GODFREY & KAHN S.C.
Investment Management Focus
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Legal and Regulatory Update

Industry Guidance

SEC Expects to Bring Enforcement Actions Relating to Payments for Distribution in Guise

Recent examination priorities for the SEC's Office of Compliance Inspections and Examinations (OCIE) stated that the SEC would be reviewing payments by advisers and funds to distributors and intermediaries, focusing on funds' payments for "distribution in guise." In March 2013, the SEC announced an exam sweep of mutual fund distribution arrangements. In recent remarks given in February 2015, Julie Riewe, co-chief of the Asset Management Unit at the SEC's Division of Enforcement, remarked that fund distribution is of particular concern to the SEC given the conflicts of interests it presents to advisers whether to use their own assets or fund assets to distribute shares. Ms. Riewe noted that she anticipated "enforcement action from the Distribution in Guise Initiative, where we are examining, among other things, conflicts presented by registered fund advisers using the fund's assets to grow the fund and, consequently, the adviser's own fee." According to a report published by BoardIQ, the practices observed during the exam sweep prompted the SEC to send deficiency letters to four fund complexes about disguised distribution payments, and to refer two cases to the Division of Enforcement.

Andrew Bowden, current head of OCIE (Mr. Bowden will be leaving at the end of April), and Andrew Ceresney, head of the Division of Enforcement, addressed the coming enforcement actions in comments made during the Investment Company Institute's (ICI) 2015 Mutual Funds and Investment Management conference. Mr. Bowden stated that the coming enforcement actions are not meant to upend the industry's current practices but that the agency wants to see that firms have a rigorous process in place for making sure fund assets are not used to pay for sales efforts, unless such payments are made through a Rule 12b-1 plan. Mr. Bowden further noted that the SEC wants to see whether advisers are giving fund boards adequate information to properly assess fund payments for distribution and fully disclosing conflicts of interest, and the SEC will be scrutinizing whether boards are adequately reviewing the information.

Mr. Ceresney indicated that the SEC will not "regulate by enforcement." He added that the coming enforcement actions relating to distribution payments are the result of clear violations of statutes or regulations and will not be in a "gray area."

In a speech at the ICI conference, David Blass, General Counsel of the ICI, addressed potential SEC actions with respect to distribution payments. Mr. Blass noted that, in his view, there are no hidden fees for legitimate non-distribution services because all fees of a fund are included in a fund's expense ratio. Additionally, Mr. Blass noted that the SEC has historically left discretion of payments to intermediaries in the hands of fund directors. Lastly, Mr. Blass encouraged the SEC to avoid rulemaking by enforcement, noting that any changes made in the area of distribution fees should be made through an open, transparent rulemaking process.

Sources: Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View, Julie M. Riewe, Co-Chief Asset Management Unit, Division of Enforcement (February 26, 2015), available at http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html; 'Distribution in Guise' Enforcement Actions in Works: SEC, Ignites, Peter Ortiz (March 5, 2015); SEC Bigs on Distribution-Fee Cases: We're Not Out for Blood, Ignites, Beagan Wilcox Volz (March 19, 2015); SEC Deficiency Letters on Distribution Hit Board Process, Board IQ, Whitney Curry Wimbish (January 27, 2015).

Cybersecurity Examination Sweep Summary

In February, OCIE published a risk alert with summary observations from its examination of 57 registered broker-dealers and 49 registered investment advisers aimed at better understanding how broker-dealers and investment advisers address the legal, regulatory and compliance issues associated with cybersecurity.

Written Policies

93% of examined broker-dealers and 83% of examined investment advisers have adopted written security policies that address cybersecurity and most of those firms conduct periodic audits to determine compliance with such policies. The policies reviewed by OCIE generally included procedures discussing mitigation of the effects of a cybersecurity incident and/or the plan to recover from such an incident. Only a small number of policies included provisions to address whether firms are responsible for losses associated with cyber incidents and even fewer offered security guarantees to protect clients against cyber-related losses. Most firm policies that were reviewed by OCIE reference external cybersecurity risk management standards, such as those published by the National Institute of Standards and Technology, the International Organization for Standardization or the Federal Financial Institutions Examination Council as models for their information security architecture.

