee equal to 35% of the revenues obtained from the lending of the funds' securities. The funds paid additional fees to BFA for investing the collateral posted by borrowers of the securities. The combined fees allegedly amounted to over 40% of the securities lending revenue, which the plaintiffs argue is approximately three times what is typical in the industry. The plaintiffs allege that, after fees, the return received by the funds on securities lending was typically between 0.25% and 0.30%, comparable to returns on lower-risk investments, such as two-year Treasury bonds and six-month certificates of deposit, during the same time period and well below the average returns allegedly achieved through self-administered lending programs (0.93%) and unaffiliated securities lending agents (0.49%). In arguing that fees unreasonably detracted from fund returns, the complaint also cites academic studies and news articles regarding the inflated fees commonly charged by affiliated securities lending agents, including one study claiming that use of an affiliated agent is associated with an average 70% reduction in lending returns.

LPL Fined for Failing to Monitor and Ensure Timely Delivery of Mutual Fund Prospectuses

On December 31, 2012, LPL Financial, LLC entered into a Letter of Acceptance, Waiver and Consent with FINRA to settle alleged rule violations in connection with the failure to timely deliver mutual fund prospectuses to its customers. FINRA alleged that, from January 2009 to June 2011, LPL failed to implement and maintain adequate supervisory systems and procedures to monitor and ensure the timely delivery of mutual fund prospectuses as required by the Securities Act, resulting in a violation of NASD Conduct and FINRA Rules. FINRA alleged that, during the relevant period, LPL relied on its registered representatives for timely delivery of mutual fund prospectuses; however, LPL's written supervisory procedures did not provide for an adequate review of the registered representatives' performance of their prospectus delivery obligations. FINRA stated that LPL's procedures, which required representatives to annually affirm proper delivery of mutual fund prospectuses and also set forth procedures for annual branch audits, were insufficient to ensure that mutual fund prospectuses were being delivered on a timely basis. LPL consented to a censure and a $400,000 fine in connection with the FINRA enforcement action.

SEC Charges Adviser with Federal Securities Law Violations Relating to Use of Options Contrary to Fund's Strategies and Policies

On December 21, 2012, the SEC charged Top Fund Management, Inc. (TFM), a registered investment adviser, and its president and sole control person, Barry C. Ziskin (together, the Respondents) with violating federal securities laws in connection with the management of the Z Seven Fund leading to significant losses and, ultimately, the fund's liquidation. The SEC alleged that, contrary to the fund's investment objective of long-term capital appreciation, its principal investment strategy of investing at least 80% of its total assets in common stocks and its fundamental investment policy restricting the use of options to hedging purposes, the Respondents primarily pursued a strategy for the fund of buying put options on stock index ETFs and stock index futures for speculative purposes. The SEC also alleged that the fund's prospectuses had no disclosure regarding options trading and no discussion of the principal risks related thereto. Moreover, the SEC alleged that the fund's certified shareholder report for the period ended June 30, 2010, for which Ziskin was responsible, inaccurately described the use of options as a means of hedging.

The SEC's order alleges that the Respondents willfully violated Sections 206(1) and 206(2) of the Advisers Act, Section 206(4) of the Advisers Act and Rule 206(4)-8(a) thereunder, Section 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 34(b) of the 1940 Act. The SEC's order also alleges that the Respondents caused violations of Section 13(a)(3) of the 1940 Act by the fund, which provides that no registered fund may deviate from any fundamental investment policy. The Respondents agreed to cease and desist from committing or causing any violations and any future violations of the foregoing provisions and TFM agreed to a censure. In addition, Mr. Ziskin consented to an industry bar. Each Respondent also submitted a sworn Statement of Financial Condition asserting an inability to pay a civil penalty.

District Court Allows Claim of Excessive Investment Management Fees to Proceed

On December 17, 2012, the U.S. District Court for the District of New Jersey granted in part and denied in part the motion to dismiss of Hartford Investment Financial Services, LLC with respect to claims brought under Section 36(b) of the 1940 Act on behalf of six Hartford mutual funds that were sub-advised. The shareholder plaintiffs alleged that Hartford, the funds' investment adviser, charged excessive investment management and distribution (12b-1) fees in violation of Section 36(b). The court granted Hartford's motion to dismiss with respect to the distribution fees but allowed the plaintiffs' claim regarding the investment management fees to proceed. In considering Hartford's motion to dismiss, the court applied the standard for Section 36(b) cases articulated in the Supreme Court's decision in *Jones v. Harris Associates L.P.* that "to face liability under Section 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." In applying this standard, the court noted that it must consider "all relevant circumstances," guided by the factors set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.* in which the *Jones* standard was first articulated. The court applied each of the Gartenberg factors in its consideration of Hartford's motion to dismiss.

