Investment Services Regulatory Update

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New Rules, Proposed Rules and Guidance

SEC Extends Temporary Rule Regarding Adviser Principal Trades

On December 17, 2014, the SEC adopted 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. Pursuant to Rule 206(3)-3T, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides written prospective disclosure regarding the conflicts arising from principal trades; (3) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; (4) provides the client with an annual report on all principal transactions with that client; and (5) sends confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

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

Division of Investment Management Issues Guidance Regarding Mixed and Shared Funding Orders

In October 2014, the staff of the Division of Investment Management of the SEC published a Guidance Update addressing whether a fund that offers its shares under a variable life and/or variable annuity contract is required to obtain a "mixed and shared funding" order prior to making such offer or, if an order previously has been obtained, whether a fund needs to comply with the terms and conditions of the order if the exemptions from the 1940 Act granted thereunder are not being relied upon.

In the Guidance Update, the staff notes that neither "mixed funding"—the sale of shares of a fund to various types of offerees (e.g., variable insurance contracts and retirement plans)—nor "shared funding"—the sale of shares of a fund as an investment option in variable insurance contracts issued by multiple unaffiliated insurance companies—is prohibited by the 1940 Act, but that insurance companies and their affiliates that seek to rely on certain SEC rules providing exemptions from Sections 9(a), 13(a) and 15(a) and (b) of the 1940 Act must comply with restrictions on mixed and shared funding. The staff further notes that, although many funds have sought and received mixed and shared funding orders to allow insurance companies and their affiliates to rely on the exemptions from Sections 9(a), 13(a) and 15(a) and (b) without complying with the restrictions on mixed and shared funding, such exemptions are very infrequently relied upon.

In light of the infrequent reliance, the staff states that: (1) a fund is not required to obtain a mixed and shared funding order prior to offering its shares as an investment option in one or more variable insurance contracts, but an insurance company and its affiliates will not have the exemptions typically granted by the orders, and (2) compliance with the terms and conditions of a previously issued order is not required if no insurance company or its affiliates are relying on the exemptions granted thereunder. The staff also notes in the Guidance Update that participation agreements between insurance companies and funds may require compliance with the terms and conditions of a fund's mixed and shared funding order and that insurance companies and funds may want to revise the terms of their participation agreements to eliminate such requirements if the insurance companies are not relying on the exemptions granted under the orders.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2014-10.pdf.

Division of Investment Management Issues Guidance on the Presentation of Consolidated Financial Statements

In October 2014, the Chief Accountant's Office of the Division of Investment Management of the SEC published a Guidance Update regarding the presentation of consolidated financial statements for feeder funds, funds of funds and business development companies (BDCs).

For feeder funds, the Guidance Update notes that the Chief Accountant's Office generally has taken the position that, because feeder funds are typically one of several investors in a master fund, unconsolidated financial statements for feeder funds are the most meaningful presentation, provided that, among other things: (1) a feeder fund attaches the financial statements of the master fund to its financial statements; (2) if a master fund is organized as a partnership, the feeder fund separately discloses on its statement of operations the net investment income, net realized gain or loss, and net change in unrealized gain or loss allocated from the master fund; and (3) if a master fund is organized as a partnership, the feeder fund includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights.

For funds of funds, the Guidance Update notes that the Chief Accountant's Office has taken the position that, because funds of funds typically invest in multiple underlying funds, unconsolidated financial statements for funds of funds are the most meaningful presentation. The Guidance Update notes that a fund of funds should consider whether investment in any single underlying fund is so significant to the fund of funds that its financial statements should be presented in a manner similar to the presentation by feeder funds.

For BDCs, the Guidance Update states that a number of BDCs have wholly-owned subsidiaries, but do not consolidate such subsidiaries even though the design and purpose of the subsidiary may be to act as an extension of the BDC's investment operations. The Guidance Update suggests that BDCs consolidate such subsidiaries, because the consolidation will provide investors with the most meaningful financial statements.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2014-11.pdf.

Other News

SEC Chair and FSOC Comment on Asset Management Regulation and Systemic Risk

In a December 11, 2014 speech, SEC Chair Mary Jo White described three initiatives that the SEC staff has been working on to address fund portfolio composition risks and operational risks. Similarly, the following week on December 18, 2014, the Financial Stability Oversight Council (FSOC) voted to issue a notice inviting public comment regarding various matters affecting the asset management industry, including liquidity and redemptions, leverage, operational risk and the failure of an asset manager.

The first SEC initiative discussed by Ms. White focuses on enhanced data reporting for investment advisers and funds. She stated that the SEC staff is developing recommendations to enhance reporting with respect to fund use of derivatives, fund liquidity and valuation of portfolio holdings and securities lending practices.

Second, Ms. White discussed the need for funds to have controls in place to identify and manage risks, including with regard to liquidity management and the use of derivatives. She stated that the SEC staff is considering whether broad risk management programs should be required for mutual funds and ETFs to address such risks.

