GODFREY & KAHN S.C.

Investment Management Focus

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Godfrey & Kahn Investment Management Team Members Responsible for this Update

Christopher M. Cahlamer
414.287.9338
ccahlamer@gklaw.com

Leah N. Cry
608.284.2232
lcry@gklaw.com

Ellen R. Drought
414.287.9517
edrought@gklaw.com

Carol A. Gehl
414.287.9255
cgehl@gklaw.com

Susan M. Hoaglund
262.951.7136
shoaglund@gklaw.com

Kristen A. Irgens
414.287.9308
kirgens@gklaw.com

Pamela M. Krill
608.284.2226
pkrill@gklaw.com

Jacqueline R. Roush
414.287.9354
jroush@gklaw.com

Legal and Regulatory Update

Latest Developments

SEC Proposes New Rule Requiring Investment Advisers to Adopt Business Continuity and Transition Plans

On June 28, 2016, the SEC proposed new Rule 206(4)-4 under the Advisers Act to require all SEC-registered investment advisers to adopt and implement a written business continuity and transition plan reasonably designed to address operational and other risks related to a significant disruption in the adviser's operations. The release emphasizes that an adviser's fiduciary obligations require the adviser to take steps to protect client interests from being placed at risk as a result of the adviser's inability to provide advisory services in light of various scenarios including business continuity events (e.g., natural disasters, acts of terrorism, cyber-attacks, technology failures, or unexpected loss of a service provider, facilities or key personnel) and business transition events (e.g., an adviser exiting the market, selling its business, or experiencing financial distress).

The SEC's 2003 adopting release for the compliance rule, Rule 206(4)-7 under the Advisers Act, stated that an adviser's compliance program should address business continuity plans (BCPs) to the extent relevant to the adviser, but the release did not identify critical components of a BCP or discuss specific issues or areas that advisers should consider in developing such plans. In the proposed rule release, the staff recognizes that advisers have taken steps to address and mitigate the risks of business disruptions by focusing on business continuity planning, disaster recovery, data protection and cybersecurity issues. However, the staff has observed disparate practices by advisers in addressing operational risk management. The staff has also observed that the operational complexity of advisers continues to increase and many advisers' operations are highly dependent on technology, including third-party vendor provided platforms and services.

To help ensure that all SEC-registered advisers have robust business continuity and transition planning in place, the proposed rule would require an adviser to adopt a business continuity and transition plan tailored to the risks associated with the adviser's operations and including certain specific components. The proposed rule release provides that such components could be consolidated into a single "business continuity and transition plan" or addressed in separate plans.

The business continuity and transition plan required under the proposed rule would require policies and procedures that address the following:

1. **Maintenance of critical operations and systems, and the protection, backup and recovery of data.**

   With respect to critical operations and systems, the plan should:

   - Identify and prioritize critical functions, operations and systems (including the identification and assessment of third-party services that support certain functions and the identification of key personnel that either provide critical functions to the adviser or support critical operations or systems of the adviser).
   - Consider alternatives and redundancies to help maintain the continuation of operations in the event of a significant business disruption (addressing the backup systems or other alternative processes that will be used in the event of a business disruption and contingency plans with respect to both the temporary or permanent loss of key personnel).

   With respect to data protection, backup and recovery, the plan should:

   - Address both hard copy and electronic backup.
   - Include an inventory of key documents (e.g., organizational documents, contracts, policies and procedures), including the location and description of the item and a list of the adviser's service provider relationships necessary to maintain functional operations.
   - Consider and address as relevant the operational and other risks related to cyber-attacks.

2. **Pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees.**

   Advisers will need to consider the geographic diversity of their offices or remote sites and employees, as well as access to the systems, technology and resources necessary to continue operations at different locations in the event of a disruption.

3. **Communications with clients, employees, service providers and regulators.**

   An adviser's communication plan generally should cover, among other things:

   - the methods, systems, backup systems and protocols that will be used for communications;
   - how employees are informed of a significant business disruption;
   - how employees should communicate during such a disruption;
   - contingency arrangements communicating who would be responsible for taking on other responsibilities in the event of a loss of key personnel; and
   - employee training.

   With respect to client communications, the plan should address:

   - the process by which the adviser would have prompt access to client records that include the name and relevant contact and account information for each client (as well as investors in private funds sponsored by the adviser);
   - how clients will be made aware of and updated about a significant business disruption that materially impacts ongoing client services; and
   - when and how clients will be contacted and advised if account access is impacted during such a

disruption.

With respect to service provider communications, the plan should address:

- how the service provider will be notified of a significant business disruption at the adviser;
- how the adviser will be notified of a significant business disruption at a service provider; and
- how the entities will communicate with one another and clients or investors during a disruption.

