GODFREY & KAHN S.C.

Investment Management Focus

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Legal and Regulatory Update

Latest Developments

SEC Announces 2016 Exam Priorities

The SEC's Office of Compliance Inspections and Examinations (OCIE) published its 2016 examination priorities for investment advisers, investment companies and broker-dealers. The priorities introduce new areas of focus, including liquidity controls, public pension advisers and product promotion, as well as two popular investment products, exchange-traded funds (ETFs) and variable annuities. SEC Chair Mary Jo White stated: "These new areas of focus are extremely important to investors and financial institutions across the spectrum."

Similar to its 2015 examination priorities, these priorities focus around the same three thematic areas: protecting retail investors and investors saving for retirement, assessing market-wide risks and analyzing data to identify and examine registrants that may be engaged in illegal activity. We have highlighted the most relevant examination priorities below. The complete list of examination priorities is available on the SEC's website.

Protecting Retail Investors and Investors Saving for Retirement. OCIE will continue to focus on protecting retail investors and retirement savers in 2016 and will likely continue this focus for the foreseeable future. OCIE is planning and/or conducting various examination initiatives to evaluate risks to retail investors that could arise from the following trends:

- **ReTIRE.** OCIE is continuing its multi-year examination initiative which focuses on investment advisers and broker-dealers and the services they offer to investors with retirement accounts. OCIE will examine the reasonable basis for recommendations made to investors, conflicts of interest, supervision and compliance controls, as well as marketing and disclosure practices.
- **ETFs.** OCIE will examine ETFs for compliance with applicable exemptive relief under federal securities laws and will also review the unit creation and redemption process. In addition, the staff will focus on sales strategies, trading practices and ETF-related disclosures, such as portfolio concentration, primary and secondary market trading risks, adequacy of risk disclosure and suitability (especially in niche or leveraged/inverse ETFs).
- **Branch Offices.** The staff will continue to monitor broker-dealers' supervision of its registered representatives and investment advisers' supervision of its investment adviser representatives in branch offices.
- **Fee Selection and Reverse Churning.** The staff will continue to monitor the variety of fee arrangements (e.g., asset-based fees, hourly fees, wrap fees, commissions) that dually-registered investment advisers/broker-dealers offer to retail investors. Examiners will pay particular attention to the recommendations of account types and whether recommendations are in the best interests of retail investors.

- **Variable Annuities.** The staff will evaluate the suitability of sales of variable annuities to investors and assess the adequacy of disclosure and the supervision of such sales.

- **Public Pension Advisers.** The staff will monitor advisers to municipalities and other government entities, concentrating on pay-to-play and other key risk areas related to advisers to public pensions, such as identification of undisclosed gifts and entertainment.

Assessing Market-Wide Risks. OCIE intends to examine structural risks and trends involving multiple firms or entire industries and will focus on:

- **Cybersecurity.** The staff will continue to focus on cybersecurity compliance and controls of investment advisers and broker-dealers, including testing and evaluation of the implementation of such procedures and controls.

- **Liquidity Controls.** The staff will examine advisers to mutual funds, ETFs and private funds that have exposure to potentially illiquid fixed income securities in light of changes in fixed income markets over the last few years. The staff will also monitor broker-dealers that have become new or expanding liquidity providers in the marketplace. The examinations will focus on firms' expanded business areas, including controls over market risk management, valuation, liquidity management, trading activity and regulatory capital.

Using Data to Identify Potentially Illegal Activity. The staff will use its enhanced data analytics to focus on the following initiatives:

- **Recidivist Representatives and Their Employers.** The staff will continue to identify individuals with a history of misconduct and examine the firms that employ them.

- **Excessive Trading.** The staff will continue to analyze information obtained from clearing brokers in order to determine whether firms and their registered representatives are engaged in or appear to be engaged in excessive trading.

- **Product Promotion.** In order to identify potential suitability issues and potential breaches of fiduciary obligations, the staff will focus on detecting the promotion of new, complex and high risk products and related sales practice issues.

Other Initiatives. In addition to the initiatives listed above, the staff also plans to allocate examination resources to the following priorities:

- **Municipal Advisors.** The staff will continue to examine newly-registered municipal advisors to evaluate their compliance with the Municipal Securities Rulemaking Board rules.

- **Private Placements.** The staff will review private placements, such as Regulation D offerings, to evaluate whether legal requirements are being met in the areas of due diligence, disclosure and suitability.

- **Never-Before-Examined Investment Advisers and Investment Companies.** The staff will continue examining registered advisers and investment companies that have not been examined by the staff by conducting focused, risk-based examinations.

- **Private Fund Advisers.** The staff will focus on fees and expenses and evaluating the controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts.