The final initiative described by Ms. White would require investment advisers to create transition plans to prepare for major business disruptions. Ms. White also noted that the SEC staff is considering ways to implement the new requirements for annual stress testing by large investment advisers and funds as required by the Dodd-Frank Act.

Ms. White also discussed systemic risk, noting that any changes undertaken by the SEC may affect the entire financial system, and stating that the work of FSOC and the SEC in this area is complementary. The following week, FSOC issued a notice requesting comments on systemic risks posed by products and activities in the asset management industry. FSOC acknowledged the SEC's initiatives as outlined by Ms. White.

The FSOC notice requests comments on the following issues:

- The extent to which redemption rights and risks in pooled investment vehicles could influence investor behavior and affect the stability of the financial system;
- The ways in which the use of leverage by investment vehicles could increase the potential for forced asset sales, or expose lenders or other counterparties to losses or unanticipated market risks, and the extent to which these risks may have implications for U.S. financial stability;
- Operational risks in the asset management industry, including those associated with the transfer of client assets between asset managers and risks that may arise when multiple asset managers rely on one or a limited number of third parties to provide important services, such as asset pricing and valuation or portfolio risk management; and
- The effect the failure or closure of an asset manager, investment vehicle or an affiliate might have on the financial markets or the economy.

The full text of Ms. White's remarks are available at www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VLRPRYrF-IJ.

The FSOC notice is available at www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.

Director of the Division of Investment Management Discusses Alternative Mutual Fund Disclosures

In a speech at the SIFMA Complex Products Forum on October 29, 2014, Norm Champ, the Director of the SEC's Division of Investment Management, discussed the Division's views regarding the accuracy and completeness of alternative mutual fund prospectus disclosures. Mr. Champ acknowledged the "challenge" involved in writing clear, concise disclosure about the complex investment strategies used by alternative mutual funds and the risks associated with such strategies. He stated that prospectus disclosures should be tailored to address the alternative investment strategies that a fund expects to be the primary means for achieving its investment objectives and that will have significant effects on its performance. He stated that a fund should focus on the degree of economic exposure an alternative investment strategy creates, in addition to the amount invested in that strategy. With respect to risk disclosures, Mr. Champ explained the staff's view that such disclosures should provide a "complete risk profile of the fund's investments taken as a whole." He suggested that a fund should disclose material risks relating to volatility, leverage, liquidity and counterparty creditworthiness that are associated with alternative investment strategies. Finally, Mr. Champ expressed the staff's concern that there may be a disconnect between an alternative mutual fund's strategies and risks disclosed in its prospectus and the strategies actually employed by the fund. He noted the staff's belief that a fund should assess, in conjunction with its annual registration statement update, the accuracy and completeness of its disclosures in light of its actual operations. Mr. Champ also reported that the staff has been reviewing data to compare the actual use of alternative investment strategies by a fund with the disclosures in its prospectus.

The full text of Mr. Champ's remarks are available at http://www.sec.gov/News/Speech/Detail/Speech/1370543319219#.VLRP0orF-IJ.

Litigation and Enforcement Actions

SEC Settles with Investment Advisory Firm over Claims of False Performance Advertising

On December 22, 2014, the SEC settled charges against investment advisory firm, F Squared Investments, Inc., in connection with false performance advertising of F Squared's AlphaSector product. The SEC also charged the firm's co-founder and former CEO, Howard Present, since according to the SEC, he was responsible for F Squared's advertising materials and also certified the accuracy of filings regarding AlphaSector with the SEC.

According to the SEC's order, F Squared advertised a seven-year track record for AlphaSector's investment strategy using data derived through backtesting (i.e., applying a model to historical market data to generate hypothetical performance for prior periods), although F Squared advertised the investment strategy as "not backtested." The SEC also alleged that the data used to calculate the track record contained a substantial performance calculation error that inflated the results by approximately 350%.

F Squared consented to the entry of the order finding that it violated various sections of the Advisers Act and the rules thereunder. The order also found that F Squared aided and abetted and caused certain mutual funds sub-advised by F Squared to violate Section 34(b) of the 1940 Act. F Squared agreed to retain an independent compliance consultant and pay disgorgement of $30 million and a penalty of $5 million.

SEC Charges Investment Advisory Firm and Top Officials with Custody Rule Violations

On October 29, 2014, the SEC brought charges against Sands Brothers Asset Management, LLC; Steven Sands and Martin Sands, the firm's co-chairmen; and Christopher Kelly, the firm's chief compliance officer and chief operating officer, for violating Rule 206(4)-2 (the custody rule) under the Advisers Act by repeatedly failing to distribute audited financial statements to the firm's private fund investors within 120 days of the end of the fiscal year. The SEC's order alleges that Sands Brothers Asset Management willfully violated the custody rule and that Steven Sands, Martin Sands and Christopher Kelly aided and abetted the violation. According to the SEC's order, Sands Brothers Asset Management and Steven Sands and Martin Sands were previously sanctioned by the SEC in 2010 for custody rule violations.

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