With respect to regulator communications, the plan should:

- address contact information for relevant regulators;
- identify the personnel responsible for notifying such regulator(s) of a significant business disruption; and
- identify the circumstances when an adviser would notify such regulator(s) of a significant business disruption.

4. **Identification and assessment of third-party services critical to the operation of the adviser.**

The business continuity and transition plan should identify critical functions and services provided by the adviser to its client, and third-party vendors supporting or conducting critical functions or services for the adviser and/or on the adviser's behalf. The staff indicates in the proposed rule release that it would generally consider "critical service providers" to at least include those providing services related to:

- portfolio management;
- the custody of client assets;
- trade execution and related processing;
- pricing;
- client servicing and/or recordkeeping; and
- financial and regulatory reporting.

Once an adviser identifies its critical service providers, it should review and assess how these service providers plan to maintain business continuity when faced with significant business disruptions (including evaluating the service provider's own business continuity planning).

5. **Plan of transition that accounts for the possible winding down of the adviser's business or the transition of the adviser's business to others in the event the adviser is unable to continue providing advisory services.**

Under the proposed rule, the transition components of a business continuity and transition plan would include:

- policies and procedures intended to safeguard, transfer and/or distribute client assets during transition;
- policies and procedures facilitating the prompt generation of any client-specific information necessary to transition each client account;
- information regarding the corporate governance structure of the adviser (including an organizational

chart and other information about the adviser's ownership and management structure, including the identity and contact information of key personnel and key affiliates);

- the identification of any material financial resources available to the adviser (e.g., material sources of funding, liquidity or capital to be sought in times of stress); and
- an assessment of the applicable law and contractual obligations governing the adviser and its clients (including pooled investment vehicles) implicated by the adviser's transition.

The staff emphasizes that the degree to which an adviser's business continuity and transition plan addresses a required component will depend on the nature of each particular adviser's business and that the plan of a large adviser with multiple locations, offices or business lines likely would differ significantly from that of a small adviser with a single office or only a few investment professionals and employees. Similarly, the business continuity and transition plan of an adviser with a complex internal technology infrastructure likely would differ from that of an adviser that primarily uses an outsourced model where third-party service providers perform various middle and back office functions.

An adviser would be required to review the adequacy of its business continuity and transition plan and the effectiveness of its implementation at least annually in an effort to determine if the plan continues to, or would, work as designed and whether changes are needed for continued adequacy and effectiveness.

Comments on the proposed rule are due on or before September 6, 2016.

Sources: Adviser Business Continuity and Transition Plans, Investment Advisers Act Release No. 4439 (June 28, 2016), available at https://www.sec.gov/rules/proposed/2016/ia-4439.pdf; SEC Proposes Rule Requiring Investment Advisers to Adopt Business Continuity and Transition Plans, Press Release No. 2016-133 (June 28, 2016), available at https://www.sec.gov/news/pressrelease/2016-133.html; ICI Memorandum "SEC Issues Business Continuity and Transition Planning Proposal for Advisers; SEC Staff Provides Business Continuity Planning Guidance to Fund Complexes" (July 5, 2016).

IM Guidance on Business Continuity Planning for Registered Investment Companies

On the same day the SEC issued a rule proposal requiring investment advisers to adopt business continuity and transition plans (discussed above), the SEC's Division of Investment Management (IM Division) issued a guidance update relating to business continuity planning for registered investment companies. Citing recent events that have impacted business continuity in the mutual fund industry, including natural disaster events (Hurricane Katrina in 2005 and Hurricane Sandy in 2012) and a systems malfunction experienced in 2015 by a large mutual fund service provider that impacted fund NAV calculations, the guidance discusses a number of measures that the staff believes funds should consider as they evaluate the robustness of their fund complex's business continuity plan (BCP) in order to mitigate business continuity risks for funds and investors.

The SEC's 2003 adopting release for Rule 38a-1 under the Investment Company Act included BCPs among other specified elements that a fund's compliance program should address. The current guidance notes that fund complexes and their service providers have continued to build and improve BCP practices to mitigate the consequences of disruptive events. However, staff observations made during recent outreach efforts with fund complexes revealed that some fund complexes could have been better prepared for the possibility of potential disruptions in services (whether provided internally at the fund complex or externally by a critical third-party service provider) that could affect a fund's ability to continue operations. The staff notes that critical third-party service providers likely would include, but would not be limited to, each named service provider under Rule 38a-1 (i.e., each investment adviser, principal underwriter, administrator and transfer agent), as well as each custodian and pricing agent. In determining whether a service provider is critical, the guidance notes that fund complexes may wish to consider the day-to-day operational reliance on the service provider and the existence of backup processes or multiple providers.