Sources:Examination Priorities for 2016, Office of Compliance Inspections and Examinations (January 11, 2016), available at: http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf; SEC Announces 2016 Examination Priorities, Press Release No. 2016-4 (January 11, 2016), available at: http://www.sec.gov/news/pressrelease/2016-4.html.

SEC Publishes "Distribution in Guise" Guidance Update

The SEC's Division of Investment Management released a guidance update relating to mutual fund distribution and sub-accounting fees, in which the staff outlined its views on problems that may arise when mutual funds make payments to financial intermediaries that provide shareholder and recordkeeping services for investors whose shares are held in omnibus and networked accounts. In particular, the guidance addresses whether a portion of those payments are being used to finance distribution and therefore, if paid by a fund, must be paid pursuant to Rule 12b-1 under the Investment Company Act.

In the guidance update, the staff made three recommendations in light of the potential for inappropriate use of fund assets when a mutual fund pays fees to financial intermediaries characterized as non-distribution related sub-transfer agent, administrative, sub-accounting, and other shareholder servicing fees (collectively, "sub-accounting fees"): (1) mutual fund boards should have procedures in place that are reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay (directly or indirectly) for distribution; (2) investment advisers and relevant service providers should provide the board with sufficient information in order for the board to have an overall picture of intermediary distribution and servicing arrangements for the mutual fund; and (3) advisers and relevant service providers should inform the board if activities or other arrangements are potentially distribution-related, and if so, the board should evaluate the appropriateness and character of those payments with heightened attention.

Board Process

There is a potential for sub-accounting fees to be used to pay for distribution, especially when the intermediary also distributes the fund's shares. The guidance update emphasizes that fund directors bear substantial responsibility for determining whether fees paid by a fund are for distribution. The staff recommends that boards should have a process in place that is reasonably designed to assist them in evaluating whether a portion of the sub-accounting fees is being used directly or indirectly for distribution.

The staff recognized that many fund boards have established procedures designed to help them in making this type of evaluation and such procedures have been based on previous staff guidance (e.g., the 1998 supermarket fee letter). The staff stated that although the factors and analysis provided in its previously-issued guidance still serve as a useful framework in establishing a process for fund boards, boards should also consider requesting information from the adviser, relevant service providers and intermediaries on several other issues. Additional relevant information would likely include, but is not limited to: (1) information about the specific services provided under the fund's sub-accounting agreements or arrangements; (2) the amount of payments; (3) whether the adviser and relevant service providers are recommending any changes to the fee structure or if any other services have materially changed; (4) whether any of the services could have direct or indirect distribution benefits; (5) how the adviser and relevant service providers ensure fees are reasonable; and (6) how the board evaluates the quality of services being delivered to beneficial owners.

The staff observed that some boards have established maximum allowable sub-accounting fees to be paid with fund assets. Such caps are often based on the level of fees the fund would otherwise pay its transfer agent for the sub-accounting services performed by the intermediary, or are based on industry surveys or benchmarks obtained from third parties. These caps are often established as a result of the board's finding that any sub-accounting fees paid in excess of the limits are likely for distribution (or are otherwise too high for shareholders to bear), and thus the board requires that any sub-accounting fees paid in excess of that cap must be paid either pursuant to a Rule 12b-1 plan or by the adviser. However, the staff cautioned that fees that are paid to transfer agents may differ from fees paid for the same services obtained elsewhere, and boards may wish to take such information into account when evaluating such fees as a benchmark or cap for fees paid for sub-accounting services. The staff recommended that boards that have already established these caps should carefully consider whether transfer agent rates used for benchmarking reflect relevant economies of scale, and whether the type and amount of services provided are comparable. Additionally, boards may wish to consider different fee caps or payment rates to intermediaries depending upon the services that are provided to the mutual fund.

The staff also observed that many funds did not have policies and procedures as part of their Rule 38a-1 compliance programs designed to prevent violations of Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder. The staff believes that adoption of a Rule 12b-1 plan alone is insufficient, and a fund should have adequate policies and procedures for reviewing and identifying any payments that may be for distribution-related services that are not paid through the plan.

Providing Boards an Overall Picture of Distribution and Servicing Arrangements

The staff recommended that advisers and service providers should provide sufficient information to fund directors to ensure directors are aware of the overall distribution and servicing arrangements of the fund as part of the board's process in evaluating whether a portion of the fees paid by funds to intermediaries that distribute fund shares are direct or indirect payments for distribution.

