August 1, 2014

Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC Adopts Money Market Fund Rule Amendments

On July 23, 2014, on a 3-2 vote, the SEC adopted amendments to certain rules under the 1940 Act, including Rule 2a-7, that govern money market funds. According to the SEC, the 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 potential contagion from heavy redemptions, (3) increase risk transparency in money market funds, and (4) preserve, to the extent possible, the benefits of money market funds for investors. The primary rule changes include the requirement for certain money market funds to operate using a floating NAV rather than a stable NAV, and the ability of money market funds to impose liquidity fees and redemption gates in certain circumstances to stem redemptions. In addition, the SEC adopted other rule and form amendments applicable to money market funds, including enhanced diversification and disclosure requirements.

Floating NAV

The rule amendments require institutional prime money market funds (i.e., those that primarily invest in corporate debt securities) and institutional municipal money market funds (i.e., those that primarily invest in tax-exempt municipal securities) to operate using a floating NAV. The amendments eliminate the valuation exemptions for these types of funds that allowed the use of amortized cost to value portfolio securities and/or permitted a fund to round its NAV to the nearest penny in order to maintain a stable share price (generally $1.00). Institutional prime money market funds and institutional municipal money market funds will be required to sell and redeem shares based on the current market value of their portfolio securities. Under the rule amendments, these funds also must round their share prices and transact in fund shares to four decimal places in the case of a $1.0000 share price or an equivalent level of accuracy for funds with a different share price (e.g., $10.000).

The floating NAV requirement does not apply to government money market funds or retail money market funds. Government money market funds are defined under the rule amendments as those funds that invest at least 99.5% of their total assets in government securities, cash and/or repurchase agreements that are collateralized by cash or government securities. (Government money market funds currently are able to invest up to 20% of total assets in non-government assets.) Retail money market funds are defined as those funds that have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. In the adopting release, the SEC recognized that in order to qualify as a retail money market fund, funds that currently have both retail and institutional investors would need to reorganize into separate retail and institutional money market funds or otherwise involuntarily redeem certain investors. To help facilitate these actions, the SEC, in the adopting release, provided exemptive relief from Sections 17(a), 18 and 22(e) of the 1940 Act, which might otherwise prohibit the reorganizations or redemptions, subject certain board determinations and notice requirements.

Liquidity Fees and Redemption Gates

The final rule amendments allow liquidity fees and/or redemption gates in certain circumstances for all non-government money market funds as compared to the proposed rule amendments which would have required them. Although government money market funds are not subject to the new liquidity fees and redemption gates provisions, these funds could voluntarily opt into them if previously disclosed to investors.

- If a money market fund's weekly liquid assets fall below 30% of its total assets, the fund may impose a liquidity fee of up to 2% on all redemptions upon a determination by the fund's board of directors (including a majority of its independent directors) that imposing such a fee is in the best interests of the fund.
- If a money market fund's weekly liquid assets fall below 30% of its total assets, the fund may suspend redemptions (impose a redemption gate) for up to 10 business days in a rolling 90-day period upon a determination by the fund's board of directors (including a majority of its independent directors) that imposing a redemption gate is in the best interests of the fund.
- If a money market fund's weekly liquid assets fall below 10% of its total assets, the fund is required to impose a liquidity fee of 1% on all redemptions unless the fund's board of directors (including a majority of its independent directors) determines that such a fee is not in the best interests of the fund or determines that a lower or higher fee (not to exceed 2%) would be in the best interests of the fund.
- If a money market fund's weekly liquid assets fall below 10% of its total assets, the fund's board of directors (including a majority of its independent directors) may permanently suspend redemptions and proceed to liquidate the fund.

Weekly liquid assets generally include cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, and securities that convert into cash within one week.