The guidance indicates that policies, procedures and BCPs adopted as part of a Rule 38a-1 compliance program should be tailored based on the nature and scope of a fund complex's businesses. Notable practices observed by the staff in discussions with fund complexes regarding BCP planning included the following:

- BCPs typically cover the facilities, technology/systems, employees and activities conducted by the adviser and any affiliated entities, as well as dependencies on critical third-party service providers.
- Employees involved in BCP programs at the fund complex level typically include senior management (including fund officers), and a broad cross-section of employees from technology, information security, operations, human resources, communications, legal, compliance and risk management.
- CCOs typically participate in the fund complex's third-party service provider oversight process, which may incorporate initial and ongoing due diligence processes, including reviews of applicable BCPs for these service providers.
- BCP presentations are typically provided to fund boards, with CCO participation, on an annual basis and are given by the adviser and/or other critical third-party service providers.
- Some form of BCP testing occurs at least annually.
- Business continuity outages experienced by the fund complex or a critical third-party service provider are monitored by the CCO and reported to the fund board as warranted.

To improve the robustness of a fund complex's BCP, the guidance indicates that the plan should contemplate arrangements with critical third-party service providers and take into account the following considerations:

- The plan should address the risk that a critical third-party service provider could suffer a significant business disruption and evaluate each service provider's back-up processes, redundancies and contingency plans and evaluate how the fund complex and service provider might respond to a business continuity disruption.
- Protocols in the plan to address business continuity disruptions might include policies and procedures addressing: (a) internal communications across the fund complex; (b) external communications with the affected service provider, investors, regulators and the press, as warranted; (c) updated and accessible contact information for essential communications with various constituencies during a disruption event; and (d) timely communications that report progress and next steps.
- Fund complexes should consider how the BCPs of the fund's critical third-party service providers relate to each other.
- The plan should address how a critical third-party service provider disruption could impact fund operations and investors and include protocols for managing the response to potential disruptions under various scenarios.

The guidance also emphasizes a fund board's oversight obligations. Such oversight should include discussions with the fund's adviser (and other affiliated service providers) and critical third-party service providers regarding the steps being taken to mitigate risks associated with business disruptions and the robustness of their business continuity planning.

Sources: Investment Management Guidance Update No. 2016-04, Business Continuity Planning for Registered Investment Companies (June 2016), available at https://www.sec.gov/investment/im-guidance-2016-04.pdf; ICI Memorandum "SEC Issues Business Continuity and Transition Planning Proposal for Advisers; SEC Staff Provides Business Continuity Planning Guidance to Fund Complexes" (July 5, 2016).

SEC Issues No-Action Relief on Auditor Independence

On June 20, 2016, the SEC staff issued a no-action letter to Fidelity Management & Research Company (FMRC) that provides guidance to registered investment companies and their investment advisers as they continue to evaluate the independence of their audit firms in light of recent uncertainty about the application of Rule 2-01(c)(1)(ii)(A) under Regulation S-X – referred to as the "loan rule."

Under the loan rule, an audit firm will not be considered independent from an audit client if the firm, any covered person in the firm, or any of his or her immediate family members has any loan to or from the audit client, or the audit client's officers, directors, or record or beneficial owners of more than 10% of the audit client's equity securities. "Audit client" is defined to include affiliates of the audit client, which, for a registered investment company, includes all entities within the "investment company complex," regardless of whether the audit firm actually provides audit services to those other entities. Because of the manner in which fund shares are often held (e.g., in omnibus accounts), the loan rule may be inadvertently violated in situations where the lender would have no ability to influence either the audit firm or the fund. The result could be disastrous for the funds involved, calling into question the validity of prior fund audits.

Given this, the SEC staff issued no-action relief to FMRC, indicating that it would not object if the funds managed by FMRC rely on audit opinions from an audit firm that fails to comply with the loan rule, provided that the following three conditions are satisfied:

1. the audit firm complies with PCAOB Rule 3526(b)(1), which requires the auditor to describe in writing any relationships between the auditor and the fund that may be reasonably thought to bear on its independence, and PCAOB Rule 3526(b)(2), which requires the auditor to discuss with the fund's audit committee the potential effects of such relationships on its independence;
2. the non-compliance of the auditor is with respect only to the lending relationships; and
3. notwithstanding non-compliance with the loan rule, the auditor concludes that it is objective and impartial with respect to other issues encompassed within its engagement.