The staff further recommended that advisers and relevant service providers should provide boards with information about sub-accounting fee payments, and other intermediary payment flows made in support of the fund's distribution and servicing activities and arrangements that would be relevant to the facts and circumstances analysis of whether payments could be for distribution. The staff suggested that advisers and service providers should also provide boards with information sufficient for them to evaluate whether and to what extent sub-accounting fee payments may reduce or otherwise affect advisers' or their affiliates' revenue sharing obligations, or the level of fees paid under a Rule 12b-1 plan. The staff believes that such information would be relevant to a board in considering whether payments are for distribution and to a board's determination of whether a Rule 12b-1 plan should be implemented or continued.

Indicia that a Payment May be Used to Pay for Distribution

The guidance update also provides additional insight into the SEC's "distribution in guise" examination initiative by listing seven examples of activities or arrangements observed by the staff during its examinations that may raise concerns that a payment, though ostensibly not for distribution-related activities, may in fact (or at least in part) be a payment for distribution services. The examples include:

- **Distribution-related activity that is conditioned upon the payment of sub-accounting fees.** Some intermediaries condition providing access to wholesalers, distribution through fund supermarkets, or placement on preferred lists on a fund's payment or rate increase of sub-accounting fees.

- **The lack of a Rule 12b-1 plan.** If a fund does not pay distribution expenses through a Rule 12b-1 plan or sales load, the board should examine how distribution expenses are paid.

- **Tiered payment structures.** Some advisers have entered into agreements with intermediaries that provide for a number of services that are paid for via tiered payment structures (e.g., payments are first made from Rule 12b-1 fees, then from sub-accounting fees and finally by the adviser). Tiered payment structures raise questions as to what services the fund actually is paying for, and whether the use of fund-paid fees reduces or subsidizes any fees for which the adviser might otherwise be responsible.

- **Lack of specificity or bundling of services.** Some intermediaries have not provided a clear list of services provided in exchange for sub-accounting fees, or payments for both sub-accounting and distribution have been bundled into a single contract.

- **Distribution benefits taken into account.** In some cases, the staff observed that distribution and sales benefits were taken into account by the adviser when recommending, instituting or raising sub-accounting fees. For example, employees of the adviser whose main job was to distribute the mutual fund were involved in establishing the level of sub-accounting fees.

- **Large disparities in sub-accounting fees paid to intermediaries.** Although recognizing that disparate sub-accounting payment rates may be a result of competitive pressures, the staff states that such disparities in payments for the same services may also indicate that they are payments for distribution-related activities. An indication that payments may be for distribution is when higher payments are paid to the fund's newest, largest, or fastest-growing distribution partners.

- **Sales data.** Intermediaries may offer to sell additional "strategic sales data" to mutual funds, their adviser or relevant service providers, providing information about the demographics of fund investors and other pertinent information regarding top sales partners and channels.

The staff recognized that boards are not involved in the day-to-day negotiations of agreements and arrangements with intermediaries, and, as such, boards should be able to rely on the information that advisers and relevant service providers supply to them. Additionally, the SEC stated that directors may receive and rely on the assistance of outside counsel, the fund's CCO or the adviser's or relevant service providers' personnel, as appropriate, to assist them in making determinations about whether sub-accounting fees represent payments for distribution.

In sum, the staff reaffirmed its focus on sub-accounting and other mutual fund-paid fees, a portion of which may be direct or indirect payments for distribution, and if such fees are not paid through a Rule 12b-1 plan, such arrangements would violate Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder. Accordingly, the staff recommended that boards establish procedures to evaluate such arrangements and request more information from advisers and relevant service providers, and, in turn, advisers and relevant service providers are responsible for providing fund boards with sufficient information to understand the types of fees being paid to financial intermediaries in order to evaluate such arrangements.

Sources: Mutual Fund Distribution and Sub-Accounting Fees, Division of Investment Management IM Guidance Update, No. 2016-01 (January 2016), available at https://www.sec.gov/investment/im-guidance-2016-01.pdf; "SEC Issues 'Distribution in Guise' Playbook," Ignites, Joe Morris (January 7, 2016); ICI Memorandum "SEC Division of Investment Management Publishes Guidance on Mutual Fund Distribution and Sub-Accounting Fees; Discusses Role of Funds Boards"(January 6, 2016).

SEC Proposes New Rule Governing the Use of Derivatives by Registered Investment Companies

On December 11, 2015, the SEC proposed Rule 18f-4 under the Investment Company Act regarding the use of derivatives and financial commitment transactions by registered investment companies (including mutual funds, ETFs and closed-end funds) and business development companies (collectively, "funds"). The proposed rule would provide an exemption from certain provisions of Sections 18 and 61 of the Investment Company Act, subject to certain conditions. The proposed rule would limit funds' use of derivatives and require them to adopt and implement risk management measures to ensure funds are not unduly speculative and have sufficient assets to meet payment obligations. SEC Chair Mary Jo White stated: "Derivatives can raise risks for a fund, including risks related to leverage, so it is important to require funds to monitor and manage derivatives-related risks and provide limits on their use."

