GODFREY & KAHN S.C.

Investment Management Focus

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Legal and Regulatory Update

Latest Developments

SEC Adopts Liquidity Risk Management Programs and Swing Pricing

On October 13, 2016, the SEC adopted new rules, forms and amendments to promote liquidity risk management across the open-end fund industry, which:

- require open-end funds, including mutual funds and open-end exchange-traded funds (ETFs) (collectively, funds), to establish liquidity risk management programs under new Rule 22e-4 (the liquidity rule);
- permit, but do not require, open-end funds (except money market funds and ETFs) (mutual funds) to use swing pricing in pricing their shares, under amendments to Rule 22c-1; and
- require funds to provide additional disclosures about redemptions, swing pricing (if applicable), and liquidity on Form N-1A, Form N-PORT, Form N-CEN, and Form N-LIQUID.

The liquidity risk management program proposal was passed by a vote of 3-0, and the swing pricing proposal was passed by a vote of 2-1 (note that there are currently two vacancies on the Commission). Commissioner Piwowar voted against swing pricing, citing several investor protection concerns, including concerns that "adopting a swing pricing threshold could open the door to harmful gaming behavior."

The final rules modify the role of the fund board in keeping with its oversight role and reflect certain concessions to the fund industry, including the simplification of classification categories from six to four, with shorter-term horizons categories, and allowing funds to classify portfolio investments via assignments to asset classes without individually classifying each portfolio position in all cases. Regarding the shortening of horizons, many commenters objected to the six categories that would require funds to make projections about asset liquidity, particularly to the extent that they would have to project a fund's ability to sell and settle a position well into the future. The proposed rule required a fund to classify each of its positions in a portfolio asset into one of six liquidity categories: (1) convertible to cash within 1 business day; (2) convertible to cash within 2-3 business days; (3) convertible to cash within 4-7 calendar days; (4) convertible to cash within 8-15 calendar days; (5) convertible to cash within 16-30 calendar days; and (6) convertible to cash in more than 30 calendar days. The final rule abandoned the three most far-reaching classification categories and includes four classification categories with short- and medium-term timeframes. Please see "Classification of the Liquidity of Fund Portfolio Investments" below.

Most funds will be required to comply with the liquidity risk management program requirements by December 1, 2018, except fund complexes with less than $1 billion in net assets will be required to comply by June 1, 2019. The swing pricing amendments will become effective two years after publication in the Federal Register. The compliance date for the form amendments will differ by form.

Liquidity Risk Management Programs
A fundamental feature of open-end funds is that they allow investors to redeem their shares daily. Funds must maintain sufficiently liquid assets in order to meet shareholder redemptions while also minimizing the impact of those redemptions on the fund's remaining shareholders. Rule 22e-4 will require mutual funds and ETFs to establish liquidity risk management programs. The rule excludes money market funds from all requirements of the rule and ETFs that qualify as "in-kind ETFs" from certain requirements.

The liquidity risk management program must include:

- assessment, management, and periodic review of a fund's liquidity risk;
- classification of the liquidity of fund portfolio investments;
- determination of a highly liquid investment minimum;
- limitation on illiquid investments; and
- board oversight.

Assessment, Management, and Periodic Review of a Fund's Liquidity Risk: A fund will be required to assess, manage, and periodically review its liquidity risk, based on specified factors. Liquidity risk is defined as the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund.

Classification of the Liquidity of Fund Portfolio Investments: A fund will be required to classify each of the investments in its portfolio into one of four liquidity categories:

- highly liquid investments;
- moderately liquid investments;
- less liquid investments; and
- illiquid investments.

The classification will be based on the number of days in which the fund reasonably expects the investment will be convertible to cash in current market conditions without significantly changing the market value of the investment, and the determination will have to take into account the market depth of the investment. For example, a highly liquid investment is an investment that the fund reasonably expects to be convertible into cash in three business days or less. An illiquid investment is an investment that the fund reasonably expects cannot be sold or disposed of in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.

Additionally, a fund may classify investments by asset class, unless market, trading, or investment-specific considerations with respect to a particular investment are expected to significantly affect the liquidity characteristics of that investment as compared to the fund's other portfolio holdings within that asset class.