The no-action letter cautions, however, that if one or more matters relating to the election of trustees or directors, the appointment of an independent auditor, or other matters that similarly could influence the objectivity and impartiality of the audit firm are put before shareholders, FMRC would be required to make reasonable inquiry as of the record date about the impact of the loan rule on the vote, stating that if FMRC determines as part of that inquiry that an institution in a lending relationship in fact exercises discretionary voting authority with respect to at least 10% of a fund's shares, the fund could not rely on the relief granted and would instead take other appropriate action, consistent with its obligations under the federal securities laws.

Although the no-action letter is addressed to FMRC, it would appear that any fund group with similar facts may also rely on it. However, the SEC staff indicated in the letter that the relief provided is temporary and will expire 18 months from the date of issuance, unless renewed by the staff. It is unclear from this statement whether the staff expects to adopt a more comprehensive solution to the loan rule, but given the importance of this issue, we expect that the industry will monitor the situation closely.

Source: No Action Letter, Fidelity Management & Research Company (June 20, 2016), available at https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm.

SEC Adopts Higher Net Worth Threshold for Qualified Clients under the Advisers Act

On June 14, 2016, the SEC issued an order to increase the net worth threshold for "qualified clients" (as defined in Rule 205-3 of the Advisers Act) from $2 million to $2.1 million. This adjustment is being made pursuant to a five-year inflation-indexing adjustment required by Section 205(e) of the Advisers Act.

By way of background, Section 205(a)(1) of the Advisers Act generally prohibits registered investment advisers from charging performance-based fees. An exemption from this prohibition is provided by Rule 205-3 under the Advisers Act for clients that meet the definition of "qualified client." Currently, Rule 205-3 provides that in order to be a qualified client, a client must have either (i) at least $1 million of assets under the management of the investment adviser, or (ii) a net worth (together, in the case of a client which is a natural person, with assets held jointly with a spouse but excluding the value of a primary residence) which the investment adviser reasonably believes to be in excess of $2 million. A qualified client also includes both a "qualified purchaser" as defined in Section 2(a)(51)(A) of the 1940 Act and an investment adviser's knowledgeable employees.

As a result of the SEC's recent action, effective August 15, 2016, the net worth threshold for qualified client status will increase to $2.1 million. The new net worth threshold will not be retroactively applied to advisory contracts entered into prior to the effective date, but any new advisory agreement or fund subscription agreement entered into after the effective date must reflect the new requirements.

Source: Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 4421 (June 14, 2016), available at https://www.sec.gov/rules/other/2016/ia-4421.pdf.

FinCEN Clarifies and Strengthens Customer Due Diligence Requirements for Mutual Funds and Broker-Dealers

The Financial Crimes Enforcement Network (FinCEN) believes the following four core elements of customer due diligence should be explicit requirements in the anti-money laundering (AML) program for all covered financial institutions, which includes mutual funds and broker-dealers:

1. Customer identification and verification;
2. Beneficial ownership identification and verification;
3. Understanding the nature and purpose of customer relationships to develop a customer risk profile; and
4. Ongoing monitoring for reporting suspicious transactions and, on a risk-basis, maintaining and updating customer information.

The first is already an AML program requirement and the second is new. According to FinCEN, the third and fourth elements are already implicitly required, but the AML program rules are being amended to include them as explicit requirements.

Beginning May 11, 2018, mutual funds and broker-dealers must identify and verify the identity of the beneficial owners of legal entity customers (other than those that are excluded) at the time a new account is opened. FinCEN provides a standard certification form, which requires the disclosure of key individuals (i.e., the beneficial owners) who own or control a legal entity (e.g., corporation, limited liability company or general partnership). Certain legal entities are excluded from the definition of "legal entity customer," including: a SEC-registered investment adviser; a SEC-registered broker-dealer; a bank; an investment company; an insurance company; a department or agency of the United States or of any state or any political subdivision of a state; any entity with stock listed on the New York, American or NASDAQ stock exchange; and an issuer of securities registered under Section 12 of the Securities Exchange Act.

Mutual funds and broker-dealers must obtain information (name, address, date of birth and Social Security number) from each individual (up to four) who owns 25% or more of the equity interests of the legal entity customer and one individual with significant responsibility for managing the legal entity customers (e.g., a chief executive officer, chief financial officer, chief operating officer, managing member, general partner, president, vice president or treasurer).

FinCEN confirmed that mutual funds and broker-dealers may treat financial intermediaries as their customers, and are not required to look through an intermediary to the underlying beneficial owners if the intermediary is identified as the accountholder. If the intermediary is an excluded legal entity, such as a broker-dealer or bank, then the mutual funds and broker-dealers do not have to obtain information about owners or control persons of the intermediary.