With respect to the plaintiffs' claim that the investment management fees charged by Hartford were excessive, Hartford argued in its motion to dismiss that the court should not consider—or should give limited weight to—the plaintiffs' allegations that Hartford's fees vastly exceeded (1) the fees paid by Hartford to the funds' sub-adviser and (2) the fees charged by Vanguard for similar services. The court rejected the first argument outright, giving full consideration to the allegation that Hartford charged the funds, on average, three times the amount it paid to the funds' sub-adviser, even though Hartford provided minimal additional supervisory or administrative services. The court proceeded to accept Hartford's argument that the comparison to fees charged by Vanguard should be given limited weight due to Vanguard's reputation as a low-cost mutual fund provider and its not-for-profit status. However, persuaded by the fact that Hartford and Vanguard employed the same sub-adviser, the court refused to discount entirely the allegation that the effective fee charged by Hartford exceeded the corresponding Vanguard fee by a factor of fifty to one. The court proceeded to apply the remaining *Gartenberg* factors, concluding that the plaintiffs' allegations gave rise to a plausible inference that Hartford's investment management fees were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arms' length bargaining.

With respect to the 12b-1 fees charged by Hartford, the plaintiffs, each of whom held only Class A shares, alleged that the mere fact that they were charged both a front-end sales load and 12b-1 fees meant that the 12b-1 fees were excessive under *Gartenberg*. In dismissing the claim, the court noted that the plaintiffs failed to cite any case law to support their contention and that, according to the SEC, charging both a front-end sales load and a 25 basis point 12b-1 fee on Class A shares was customary in the industry. The court also dismissed the plaintiffs' parallel claim on behalf of Class B shareholders due to lack of standing, noting that while mutual fund investors may have statutory standing to pursue claims on behalf of shareholders of other classes, such plaintiffs "still must allege a distinct and palpable injury to [themselves]."

District Court Rules on Industry Challenges to CFTC Rule 4.5

On December 12, 2012, the U.S. District Court for the District of Columbia ruled in *Investment Company Institute et al. v. United States Commodity Futures Trading Commission* (CFTC). The plaintiffs in the case, the ICI and the U.S. Chamber of Commerce, challenged amendments to Rule 4.5 under the Commodity Exchange Act (CEA), which sets forth an exclusion from the definition of "commodity pool operator" for registered investment companies, and amendments to Rule 4.27. The plaintiffs alleged that the rule-making process did not meet the standards set forth in the CEA relating to cost-benefit analysis and was arbitrary and capricious under the Administrative Procedures Act.

In denying the plaintiffs' motion for summary judgment, granting the CFTC's motion to dismiss in part and granting the CFTC's cross-motion for summary judgment, the court found the following:

- There was no basis on which to disturb the CFTC's findings.
- The rule-making process met all the requirements under the CEA and the final rule was a "logical outgrowth" of the proposed rule.
- The CFTC "provided a reasoned explanation for its actions" and considered the costs and benefits as required.
- The CFTC provided an adequate basis for the shift in its views from the 2003 amendments to Rule 4.5.

- The challenged amendments were aligned with the intent of the Dodd-Frank Act to give the CFTC greater power to oversee swaps and the derivatives markets and to bring more transparency to those markets. Thus, the CFTC's actions were not arbitrary and capricious.

- The plaintiffs have appealed the court's decision to the U.S. Court of Appeals for the District of Columbia Circuit.

SEC Charges Eight Fund Directors for Failure to Properly Oversee Fair Valuations

On December 10, 2012, the SEC filed an order instituting enforcement proceedings against eight former directors, including six independent directors, of five registered investment companies advised by Morgan Asset Management, Inc. (Morgan Keegan) alleging that the directors failed to satisfy their statutory obligations with respect to the fair valuation of mortgage-backed securities held by the funds. The SEC's order alleges that the directors delegated their asset-pricing responsibilities to Morgan Keegan without giving adequate guidance on how fair valuations should be made or ascertaining how fair values were determined. The SEC action against the directors follows a related $200 million settlement by Morgan Keegan with the SEC, state regulators and FINRA in 2011.

The SEC's order states that between January 2007 and August 2007, a significant portion (in some cases up to 60%) of the funds' portfolios contained below-investment grade debt securities, including a large number of securitized products backed by subprime mortgages, for which market quotations were not readily available. The SEC's order notes that, pursuant to Section 2(a)(41)(B) of the 1940 Act, such securities were required to be valued at a fair value as determined in good faith by the directors. The SEC alleges that the process employed in making fair valuation determinations for the funds' securities was deficient in many respects. The SEC's order alleges that the directors did not know and did not inquire as to the manner in which Morgan Keegan was making fair value determinations for particular types of securities and did not receive information that would allow the directors to understand the methodology that was being used to fair value securities. The SEC notes that, although the directors met more frequently and inquired about liquidity and valuation matters after being contacted by the SEC staff regarding valuation issues in July 2007, the directors never asked specific questions about valuation methodology and testing. The SEC's order alleges that these failures were "particularly egregious" given that fair valued securities made up the majority of the funds' net asset values.

The SEC's order alleges that the directors caused the funds to violate the following rules under the 1940 Act: (1) for the open-end funds, Rule 22c-1 by redeeming and repurchasing securities at a price other than the current net asset value; (2) Rule 30a-3(a) by failing to maintain internal control over financial reporting; and (3) Rule 38a-1 by failing to adopt and implement meaningful fair-valuation methodologies and related procedures. The SEC's order also alleges that, as a result of their conduct, the directors caused certain of the funds' registration statements to contain statements that were false or misleading with respect to material facts or to omit material facts which were required to be stated in the registration statements.

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