Periodic Risk Assessments

93% of examined broker-dealers and 79% of examined investment advisers conduct periodic risk assessments to identify cybersecurity threats, vulnerabilities, and potential business consequences. While 84% of broker-dealers require cybersecurity risk assessments of vendors with access to the firm's network, only 32% of examined investment advisers required such risk assessments.

Cybersecurity Incidents

88% of examined broker-dealers and 74% of examined investment advisers reported experiencing cyber-attacks directly or through one or more of their vendors, most of which were related to malware and fraudulent emails. 54% of broker-dealers and 43% of advisers reported receiving fraudulent emails seeking to transfer client funds. The investment adviser and several broker-dealers that reported losses attributed the losses to employees not following the firms' identity authentication procedures. Roughly two-thirds of broker-dealers that received fraudulent emails reported them to the Financial Crimes Enforcement Network but only a small number reported fraudulent emails to law enforcement or regulatory agencies. Investment advisers generally did not report incidents related to fraudulent emails.

Best Practices

Almost half of the broker-dealers examined were members of industry groups, associations or organizations that exist for the purpose of sharing information regarding cybersecurity attacks and identifying effective controls to mitigate harm. Investment advisers, on the other hand, more frequently rely on discussions with industry peers, attendance at conferences and independent research in identifying best practices and learning about guidance from regulators.

Additional Exam Observations

- Most examined firms reported taking inventory of their physical devices and systems, software platforms and applications, network resources, connections and data flows, connections to firm networks from external sources, hardware, data and software and logging capabilities and practices.
- While most broker-dealers incorporate requirements relating to cybersecurity risk into their contracts with vendors and business partners, only 24% of examined investment advisers incorporate such requirements.
- Almost all examined broker-dealers and investment advisers make use of encryption in some form.

- Broker-dealers with retail customers that offer online access and investment advisers that primarily advise retail clients and permit those clients to access their account information online generally provide those clients with information about steps that can be taken to reduce their cybersecurity risks when conducting business with the firm.
- Approximately two-thirds of examined broker-dealers and 30% of examined investment advisers have an individual designated as the firm's chief information security officer.
- Over half of broker-dealers maintain insurance for cybersecurity incidents but only 21% of investment advisers maintain insurance that covers losses related to such incidents.

SEC staff is still reviewing the information obtained in the examinations. As noted in its 2015 examination priorities, OCIE will continue to focus on cybersecurity.

Source: Cybersecurity Examination Sweep Summary, National Exam Program Risk Alert, Office of Compliance Inspections and Examinations, Volume IV, Issue 4 (February 3, 2015), available at http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

Department of Labor Proposes Fiduciary Rule and Prohibited Transaction Exemptions

On April 14, the Department of Labor (DOL) proposed a new regulation that would treat more persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner as fiduciaries under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (the Code). In the absence of fiduciary status, persons who provide investment advice would not be subject to ERISA's fiduciary standards, or accountable under ERISA or the Code for imprudent or disloyal advice. The proposal will be subject to a 75-day public comment period.

Currently, a person is a fiduciary to an employee benefit plan or IRA to the extent he or she renders investment advice to such plan or IRA for direct or indirect compensation. Existing regulations adopted in 1975 apply a five-part test to determine if a person is rendering investment advice for a fee (fiduciary investment advice). A person renders fiduciary investment advice if he or she renders advice:

- as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property;
- on a regular basis;
- pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary;
- that will serve as a primary basis for investment decisions with respect to plan assets; and
- that will be individualized based on the particular needs of the plan or IRA.

The existing regulation allows some advisers, brokers, consultants and valuation firms to play a central role in shaping employee benefit plan and IRA investments without being subject to fiduciary obligations under ERISA or the Code.

Proposed Rule

The proposed rule replaces the five-part test with a new definition that describes the kinds of communications and relationships that would generally constitute fiduciary investment advice if an adviser receives a fee or other compensation. Under the proposed rule, a person renders investment advice to an employee benefit plan, plan participant, plan fiduciary, IRA or IRA owner if such person provides:

- a recommendation regarding the advisability of acquiring, holding, disposing of or exchanging securities or other property, including recommendations as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;
- a recommendation as to the management of securities, including individualized recommendations regarding proxy voting;

- an appraisal or fairness opinion concerning the value of securities if provided in connection with a specific transaction involving the acquisition, disposition or exchange of such securities by the plan or IRA; or

- a recommendation of another person to provide investment advice or investment management services.