Source: Customer Due Diligence Requirements for Financial Institutions (May 11, 2016), available at https://www.federalregister.gov/articles/2016/05/11/2016-10567/customer-due-diligence-requirements-for-financial-institutions.

Litigation and SEC Enforcement Actions

SEC Orders Fund Adviser to Pay $1.5 Million for Failing to Scrutinize Consultant

The SEC settled an enforcement action brought against Federated Global Investment Management Corp. (FGIMC), a registered investment adviser and a sub-adviser to the Federated Kaufmann Funds (the Funds), for failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information. The SEC staff found that FGIMC's policies and procedures were not reasonably designed to prevent the misuse of material, nonpublic information with respect to outside consultants.

From approximately 2001 to 2010, investment management professionals of FGIMC regularly worked closely with outside consultants, one of whom provided securities research services and specific recommendations related to pharmaceutical and biotechnology investments. During their consulting relationship, FGIMC's senior management and compliance department were unaware that the consultant was also a board member of certain publicly-traded biotechnology companies, giving him access to material, nonpublic information regarding those companies. Specifically, the investigation found that the Funds were shareholders of, and traded the securities of, four different companies of which the third-party consultant was a board member. In addition, the SEC found that at times the consultant had access to nonpublic information regarding the Funds, including some of the Funds' holdings. The SEC also found that at times the consultant purchased and sold in his personal brokerage accounts securities of the same pharmaceutical and biotechnology companies that the Funds held, sometimes in close proximity to trades by the Funds.

During the relevant time period, FGIMC had several written policies and procedures relating to the treatment of material, nonpublic information, including a Code of Ethics, a Policy on Trading and Confidentiality, Procedures Regarding Confidential Information, and a Code of Business Conduct and Ethics. However, FGIMC did not have any policies or procedures to identify whether particular consultants who were not employees should be designated as "access persons" under the Code of Ethics. Based on the consultant's access to nonpublic information concerning the Funds' holdings, and his functional role similar to that of a part-time employee, the SEC staff determined that the consultant should have been an "access person" subject to the restrictions of the Code of Ethics. Although the SEC staff did not identify any instances of actual misuse of confidential information, they deemed the gap in FGIMC's compliance program with respect to consultants to be a violation of Section 204A of the Advisers Act, which requires advisers to reasonably design policies and procedures to prevent the misuse of material, nonpublic information.

The SEC ordered FGIMC to cease and desist from similar future securities law violations with respect to outside consultants. In determining to accept FGIMC's settlement offer, the SEC staff took into account the remedial steps taken by FGIMC. After identifying the consultant as serving on boards of directors, but before learning of the SEC's investigation, FGIMC terminated its relationship with the consultant, reviewed its use of information provided by the consultant, and adopted policies and procedures that allowed for FGIMC to determine whether outside consultants used by FGIMC had access to or were in possession of material, nonpublic information. Ultimately, FGIMC consented to the SEC's order without admitting or denying the findings and agreed to pay $1.5 million to settle the charges.

Source: In the Matter of Federated Global Investment Management Corp., Investment Advisers Act Release No.4351 (May 27, 2016), available at https://www.sec.gov/litigation/admin/2016/ia-4401.pdf.

Morgan Stanley to Pay $1 Million for Failure to Safeguard Customer Data

On June 8, 2016, the SEC announced that Morgan Stanley Smith Barney LLC (MSSB) agreed to pay a penalty of $1 million to settle charges that MSSB failed to adopt written policies and procedures reasonably designed to protect customers' records and information in violation of Regulation S-P, the safeguards rule.

The safeguards rule requires SEC-registered broker-dealers and investment advisers to adopt written policies and procedures that are reasonably designed to ensure the confidentiality and security of customer records and information, protect against any anticipated threats or hazards to the integrity or security of customer records and information, and protect against unauthorized access to or use of customer records or information.

MSSB stored sensitive personally identifiable information of customers, including full names, phone numbers, addresses, and account numbers, on two internal web portals. MSSB employees were able to access customers' personal information and a MSSB employee misappropriated data regarding approximately 730,000 customer accounts by accessing the portals and downloading this information on his personal server, which was subsequently hacked by third parties who posted portions of the data to internet sites along with an offer to sell additional data.

The SEC found that MSSB violated the safeguards rule because its policies and procedures failed to include: (i) reasonably designed and operating authorization modules for the portals to restrict employee access to employees with a legitimate business need, (ii) auditing and/or testing the effectiveness of such authorization models, and (iii) monitoring and analysis of employees access and use (or misuse) of the portals.

