September 2, 2014

Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC Proposes Extending Temporary Rule Regarding Adviser Principal Trades

On August 12, 2014, the SEC proposed an amendment to Rule 206(3)-3T to extend the Rule's expiration date by two years until December 31, 2016. 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 20, 2012, the SEC extended Rule 206(3)-3T until December 31, 2014. Pursuant to Rule 206(3)-3T, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides written prospective disclosure regarding the conflicts arising from principal trades; (3) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; (4) provides the client with an annual report on all principal transactions with that client and (5) sends confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC proposed no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension would provide adequate protection to advisory clients while the SEC continues to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.

Comments on the proposal are due by September 17, 2014.

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 on October 14, 2014. The compliance date for the floating NAV, liquidity fees and redemption gates amendments is October 14, 2016. The compliance date for the diversification, disclosure and stress testing amendments is April 14, 2016. The compliance date for reports on new Form N-CR is July 14, 2015.

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 by October 14, 2014.

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" (NIST Framework) stating that it is a place for a board to begin in assessing a company's cybersecurity readiness. He stated that the NIST Framework is intended to provide companies with a set of industry standards and best practices for managing cybersecurity.

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

Litigation and Enforcement Actions

District Court Grants Summary Judgment and Dismisses Case Regarding Insider Trading Prohibitions and Mutual Fund Redemptions

On August 29, 2014, the U.S. District Court for the Eastern District of Wisconsin granted Jilaine H. Bauer's motion for summary judgment in *Securities and Exchange Commission v. Bauer* and dismissed the SEC's case, determining that an insider trading claim brought under a "misappropriation theory" was not properly presented to the court and that a "misappropriation theory" did not properly apply to the conduct of Ms. Bauer, who at all relevant times was a corporate insider.

In the fall of 2000, Ms. Bauer served as general counsel, chief compliance officer and chairperson of the pricing committee for Heartland Advisors, Inc. (HAI), and as vice president and secretary of Heartland Group, Inc. (HGI), an open-end fund. HAI was the investment adviser, principal underwriter and distributor for the HGI mutual funds, including the Short Duration Fund and the High Yield Fund (the Funds). Beginning in 1999 and continuing through October 2000, the Funds experienced substantial net redemptions, resulting in significant decreases in NAV and increased illiquidity. In addition, several of the Funds' portfolio securities had defaulted or were in danger of default. In order to generate the cash required to meet redemption demands, the Funds began selling off securities at discounted prices. Ms. Bauer redeemed all of her shares in the Short Duration Fund on October 3, 2000. Ten days later, HAI's pricing committee instituted across-the-board "haircuts" on the Funds' securities, resulting in NAV decreases of 44.02% and 69.41% for the two Funds, which entered receivership five months later.

On December 11, 2003, the SEC charged Ms. Bauer with insider trading, and on May 25, 2011, the district court granted summary judgment to the SEC under the "classical theory" of insider trading, which "targets a corporate insider's breach of duty to shareholders with whom the insider transacts." In order to expedite the entry of judgment against Ms. Bauer on the insider trading claim, the SEC filed an unopposed voluntary motion to dismiss with prejudice all claims against Ms. Bauer other than the counts of insider trading discussed in the May 25, 2011 opinion. The district court granted the SEC's voluntary motion to dismiss on September 20, 2011.

On appeal to the U.S. Court of Appeals for the Seventh Circuit, Ms. Bauer argued that the "classical theory" is inapplicable to mutual fund redemptions because the trading counterparty—the mutual fund itself—is inherently fully informed and "cannot be duped through nondisclosure." The SEC abandoned the "classical theory" on appeal, instead arguing that Ms. Bauer was liable under the "misappropriation theory" of insider trading, whereby the disclosure obligation "runs to the source of the information" rather than the trading counterparty.

On July 22, 2013, the Seventh Circuit reversed the district court's ruling and remanded for further proceedings to consider the novel issue of whether and how the "misappropriation theory" of insider trading applies to mutual fund redemptions. In reversing the district court's order of summary judgment, the Seventh Circuit found that the lower court did not "weigh the novelty of the SEC's claims in the mutual fund context" because the SEC had not asserted the "misappropriation theory" of insider trading at the district court level. The Seventh Circuit remanded for further proceedings to consider the applicability of the "misappropriation theory" to Ms. Bauer's redemptions and to resolve questions of fact related to the materiality of Ms. Bauer's non-public information and whether Ms. Bauer acted with scienter.

