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Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC and CFTC Adopt Rules to Help Detect and Prevent Identity Theft

On April 10, 2013, the SEC and the CFTC adopted joint rules and guidelines in order to address identity theft, as required by the Dodd-Frank Act. The rules and guidelines adopted by the SEC and CFTC are substantially similar to the identity theft rules jointly adopted in 2007 by the Federal Trade Commission and several other federal agencies (the "Agencies"). Entities regulated by the SEC and CFTC that are currently subject to the Agencies' identity theft rules will now be subject to the SEC and CFTC rules. The adopting release notes that the final SEC and CFTC identity theft rules do not contain any requirements not already in the Agencies' rules, nor do they expand the scope to cover any entities not already covered by the Agencies' rules.

The final SEC and CFTC identity theft rules require "financial institutions" and "creditors" that offer or maintain "covered accounts" to develop and implement a written identity theft prevention program that includes reasonable policies and procedures to: (1) identify relevant red flags for the covered accounts; (2) detect the occurrence of red flags; (3) respond appropriately to any red flags when detected; and (4) periodically update the program to reflect changes in risks. With respect to the SEC rules, the scope of the definition of financial institutions generally covers broker-dealers, investment advisers and investment companies. With respect to the CFTC rules, the scope of the definition of financial institutions generally covers commodity pool operators, futures commission merchants and introducing brokers, among others. The SEC and CFTC rules also include guidelines that provide examples of red flags and the means to detect certain types of red flags, and other information intended to assist in the formulation and administration of an identity theft program.

The identity theft rules become effective on May 20, 2013, with a compliance date of November 20, 2013.

Division of Investment Management Issues Guidance on Requirements for Filing Social Media Communications

On March 15, 2013, the staff of the SEC's Division of Investment Management issued guidance regarding the obligations of investment companies to file certain materials posted on their social media sites. The staff noted that many investment companies have been unnecessarily filing certain social media communications with FINRA out of an abundance of caution. The guidance provides examples of communications the staff believes do not need to be filed and those that should be filed, but cautions that whether or not a communication needs to be filed depends on the content, context and presentation of the particular communication and requires an examination of the underlying substantive information transmitted to the social media user along with consideration of any other facts and circumstances.

The following are examples of social media communications that the staff believes need not be filed:

- communications that include an incidental mention of a specific fund that is unrelated to a discussion of the investment merits of the fund;

- communications that include an incidental use of the word “performance” in connection with a fund without specifically mentioning some or all of the elements of the fund’s return;
- communications that include a factual introductory statement forwarding or including a hyperlink to information previously filed;
- communications that include an introductory statement unrelated to a discussion of the investment merits of a fund that forwards or includes a hyperlink to general investment and financial information; and
- communications that provide discrete factual information unrelated to a discussion of the investment merits of a fund in response to a social media user’s question. The response may direct the social media user to the prospectus or provide contact information of the issuer.

The following are examples of social media communications that the staff believes should be filed:

- communications that include a specific discussion of fund performance that either mentions some or all of the elements of a fund’s returns or promotes a fund’s returns; and
- communications, initiated by a fund, that discuss the investment merits of the fund.

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%).

Other News

OCIE Issues Risk Alert on Investment Adviser Custody Rule

On March 4, 2013, the staff of the National Examination Program (NEP) of the SEC’s Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert discussing compliance with the custody rule for investment advisers. The Risk Alert comes after the NEP identified significant custody-related deficiencies in about one-third of recent investment adviser examinations. The Risk Alert highlights the following common custody deficiencies and notes that investment advisers may want to consider their policies and procedures and compliance with the custody rule in light of such common deficiencies:

- *Failure by investment advisers to recognize that they have custody*. The NEP staff identified several situations where an investment adviser failed to recognize that it had custody over client assets, including where the investment adviser: served as trustee or had power of attorney for client accounts; provided bill-paying services for clients; had online access to clients’ personal accounts or had physical possession of client assets; received checks made out to clients without promptly returning to the sender; or acted as a general partner for a limited partnership or held a comparable position for a different type of pooled investment vehicle.
- *Failure to meet the custody rule’s surprise exam requirements*. The NEP staff noted the following deficiencies with respect to surprise exams: failure to file a Form ADV-E within 120 days after the date of the surprise exam and exams that were not true “surprises” because they were conducted at the same time every year.

