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Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC Proposes Money Market Fund Rule Amendments

On June 5, 2013, the SEC proposed amendments to certain rules under the 1940 Act that govern money market funds. The proposed rule amendments seek to: (1) limit money market funds' susceptibility to heavy redemptions during periods of market stress, (2) improve money market funds' ability to deal with contagion from heavy redemptions, (3) preserve to the extent possible the benefits of money market funds for investors, and (4) increase risk transparency in money market funds. The SEC proposed two principal alternative reforms—a floating NAV and liquidity fees/redemption gates—that could be adopted alone or in combination. In addition, the SEC proposed changes to money market fund diversification and disclosure requirements that would apply under either of the alternative reforms.

As proposed, the floating NAV rule amendments would:

- prohibit money market funds, other than government and retail money market funds, from using the amortized cost method to value portfolio securities and require fund share prices to reflect market-based valuation factors—i.e., allow NAV per share to float instead of remaining at a stable $1.00 share price;
- require money market funds, other than government and retail money market funds, to round share prices to the nearest 1/100th of 1% (basis point rounding method), instead of rounding to the nearest 1% (penny rounding method), in order to allow fund investors to see the fluctuations in share price; and
- allow government money market funds (funds that hold at least 80% of their assets in cash, government securities or repurchase agreements collateralized with government securities) and retail money market funds (funds that limit each shareholder's redemptions to no more than $1 million per business day) to use the penny rounding method to maintain a stable NAV per share, but prohibit the use of the amortized cost method.

As proposed, the liquidity fees and redemption gates rule amendments would:

- require money market funds to charge a liquidity fee of 2% on redemptions if the fund's weekly liquid assets (assets such as cash, U.S. Treasury obligations, certain other government securities with remaining maturities of 60 days or less and securities that convert into cash in one week) fall below 15% of total assets, unless the board determines it is not in the best interest of the fund or approves a lower fee;
- allow the board of a money market fund to temporarily suspend, or "gate," redemptions if the fund's weekly liquid assets fall below 15% of total assets;
- require that any redemption gate imposed must be lifted within 30 days and limit redemption gates to no more than 30 days in a 90-day period;
- require prompt public disclosure of the crossing of the 15% weekly liquid assets threshold, the imposition and removal of any liquidity fee or redemption gate and the board's analysis in determining whether or not to impose a liquidity fee or a redemption gate;
- allow all money market funds to use the penny rounding method to maintain a stable NAV per share, but prohibit the use of the amortized cost method; and

- exempt government money market funds from the requirement to impose a liquidity fee, but permit them to impose liquidity fees and redemption gates if there is appropriate disclosure in the fund's prospectus.

The SEC also stated that it is considering a combination of the two alternatives. If a combination of the two alternatives is adopted, money market funds, other than government and retail money market funds, would be required to maintain a floating NAV and non-government money market funds would be able to impose liquidity fees and redemption gates in certain circumstances.

In addition to the two alternative reforms, the SEC proposed rule amendments to:

- improve disclosure by requiring money market funds to disclose (1) on the money market fund's website, on a daily basis, the fund's daily and weekly liquid assets and market-based NAV, (2) new events such as the imposition of a liquidity fee or gate, sponsor support, portfolio security defaults and a decline in NAV per share below $0.9975 on a new Form N-CR, and (3) historic instances of sponsor support in the fund's statement of additional information;
- amend Form N-MFP to add new reporting requirements and to eliminate the 60-day delay on the public availability of the information filed;
- amend Form PF to enable the SEC to monitor the movement of assets from money market funds to private liquidity funds in response to money market fund reforms by requiring liquidity fund advisers with at least $1 billion in combined money market fund and liquidity fund assets to report substantially the same portfolio information on Form PF as registered money market funds would report on Form N-MFP;
- tighten the diversification requirements under Rule 2a-7 by requiring money market funds to (1) aggregate affiliates for purposes of determining whether they are complying with the 5% concentration limitation in any one issuer, (2) remove the rule, which allows as much as 25% of the value of securities held in a money market fund's portfolio to be subject to guarantees or demand features from one institution, and (3) aggregate all of the asset-backed securities vehicles sponsored by the same entity for purposes of the 10% guarantor diversification limit, unless the board determines that the money market fund is not relying on the sponsor's strength or the structural enhancements of the asset-backed security; and
- require money market funds to stress test against the fund's level of weekly liquid assets falling below 15% of total assets.

Comments on the proposed amendments are due by September 17, 2013.