In order to be considered a fiduciary, the proposed regulation also requires that any person giving such investment advice either represent or acknowledge that it is acting as a fiduciary or render the advice pursuant to an agreement or understanding that the advice is individualized or directed to the recipient for consideration in making investment or management decisions with respect to securities of an employee benefit plan or IRA.

Carve-Outs

For persons who do not represent that they are acting as fiduciaries, the proposed rule creates a number of carve-outs for certain types of advice that would not be treated as investment advice. The carve-outs include:

- the seller's carve-out: incidental advice provided in connection with an arm's-length sale, purchase, loan, or bilateral contract between an expert plan investor and the adviser;

- the swap carve-out: swap dealers, security-based swap dealers, major swap participants and security-based major swap participants may make recommendations to plans when acting as counterparties to a swap or security-based swap transaction, provided the person making such recommendations obtains a representation from the independent plan fiduciary that the fiduciary will not rely on such recommendations;

- the carve-out for employees of the plan sponsor: employees of a plan sponsor (e.g., members of a company's human resources department) would not be treated as investment advice fiduciaries with respect to advice they provide to fiduciaries of the sponsor's plan as long as they do not receive any compensation for the advice beyond their normal compensation;

- the carve-out for platform providers: marketing or making available a platform of investment alternatives to be selected by a plan fiduciary of a 401(k) plan, providing general financial information that falls short of constituting actual investment advice or recommendations, such as information on the historic performance of asset classes, or identifying investment alternatives using objective third-party criteria (e.g., expense ratios or fund size); and

- the carve-out for "investment education": making available information and materials in four general categories (1) plan information, (2) general financial, investment and retirement information, (3) asset allocation models, and (4) interactive investment materials.

Prohibited Transaction Exemptions

In addition to proposing an amended definition of what constitutes a "fiduciary," the DOL also proposed a new exemption from prohibited transactions, the "best interest contract exemption," to promote the provision of investment advice that is in the best interest of retail investors, such as plan participants and beneficiaries, IRA owners and small plans. ERISA and the Code generally prohibit fiduciaries from receiving payments from third parties and from acting on conflicts of interest, including using their authority to affect or increase their own compensation, in connection with transactions involving an employee benefit plan or IRA. Certain types of fees and compensation common in the retail market, such as brokerage or insurance commissions, 12b-1 fees and revenue sharing payments, fall within these prohibitions when received by fiduciaries as a result of transactions involving advice to the plan participants and beneficiaries, IRA owners and small plan sponsors. To facilitate continued provision of advice to such retail investors and under conditions designed to safeguard the interest of these investors, the exemption would allow certain fiduciaries, including broker-dealers and insurance agents, to receive these various forms of compensation that, in the absence of an exemption, would not be permitted under ERISA and the Code.

The best interest contract exemption imposes a "best interest" standard on fiduciaries which would require them to expressly agree to provide advice that is in the best interest of retirement investors. Under the proposed exemption, investment advice would be in the "best interest" of an investor when the fiduciary providing the advice acts with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial

circumstances and needs of the retirement investor, without regard to the financial or other interests of the adviser or any of its affiliates.

Fiduciaries relying on the best interest contract exemption would be prohibited from recommending an investment if the total amount of compensation anticipated to be received by the adviser or its affiliates exceeds reasonable compensation in relation to the total services provided. Reliance on the exemption also requires persons to warrant that they have adopted policies and procedures designed to mitigate the dangers posed by material conflicts of interest. The proposed exemption also requires certain disclosures in a written contract, including identifying material conflicts of interest and informing the investor that he or she has the right to obtain complete information about all fees associated with his or her investments.

The best interest contract exemption would prohibit contracts from including exculpatory provisions disclaiming or limiting liability of the adviser for a violation of the contract's terms. The exemption would ensure that IRA owners and investors have a contract-based claim to hold their fiduciaries accountable if they violate basic obligations of prudence and loyalty.

In addition to the new best interest contract exemption, the proposal also includes other new exemptions. For example, the proposal includes a new exemption for principal transactions in which broker-dealers sell certain debt securities to plans and IRAs out of their own inventory. The proposal also asks for comment on whether the DOL should issue a "low-fee exemption" that would allow firms to receive otherwise prohibited compensation when recommending the lowest-fee products in a given product class, subject to fewer conditions than contained in the best interest contract exemption.