Determination of a Highly Liquid Investment Minimum: A fund will be required to determine a minimum percentage of its net assets that must be invested in highly liquid investments, defined as cash or investments that are reasonably expected to be converted to cash within three business days without significantly changing the market value of the investment. The fund also will be required to implement policies and procedures for responding to a highly liquid investment minimum shortfall, which must include board reporting in the event of a shortfall.

Limitation on Illiquid Investments: A fund will not be permitted to purchase additional illiquid investments if more than 15% of its net assets are illiquid assets. An illiquid investment is an investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days without significantly changing the market value of the investment. The determination will have to follow the same process as the other liquidity classifications, and funds will have to review their illiquid investments at least monthly. If a fund exceeds the 15% limit, the occurrence must be reported to the board, along with an explanation of how the fund plans to bring its illiquid investments back within the limit within a reasonable period of time, and if it is not resolved within 30 days, the board must assess whether the plan presented to it is in the best interest of the fund and its shareholders.

Board Oversight: A fund's board, including a majority of the fund's independent directors, will be required to approve the fund's liquidity risk management program and the designation of the fund's adviser or a fund officer to administer the program. The fund's board will also be required to review, at least annually, a written report on the adequacy of the program and the effectiveness of its implementation. Relative to the proposed rule, the final rule reduces the responsibilities of a fund's board. Under the final rule, the board is not required to approve the fund's highly liquid investment minimum or material changes to the fund's liquidity risk management program.

Implementation Costs

One-Time Costs. The final rule includes a cost-benefit analysis that assumes the process of classifying assets would constitute approximately 75% of a fund's costs of complying with Rule 22e-4, resulting in one-time costs for funds that range from approximately $0.8 million to $10.2 million, with an average cost per fund complex of $1 million. The estimated one-time costs are attributable to developing policies and procedures and related recordkeeping requirements; system modifications; implementing policies and procedures (including classifying the liquidity of each of the fund's portfolio investments); training; and costs associated with educating the fund's board and obtaining approval of the program. The SEC noted that third party vendors are developing asset classification programs that may lower costs. However, the final rule emphasizes that it is ultimately each fund's responsibility to classify its positions.

Ongoing Costs. The SEC estimates a range of ongoing costs across all funds of $40,000 to $3.3 million per fund complex, attributable to (1) classification of the liquidity of each fund's portfolio investments, as well as at-least-monthly reviews of the fund's liquidity classifications; (2) periodic review of the fund's liquidity risks; (3) periodic review of the highly liquid investment minimum; (4) staff training; (5) approval, annual review and general oversight by the fund board; and (6) recordkeeping.

The SEC stated that depending on the personnel (and/or third party service providers) involved in establishing and implementing a liquidity risk management program, certain of the estimated one-time costs could be borne by the fund, and others could be borne by the fund's adviser or other service providers. The SEC stated that cost allocation would be dependent upon the facts and circumstances and would not estimate which costs would typically be allocated to the fund.

Swing Pricing

Swing pricing is the process of adjusting a mutual fund's net asset value (NAV) per share to pass on to purchasing or redeeming shareholders certain of the costs associated with their trading activity in fund shares. It is designed to protect existing shareholders from dilution associated with shareholder purchases and redemptions. Pooled investment vehicles in certain foreign jurisdictions currently use varying forms of swing pricing. The amendments to Rule 22c-1 will permit, but not require, mutual funds to use swing pricing.

A mutual fund that chooses to use swing pricing will adjust its NAV per share by a specified amount, the swing factor, once the level of net purchases into or net redemptions from the fund exceeds a specified percentage of the fund's NAV, known as the swing threshold. A mutual fund's swing pricing policies and procedures must specify the process for how the fund's swing factor and swing threshold will be determined (taking into account certain considerations) and establish and disclose an upper limit on the swing factor used, which may not exceed two percent of NAV per share.

The mutual fund's board must approve the fund's swing pricing policies and procedures and periodically review a written report that will, among other things, review the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation. The board will also be required to approve the fund's swing factor upper limit, swing pricing threshold, and any changes.