Enhanced Disclosure, Diversification and Stress Testing

The rule amendments provide several changes to money market fund disclosure requirements. Advertisements and summary prospectuses must include specific disclosure regarding risks associated with a money market fund, the use of liquidity fees or redemption gates, the use of a stable NAV or a floating NAV, as applicable, and sponsor support of the fund. Websites of money market funds must disclose, on a daily basis, the levels of daily and weekly liquid assets, net inflows and outflows, market-based NAVs per share, the use of any liquidity fees and redemption gates and any sponsor support. Form N-MFP was also amended to add new reporting requirements and to eliminate the 60-day delay on the public availability of the information filed. Finally, the rule amendments require money market funds to promptly disclose certain significant events on new Form N-CR, including security defaults, sponsor support, the use of liquidity fees or redemption gates and, for retail and government money market funds, a decline in the fund's market-based NAV below $0.9975 or its equivalent for funds with a different share price.

The rule amendments also change the investment diversification requirements for money market funds. Currently, money market funds generally must limit their investments in (1) securities of any one issuer to no more than 5% of fund assets and (2) securities subject to a demand feature or a guarantee to no more than 10% of fund assets from any one provider; however, as much as 25% of the value of securities held in a money market fund's portfolio may be subject to guarantees or demand features from one institution (25% basket). The rule amendments require money market funds to treat certain entities affiliated with each other as single issuers for purposes of complying with the 5% diversification limit. The rule amendments also require funds to treat the sponsors of asset-backed securities as guarantors subject to the 10% diversification limit, unless the board of directors makes certain determinations that the fund is not relying on the sponsor's financial strength or credit support when determining the security's quality or liquidity. Finally, the rule amendments eliminate the 25% basket for all money market funds except municipal money market funds, which may now only invest up to 15% in securities subject to guarantees or demand features from one institution.

The rule amendments also enhance the stress testing requirements applicable to money market funds. The rule amendments require money market funds to test their ability to maintain weekly liquid assets of at least 10% and to minimize principal volatility (and, for stable NAV money market funds, the ability to maintain a stable share price) in response to certain prescribed scenarios.

Tax Implications

In connection with the SEC's adoption of the money market fund rule amendments, the IRS adopted a revenue procedure exempting floating NAV money market funds from the wash sale rules. In addition, the IRS proposed regulations to provide a simplified method of accounting for gains and losses on shares of floating NAV money market funds.

Compliance Dates

The new rule amendments become effective 60 days after publication in the Federal Register. The compliance date for the floating NAV, liquidity fees and redemption gates amendments is two years after the effective date. The compliance date for the diversification, disclosure and stress testing amendments is 18 months after the effective date. The compliance date for reports on new Form N-CR is 9 months after the effective date.

SEC Re-Proposes Amendments to Remove References to Credit Ratings from Money Market Fund Rule

On July 23, 2014, the SEC re-proposed, with changes, amendments to Rule 2a-7 under the 1940 Act and Form N-MFP that were initially proposed in March 2011 and intended to comply with the requirements of the Dodd-Frank Act that any references to credit ratings in the SEC's regulations be removed and replaced with other standards of creditworthiness. The SEC also proposed an additional amendment to the diversification requirements under Rule 2a-7.

The re-proposed amendments to remove credit ratings would affect the following elements of Rule 2a-7: (1) determination of whether a security is an eligible security and the distinction between first and second tier securities, (2) credit quality standards for securities with a conditional demand feature, (3) requirements for monitoring securities for ratings downgrades and other credit events and (4) stress testing.

As re-proposed, the definition of "eligible security" would be amended to remove references to credit ratings provided by nationally recognized statistical rating organizations (NRSROs). Under the proposed rule amendments, an eligible security would be a security with a remaining maturity of 397 calendar days or less that a money market fund's board of directors (or its delegate) determines presents minimal credit risks, which determination includes a finding that the security's issuer has an exceptionally strong capacity to meet its short-term obligations. This single standard would eliminate the current distinction between first and second tier securities under Rule 2a-7 and therefore the SEC also is proposing to remove the current prohibition on money market funds from investing more than 3% of their assets in second tier securities. However, the SEC stated in the proposing release its belief that securities rated in the third-highest rating category would not satisfy the proposed "exceptionally strong capacity" standard and therefore would not be eligible securities under Rule 2a-7.