As described in further detail below, the principal elements of the proposed rule include the following requirements: (1) a fund must comply with one of two portfolio limitations: (a) Exposure-Based Portfolio Limit (150% of net assets) or (b) Risk-Based Portfolio Limit (300% of net assets if the fund satisfies a "value-at-risk" test (VaR test)); (2) a fund must 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 (3) a fund must establish a formalized risk management program if the fund engages in more than a limited use of derivatives or uses complex derivatives. The rule proposal would also amend two forms (Form N-PORT and Form N-CEN) that the SEC proposed in May 2015 that are not yet finalized.

Portfolio Limitations for Derivatives Transactions

The proposed rule would require a fund's board, including a majority of the independent directors, to approve one of two alternative portfolio limitations designed to limit the amount of leverage the fund may obtain through derivatives and certain other transactions:

- **Exposure-Based Portfolio Limit.** A fund relying on this exposure-based portfolio limit would be required to limit its aggregate exposure to 150% of the fund's net assets. "Exposure" is calculated as the aggregate notional amount of the fund's derivatives transactions, together with its obligations under financial commitment transactions and certain other transactions.

- **Risk-Based Portfolio Limit.** As an alternative to the exposure-based portfolio limit, a fund relying on the risk-based portfolio limit would be permitted to obtain exposure of up to 300% of the fund's net assets so long as the fund satisfies the VaR test. The VaR test measures whether the fund's aggregate use of derivatives results in a fund portfolio that is subject to less market risk than if the fund did not use derivatives.

Asset Segregation Requirements

Derivatives Transactions. In addition to the proposed portfolio limitations for derivatives transactions, the proposed rule would require a fund to maintain a certain amount of "qualifying coverage assets" for each derivatives transaction, determined pursuant to policies and procedures adopted by a fund's board, including a majority of the independent directors. The rule proposal defines "qualifying coverage assets" for derivatives transactions as fund assets that either are: (1) cash and cash equivalents; or (2) with respect to any derivatives transaction under which the fund may satisfy its obligations for the transaction by delivery of a particular asset, that particular asset.

Accordingly, for each derivatives transaction, a fund would be required to manage derivatives risks by segregating certain assets (generally cash and cash equivalents) to equal the sum of the following two amounts:

- **Mark-to-Market Coverage Amount.** The amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of determination; and
- **Risk-Based Coverage Amount.** An additional amount that represents a reasonable estimate of the potential amount the fund would pay if the fund were to exit the derivatives transaction under stressed conditions.

The proposed rule would require a fund to identify qualifying coverage assets for derivatives transactions on the books and records of the fund pursuant to policies and procedures adopted by the fund's board. The proposed rule would also permit a fund to reduce the mark-to-market coverage amount by the value of any assets that represent variation margin or collateral to cover the fund's mark-to-market loss with respect to the derivatives transaction.

Financial Commitment Transactions. The asset segregation requirements for derivatives transactions described above are different than the requirements for financial commitment transactions (e.g., reverse repurchase agreements, short sale borrowings, firm or standby commitment agreements or similar agreements). Specifically, a fund that enters into financial commitment transactions would be required to segregate assets with a value equal to the full amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under those transactions.

For a financial commitment transaction, the proposed rule has a broader definition of "qualifying coverage assets," where such term means either: (1) cash and cash equivalents; (2) with respect to any financial commitment transaction under which the fund may satisfy its obligations for the transaction by delivery of a particular asset, that particular asset; or (3) assets that are convertible to cash or that will generate cash equal in amount to the financial commitment obligation prior to the date on which the fund can be expected to be required to pay such obligation or have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures adopted and approved by the fund's board. Similar to the derivatives transactions obligation, a fund is required to identify on its books and records the qualifying coverage assets for financial commitment transactions.

Risk Management Program

Funds that engage in more than limited derivatives transactions or that use complex derivatives would be required to adopt and implement a formalized derivatives risk management program. The proposed rule lists four elements that would be required for the derivatives risk management program:

- **Assessment of Risks.** The first element of the program requires a fund to have policies and procedures in place that are reasonably designed to evaluate certain identified potential risks that are common to derivatives transactions, including, but not limited to, leverage, market, counterparty, liquidity and operational risks.
- **Management of Risks.** The second element of the program requires a fund to adopt policies and procedures reasonably designed to manage the risks. The proposed rule suggests that the policies and procedures might include portfolio tracking systems, exception reporting, and other mechanisms designed to monitor derivatives risks. Funds should design these mechanisms to manage risks from derivatives transactions such that the risks are consistent with a fund's investment guidelines, portfolio limitations, disclosure, and investment strategy.