Additional Disclosure and Reporting Requirements

Form N-1A. A fund must describe its procedures for redeeming fund shares, the number of days in which the fund typically expects to pay redemption proceeds, and its methods for meeting redemption requests. Amendments to Form N-1A and Regulation S-X also address financial statement and performance reporting related to swing pricing, and require a fund that uses swing pricing to provide an explanation of its use in the registration statement. Funds will be required to comply with Form N-1A amendments related to swing pricing as of the effective date of Rule 22c-1(a)(3) (i.e., two years after publication in the Federal Register).

Form N-PORT. A fund must report the aggregated percentage of its portfolio representing each of the four classification categories. A fund must also report to the SEC, on a confidential basis, position-level liquidity classification information and information regarding a fund's highly liquid investment minimum.

Form N-CEN. A fund must disclose information regarding the use of lines of credit and interfund borrowing and lending. An ETF must report if it is an "in-kind ETF" under the rule. A fund using swing pricing must report information regarding its use, including its swing factor upper limit.

Form N-LIQUID: This new form will generally require a fund to confidentially notify the SEC when the fund's level of illiquid assets exceeds 15% of its net assets or when its highly liquid investments fall below its minimum for more than a brief period of time.

Sources: Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016), available at www.sec.gov/rules/final/2016/33-10233.pdf; Investment Company Swing Pricing, Investment Company Act Release No. 32316 (Oct. 13, 2016), available at www.sec.gov/rules/final/2016/33-10234.pdf; SEC Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs, and Permit Swing Pricing, Press Release 2016-215 (October 13, 2016), available at https://www.sec.gov/news/pressrelease/2016-215.html; Statement at Open Meeting on Investment Company Liquidity Risk Management Programs, Investment Company Swing Pricing, and Investment Company Reporting Modernization Releases, Commissioner Michael S. Piwowar (Oct. 13, 2016), available at http://www.sec.gov/news/statement/piwowar-statement-open-meeting-101316.html.

SEC Adopts Investment Company Reporting Modernization

On October 13, 2016, the SEC adopted the following changes to modernize reporting and disclosure requirements for mutual funds, ETFs and other registered investment companies (collectively, funds):

- rescinded Form N-Q and adopted new Form N-PORT, which will require funds to report information regarding their portfolio holdings to the SEC on a monthly basis (information will remain publicly available on a quarterly basis);
- amended Regulation S-X to require standardized and enhanced derivatives disclosures in financial statements; and
- rescinded Form N-SAR and adopted new Form N-CEN, which will require funds to report census-type information on an annual basis.

The proposal was passed by a vote of 2-1. Commissioner Piwowar voted against the reporting modernization rule because it deferred adoption of proposed Rule 30e-3, which would have permitted, but not required, a fund to make shareholder reports available online instead of mailing them to shareholders. Commissioner Piwowar characterized proposed Rule 30e-3 as "the one component of the reporting modernization proposal that promised a reduction in costs for fund shareholders." The SEC received letters from over 900 commenters expressing views on the proposed Rule 30e-3, and opponents to the rule include Broadridge Financial Solutions, Inc., the National Association of Letter Carriers, paper industry employees and the Consumer Federation of America. SEC Chair White has indicated that the staff will bring the SEC a recommendation on Rule 30e-3 by the end of the year.

Most funds will be required to begin filing reports on new Forms N-PORT and N-CEN no later than July 30, 2018, except fund complexes with less than a $1 billion in net assets are required to begin filing reports on Form N-PORT no later than July 30, 2019.

Monthly Portfolio Reporting

Funds currently report their complete portfolio holdings quarterly on Form N-Q (at the end of the first and third fiscal quarters) and Form N-CSR (at the end of the second and fourth fiscal quarters). The SEC rescinded Form N-Q and adopted Form N-PORT.

Form N-PORT. A new portfolio reporting form, Form N-PORT, requires registered investment companies (except for money market funds and small business investment companies) and ETFs organized as unit investment trusts to provide portfolio-wide and position-level holdings data to the SEC on a monthly basis in a structured XML format. The form requires reporting regarding the fund and its investments, including:

- general information about the fund;
- information regarding assets and liabilities;
- portfolio-level risk metrics (e.g., interest rate risk and credit spread risk);
- information regarding securities lending counterparties;
- monthly returns;
- flow information (including shares sold and shares redeemed or repurchased);
- information related to derivatives;

- schedule of portfolio investments; and
- identifying and reporting about miscellaneous securities (if any).