With respect to securities with a conditional demand feature, the re-proposed rule amendments would replace references to NRSRO ratings with a requirement that a money market fund's board of directors (or its delegate) evaluate the long-term risk of the underlying security and determine that it "has a very strong capacity for payment of its financial commitments." Under the re-proposed rule amendments, the current requirement for a money market fund's board of directors (or its delegate) to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks would be replaced with the requirement that a money market fund adopt written procedures requiring the fund's adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks. Finally, the re-proposed rule amendments would remove references to credit rating downgrades from the "stress test" requirements by replacing the hypothetical event of a downgrade with a requirement that money market funds stress test for an event indicating or evidencing credit deterioration of particular portfolio security positions. The proposed rule amendments would describe the types of hypothetical events money market funds should stress test for, including downgrades or defaults as examples.

The SEC also re-proposed amendments to Form N-MFP to require money market funds to disclose, for each portfolio security, (1) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO's services, as well as the name of the agency providing the rating and (2) any other NRSRO rating that the fund's board of directors (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating.

Finally, the SEC proposed amendments to the diversification requirements under Rule 2a-7 which would eliminate an exclusion that is currently available for securities subject to guarantees issued by a non-controlled person (i.e., a person not controlling, controlled by or under common control with the issuer of the security subject to the guarantee). Currently, under Rule 2a-7, money market funds are not allowed to invest more than 5% of their total assets in any one issuer. They also must limit investments in securities subject to a demand feature or a guarantee to no more than 10% of their total assets from any one provider. Consequently, although Rule 2a-7 requires diversification with respect to providers of guarantees or demand features, it does not require diversification with respect to issuers of securities that are guaranteed by a non-controlled person. The proposed amendment would eliminate this exclusion by requiring money market funds that invest in securities subject to guarantees to comply with the 5% diversification requirement for issuers.

Comments on the proposed rule amendments are due 60 days after publication in the Federal Register.

FinCEN Proposes Anti-Money Laundering Rules

On July 23, 2014, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued a Notice of Proposed Rulemaking that would amend existing Bank Secrecy Act regulations with respect to customer due diligence (CDD) requirements for certain covered financial institutions, including mutual funds, brokers or dealers in securities and futures commission merchants and introducing brokers in commodities. The proposed rules would formalize certain CDD requirements and also require that covered financial institutions "identify and verify the beneficial owners of legal entity customers." FinCEN's proposal includes a standard certification form that covered financial institutions would be required to use for documenting the beneficial ownership of their legal entity customers. An individual may qualify as a "beneficial owner" of a legal entity customer if the individual either (1) owns 25% or more of the equity interests of the entity, or (2) has significant management responsibilities within the entity. As proposed, covered financial institutions would be exempted from identifying the beneficial owners of an intermediary's underlying clients if the covered financial institution has no customer identification program obligation with respect to those underlying clients.

Comments on the Notice of Proposed Rulemaking are due by October 3, 2014.

Division of Investment Management Issues Guidance Regarding Enhanced Mutual Fund Disclosure

In June 2014, the staff of the Division of Investment Management of the SEC published a Guidance Update related to the enhanced mutual fund disclosure amendments adopted in 2009, which require funds to include a summary section, written in plain English, containing certain information (i.e., investment objectives and strategies, risks, costs and performance) at the beginning of each mutual fund statutory prospectus.

According to the Guidance Update, since the adoption of these amendments, a significant number of summary sections still contain "complex, technical and duplicative" information. The Guidance Update highlights certain rule and form requirements, as well as comments the staff provided to funds related to these amendments, including:

- *Investment Strategies and Risks*: Form N-1A requires that a summary section include a summary of principal strategies and risks. Funds often repeat the principal investment strategies and risk disclosure contained elsewhere in the prospectus, rather than summarizing this information. Duplicative disclosure increases the length of a prospectus and undermines the purpose of the amendments. Additionally, Form N-1A provides that non-principal strategies and risks should be disclosed in the SAI. Many funds include the additional, non-principal strategies and risks elsewhere in their prospectuses and do not clearly indicate whether the strategies/risks are principal or non-principal.