  In addition, the proposed rule would require a fund to designate, and the board to approve, a person to act as the derivatives risk manager and administer the derivatives risk management program. The derivatives risk manager must be an employee or officer of the fund or its adviser, but may not be a portfolio manager of the fund. Depending on the size and structure of a fund, there may already be a chief risk officer or manager ready to administer this program. However, in many instances, the oversight of this program may be left to the fund's CCO.

- **Segregation of Functions.** The third element of the program requires that a fund should institute policies and procedures that are reasonably designed to segregate the fund's derivatives risk management functions from the fund's portfolio management. The rule proposal also emphasizes the importance of regular communication between a fund's portfolio manager(s) and the derivatives risk manager.

- **Periodic Review.** The fourth element of the program requires that a fund reviews and updates it derivatives risk management program at least annually.

The rule proposal identifies the board as being the responsible party for general oversight of the program. The board would be required to approve a fund's initial derivatives risk management program and any material changes to the program. The board would also be required to approve the fund's designation of the derivatives risk manager and to review the adequacy and effectiveness of the program quarterly.

Amendments to Forms N-PORT and N-CEN

The rule proposal also includes amendments to proposed Forms N-PORT and N-CEN. The amendments would require funds that are required to implement a formalized risk management program to report on Form N-PORT certain portfolio and position-level risk metrics, as well as requiring funds engaging in derivatives transactions to indicate on Form N-CEN whether the fund is relying on the Exposure-Based Portfolio Limit or the Risk-Based Portfolio Limit (described above) during that reporting period.

Comments on the proposed rule are due by March 28, 2016.

Sources: Use of Derivatives by Registered Investment Companies and Business Development Companies, Release No. IC-31933 (December 11, 2015), available at http://www.sec.gov/rules/proposed/2015/ic-31933.pdf; SEC Proposes New Derivatives Rules for Registered Funds and Business Development Companies, Press Release No. 2015-276 (December 11, 2015), available at: http://www.sec.gov/news/pressrelease/2015-276.html; ICI Memorandum "SEC Proposes New Derivatives Rules for Registered Funds" (December 17, 2015); "CCOs Face Prospect of Donning Derivatives Hat," Ignites, Peter Ortiz (December 18, 2015).

OCIE Issues Risk Alert Regarding Outsourced CCOs

On November 9, 2015, OCIE issued a National Exam Program (NEP) Risk Alert to provide a summary of the results of examinations of investment advisers and investment companies that outsource their CCOs to unaffiliated third parties. The staff reviewed approximately 20 advisers and investment companies and evaluated the effectiveness of compliance programs and outsourced CCOs and considered whether:

- The CCO: (1) was administering a compliance environment that addressed and supported the goals of the federal securities laws (i.e., if compliance risks were adequately identified, mitigated and managed); and (2) appeared to have sufficient authority to influence adherence to compliance policies and procedures and adequate resources to perform his or her responsibilities as the CCO;

- The compliance program: (1) was reasonably designed to prevent, detect and address violations of federal securities laws; (2) supported open communication between service providers and those with compliance oversight responsibilities; (3) appeared to be proactive rather than reactive; and

- Compliance appeared to be an important part of the registrant's culture.

The staff observed that in situations where an outsourced CCO was generally effective, the CCO typically had regular (and oftentimes in-person) communications with the registrant, a strong relationship with the registrant, sufficient support from the registrant, sufficient access to a registrant's documents and information and knowledge about applicable regulatory requirements and the registrant's business.

The staff provided information and recommendations regarding the strength and effectiveness of a registrant's compliance program, such as:

- **Meaningful Risk Assessments.** The staff noted that some outsourced CCOs used questionnaires and standardized checklists that, though helpful in identifying conflicts of interest and assessing risk, were sometimes too generic and did not appear to fully capture a registrant's business practices and compliance risks. Further, the staff observed that some outsourced CCOs did not appear sufficiently knowledgeable about a registrant to identify or pursue incorrect or inconsistent information regarding a registrant's business practices captured in responses to the questionnaires. Lastly, the staff noted that several registrants did not have adequate policies, procedures and/or disclosures in place to address conflicts of interest identified by the staff in areas critical to clients, including portfolio valuation, trade allocations and personal securities transactions by access persons.

- **Compliance Policies and Procedures.** The staff noted instances where compliance policies and procedures were not followed or a registrant's actual practices were inconsistent with the description in the registrant's compliance manual. For example, the staff observed in some instances that CCOs were assigned responsibility for compliance reviews that were never conducted. The Risk Alert stated that several of the compliance manuals that were reviewed by the staff were templates from the outsourced CCO and were not tailored to the registrant's business and practices.

