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Regulatory Update and Recent SEC Enforcement Actions Affecting Investment Companies and Registered Investment Advisers

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Regulatory Update

- OCIE Cybersecurity Exam Initiative
  - On September 15, 2015, the Staff of the Securities and Exchange Commission ("Staff") issued a risk alert release announcing that the Office of Compliance Inspections and Examinations ("OCIE") will be conducting a new Cybersecurity Examination Initiative (the "Initiative"). OCIE will undertake examinations of registered broker-dealers and investment advisers' cybersecurity preparedness in light of recent breaches and continuing threats against financial services firms.
  - OCIE will focus evaluating and testing controls in the following areas when conducting their examinations:
    - *Governance and Risk Assessment*: whether registrants have cybersecurity governance and risk assessment processes and whether those controls and processes are evaluated regularly and adequately personalized to the firm.
    - *Access Rights and Controls*: how firms control access to systems and data through management of user credentials, authentication and authorization, including controls associated with remote access, customer logins and passwords.
    - *Data Loss Prevention*: how firms review the volume of content transferred outside of the firm by employees or through third parties, such as by e-mail attachments or uploads. This includes an assessment of how firms monitor for unauthorized data transfers and verify the authenticity of a customer request to transfer funds.
    - *Vendor Management*: review the firm practices and controls related to vendor management, such as due diligence in selecting a vendor, monitoring and oversight of vendors and contract terms.
    - *Training*: how training is customized to specific job functions and designed to encourage responsible employee and vendor behavior. Also, review of procedures for responding to cyber incidents under an incident response plan.
    - *Incident Response*: whether firms have established policies, assigned roles, assessed system vulnerabilities and developed plans to address a possible future cyber event.

- January 2016 Guidance from the Division of Investment Management ("IM") related to Rule 12b- 1
  - IM issued guidance relating to payments by mutual funds to financial intermediaries that provide administrative and shareholder services and the extent to which those payments may be used for distribution purposes. If fund payments are used for distribution, those payments must be made in accordance with Rule 12b-1 of the Investment Company Act of 1940, as amended. Rule 12b-1 prohibits mutual funds from engaging, directly or indirectly, in the financing of any activity

which is primarily intended to result in the sale of fund shares except pursuant to a 12b-1 plan. This limitation applies to payments that are recognized as distribution fees, but also to payments that are used in ways that finance distribution even if made for some other purpose.

- The Staff has conducted numerous exams on mutual fund complexes, investment advisers, transfer agents and broker dealers and found that certain fees including administrative, sub-accounting and shareholder servicing fees were potentially being used for distribution.
- The Staff has recommended that mutual fund boards establish procedures to assess whether certain sub-accountings fees are directly or indirectly being used for distribution. When board members are reviewing such fees they should "consider the interrelationship between the plan and the activities of any other person who finances or has financed distribution of the company's shares, including whether any payments by the company to such other person are made in such a manner as to constitute the indirect financing of distribution by the company" according to the Staff.
- In particular mutual fund boards should look at the following to help determine whether or not certain fees are being used directly or indirectly for distribution:
    - Distribution related activities that are dependent on the payment of sub-accounting fees.
    - Mutual funds that do not pay distribution expenses through a 12b-1.
    - Advisers who enter into agreements with intermediaries who provide numerous services to the fund and the established payment structure.
    - Intermediaries who do not specifically state what sub-accounting services are being provided and include payments for sub-accounting and distribution into one contract.
    - Distribution benefits derived from an adviser or service provider from recommending or increasing sub-accounting fees.
    - Large inconsistencies in sub-accounting fees paid to intermediaries for similar services to be provided.
    - Payments made for additional "strategic sales data" that is related to distribution.

- February 2016 Announcement Regarding Registered Investment Adviser Oversight
    - Due to a budget increase for the fiscal year of 2016, the Staff intends to increase the number of registered investment adviser ("RIA") examiners and examinations by nearly 20%.
    - The Staff will shift broker-examination staff to RIA exam staff and is considering permitting third parties to conduct the examination in order to increase the number of RIA examiners.