- *Plain English Requirements*: Form N-1A requires that a summary section be written in plain English. Many funds still use technical terms, unnecessary defined terms and long, dense paragraphs in summary sections which undermine the stated goal of creating useable summaries for investors.
- *Inclusion of Required or Permitted Information*: Form N-1A requires that a summary section only include disclosures required or permitted by the Form. The Guidance Update highlights certain fee table footnotes and purchase and sale information as examples of disclosure that funds often incorrectly include in summary sections.
- *Cross-References*: Form N-1A provides that funds should avoid cross-references to the SAI or shareholder reports. Some funds have numerous cross-references in their summary sections, which unnecessarily add to summary section complexity.

The Guidance Update encourages funds to revisit their disclosure in light of the established framework of Form N-1A and the Guidance Update.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2014-08.pdf.

SEC Divisions Issue Guidance Regarding Proxy Voting

In June 2014, the staff of the Divisions of Investment Management and Corporation Finance of the SEC jointly published Staff Legal Bulletin No. 20 (SLB 20) regarding (1) investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms and (2) the availability and requirements of two exemptions from the Exchange Act proxy rules. SLB 20 consists of questions and answers regarding proxy voting responsibilities and exemptions in order to assist investment advisers and proxy advisory firms, respectively, in making changes to their current systems and processes in advance of next year's proxy season. In particular, SLB 20 notes the following:

- Investment advisers and their clients do not need to agree that the adviser will undertake all of the proxy voting responsibilities. Rule 206(4) 6 under the Advisers Act only requires investment advisers to vote in accordance with their client's wishes, including not voting at all, only voting on some matters, or voting in favor of management or certain proponents.
- Where the client gives the investment adviser the authority to vote, the investment adviser must take steps to demonstrate that proxy votes are cast in accordance with clients' best interests and the adviser's procedures. SLB 20 suggests periodically sampling proxy votes to review whether they comply with the investment adviser's proxy voting policies and review, at least annually, the adequacy of proxy voting policies and procedures.
- An investment adviser choosing to rely on recommendations of a proxy advisory firm should ascertain whether the proxy advisory firm has the capacity and competency to make voting recommendations based on materially accurate information. If an investment adviser finds that a proxy advisory firm's recommendation is based on a material factual error (for example, as a result of a supplemental proxy filing by the issuer), the adviser should take reasonable steps to investigate the error and seek to determine whether the proxy advisory firm is taking reasonable steps to reduce similar errors in the future.
- An investment adviser that retains a proxy advisory firm should adopt policies and procedures reasonably designed to provide sufficient oversight of the proxy advisory firm, and to identify and address the conflicts of the proxy advisory firm (which, as discussed below, will be disclosed by the proxy advisory firms), in order to ensure that the investment adviser, in acting based on the proxy advisory firm, continues to vote proxies in the best interests of its clients.
- A proxy advisory firm is subject to the Exchange Act proxy rules when it engages in "solicitation," which includes "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."
- SLB 20 describes certain exemptions available to proxy advisory firms from the filing and disclosure requirements of the Exchange Act proxy rules. To rely on certain of these exemptions, a proxy advisory firm must disclose significant relationships or material interests. Where a significant relationship or material interest is found, the proxy advisory firm must disclose the conflict, including the scope of the relationship

or interest and steps taken to mitigate the conflict. Rule 14a 2(b)(3) under the Exchange Act imposes an affirmative duty to disclose these significant relationships or material interests to the recipient of a proxy advisory firm's advice. Providing the information "upon request" will not satisfy the rule.