- **Annual Review of Compliance Programs.** The staff observed a general lack of documentation evidencing annual reviews and testing for compliance with existing policies and procedures by outsourced CCOs. Additionally, certain outsourced CCOs rarely visited registrants' offices and conducted only limited reviews of documents or training on compliance-related matters while on-site. Such infrequent visits led to outsourced CCOs having limited authority within the firm to improve adherence to the registrants' compliance policies and procedures.

The staff recommended that advisers and investment companies that outsource their CCO positions should review their business practices in light of the risks identified in the Risk Alert to determine whether these practices comport with their responsibilities under the compliance rules, namely Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the Investment Company Act.

Sources: OCIE's Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers, National Exam Program Risk Alert, Vol. V, Issue 1 (November 9, 2015), available at https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf;ICI Memorandum "OCIE Publishes Risk Alert Summarizing Findings From Its Examination of Advisers/Funds Using Outsourced CCOs" (November 11, 2015).

Excessive-Fee Litigation Update

Litigation involving Section 36(b) excessive fee claims filed against fund firms continues to be a current trend. In December 2015, the excessive fee lawsuit against First Eagle Investment Management moved forward after a U.S. district judge denied the firm's motion to dismiss. The plaintiffs in that action alleged First Eagle violated Section 36(b) of the Investment Company Act by charging excessive management fees to the First Eagle Global Fund and the First Eagle Overseas Fund. Management fees were 75 basis points for each fund at the time the lawsuit was filed, and plaintiffs alleged such fees were excessive in comparison to the subadvisory fee First Eagle receives from a separate subadvisory engagement with a registered fund. In its motion to dismiss, First Eagle argued that these subadvisory fees were hypothetical, and it does not follow that that the advisory fees for the two funds at issue were inconsistent with the services the firm provided. The U.S. district judge disagreed with First Eagle, ruling that the magistrate judge who proceeded over the case was "correct in rejecting defendant's attempt to shield itself from liability by hiding behind its non-disclosure of the actual fee rate it charges to the sub-advised fund" and the plaintiff's complaint sufficiently provided specific factual allegations to meet the federal pleading requirements for a Section 36(b) claim.

In January 2016, the excessive fee lawsuit filed against Fiduciary Management, Inc. (FMI) was dismissed with prejudice. On the same day, FMI filed a prospectus supplement reflecting new breakpoints for three funds for which FMI serves as investment advisor (the advisory fee for one of these funds was also lowered). The plaintiff's complaint had alleged that the advisory fees charged by FMI to the three funds for which it serves as investment adviser were materially higher than those charged by FMI to other subadvisory fund clients receiving substantially similar services.

Other lawsuits where plaintiffs have raised Section 36(b) excessive fee claims under circumstances where advisers are allegedly charging excessive fees for work done primarily by subadvisers have been filed against the following firms: Axa, BlackRock, Calamos, Davis Selected Advisers, Harbor Funds, The Hartford, John Hancock, J.P Morgan, New York Life Investment Management, The Principal, Russell, SEI, State Farm and Voya.

Sources: "First Eagle Excessive-Fee Suit Survives Motion to Dismiss," Ignites, Emile Hallez (December 10, 2015); Order Denying First Eagle Investment Management, LLC's ("First Eagle") Motion to Dismiss, The Lynn M. Kennis Trust, et al, v. First Eagle, 14-CV-00585-SLR-SRF (D. Del. Dec. 8, 2015); "FMI Lowers Funds Fees, Lawsuit Dismissed," Ignites, Emile Hallez (January 6, 2016); Order adopting Stipulation of Dismissal, Wayne County Employees' Retirement System v. Fiduciary Management, Inc., 15-CV-1170-JPS (E. D. Wis. Jan. 4, 2016).

Additional Rule Proposals, Rule Adoptions and Guidance

FAST Act: Annual Privacy Notice Requirement Amended

Congress recently enacted H.R. 22, Fixing America's Surface Transportation Act, or the FAST Act. The FAST Act took effect immediately on December 4, 2015, when President Obama signed it into law. The FAST Act chiefly authorizes highway funding, but it also included several amendments to securities and financial services laws, including amending the annual privacy notice requirement under Section 503 of the Gramm-Leach Bliley Act. The FAST Act added subsection (f) to Section 503, which provides that financial institutions are not subject to the annual privacy notice requirement if: (1) there has been no change in the financial institution's policies and practices regarding the sharing of nonpublic personal information since its last circulation of the privacy notice; and (2) the financial institution does not share nonpublic personal information with third parties for marketing purposes. Accordingly, SEC registrants that are subject to Regulation S-P are no longer required to send an annual privacy notice so long as they comply with Section 503(f).