Form N-PORT must be filed no later than 30 days after the close of each month. Information contained on reports for the last month of each fund's fiscal quarter will be available to the public after 60 days. The SEC believes this reporting schedule addresses the need for public disclosure while mitigating the potential for front-running and "copycatting."

Financial Statement Disclosure of Derivatives

Regulation S-X prescribes the form and content of financial statements required in registration statements and shareholder reports. It also establishes general requirements for portfolio holdings disclosures in fund financial statements. However, with the exception of options, there are currently no standards for reporting information about derivative instruments. The SEC added disclosures for derivatives in a fund's financial statements that are similar to the disclosures required by Form N-PORT. The amendments to Regulation S-X:

- require new and standardized disclosures for holdings in open futures contracts, open forward foreign currency contracts, and open swap contracts;
- require additional disclosures for holdings of written and purchased option contracts;
- update disclosures for other investments (such as investments in and advances to affiliates) and reorganize the order in which some investments are presented;
- amend the rules regarding the general form and content of financial statements to better house the new information; and
- require prominent placement of details regarding investments in derivatives in a fund's schedule of investments, rather than allowing such details to be embedded in the notes to the financial statements.

The SEC did not adopt its proposal to require new disclosure in the notes to the financial statements relating to securities lending activities. After consideration of comment letters on the proposal, the SEC determined that it was appropriate to require funds to include these disclosures in their Statement of Additional Information (or, for closed-end funds, in their reports on Form N-CSR), rather than requiring their inclusion in fund financial statements, and the SEC amended Form N-1A and Form N-CSR accordingly.

Annual Census Reporting

Currently, funds report census-type information on Form N-SAR semi-annually. However, the SEC has found the utility of the information provided on Form N-SAR has become increasingly limited in light of new market developments, products, investment practices, and risks. Therefore, the SEC rescinded Form N-SAR and adopted Form N-CEN, a new annual reporting form.

Form N-CEN. Form N-CEN will require registered investment companies to annually report certain census-type information to the SEC in a structured XML format. The form streamlines and updates information reported to the SEC to reflect current information needs, such as requiring more information on ETFs and securities lending. Reports must be filed annually within 75 days of the fund's fiscal year-end.

Sources: SEC Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs, and Permit Swing Pricing, Press Release No. 2016-215 (October 13, 2016), available at https://www.sec.gov/news/pressrelease/2016-215.html; Investment Company Reporting Modernization, Investment Company Act Release No. 32314 (October 13, 2016), available at https://www.sec.gov/rules/final.shtml;Statement at Open Meeting on Investment Company Liquidity Risk Management Programs, Investment

Company Swing Pricing, and Investment Company Reporting Modernization Releases, Commissioner Michael S. Piwowar (Oct. 13, 2016), available at http://www.sec.gov/news/statement/piwowar-statement-open-meeting-101316.html; Industry Squares Off With Consumer Group Over SEC Rule, Ignites, Beagan Wilcox Volz (August 17, 2015).

SEC Adopts Amendments to Form ADV and Books and Records Rules

On August 25, 2016, the SEC adopted amendments to Form ADV and the Advisers Act that were originally proposed in May 2015. The amendments will take effect for most advisers (i.e., advisers with December 31 fiscal year-ends) beginning with the annual update to Form ADV due in March 2018.

The amended Form ADV will require investment advisers to make additional disclosures, the most notable of which concern separately managed account clients (SMAs) and social media accounts. The SEC believes that the additional Form ADV disclosures will fill certain data gaps and facilitate the SEC's risk assessment and monitoring functions. The SEC has published a redline that shows most of the revisions to Form ADV at *https://www.sec.gov/rules/final/2016/ia-4509-form-adv-summary-of-changes.pdf*.

In addition, the amended Form ADV will allow multiple private fund advisers operating as a single advisory business to register under one Form ADV. This "umbrella registration" is intended to simplify the registration process for those advisers and give the SEC a better understanding of groups of private fund advisers that operate a single advisory business through multiple legal entities.

The final rule also amends the requirements of Rule 204-2 of the Advisers Act, commonly known as the books and records rule, to require advisers to maintain additional records of performance calculations and performance-related communications.