- March 2016 IM Guidance Update
  - The Staff issued guidance to foster investor protection by reminding fund managers to periodically evaluate fund disclosures to provide investors with ample and truthful information about fund risks.
  - The guidance update was intended to address risk disclosure associated with changes in a fund's susceptibility to risk and the need for funds to review and assess risk disclosures in light of changing market conditions.
  - The Staff recommends the following steps be implemented in order to provide fulsome risk disclosures to investors:

    - *Monitor market conditions*. Funds should monitor market conditions on an ongoing basis and assess how any changes in the market impact the fund and its risk.
    - *Determine whether changes in market conditions should be communicated to investors*. If varying market conditions impact the risk of a fund, the fund should assess the significance of the change and determine whether the change is material to investors. Funds should also consider whether existing disclosures are adequate.
    - *Communicate with investors*. A fund that determines that the current market conditions resulted in material changes to the fund's risk should update investors. This may include changing the prospectus, shareholder reports, investor letters, as well as less formal methods such as website disclosures.

Overview of Enforcement Actions since September 2015:

- In the Matter of R.T. Jones Capital Equities Management, Inc. (September 2015; Admin. Proc. File No. 3-16827)
  - An investment adviser agreed to settle charges that it failed to establish the required cybersecurity policies and procedures in advance of a breach that compromised the personally identifiable information of approximately 100,000 individuals, including thousands of the firm's clients. However, no client suffered financial harm as a result of the cyber attack.
  - The federal securities laws require RIAs to adopt written policies and procedures reasonably designed to protect customer records and information.
  - During nearly a four-year period, R.T. Jones Capital Equities Management, Inc. ("R.T. Jones") failed to adopt any written policies and procedures to ensure the security and confidentiality of personally identifiable information and protect the information from anticipated threats or unauthorized access.
  - Specifically, R.T. Jones failed to conduct periodic risk assessments, implement a firewall, encrypt personally identifiable information stored on its server, or maintain a response plan for cybersecurity incidents.

- R.T. Jones violated Rule 30(a) of Regulation S-P under the Securities Act of 1933, agreed to be censured and pay a $75,000 penalty.

- SEC v. Bennett Group Financial Services, LLC and Dawn J. Bennett (Admin. Proc. File No. 3-16801; September 2015)
  - The Staff brought fraud charges against a Maryland-based financial services firm and its founder/CEO, accusing them of grossly inflating the amount of managed assets and exaggerating the investment returns actually obtained for customers.
  - For over two years, Dawn Bennett ("Bennett") made false statements on radio shows claiming that her firm managed between $1.1 billion and $1.8 billion in assets, when it actually managed around $407 million. The Staff alleges that as a result, a media organization ranked Bennett fifth in the category of "Top 100 Women Financial Advisors" and second in its listing of the "2011 Top Advisors" in Washington.
  - The Staff alleges that compliance and controls at Bennett Group Financial Services, LLC (the "Firm") were not up to snuff, including that the Firm's compliance manual lacked adequate safeguards and the chief compliance officer did not take steps to follow up on the numbers Bennett produced for the amount of assets supposedly under management.
  - Bennett and her Firm fought back by asking the Staff's Administrative Law Judge either to dismiss or stay the proceeding against her on the grounds that the agency has an unconstitutional process for appointing judges. The request was denied and Bennett appealed that decision, which was denied on appeal.
  - Bennett and her firm refused to participate in the administrative proceeding hearing.
  - The Staff seeks up to $15 million in disgorgement and fines.

- *In the Matter of UBS Willow Management L.L.C.* (Admin. Proc. File No. 3-16909; October 2015)
  - An example of the Staff bringing an enforcement action predicated on the failure of a firm to comply with its operating documents.
  - The advisers to a fund failed to inform investors that they effectively changed the investment strategy by altering the composition and risk of its portfolio.
  - UBS Willow Management was a registered investment adviser. The Offering Memorandum of the fund stated that the fund primarily invested in distressed debt. The document also specified that the fund invested in other types of securities, including derivatives for hedging and speculation.
  - Through 2008, the fund invested primarily in distressed debt. It then changed the composition of the investment portfolio by significantly increasing the short exposure of the fund. By the end of the first quarter of 2009, 25% of the portfolio was no longer invested in distressed debt. That switch changed the risk profile of the fund. It also contributed to significant losses starting in early 2009 and eventually led to the liquidation of the fund in 2012.

- The Offering Memorandum did not reflect the change in portfolio composition. Likewise, investor letters disseminated by Willow Management did not record the change. Nor did the filings made with the Staff.
- The fund adviser was aware of the change in investment strategy. Nevertheless, it never directed management to reduce the fund's non-distressed debt exposure. The Staff found that the fund adviser thus failed to reasonably supervise management.
- To resolve the proceedings, Respondents compensated Fund investors $8,223,110 and paid prejudgment interest.