SLB 20 is available at www.sec.gov/interps/legal/cfslb20.htm.

Other News

SEC Commissioner Confirms Cybersecurity as a Board-Level Concern

In a June 10, 2014 speech delivered at the New York Stock Exchange, SEC Commissioner Luis Aguilar addressed the important role of boards in overseeing cyber risk management. In his speech, Mr. Aguilar focused on what boards can do and should be doing to ensure that their organizations are appropriately considering and addressing cyber risks. Mr. Aguilar emphasized the duties of boards, highlighting business interruption and the potential for reputational harm as posing serious threats to a company's bottom line. According to Mr. Aguilar, boards have assumed greater responsibility for overseeing risk management efforts, and these efforts should include cybersecurity. Mr. Aguilar stated that, although the primary responsibility for risk management has historically belonged to management, a board is responsible for ensuring that a company has established appropriate risk management programs and for overseeing how management implements these programs.

Mr. Aguilar also addressed the risk of shareholder lawsuits if boards choose to minimize or ignore their cybersecurity oversight responsibilities. Mr. Aguilar urged boards to take a proactive approach to mitigating liability exposure. In discussing what boards can do and should be doing on cybersecurity issues, Mr. Aguilar cited a February 2014 report from the National Institute of Standards and Technology, entitled "Framework for Improving Critical Infrastructure Cybersecurity" (NITS Framework) stating that it is a place for a board to begin in assessing a company's cybersecurity readiness. He stated that the NITS Framework is intended to provide companies with a set of industry standards and best practices for managing cybersecurity.

The NITS Framework is available at www.nist.gov/cyberframework/upload/cybersecurity-framework-021214-final.pdf.

CFTC Staff Announces Expedited No-Action Relief for CPO Delegation

On May 12, 2014, the staff of the Commodity Futures Trading Commission (CFTC) issued a letter setting forth the criteria for seeking streamlined registration no-action relief for commodity pool operators (CPOs) who delegate their status and responsibility as a CPO to another party. The letter clarified that no-action relief is required if a CPO seeks to delegate its responsibilities to another party. While an investment adviser is deemed to be the CPO of a registered investment company (RIC) that also is a commodity pool (and therefore delegation is not necessary), the same does not apply to a wholly-owned subsidiary of a RIC. Each director of the wholly-owned subsidiary will likely have to seek no-action relief to delegate their CPO status and responsibilities to the investment adviser to the wholly-owned subsidiary. The CFTC staff's letter details the criteria which must be satisfied in order for a delegating CPO to use the streamlined process for relief. The relief is not self-executing and the delegating CPO (e.g., the directors) must complete a form of no-action request and file such request with the CFTC, which the CFTC staff will review on an expedited basis. If a delegating CPO does not qualify for the streamlined no-action relief, the CFTC staff will continue to evaluate requests for CPO registration no-action relief on a non-expedited basis.

The CFTC staff letter is available at www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-69.pdf.

Litigation and Enforcement Actions

SEC Settles Charges Against Hedge Fund Adviser for Conducting Prohibited Transactions and Retaliating Against Whistleblower

On June 16, 2014, the SEC settled charges against a hedge fund advisory firm, Paradigm Capital Management, Inc., for engaging in principal transactions with an affiliated broker-dealer without providing effective disclosure to, or obtaining effective consent from, a hedge fund client. The SEC also settled charges against the firm's owner, Candace Weir, for causing the improper principal transactions. According to the SEC's order, Paradigm's former head trader made a whistleblower submission to the SEC that revealed the principal transactions between Paradigm and the affiliated broker-dealer. The SEC found that, after learning that its head trader had reported potential violations to the SEC, Paradigm engaged in a series of retaliatory actions that ultimately resulted in the head trader's resignation. This is the first time the SEC has filed a case under its new authority to bring anti-retaliation enforcement actions.