- *Failure to satisfy the qualified custodian requirements*. The NEP staff noted that investment advisers failed to meet the “qualified custodian” requirements by: holding client assets in an account in the investment adviser’s name but not designating the investment adviser as trustee or agent; commingling client, proprietary and employee assets in one account; holding client certificates of securities in a safe deposit box controlled by the investment adviser; lacking a reasonable belief that a qualified custodian was sending account statements to a client on a quarterly basis; and failing to include a notification on account statements urging clients to compare the investment adviser’s account statements to the custodian’s account statements.
- *Failure to meet the audit approach requirements*. The NEP staff noted that some investment advisers relying on the “audit approach” with respect to pooled investment vehicles failed to comply with the custody rule because: the accountant that conducted the financial statement audit was not independent; the audited financial statements were not prepared in accordance with GAAP; the investment adviser made the audited financial statements available upon request rather than distributing them to all investors; the audited financial statements were not sent to investors within 120 days for private funds; the auditor was not registered with the PCAOB; or a final audit was not performed on liquidated pooled investment vehicles.

The Risk Alert is available at: http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf

Director of the Division of Investment Management Identifies Division Regulatory Initiatives and Discusses Intent to Dialogue with Fund Directors

In recent speeches to industry groups, Norm Champ, the new Director of the SEC’s Division of Investment Management, provided insight on the Division’s short-term and long-term regulatory initiatives. He also discussed the Division’s intent to seek to establish a dialogue with fund directors on various topics of interest to the Division. With respect to current Division regulatory initiatives, Mr. Champ identified three short-term priorities that are actively being worked on by Division staff: potential money market fund reform; finalized identity theft red flag rules and valuation guidance. He also highlighted five longer-term regulatory projects: a review of rules that apply to private fund advisers; a derivatives concept release; an ETF rule to eliminate the need to file certain exemptive applications; a variable annuity summary prospectus; and enhancements to fund disclosures about portfolio holdings and operations. With respect to the Division’s plans to dialogue with fund directors, Mr. Champ stated that the Division is interested in hearing about areas where directors believe directors add value and also those areas where oversight is more difficult to manage. Specifically, Mr. Champ stated that the Division would like to discuss whether directors are asked to oversee too many funds, whether directors’ responsibilities are appropriately allocated and whether they spend time on the issues where they can provide the most value. Since many issues faced by fund directors relate to individual fund expenses and performance, Mr. Champ noted that the Division staff wants to ensure that directors are able to focus their attention on a fund-by-fund basis. Other areas for discussion identified by Mr. Champ include whether fund directors are appropriately focused on fees paid to a fund’s sub-adviser as compared to the fees paid to the fund’s investment adviser in light of the services provided by each and whether fund directors are focused on fee arrangements with affiliated securities lending agents, including “fee-splits” on the investment returns of securities lending collateral.

The full texts of Mr. Champ’s remarks can be found at:

- http://www.sec.gov/news/speech/2013/spch031113nc.htm
- http://www.sec.gov/news/speech/2013/spch031813nc.htm

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.

Litigation and Enforcement Actions

SEC Settles Charges Against Trustees and Service Providers of "Turnkey" Investment Company

On May 2, 2013, the SEC settled charges against the trustees, administrator and CCO service provider of the Northern Lights Fund Trust and the Northern Lights Variable Trust (the "Trusts"), finding that the trustees, administrator and CCO service provider violated the 1940 Act and various rules thereunder in connection with disclosures regarding the trustees' approval of certain investment advisory contracts and approval of the compliance programs of the advisers to the Trusts' series. The trustees, administrator and CCO service provider agreed to settle the SEC's charges without admitting or denying the SEC's findings. The Trusts offer multiple series managed by different unaffiliated advisers, administered by a single administrator and overseen by a single board of trustees, in an arrangement known as a "turnkey" investment company platform.