Separately Managed Account Clients

Disclosure of SMA Asset Categories. New Item 5.K.(1) of Part 1A of Form ADV and new Section 5.K.(1) of Schedule D require advisers to report the approximate percentage of their SMA regulatory assets under management (Regulatory AUM) invested in each of the following twelve broad asset categories:

- exchange-traded equity securities;
- non-exchange-traded equity securities;
- U.S. government/agency bonds;
- U.S. state and local bonds;
- sovereign bonds;
- investment grade corporate bonds;
- non-investment grade corporate bonds;
- derivatives;
- securities issued by registered investment companies or BDCs;
- securities issued by pooled investment vehicles (other than registered investment companies or BDCs);
- cash and cash equivalents; and
- other.

Advisers with at least $10 billion in Regulatory AUM attributable to SMAs will be required to report, on an annual basis, both mid-year and year-end percentages. Advisers with less than $10 billion in Regulatory AUM attributable to SMAs will be required to report information only as of year-end.

SMA Use of Borrowings and Derivatives. New Section 5.K.(2) will require advisers with at least $500 million in Regulatory AUM attributable to SMAs to report information regarding the use of borrowings and derivatives in SMAs. Advisers are required to respond to different sub-sections depending on the total value of their Regulatory AUM attributable to SMAs as follows:

- Advisers with at least $500 million but less than $10 billion are required to report the amount of Regulatory AUM attributable to SMAs and the dollar amount of borrowings attributable to those assets that correspond to three levels of gross notional exposure.
- Advisers with at least $10 billion must report the same information as above, as well as the derivatives exposures attributable to those assets across the following six categories of derivatives: interest rate, foreign exchange, credit, equity, commodity, and other.

Advisers may elect to exclude individual accounts of less than $10 million from their response.

Custodians. Advisers must identify custodians that account for at least ten percent of their SMA Regulatory AUM and quantify the amount of SMA Regulatory AUM held by the custodian.

Additional Information Regarding Investment Advisers
Item 1 of Part 1A of Form ADV has been amended to require the following additional identifying information from advisers:

- *Offices.* The total number of offices at which the adviser conducts investment advisory business and, for each of the 25 (increased from the current five) largest offices, information about the offices and employees (Item 1.F.).
- *Social Media.* In addition to websites, advisers now must disclose accounts held on publicly available social media platforms, such as Twitter, Facebook, and LinkedIn, for which the adviser controls the content (Item 1.I.).
- *Outsourced Chief Compliance Officer.* Advisers must indicate if their chief compliance officer (CCO) is compensated or employed by someone other than the adviser. SEC examination staff has observed a wide spectrum of both quality and effectiveness of outsourced CCOs and firms. Identifying information for outsourced CCOs allows the SEC to identify all advisers relying on a particular CCO or firm (Item 1.J.2.).

Item 5 of Part 1A of Form ADV has been amended to require advisers to report the following:

- *Non-Discretionary Accounts.* The number of clients for whom the adviser does not control Regulatory AUM but provides advisory services (Item 5.C.).
- *Types of Clients.* The specific number of clients and the amount of Regulatory AUM attributable to each category of clients (Item 5.D.) (e.g., individuals, high net worth individuals, etc.).
- *Wrap Fee Programs.* The total amount of Regulatory AUM attributable to acting as a sponsor and/or portfolio manager of a wrap fee program and any SEC file numbers and/or CRD numbers for that sponsor (Item 5.I).

Amendments to Books and Records Rule: Performance Information

Rule 204-2(a)(16) currently requires advisers to maintain records supporting performance claims in communications distributed to ten or more persons. The SEC amended the rule by removing "ten or more persons" and replacing it with "any person." As amended, Rule 204-2(a)(16) requires advisers to maintain records that demonstrate the calculation of performance or rate of return in any communication distributed, directly or indirectly, to any single person.

Rule 204-2(a)(7) currently requires advisers to maintain certain categories of written communications received and copies of written communication sent. As amended, Rule 204-2(a)(7) requires advisers to also maintain originals of all written communications received and copies of written communications sent relating to the performance or rate of return of any or all managed accounts or securities recommendations.

Compliance Date

The compliance date for the amendments to Form ADV and the books and records rule is October 1, 2017.