▪ In the Matter of Virtus Investment Advisers, Inc. (Admin. Proc. File No. 3-16959; November 2015)
  - The Virtus Investment Advisers, Inc. ("Virtus") matter is an important statement from the Staff of its views that each investment adviser is ultimately responsible for verifying the accuracy of any performance data presented in its advertisements and should adopt and implement procedures reasonably designed to accurately verify the contents of such materials.
  - The Staff instituted and settled proceedings against Virtus based on, among other things, its inclusion in advertisements and filings of allegedly false and misleading performance data that had been provided to it by one of its third-party sub-advisers, F-Squared Investments, Inc. ("F-Squared").
  - In the order, the Staff acknowledged that F-Squared and its President had lied to Virtus about the history and performance of one of F-Squared's strategies, and alleged that Virtus had relied on F-Squared's representations without properly verifying them.
  - In addition, based on statements made by Virtus in advertisements and filings, which were based on the representations made by F-Squared to Virtus, the Staff alleged that Virtus itself made false and misleading statements about past performance.
  - Virtus is also subject to a class action lawsuit alleging that it knowingly marketed F-Squared's allegedly bogus track record in pushing its funds, in the process giving an artificial lift to Virtus' share price.

▪ *In the Matter of Fenway Partners, LLC* (Admin. Proc. File No. 3-16938; November 2015)
  - The private equity adviser Fenway Partners, LLC ("Fenway Partners") and four executives, including its chief compliance officer, agreed to pay a combined $10.2 million to settle claims that they failed to disclose conflicts of interest around payments to an affiliate and former employees.
  - According to the Staff, Fenway Partners used more than $20 million of fund and portfolio company assets to pay for consulting work by an affiliate that previously had been performed internally and to reward former employees for work they primarily performed while they were on staff at Fenway Partners. The payments were not fully disclosed to the fund's board.

- Moreover, even though millions of dollars were paid to the affiliate for its services, the money was not used to offset the advisory fees Fenway Partners charged the fund's investors, even though the fund's offering documents disclosed that such fees would be used as an offset. By not doing so, the firm effectively collected larger advisory fees from investors.

- *In the Matter of Marwood Group Research, LLC* (Admin. Proc. File No. 3-16970; November 2015)
  - Marwood Group Research, LLC ("Marwood Group") agreed to settle charges over its handling of government information by paying a $375,000 penalty for compliance issues and to establish new safeguards.
  - The settlement came amid multiple investigations looking into whether policy-research firms violated insider-trading rules by passing sensitive information about government policy to Wall Street clients.

- *In the Matter of Equinox Fund Management, LLC* (Admin. Proc. File No. 3-17057; January 2016)
  - Equinox Fund Management, LLC ("Equinox"), an asset management firm and RIA, was sued by the Staff alleging that one particular fund in the family of Equinox funds failed to adhere to disclosed policies and procedures regarding three key items: (1) the manner in which fees were charged and whether the fees were actually calculated based on the NAV for each series; (2) valuation of derivatives; and (2) value of an option transferred between two series.
  - The policies and procedures required that Equinox take into account the manner in which the same or similar securities held by other managed funds were valued in those funds.
  - To resolve the proceeding, Respondent consented to the entry of a cease and desist order, and the adviser agreed to pay disgorgement of $6,000,067, prejudgment interest and a penalty of $400,000.

- In the Matter of Royal Alliance Associates, Inc. (Admin. Proc. File No. 3-17169; March 2016)
  - Respondents, registered broker-dealers and investment advisers, consented to the entry of a cease and desist order stemming from conflicts of interests, and were also censured and fined nearly $9.5 million.
  - The proceeding centered on undisclosed conflicts and the failure to properly implement procedures to avoid reverse churning despite warnings from OCIE.
  - Over a two-year period, the Respondents invested advisory clients in mutual fund share classes with 12b-1 fees when there were lower-fee classes of the same funds available that did not have such charges.
  - In their capacity as broker-dealers, Respondents were paid the 12b-1 fees from advisory client investments. This resulted in Respondents being paid about $2 million in 12b-1 fees that would otherwise not have been available. While the firms disclosed in Forms ADV that 12b-1 fees were paid, the conflict

with regard to the selection of mutual fund shares was not. This resulted in a breach of fiduciary duty by Respondents.
- In addition, under the advisory compliance policies and procedures, the Respondents were required to monitor the level of trading activity in their advisory accounts for inactivity or reverse churning. OCIE discovered that nearly 1,400 clients were owed reimbursement of fees.
- It is important to remember that over the past few years, OCIE has become aggressive and taken on a quasi-enforcement role.