The SEC found that certain disclosures included in the Trusts' shareholder reports relating to the factors the trustees considered in approving or renewing advisory contracts contained boilerplate language with false or misleading information. The SEC stated that, in one instance, the disclosure claimed that the trustees had considered peer group information about the advisory fee, yet the trustees never received this information. The SEC noted two other instances where the shareholder report disclosure implied that the advisory fee was not materially higher than the peer group range, when it was almost twice as high as the peer group's mean. The SEC also determined that the administrator did not ensure that all applicable shareholder reports contained the mandatory disclosures about the trustees' evaluation of advisory contracts and also failed to ensure that numerous series maintained and preserved their contract renewal files.

The SEC also found that the trustees did not follow the Trusts' policies and procedures for approval of the compliance programs of advisers to the series of the Trusts. The SEC stated that the Trusts' policies and procedures called for the trustees to approve the advisers' compliance programs only after reviewing the advisers' compliance manual or after receiving a summary of the essential parts of the compliance program from the CCO service provider. However, according to the SEC, the trustees' approval of the advisers' compliance programs was based primarily on their review of a brief written statement prepared by the CCO service provider stating that the advisers' compliance manuals were "sufficient and in use" and a verbal representation by the CCO service provider that such manuals were adequate.

The SEC order found that the trustees caused violations of Section 34(b) of the 1940 Act; the trustees and the CCO service provider caused violations of Rule 38a-1 under the 1940 Act; and the administrator caused violations of Sections 30(e) and 31(a) of the 1940 Act and Rules 30e-1 and 31a-2 thereunder. The administrator and the CCO service provider agreed to pay $50,000 penalties each, and the administrator, the CCO service provider and the trustees agreed to engage an independent compliance consultant to address the violations found in the SEC order.

Supreme Court Unanimously Limits the SEC's Ability to Bring Civil Penalty Claims for Fraudulent Conduct Older Than Five Years

In *Gabelli v. SEC*, a unanimous decision issued on February 27, 2013, the U.S. Supreme Court reversed the Court of Appeals for the Second Circuit and limited the ability of the SEC to bring enforcement actions for civil penalties arising out of fraudulent conduct, requiring that such actions be brought within five years of the time when the fraud occurs. In so doing, the Court flatly rejected the SEC's contention that the five year statute of limitations under 28 U.S.C. § 2462 did not start to run until the SEC discovered the fraud.

In April 2008, the SEC filed a civil fraud action in district court alleging that Bruce Alpert and Marc Gabelli of Gabelli Funds, LLC, a registered investment adviser, aided and abetted violations by the adviser of the antifraud provisions of the Advisers Act by permitting one large investor in Gabelli Global Growth Fund to secretly engage in "market timing" practices in the fund between 1999 and 2002. The District Court dismissed the SEC's claims for civil penalties as time-barred, ruling that § 2462 required the SEC to bring its action "within five years from the date when the claim first accrued." The Second Circuit reversed and reinstated the SEC's civil-penalty claim, holding that because the SEC's claims sounded in fraud, it is entitled to benefit from the "discovery rule," meaning that the applicable limitations period did not start to run until the SEC discovered (or reasonably should have discovered) the fraud.

In a unanimous opinion, the Supreme Court reversed the Second Circuit and held that because "accrued" normally means the moment a cause of action comes into existence, the most natural reading of § 2462 is that the limitations period begins to run when the fraud occurs, as a cause of action exists at that time. The Court explained that the SEC does not warrant the protections afforded by the discovery rule, which is intended to preserve the claim of an unsuspecting victim of fraud to obtain recourse once fraud is discovered. The Court reasoned that, "[u]nlike the private party who has no reason to suspect fraud, the SEC's very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit." Noting that the Court has never applied the discovery rule where the plaintiff is the government bringing an enforcement action for civil penalties, the Court distinguished the private plaintiff seeking to recover fraudulently induced losses from the SEC "as enforcer," seeking civil penalties to "punish, and label defendants wrongdoers." Moreover, the Court considered the impracticality of applying the discovery rule to the government, noting that, if applied, a trial court would have to determine when, among the "hundreds of employees, dozens of offices and several levels of leadership" that characterize a typical agency, the government knew or should have known of the fraudulent conduct.

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Investment Services Group

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