Sources: Form ADV and Investment Advisers Act Rules, Securities and Exchange Commission, Investment Advisers Act Release No. 4509 (August 25, 2016), available at https://www.sec.gov/rules/final/2016/ia-4509.pdf; SEC Adopts Rules to Enhance Information Reported by Investment Advisers, Press Release No. 2016-168 (August 25, 2016), available at https://www.sec.gov/news/pressrelease/2016-168.html.

Excessive-Fee Litigation Update

AXA Equitable Prevails in Excessive Fee Lawsuit

Following a 25-day bench trial, the U.S. District Court for the District of New Jersey found that the plaintiffs failed to demonstrate that AXA Equitable Insurance Company and AXA Equitable Funds Management Group, LLC (together, AXA) breached their fiduciary duty in violation of Section 36(b) of the Investment Company Act, and also failed to show any actual damages. AXA had been sued by mutual fund shareholders in 2011 and the case was brought to trial in January 2016. The plaintiffs alleged that the adviser charged excessive investment management and administrative fees to certain funds and then delegated those same duties to sub-advisers and sub-administrators for nominal fees.

In their complaint, the plaintiffs alleged the following:

- The adviser charged fees that were disproportionally high when compared to the fees of sub-advisers and sub-administrators;
- The board of trustees breached its fiduciary duty by authorizing such disproportionate fees; and
- The adviser manipulated the board meeting materials and "duped" the board by providing misleading and unreliable materials in the fee approval process.

In sum, the plaintiffs contended that the adviser's compensation could not have been the product of arm's length bargaining.

In its lengthy decision (159 pages), the court performed a detailed factual analysis, applying the factors used in *Gartenberg v. Merrill Lynch Asset Management* and affirmed by the U.S. Supreme Court in *Jones v. Harris Associates*.

The Independence and Conscientiousness of the Mutual Fund Board. The court found that the board was "sufficiently diverse and independent" and "robustly reviewed" the adviser's compensation.

The Nature, Extent and Quality of Services Provided. The plaintiffs alleged that the adviser delegated essentially all investment management duties to sub-advisers, pointing to the similarity of the description of the services in the advisory and sub-advisory agreements. The court remarked that looking only to the contract language would "ignore voluminous testimony of credible witnesses," which demonstrated that the adviser retained overall supervisory responsibility with respect to the sub-advisers and continued to perform investment management duties. The court similarly found that the adviser retained supervisory responsibility over the sub-administrators and continued to perform administrative duties.

Profitability. The plaintiffs disputed the adviser's calculation of its profitability. The court found the plaintiffs' experts lacked credibility and ruled that the plaintiffs failed to establish that it was improper for the adviser to treat sub-advisory and sub-administration fees as an expense and to use revenue to allocate costs.

Economies of Scale. The court found that the adviser used breakpoints, expense limitation agreements and other cost-saving methodologies in order to pass on savings to investors.

Fall-Out Benefits. The plaintiffs' experts were unable to show that the adviser received fall-out benefits that were not adequately disclosed to and considered by the board.

Comparative Fees. The plaintiffs contended that the Lipper data used by the adviser was not independent, objective or authoritative. Moreover, the plaintiffs asserted that the Lipper data compared dissimilar funds, such as comparing index and passive funds to actively managed funds. The court concluded that the plaintiffs' experts gave inconsistent testimony about the alleged problems with the comparative fee data, and one of the experts even admitted to using Lipper data when creating his own comparative fee analysis.

The court noted that *Jones v. Harris* requires that courts look beyond the *Gartenberg* factors and "all pertinent facts must be weighed." With this in mind, the court discussed the topic of fund performance and cited prior case law noting that courts are hesitant to attach "too much significance to a fund's financial performance" and that "allegations of underperformance alone are insufficient to prove that an investment adviser's fees are excessive." Finally, the court noted the benefits of the lawsuit and found that the filing of the complaint "engendered positive change," including changes in board composition (e.g., naming a new lead independent trustee) and an improvement in the quality of the materials presented to the board.

The plaintiffs filed a motion to Alter or Amend Findings of Fact, Conclusions of Law and Judgment, and the court scheduled oral arguments on the motion in October 2016. An attorney for the plaintiffs said they plan to appeal the decision.