Regulatory Updates

- Limit Derivatives in Mutual Funds
  - In December 2015, the Staff proposed new rules that will require a fund that enters into a derivative transaction to comply with certain asset requirements and portfolio limitations as well as create a derivative risk management program if the fund's exposure reaches a specific threshold.
  - The proposed rule was the result of the Staff's concern that the growing use of derivatives by investment companies may involve degrees of leverage that create the potential for speculation and abuses that Congress wanted to prevent when it designed the Investment Company Act of 1940.
  - The proposed rule will also seek to manage risks related to derivative transactions by segregating assets in an amount that is adequate to allow the fund to meet its specific obligations to shareholders during distressed market conditions.
  - Any fund that participates in more than a minor amount of derivative transactions will be required under the rule to create a formalized derivatives risk management program.
  - The proposed new rules would also require fund directors to approve a derivatives risk management program, unless the fund limits its aggregate exposure to derivatives transactions to no more than 50% of its NAV and does not use "complex derivatives" without regard to the 50% threshold. In order to carry out this responsibility, a director must know whether the fund invests in "complex derivatives." The rule would define complex derivatives, generally, as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise (i) depends on the value of the underlying reference asset at multiple points in time during the term of the transaction, or (ii) is a "non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price."
  - The proposed new rules only apply to derivatives that involve a continuing obligation of a fund to pay anything during the life of the instrument or at maturity or early termination, as would typically be the case with derivatives involving explicit leverage. The proposed rules would not affect the ability of a fund to invest in securities providing indirect or "economic"

leverage that do not involve an ongoing potential obligation to pay money to a counterparty.
  - Industry trade groups such as SIFMA and Investment Adviser Association (IAA) have opposed the proposed portfolio limits in the Staff's proposed rule.

- Department of Labor Fiduciary Rule
  - The Department of Labor has issued long-awaited regulations and related guidance that define what activities are "investment advice" for purposes of retirement plan administration, including retirement plans subject to ERISA and retail plans such as IRAs that may not be subject to ERISA.
  - The guidance is concerned with a portion of the definition of "fiduciary" in ERISA and the Internal Revenue Code. One of the ways that a person becomes a fiduciary with respect to a plan is if "he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan." A fiduciary must act prudently and in the best interests of the plan participants.
  - More troublesome are the "prohibited transaction" rules which strictly prohibit a fiduciary from using his or her fiduciary authority in a manner that would inure to the fiduciary's benefit. For example, an investment adviser fiduciary may not advise an IRA beneficiary to invest IRA assets in a mutual fund that pays 12b-1 fees to the fiduciary.
  - The regulations issued back in 1975 limited the definition of fiduciary for investment advice purposes to situations in which there is an ongoing relationship between the investment adviser and the plan and the advice is expected to be the "primary" basis for making the investment decision. Thus, a sales pitch would typically not be a fiduciary action, and communications at the retail level may not be fiduciary since there is often not an ongoing relationship between adviser and plan.
  - The new regulations, which are effective in one year, expand the definition of fiduciary for investment advice purposes. Most significantly they remove the requirements that the advice be ongoing and serve as the primary basis for the investment decision. Now, any "recommendation" directed "to a specific recipient" regarding the "advisability of a particular investment or management decision" with respect to the plan's investment assets, for which the adviser or the adviser's affiliates receive direct or indirect compensation, would be considered fiduciary in nature.
  - This could sweep up certain sales practices and one-off conversations and, with the consolidation of the financial services industry, it is ever more likely that some affiliate is receiving direct or indirect compensation with respect to the plan.
  - There are, however, several meaningful and helpful exemptions. Most broadly is an exemption for so-called "Best Interest Contracts," which permits professional advisers to receive compensation for investment advice in the retail retirement sector if the adviser acknowledges it is a fiduciary and the

advice adheres to "impartial conduct standards" as spelled out by the Department and all compensation is fully disclosed.

- Penalties for non-compliance with the regulations include significant excise taxes, the probability that transactions that violate the rules must be reversed and the possible exclusion of the firm from the retirement plan business.
- Although some firms are rumored to be considering leaving the retirement plan space, we expect that most of the activity in this area will be to comply with one of the other exemptions.

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