Andrew Ceresney, Director of the SEC's Division of Enforcement (Enforcement Division), stated "Given the dangers and impact of cyber breaches, data security is a critically important aspect of investor protection. We expect SEC registrants of all sizes to have policies and procedures that are reasonably designed to protect customer information." In a separate order, the MSSB employee was barred from the industry with the right to apply for reentry after five years and was also criminally convicted in 2015 and received 36 months of probation and a $600,000 restitution order.

Sources: In the Matter of Morgan Stanley Barney LLC, Investment Advisers Act Release No. 4415 (June 8, 2016), available at: https://www.sec.gov/litigation/admin/2016/34-78021.pdf; Morgan Stanley Failed to Safeguard Customer Data, SEC Press Release 2016-112 (June 8, 2016), available at: https://www.sec.gov/news/pressrelease/2016-112.html.

Broker-Dealer Settles with SEC Over Deficient Privacy Policies and Procedures

In April 2016, the SEC announced that it had reached a settlement with broker-dealer Craig Scott Capital, LLC (CSC) over charges that it failed to adopt written policies and procedures to protect confidential customer information and records in violation of the safeguards rule and failed to keep and maintain copies of all business communications.

The SEC cited the following deficiencies in its order:

- CSC's use of e-mail addresses other than those with the firm's domain name to electronically receive more than 4,000 faxes, often including sensitive customer records, from customers and other third parties;
- CSC's use of personal e-mail addresses for matters relating to the business;
- CSC's failure to maintain and preserve the faxes and e-mails as required under the Securities Exchange Act; and
- CSC's use of written supervisory procedures (WSPs) that were not reasonably designed to protect customer records and information. The SEC found that the firm's WSPs failed to designate the responsible supervisor and address how electronic transmittal of customer records through the fax system was to be accomplished, among other deficiencies.

Without admitting or denying any of the SEC's findings, CSC agreed to pay a $100,000 penalty. CSC's two principals also agreed to each pay a $25,000 penalty for their alleged role in aiding and abetting the firm's violations.

Sources: In the Matter of Craig Scott Capital, LLC, Craig S. Taddoni, and Brent M. Porges, Securities Exchange Act Release No. 77595 (April 12, 2016), available at https://www.sec.gov/litigation/admin/2016/34-77595.pdf; Broker-Dealer and Principals Charged with Violations Related to the Protection of Confidential Customer Information and Use of Personal Email, Administrative Proceeding File No. 3-17206 (April 12, 2016), available at https://www.sec.gov/litigation/admin/2016/34-77595-s.pdf.

Private Equity Fund Adviser Settled Charges for Acting as an Unregistered Broker and Failure to Comply with Fund Agreements

On June 1, 2016, the SEC announced that Blackstreet Capital Management, LLC, a Maryland-based private equity fund adviser (Blackstreet), and its principal owner agreed to pay the SEC more than $3.1 million to settle charges against Blackstreet and its principal owner for engaging in brokerage activity, including receiving transaction-based compensation for brokerage services, without registering as a broker-dealer with the SEC and failing to follow the terms of the corporate governance documents of Blackstreet's funds.

The SEC found that Blackstreet performed brokerage services for clients instead of using an investment bank or broker-dealer to handle the purchase and sale of portfolio companies or their assets for two private equity funds advised by Blackstreet. Of note, Blackstreet disclosed to its funds and fund shareholders that it would provide such brokerage services in exchange for a fee; however, the SEC found that Blackstreet failed to comply with registration requirements to operate as a broker-dealer. Some of Blackstreet's brokerage services included soliciting deals, identifying buyers and sellers, negotiating and structuring deals and arranging financing. Andrew J. Ceresney, Director of the Enforcement Division, explained: "Blackstreet clearly acted as a broker without fulfilling its registration obligations," and that "the rules are clear: before a firm provides brokerage services and receives compensation in return, it must be properly registered within the regulatory framework that protects investors and informs our markets."

The SEC also found that Blackstreet inadequately disclosed fees and expenses and engaged in transactions that presented conflicts of interest. For example, Blackstreet used fund assets to pay for political and charitable contributions and entertainment expenses, and such expenditures were not authorized by the funds' corporate governance documents.

Blackstreet also charged fees to portfolio companies in one of its funds for providing operating partner oversight; however, that fund's corporate governance documents failed to disclose Blackstreet received these fees. This resulted in a conflict of interest because Blackstreet was using fund assets to pay itself.

Based on its findings, the SEC determined that Blackstreet failed to adopt and implement reasonably designed policies and procedures to prevent violations under the Advisers Act regarding the improper use of fund assets and undisclosed receipt of fees. In addition to the $3.1 million penalty, Blackstreet agreed to be censured, and its principal owner must cease and desist from further violations.