On remand, the district court granted summary judgment to Ms. Bauer and dismissed the remainder of the SEC's insider trading case. In granting summary judgment, the district court noted that the SEC never properly raised the "misappropriation theory" before the court, and that, as a general matter, any theory not raised before the district court is deemed waived or forfeited. In addition, the district court noted that the "misappropriation theory" was different from the insider trading claim discussed in the court's May 25, 2011 opinion and, as a result, any claim based on such theory would have been dismissed with prejudice pursuant to the SEC's voluntary motion to dismiss granted on September 20, 2011. Moreover, the district court refused to extend the "misappropriation theory" of insider trading to Ms. Bauer given her status as an officer of the investment adviser to the Funds at all relevant times. The district court could find no precedent supporting the extension of the "misappropriation theory," which has generally been interpreted to apply only to conduct by corporate outsiders, to a corporate insider and stated that the SEC did not sufficiently explain "how an officer at a mutual fund investment adviser can be fairly considered a corporate 'outsider' given the investment adviser's deeply entwined role as sponsor and external manager of the fund."

FINRA Fines Merrill Lynch for Failing to Identify and Apply Mutual Fund Sales Charge Waivers Available for Retirement Accounts and Charitable Organizations

On June 16, 2014, Merrill Lynch, Pierce, Fenner & Smith Incorporated entered into a Letter of Acceptance, Waiver and Consent with the Financial Industry Regulatory Authority to settle alleged rule violations in connection with the firm's failure to apply mutual fund sales charge waivers at various times since at least January 2006 for approximately 41,000 small business retirement plan accounts and approximately 6,800 accounts of charitable organizations and 403(b) retirement accounts available to ministers and employees of public schools. Although most of the mutual funds available on Merrill Lynch's platform offered waivers of front-end sales charges for the eligible retirement plan accounts and charities and disclosed those waivers in their prospectuses, FINRA alleged that Merrill Lynch treated the eligible accounts in the same manner as non-retirement or ordinary retail customer accounts and, as a result, the eligible accounts either unnecessarily paid sales charges when purchasing shares, or purchased other share classes that subjected them to higher ongoing fees and expenses.

With respect to the small business retirement plan accounts, FINRA alleged that certain supervisory, compliance and legal personnel at Merrill Lynch became aware in 2006 that such accounts were being disadvantaged by not purchasing the most favorable Class A shares with sales charge waivers, but the firm elected not to notify its financial advisers and, in fact, allowed its financial advisers to sell Class A shares with front-end sales charges or more costly Class B and Class C shares to these accounts until 2011. FINRA also alleged that Merrill Lynch's policies and procedures for mutual fund purchases on its retail brokerage platform, where the small business retirement plan accounts at issue were maintained, were not designed to adequately supervise the administration of mutual fund sales charge waivers for such accounts. Merrill Lynch formed an internal task force to evaluate the small business retirement plan account problems and, after determining that the firm's systems and procedures were not designed to systematically identify and provide mutual fund Class A sales charge waivers to such eligible accounts, recommended that the firm develop and implement technological improvements that would permit the firm to more readily identify customer accounts eligible for sales charge waivers. However, FINRA alleged that development work on the improvements was never fully funded or implemented. In addition, FINRA alleged that Merrill Lynch advised its sales force in October 2010 that financial advisers were responsible for determining whether a sales charge waiver was available pursuant to mutual fund prospectuses, but did not provide its financial advisers or supervisors with any other guidance or training to determine whether accounts qualified for such waivers. Similarly, according to FINRA's allegations, Merrill Lynch solely relied upon its financial advisers to determine opportunities for 403(b) retirement accounts and accounts for charitable organizations to purchase shares with sales charge waivers, but did not have adequate written policies or procedures to help financial advisers or supervisors determine the eligibility of such accounts, and did not have controls to detect instances in which sales charge waivers should have been applied.

FINRA concluded that Merrill Lynch failed to establish and maintain an adequate supervisory system and written procedures to identify Class A mutual fund sales charge waivers in fund prospectuses, failed to adequately notify and train its financial advisers regarding mutual fund sales waiver eligibility requirements, and failed to have an adequate supervisory system to ensure that eligible accounts purchased Class A shares with sales charge waivers, resulting in violations of NASD Rules 3010 and 2110 and FINRA Rule 2010. Merrill Lynch consented to a censure and a fine of $8 million and agreed to pay $24.4 million in restitution to affected customers, in addition to $64.8 million the firm already paid.

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.

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