Sources: Fixing America's Surface Transportation Act, H.R. 22 (December 4, 2015), available at https://www.congress.gov/114/crpt/hrpt357/CRPT-114hrpt357.pdf; ICI Memorandum "Congress Revises Annual Privacy Notice Requirement" (December 8, 2015); IA Watch Weekly Briefing "Your Obligation to Send Out Annual Privacy Notices Ends – If You Don't Make Changes" (December 14, 2015).

CFTC Rule 4.5 Annual Affirmation and NFA Guidance

Under Rule 4.5 of the Commodity Exchange Act (CEA), each registered investment company that has previously filed a Rule 4.5 notice of exemption or exclusion must reaffirm the notice within 60 days of the calendar year end or withdraw the exclusion. The deadline for filing the reaffirmation or withdrawal is February 29, 2016.

In connection with the approaching deadline, the National Futures Association (NFA) published guidance on how to complete the annual affirmation process through the NFA's Exemption System. In its guidance, the NFA emphasized that if a filer does not affirm the applicable exemption or exclusion under the CEA by February 29, 2016, the filer's exemption or exclusion will be withdrawn on March 1, 2016. In that instance, a fund's investment adviser would be required to register as a commodity pool operator (CPO) or be subject to enforcement action by the CFTC.

The NFA also clarified that if its records reflect an exemption or exclusion for a fund that is no longer active, then: (1) firms registered with the NFA can update the information and withdraw the exemption or exclusion on the NFA's Exemption System; and (2) firms not registered with the NFA must send written notification via email to the NFA at exemptions@nfa.futures.org to withdraw the exemption or exclusion.

Sources: National Futures Association Notice to Members, Notice I-15-26 (December 1, 2015); ICI Memorandum "Funds Relying on CFTC Rule 4.5 Must Reaffirm the Exclusion by February 29, 2016; NFA Provides Guidance on Filing" (December 4, 2015).

Form ADV Annual Updating Amendment Deadline

Given that 2016 is a leap year, March 30, 2016 (not March 31, 2016) is the deadline for advisers with a December 31 fiscal year end to file their Form ADV annual updating amendments. Advisers have 90 days after their fiscal year end to file their Form ADV annual updating amendments.

Source: IA Watch Weekly Briefing "Form ADV Alert" (December 14, 2015).

Litigation and SEC Enforcement Actions

J.P. Morgan to Pay $267 Million for Failure to Disclose Conflicts of Interest

On December 18, 2015, the SEC announced that two of J.P. Morgan's wealth management subsidiaries, JP Morgan Chase Bank, N.A. (JPMCB) and J.P. Morgan Securities LLC (JPMS), agreed to pay $267 million and admit wrongdoing to settle charges that JPMCB and JPMS failed to disclose conflicts of interests arising from, as applicable, preferences for (1) JPMorgan-managed mutual funds, (2) JPMorgan-managed private hedge funds, and (3) third-party-managed private hedge funds that shared client fees with a JPMCB affiliate.

"Firms have an obligation to communicate all conflicts so a client can fairly judge the investment advice they are receiving," said Andrew J. Ceresney, Director of the SEC Enforcement Division. "These J.P. Morgan subsidiaries failed to disclose that they preferred to invest client money in firm-managed mutual funds and hedge funds, and clients were denied all the facts to determine why investment decisions were being made by their investment advisers."

Julie M. Riewe, Co-Chief of the SEC Enforcement Division's Asset Management Unit, was quoted in the SEC's press release stating, "In addition to proprietary product conflicts, JPMS breached its fiduciary duty to certain clients when it did not inform them that they were being invested in a more expensive share class of proprietary mutual funds, and JPMCB did not disclose that it preferred third-party-managed hedge funds that made payments to a J.P. Morgan affiliate. Clients are entitled to know whether their adviser has competing interests that might cause it to render self-interested investment advice."

Sources: In the Matter of JPMorgan Chase Bank, N.A. and J.P. Morgan Securities, LLC,, Investment Advisers Act Release No. 4295 (December 18, 2015), available at https://www.sec.gov/litigation/admin/2015/33-9992.pdf; J.P. Morgan to Pay $267 Million for Disclosure Failures, SEC Press Release 2015-283 (December 18, 2015), available at https://www.sec.gov/news/pressrelease/2015-283.html.

Investment Adviser Fined for Repeated Custody Rule Violations

Sands Brothers Asset Management, LLC, an investment advisory firm, its co-founders and its former CCO agreed to settle charges that the firm again violated the custody rule, Rule 206(4)-2 under the Advisers Act. The firm had previously been reprimanded for violating the custody rule in 2010.