According to the SEC, Ms. Weir conducted transactions between Paradigm and an affiliated broker-dealer while trading on behalf of a hedge fund client. The SEC's order also found that Paradigm failed to provide effective written disclosure to the hedge fund and did not obtain its consent as required prior to the completion of each principal transaction. The SEC's order stated that Paradigm attempted to satisfy the written disclosure and consent requirements by establishing a conflicts committee to review and approve each of the principal transactions on behalf of the hedge fund. The SEC's order found that the conflicts committee itself, however, was conflicted, because its two members, Paradigm's chief financial officer and chief compliance officer, each reported to Ms. Weir and Paradigm's CFO also served as CFO of the affiliated broker-dealer. The SEC also found that Paradigm's Form ADV was materially misleading for failing to disclose its CFO's conflict as a member of the conflicts committee.

The SEC's order found that Paradigm violated, among other things, Sections 206(3) and 207 of the Advisers Act. The SEC's order also found that Ms. Weir caused Paradigm's violations of Section 206(3) of the Advisers Act. Paradigm and Ms. Weir agreed to jointly and severally pay disgorgement of $1.7 million for distribution to current and former investors in the hedge fund, and pay prejudgment interest of $181,771 and a penalty of $300,000. Paradigm also agreed to retain an independent compliance consultant.

SEC Settles Charges Against Portfolio Manager for Improperly Benefiting Hedge Fund Client at Expense of U.S. Fund Investors

On June 2, 2014, the SEC settled charges against Christopher Ruffle, a portfolio manager and head of China operations for the UK-based Martin Currie group of institutional money managers, for structuring a prohibited joint transaction between a U.S.-registered investment company client and a hedge fund client.

According to the SEC's order, in April 2009, in the midst of the financial crisis, Martin Currie used its U.S.-registered investment company client, The China Fund, Inc., to invest in a convertible bond transaction which directly benefited a Martin Currie hedge fund client. The SEC's order states that the hedge fund client, an affiliated person of the China Fund, had previously acquired significant amounts of illiquid bonds of a single Chinese company and needed liquidity to meet increasing redemption requests from its investors.

According to the SEC's order, Mr. Ruffle negotiated a convertible bond transaction and, together with others at Martin Currie, caused the China Fund to invest in convertible bonds issued by a subsidiary of the Chinese company in which the hedge fund client was invested. The SEC's order states that the Chinese company used 44% of the investment proceeds to redeem a significant portion of the pre-existing bonds held by the hedge fund client, which alleviated the hedge fund's liquidity concerns. Nevertheless, according to the SEC order, the China Fund's board wrote down the value of the convertible bonds to zero in November 2010 and the China Fund sold the bonds for 55% of their face value in April 2011.

The SEC's order found that Mr. Ruffle willfully aided and abetted and caused violations of Section 17(d) of the 1940 Act and Rule 17d 1 thereunder. Mr. Ruffle agreed to a one-year industry bar and to pay a $150,000 penalty.

SEC Charges Investment Advisory Firm and Its President for Fraudulently Hiding Account Shortfall

On May 5, 2014, the SEC announced fraud charges and an asset freeze against an investment advisory firm and its president for repeatedly hiding a shortfall of more than $700,000 in client assets. According to the SEC's complaint filed in U.S. District Court for the Southern District of Ohio, Professional Investment Management (PIM) reported to clients that the firm held approximately $7.7 million of client money in a money market fund account when the actual amount held was less than $7 million. The account shortfall was discovered when the SEC conducted an examination of the firm to verify the existence of client assets. The SEC alleges that Douglas Cowgill, the president and chief compliance officer of PIM, attempted to disguise the money market fund account shortfall from SEC examiners by entering a fake trade in PIM's account records and also transferring funds from a separate client cash account to the money market fund account.

The SEC's complaint alleges that: (1) PIM and Mr. Cowgill violated the antifraud provisions of the federal securities laws; (2) PIM violated the registration and custody provisions of the Advisers Act; and (3) Mr. Cowgill aided and abetted and caused PIM's Advisers Act violations.

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