Sources: In the Matter of Blackstreet Capital Management, LLC, Investment Advisers Act Release No. 4411 (June 1, 2016), available at: https://www.sec.gov/litigation/admin/2016/34-77959.pdf; Private Equity Fund Adviser Acted as Unregistered Broker, SEC Press Release No. 2016-100 (June 1, 2016), available at: https://www.sec.gov/news/pressrelease/2016-100.html.

SEC Charges Investment Adviser with Failure to Disclose Fees to Clients

The SEC charged Connecticut-based investment adviser Momentum Investment Partners LLC (d/b/a Avatar Investment Management) with fraud for allegedly moving some of its advisory clients' assets from separately managed accounts into newly-formed mutual funds, with the same investment strategy and higher fees, without disclosing the higher fees to its clients.

In May 2013, Avatar and its founder and CEO Ronald J. Fernandes moved some of Avatar's advisory clients' assets into four new mutual funds. The new mutual funds used the same investment strategy as had been used to manage the clients' individual accounts, namely, investing in a mix of exchange-traded funds (ETFs). However, the mutual funds charged annual management fees ranging from 1.15% to 1.45% of the funds' assets, over and above the advisory fee of between 0.10% and 0.60% that Avatar's clients paid for Avatar's management of their accounts. Therefore, the SEC alleges that these clients were charged, and Avatar received, an additional fee for the exact same services and investment strategy they had been receiving prior to the transfer of their assets into the mutual funds.

The SEC alleges that Avatar and Mr. Fernandes failed to inform their clients of this material conflict of interest. It further alleges that they did not inform their clients that their assets were to be moved to the mutual funds and used as the seed money for their launch. Avatar was unsuccessful in raising additional assets for the Avatar mutual funds and the funds were subsequently closed. According to the SEC, the additional fees charged to clients as a result of the movement of their assets to the mutual funds totaled $111,000, with $61,000 paid to Avatar.

The SEC has charged Avatar and Mr. Fernandes with engaging in fraudulent or deceptive conduct with respect to investment advisory clients in violation of the Advisers Act. The SEC is seeking a jury trial in the United States District Court in the District of Connecticut.

Sources: SEC Charges Connecticut-Based Investment Adviser for Failure to Disclose Fees to Clients, SEC Litigation Release No. 23549 (May 31, 2016), available at https://www.sec.gov/litigation/litreleases/2016/lr23549.htm; Complaint, Securities and Exchange Commission v. Momentum Investment Partners LLC, Case 3:16-cv-00832-VLB (D. Conn. May 31, 2016), available at https://www.sec.gov/litigation/complaints/2016/comp23549.pdf.

Excessive-Fee Litigation Update

Federal Judge Dismisses State Farm Excessive-Fee Case

In June 2016, a federal judge granted State Farm Investment Management Corporation's motion to dismiss plaintiffs' complaint alleging that State Farm breached its fiduciary duties by collecting excessive management fees. State Farm's LifePath® Target Date Funds are sub-advised by BlackRock Fund Advisors, and the plaintiffs alleged that the portion of the advisory fee retained by State Farm was so disproportionately large that it bore no reasonable relationship to the services provided by State Farm. In dismissing the case, the judge stated that "based on the largely unsupported allegations of the amended complaint, plaintiffs have not demonstrated some connection between the services provided and fees charged that could establish fees charged beyond the outer bounds of arm's length bargaining that is plausible rather than merely possible." The decision in this case is unusual in that most similar cases have survived the defendants' motions to dismiss.

Sources: State Farm Wins Rare Dismissal in Excessive-Fee Case, Ignites, Beagan Wilcox Volz (June 24, 2016); Amy L. Ingenhutt and Teresa L. Odell v. State Farm Investment Management Corporation, Case No. 15-1303 (June 22, 2016).

MassMutual Settles Excessive-Fee Case for Almost $31 Million

In June 2016, MassMutual settled an excessive-fee case brought by current and former participants in its retirement plans for $30.9 million. In the class-action suit, the plaintiffs alleged that MassMutual and key executives breached their fiduciary duty under the Employee Retirement Income Security Act (ERISA) by causing unreasonable administrative expenses to be charged to the plans; providing unreasonably priced and poor-performing investment options; and providing a fixed-income investment option that was unduly risky and expensive.