The custody rule requires advisory firms with custody of client money to follow certain procedures as a safeguard against misuse or theft. One way for advisory firms to comply with the rule is to distribute audited financial statements to investors of pooled investment vehicles within 120 days of the fiscal year end. As we reported in our *January 2015 Update*, the SEC alleged that the firm was repeatedly late in providing audited financial statements to investors. Without admitting or denying the charges, the firm and its co-owners agreed to pay a $1 million penalty, and the former CCO agreed to pay a $60,000 penalty.

Andrew M. Calamari, Director of the SEC's New York Regional Office, stated that the co-founders "missed their opportunity to right a previous wrong and instead merely repeated their custody rule violations, so now they face more severe consequences." In addition to the monetary penalties, the firm and its co-founders are suspended for a year from raising money from new or existing investors and must have a compliance monitor for three years. The former CCO is barred from acting as a CCO or appearing or practicing before the SEC as an attorney for one year.

Sources: In the Matter of Sands Brothers Asset Management, LLC, Steven Sands, Martin Sands and Christopher Kelly, Investment Advisers Act Release No. 4273 (November 19, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4273.pdf; In the Matter of Sands Brothers Asset Management, LLC, Steven Sands, Martin Sands and Christopher Kelly, Investment Advisers Act Release No. 4274 (November 19, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4274.pdf; Custody Rule Violators Settle Charges, SEC Press Release 2015-262 (November 19, 2015), available at https://www.sec.gov/news/pressrelease/2015-262.html.

Virtus Investment Advisers Settled Charges regarding False Performance Claims

On November 16, 2015, the SEC announced that Virtus Investment Advisers, Inc., a Connecticut-based investment management firm, agreed to pay $16.5 million to settle charges that Virtus misled mutual fund investors and others with advertisements containing false historical performance data about a major ETF portfolio strategy, AlphaSector. The order alleges that Virtus publicized a materially inflated, and hypothetical and back-tested, performance track record it received from its subadviser, F-Squared Investments, Inc. Virtus hired F-Squared as a subadviser to its mutual fund and to other clients that used F-Squared's AlphaSector strategy. As we reported in our *January 2015 Update*, F-Squared settled with the SEC in December 2014 regarding charges that it defrauded investors through false performance advertising. F-Squared 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.

In client presentations, marketing materials, SEC filings and other communications, Virtus falsely stated that the AlphaSector strategy had a performance history dating back to April 2001, and outperformed the S&P 500 Index for several years. The SEC found in its investigation that no F-Squared or other clients had tracked the strategy from April 2001 to September 2008 and that F-Squared had miscalculated the historical performance of the AlphaSector strategy during that same period, which substantially inflated the historical performance. Accordingly, Virtus advertised materially inflated performance data for the AlphaSector strategy to its clients. Andrew J. Ceresney, Director of the SEC Enforcement Division stated, "Virtus accepted F-Squared's historical performance misrepresentations at face value and ignored red flags that called these statements into question."

The SEC also found that Virtus failed to adopt and implement adequate compliance policies and procedures that were designed to prevent violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Sources: In the Matter of Virtus Investment Advisers, Inc., Investment Advisers Act Release No. 4266 (November 16, 2015), available at https://www.sec.gov/litigation/admin/2015/ia-4266.pdf; Mutual Fund Adviser Advertised False Performance Claims, SEC Press Release 2015-258 (November 16, 2015), available at https://www.sec.gov/news/pressrelease/2015-258.html.

SEC Awards More than $325,000 to Whistleblower

On November 4, 2015, the SEC announced an award to a whistleblower of more than $325,000. The whistleblower was a former investment firm employee who provided the SEC with a detailed description of the firm's misconduct and identified specific individuals engaged in the wrongdoing, which enabled the SEC's enforcement staff to open an investigation and uncover fraudulent activity. Agency officials say the award could have been higher if the whistleblower had not waited until after leaving the firm to report the misconduct to the SEC. Sean X. McKessy, Chief of the SEC Office of the Whistleblower, said the "award recognizes the value of the information and assistance provided by the whistleblower while underscoring the need for whistleblowers to report information to the agency expeditiously." Since the whistleblower program's inception in 2011, the SEC has paid more than $54 million to 22 whistleblowers who provided the SEC with information that contributed to successful enforcement actions. The confidentiality of whistleblowers is protected by law, and the SEC does not disclose information that may reveal a whistleblower's identity.

Sources: In the Matter of the Claim for Award in connection with [Redacted], Securities Exchange Act Release No. 76338 (November 4, 2015), available at https://www.sec.gov/rules/other/2015/34-76338.pdf; SEC Announces Whistleblower Award of More than $325,000, SEC Press Release No. 2015-252 (November 5, 2015), available at https://www.sec.gov/news/pressrelease/2015-252.html.