Sources: Sivolella v. AXA Equitable Life Insurance, No. 11-cv-4194 (D. N. J. Aug 25, 2016), available at http://www.investorscoalition.com/sites/default/files/Sivolella%20v%20AXA%20-%20District%20Court%20Opinion%208-25-2016.pdf; AXA Plaintiffs to Judge: Here's the Evidence You Missed, Ignites (September 23, 2016).

Litigation and SEC Enforcement Actions

Compliance Failures with Wrap Fee Programs

On September 8, 2016, the SEC announced that two investment advisory firms settled charges related to compliance failures with their wrap fee programs. SEC investigations found that both firms failed to establish policies and procedures necessary to determine the amount of commissions their clients were charged when sub-advisers "traded away" (i.e., used a broker other than the sponsoring broker to execute trades). Without this information, the firms' financial advisors were unable to disclose the magnitude of these costs to clients and allegedly did not consider these commissions when evaluating whether the sub-advisers or wrap free programs were suitable for clients. According to the SEC, certain clients were unaware that they were paying costs in addition to the single wrap fee paid for bundled investment services.

The SEC's National Exam Program has included wrap fee programs among its annual examination priorities, particularly assessing whether advisers are fulfilling fiduciary and contractual obligations to clients and properly managing such aspects as disclosures, conflicts of interest, best execution, and trading away from the sponsoring broker.

Concurrent with its September 8, 2016 announcement, the SEC updated its Investor Bulletin on "How Fees and Expenses Affect Your Investment Portfolio." The SEC added a discussion of wrap fee accounts and explained how the practice of "trading away" results in a commission charge, in addition to the wrap fee, to the client.

Sources: Two Firms Charged With Compliance Failures in Wrap Free Programs, Press Release No. 2016-181 (September 8. 2016), available at https://www.sec.gov/news/pressrelease/2016-181.html; Updated Investor Bulletin: How Fees and Expenses Affect Your Investment Portfolio (September 8, 2016), available at https://www.sec.gov/investor/alerts/ib_fees_expenses.pdf.

SEC Settles with Adviser for Omission of Material Fact in Application for Exemptive Relief

On August 25, 2016, Orinda Asset Management, LLC (Orinda), an investment adviser to two funds in a series trust, agreed to cease and desist from further violations of Section 34(b) of the Investment Company Act and pay a $75,000 civil penalty to settle charges against it for failing to disclose that it had waived its right to discharge or recommend the discharge of the sub-adviser to the funds. Section 34(b) makes it unlawful for any person to make any untrue or misleading statement of material fact in any registration statement or application filed with the SEC, or to omit any fact necessary in order to prevent the statements made to be materially misleading.

Orinda and the trust filed an initial application for multimanager exemptive relief with the SEC's Division of Investment Management (IM) in order to more freely enter into and materially amend sub-advisory agreements without shareholder approval and avoid certain disclosure requirements. This initial application disclosed that Orinda entered into a side agreement with its lead sub-adviser requiring Orinda to pay the sub-adviser a termination fee for recommending its termination to the board of trustees for anything other than cause. According to the SEC, the board took steps to ensure that any termination payments would flow from Orinda (rather than the funds), and retained its right to terminate the sub-adviser without restriction.

In reviewing the application, IM objected to the side agreement based on the prohibition against termination restrictions in Section 15(a)(3) of the Investment Company Act and conditioned approval of the exemptive order on its removal. Orinda terminated the side agreement and filed an amended application, and IM granted the exemptive order.

The SEC alleges that, in the interim, however, Orinda had entered into a second, revised side agreement with the sub-adviser. The revised side agreement replaced the termination penalty with a termination waiver. Rather than obligating itself to pay a termination fee, Orinda waived its right to terminate or to recommend termination of the sub-adviser. As with the first side agreement, the board retained the right to terminate the sub-adviser. Neither Orinda nor the trust informed IM of the revised side agreement.

The SEC investigation also found that the funds' registration statements inaccurately stated that all of its sub-advisory agreements could be terminated at any time by Orinda and failed to disclose any side agreements.

Source: In the Matter of Orinda Asset Management, LLC, Investment Advisers Act Release No. 4513 (August 25, 2016), available at https://www.sec.gov/litigation/admin/2016/ia-4513.pdf.