Under the terms of the settlement, MassMutual also agreed to hire an independent consultant for four years to review and evaluate investment options. The plan fiduciaries, with the assistance of the independent consultant, will consider (1) the lowest-cost share class available for any particular mutual fund considered for inclusion in the plans; (2) collective investment trusts and single client separately managed account investments (SMAs); and (3) passively managed funds for each category or fund offering that will be made available under the plans. The independent consultant will provide the plan fiduciaries with at least three investment options to consider for each investment style represented on the menu. If the plans offer a SMA that invests in a mutual fund that engages a sub-advisor, the investment consultant, in evaluating the reasonableness of the fund's fees, will consider the portion of the fees paid to the sub-advisor. Additionally, MassMutual agreed to ensure for a period of four years that plan participants are charged no more than $35 each for standard recordkeeping services. These fees will be set as a flat rate, rather than as a percentage of plan assets. Plan fiduciaries will also be required to attend a fiduciary responsibility presentation by an experienced ERISA lawyer and an independent investment consultant.

Sources: MassMutual to Pay $31M in Excessive-Fee Settlement, Ignites, Joe Morris (June 20, 2016); Dennis Gordon v. Massachusetts Mutual Life Insurance Co., Case No. 13-CV-30184, U.S. District Court, District of Massachusetts (June 15, 2016).

Updates on Pending SEC Rule Proposals

Investment Company Reporting Modernization

As discussed in our July 2015 regulatory update, in May 2015 the SEC proposed the following changes to modernize reporting and disclosure requirements for registered investment companies:

- rescind Form N-Q and adopt new Form N-PORT, which would require funds to report information regarding their monthly portfolio holdings as well as derivatives, securities lending and other information;
- require standardized and enhanced derivatives disclosures in financial statements;
- permit a fund to deliver shareholder reports by making the reports accessible on its website; and

- rescind Form N-SAR and replace it with new Form N-CEN, which would require funds to report census-type information on an annual basis.

  See http://www.gklaw.com/news.cfm?action=pub_detail&publication_id=1515

Amendments to Form N-PORT and Form N-CEN are also proposed in the "Liquidity Risk Management Programs; Swing Pricing" proposal and the "Use of Derivatives by Registered Investment Companies" proposal. Accordingly, the comment period was re-opened and comments are still being accepted.

The Investment Company Institute (ICI), the Independent Directors Council and the Mutual Fund Directors Forum have submitted comment letters supporting the option for online delivery of shareholder reports. Fund industry commenters have expressed concerns with the ability to compile the necessary data for N-PORT within 30 days. *See* Jackie Noblett, "Funds to SEC: You Want N-PORT? We Need Time," *Ignites*, September 15, 2015. Commenters expect this proposal to be the first of the SEC's three big proposals to be finalized in 2016. *See* Beagan Wilcox Volz, "Data Modernization Rule Likely First on SEC's List to Finalize," *Ignites*, April 28, 2016.

SEC Proposal for Liquidity Management and Swing Pricing

As discussed in our October 2015 regulatory update, in September 2015 the SEC proposed rule reforms that would require funds to establish liquidity risk management programs, increase disclosure regarding the liquidity of fund assets and give funds the ability to use "swing pricing" in times of increased purchase and/or redemption activity. *See http://www.gklaw.com/news.cfm?action=pub_detail&publication_id=1554*

In a keynote address at the ICI's General Membership Meeting in May 2016, SEC Chair Mary Jo White noted that although commenters have been generally supportive of enhanced liquidity risk management for funds, many have expressed concerns about the liquidity classification framework and operational challenges involved with swing pricing. The ICI has submitted a number of comment letters and opposes the proposal for an asset classification scheme and the three-day liquid asset requirement. The industry is also concerned about the additional responsibilities imposed on fund boards. *See* Joe Morris, "Directors Wary of New Liquidity Liabilities," *Ignites*, May 16, 2016. Comments are still being accepted, even after the January 2016 deadline, as the SEC staff finalizes recommendations related to the proposal. The SEC plans to finalize the proposal in 2016.

SEC Proposal Governing the Use of Derivatives by Registered 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:

1. 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);

2. 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. establish a formalized risk management program if the fund engages in more than a limited use of derivatives or uses complex derivatives.

See http://www.gklaw.com/news.cfm?action=pub_detail&publication_id=1587

At the ICI's General Membership Meeting in May 2016, SEC Chair Mary Jo White noted that while commenters have expressed support for the SEC to provide an updated and more comprehensive approach to the regulation of a fund's use of derivatives, many are not in favor of the proposal's portfolio limitations. The ICI's comment letter opposed the proposed portfolio limits but supported the asset segregation requirements. The SEC staff is currently working to finalize the recommendations on the rulemaking.

The information contained herein is based on a summary of legal principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.