Division of Investment Management Issues Guidance Update Regarding Compliance with Exemptive Orders

In May 2013, the SEC's Division of Investment Management issued a guidance update emphasizing the importance of complying with representations and conditions of exemptive orders. The guidance follows a June 2011 report from the SEC's Office of Inspector General which noted examples of firms failing to comply with the representations and conditions of exemptive orders and made recommendations intended to enhance the SEC's oversight of compliance with exemptive orders. Additionally, in February 2013, the SEC's Office of Compliance Inspections and Examinations listed compliance with exemptive orders as a 2013 examination focus area. For entities that receive and rely on exemptive orders, the guidance update serves as a reminder that non-compliance with the representations and conditions of such orders may result in a violation of the federal securities laws and that the consequences of non-compliance may be severe. The Division of Investment Management suggests that investment companies and investment advisers adopt and implement policies and procedures reasonably designed to ensure compliance with each representation and condition of an order.

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 became effective on May 20, 2013, with a compliance date of November 20, 2013.

Other News

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

D.C. Circuit Affirms District Court Ruling on Industry Challenges to CFTC Rule 4.5

On June 25, 2013, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the district court ruling in Investment Company Institute et al. v. 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 the conditions pursuant to which a registered investment company may claim an exclusion from the definition of "commodity pool operator," 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 (APA).

On December 12, 2012, the U.S. District Court for the District of Columbia denied the plaintiffs' motion for summary judgment, granted the CFTC's motion to dismiss in part and granted the CFTC's cross-motion for summary judgment. The plaintiffs appealed the ruling granting summary judgment to the CFTC. In affirming the district court, the D.C. Circuit found the following:

- The CFTC engaged in "reasoned decision-making" and provided an adequate basis for the shift in its views from the 2003 amendments to Rule 4.5;
- The CFTC considered the costs and benefits as required and the CFTC's cost-benefit analysis was not arbitrary and capricious;

- Three specifically challenged provisions—the inclusion of swaps in the registration threshold, the exclusion of risk management strategies from the definition of "bona fide hedging transactions" and the 5% registration threshold itself—were sufficiently explained such that the CFTC's actions were not arbitrary and capricious; and
- The CFTC provided "adequate opportunity for notice and comment," satisfying the requirements of the APA.

Former Mutual Fund Directors Settle Claims that They Failed to Properly Oversee Asset Valuation

On June 13, 2013, the SEC settled enforcement proceedings against eight former directors, including six independent directors, of five registered investment companies advised by Morgan Asset Management, Inc. (Morgan Keegan). The SEC's order instituting enforcement proceedings (Original Order), brought on December 10, 2012, alleged that the directors failed to satisfy their statutory obligations with respect to the fair valuation of mortgage-backed securities held by the funds. The June 13 settled order (Settled Order) found 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's settlement with the directors follows a related $200 million settlement by Morgan Keegan with the SEC, state regulators and FINRA in 2011.

The Original Order stated 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 Original Order noted 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 alleged that the process employed in making fair valuation determinations for the funds' securities was deficient in many respects. The Original Order alleged 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 Original Order alleged that these failures were "particularly egregious" given that fair valued securities made up the majority of the funds' net asset values.

The findings of the Settled Order generally followed the allegations of the Original Order; however, the SEC made several findings in the Settled Order that were not alleged in the Original Order. The Settled Order found that the valuation procedures did not require the directors to ratify any fair value determinations made by Morgan Keegan, and the directors did not ratify any such determinations. The Settled Order alleged that Morgan Keegan repeatedly accepted price adjustments from the portfolio manager, but the directors never provided any guidance as to how Morgan Keegan should evaluate the reasonableness of such adjustments. The Settled Order also discussed the directors' statutory responsibilities with respect to determining the fair value of securities and reviewed SEC guidance with respect to securities valuation. The Settled Order stated that SEC guidance indicated that "the ultimate responsibility for determining fair value lies with a fund's directors, and that this responsibility cannot be delegated away."

The Original Order alleged 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 Original Order also alleged 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. The Settled Order found only that the directors caused the funds to violate Rule 38a-1. The directors were ordered to cease and desist from committing or causing any violations and any future violations of that rule. The directors consented to the entry of the Settled Order without admitting or denying any of the findings.

SEC Settles Charges Against Proxy Adviser for Failure to Safeguard Client Information

On May 23, 2013, the SEC settled charges against Institutional Shareholder Services Inc. (ISS) for failing to safeguard the confidential proxy voting information of clients. The SEC found that from 2007 to 2012, an ISS employee provided a proxy solicitor with material nonpublic information revealing how more than 100 of ISS's clients were voting their proxy ballots. The SEC stated that, in exchange for this voting information, the proxy solicitor provided the ISS employee with approximately $11,500 in concert and sporting event tickets and charged approximately $20,000 in meals with the employee and other ISS employees. The SEC determined that ISS lacked sufficient controls over employee access to confidential client voting information. While ISS had a code of ethics prohibiting unauthorized disclosure of confidential client information, the SEC stated that ISS willfully violated Section 204A of the Advisers Act by failing to establish and enforce policies and procedures reasonably designed to prevent the misuse of confidential client information. ISS agreed to pay a civil penalty of $300,000 and to retain a compliance consultant to conduct a comprehensive review of its supervisory and compliance policies and procedures.

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.

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