SEC Announces Penalties for Advisers Relying on Sub-Adviser's False Performance Claims

As reported in our January 2015 regulatory update, F-Squared Investments, Inc. (F-Squared), a registered investment adviser, agreed to pay a $30 million disgorgement and a $5 million penalty to settle charges that it defrauded investors through false performance advertising of its AlphaSector strategy. F-Squared also agreed to an order finding that it aided and abetted and caused certain mutual funds sub-advised by F-Squared to violate the Investment Company Act. As reported in our January 2016 regulatory update, Virtus Investment Advisers agreed to pay $16.5 million to settle charges that Virtus publicized a materially inflated, and hypothetical and back-tested, performance track record it received from F-Squared.

Following an SEC enforcement sweep, the SEC recently found that thirteen additional advisory firms accepted and negligently relied upon F-Squared's performance claims. According to the SEC, the firms repeated many of F-Squared's claims while recommending the investment to their own clients without obtaining sufficient documentation to substantiate the information being advertised. The penalties assessed against the firms ranged from $100,000 to $500,000 based upon the fees each firm earned from AlphaSector-related strategies.

"When an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact," said Andrew J. Ceresney, Director of the SEC Enforcement Division. "These advisers negligently passed many of F-Squared's claims onto their own clients, who were consequently relying upon false and misleading information when making investment decisions."

Sources: Investment Advisers Paying Penalties for Advertising False Performance Claims, Press Release No. 2016-167 (August 25, 2016), available at https://www.sec.gov/news/pressrelease/2016-167.html; Virtus Investment Advisers Settled Charges Regarding False Performance Claims, Godfrey & Kahn Investment Management Focus (January 2016), available at http://www.gklaw.com/Resources/Documents/InvestmentManagement012216.pdf; SEC Settles with F-Squared on Claims of Hypothetical Performance, Godfrey & Kahn Investment Management Focus (January 2015), available at http://www.gklaw.com/Resources/Documents/InvestmentManagement011515.pdf.

Updates of Pending SEC Rule Proposals

SEC Proposal Governing the Use of Derivatives by Investment Companies

As discussed in our January 2016 regulatory update, the SEC proposed a new rule governing the use of derivatives by registered investment companies in December 2015. The proposed rule provides that a fund must:

- comply with an exposure-based portfolio limit (150% of net assets) or a risk-based portfolio limit (300% of net assets if the fund satisfies a "value-at-risk" test);
- maintain an amount of assets designed to enable the fund to meet its obligations under a fund's derivatives and financial commitment transactions so that a fund can manage the risks associated with such transactions; and
- establish a formalized risk management program if the fund engages in more than a limited use of derivatives or uses complex derivatives.

The SEC staff is currently working to finalize the recommendations on the rulemaking. Speaking at a conference in October, Commissioner Piwowar indicated his belief that the SEC would not vote on any final rules for derivatives before a change in the presidential administration after the November election.

Sources: Godfrey & Kahn Investment Management Focus (January 2016), available at http://www.gklaw.com/Resources/Documents/InvestmentManagement012216.pdf; Rule on Funds' Derivatives Use Unlikely This Year: U.S. SEC Commissioner, Reuters (October 12, 2016), available at http://www.reuters.com/article/us-sec-funds-derivatives-idUSKCN12C21W.

Update on DOL Fiduciary Rule

DOL Expected to Issue Guidance This Fall

The DOL plans to issue FAQs on its new fiduciary rule and best interest contract exemption (BICE) this fall on an unspecified date, and will continue to do so on an ongoing basis, according to Timothy D. Hauser, the Deputy Assistant Secretary for Program Operations of the Employee Benefits Security Administration. "We have received a lot of questions and we have drafted quite a few answers. We really can't wait [to issue just one FAQ] until we receive every single question," said Hauser, who spoke at the final session of the Financial Planning Association's annual conference in September. Please see our April 2016 regulatory update for more information about the DOL fiduciary rule and BICE.

Sources: Got a Fiduciary Question? DOL to Issue FAQs Soon, Financial Planning (September 16, 2016), available at http://www.financial-planning.com/news/got-a-fiduciary-question-dol-to-issue-faqs-soon; 'Rolling' DOL Fiduciary Guidance Begins in Fall DOL's Hauser (September 16, 2016), available at http://www.thinkadvisor.com/2016/09/16/rolling-dol-fiduciary-guidance-begins-in-fall-dols.