Sources: Proposed Best Interest Contract Exemption, 29 CFR Part 2550, Department of Labor (April 14, 2015), available at http://www.dol.gov/ebsa/pdf/conflictsofinterestproposedrulexemption1.pdf; Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment Advice, 29 CFR Parts 2509 and 2510, Department of Labor (April 14, 2015), available at http://www.dol.gov/ebsa/pdf/conflictsofinterestproposedrule.pdf.

SEC Publishes Guidance Regarding Acceptance of Gifts or Entertainment by Fund Advisory Personnel

The SEC's Division of Investment Management recently issued guidance highlighting the conflict of interest that may exist when personnel of a mutual fund's investment adviser are offered gifts, favors or other forms of consideration from persons hoping to do business with the fund. Acceptance of such gifts may constitute a violation of Section 17(e)(1) of the Investment Company Act, which prohibits a fund's affiliated persons, including employees of the fund's investment adviser, from accepting any compensation (other than a regular salary or wages) for "the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker." The SEC notes, for example, that a portfolio manager accepting gifts or entertainment from a broker-dealer for the purchase or sale of a mutual fund's portfolio securities would violate the Investment Company Act.

The SEC's guidance further notes that receipt of gifts or entertainment by advisory personnel should be addressed by a fund's compliance policies and procedures adopted under Rule 38a-1. While the appropriate policies and procedures will depend on the nature of the adviser's business, the SEC suggests some funds and advisers might consider either a blanket prohibition on the receipt of gifts or entertainment by advisory personnel or some type of pre-clearance mechanism.

Source: Acceptance of Gifts or Entertainment by Fund Advisory Personnel, Division of Investment Management IM Guidance Update, No. 2015-01 (February 2015), available at http://www.sec.gov/investment/im-guidance-2015-01.pdf.

Report on Funds' Use of Proxy Advisory Firms

Earlier this year, the ICI released a report summarizing practices and providing guidelines for mutual funds (and their advisers) that employ proxy advisory services. The report references the SEC staff's recent legal bulletin on investment advisers' proxy voting responsibilities and addresses the following topics in Q&A format. *See "Proxy Voting Responsibilities of Investment Advisers" in our July 2014 Update.*

Proxy Advisory Firm Services
The report notes that proxy advisory firms may provide a variety of services to mutual funds including:

- assisting with administrative tasks associated with proxy voting such as keeping track of meeting dates and voting instructions, executing proxies in accordance with client instructions, generating voting reports, providing coverage and translation services and compiling information for funds' annual proxy voting filings with the SEC;
- analyzing, providing research and making recommendations on the matters presented for shareholder vote;
- providing research and commentary on trends in prior and upcoming proxy seasons and aggregated data;
- assisting with formulation of and amendments to proxy voting guidelines; and
- helping advisers mitigate conflict of interest concerns.

Board Oversight of Proxy Advisory Firms
Based on prior SEC guidance, an investment adviser that has retained a proxy advisory firm to assist with proxy voting responsibilities should adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the proxy advisory firm and to ensure that the proxy advisory firm continues to vote in the best interest of fund clients. The report notes that policies and procedures for satisfying the requirements of the Investment Advisers Act with respect to the ongoing oversight of proxy advisory firms will depend largely on the nature of services provided.

The report notes that boards of directors are involved to varying degrees in the selection and approval of proxy advisory firms. Boards typically delegate to the fund adviser the day-to-day oversight of the proxy advisory firm and could either approve a proxy advisory firm based on the fund adviser's recommendation or delegate the selection of the proxy advisory firm to the fund adviser, subject to the board's oversight.

Oversight of proxy advisory firms flows from the board's oversight of service providers generally. Where a board has delegated day-to-day oversight of the proxy advisory firm to the fund's adviser, the board will rely on the adviser to report to it on the firm's performance. Such reports will vary in frequency and content based on the level and types of proxy advisory services used by the fund. Reports may include:

- a list of services offered by the proxy advisory firm and those services being used by the fund adviser;
- the fund adviser's process for overseeing proxy advisory firms;
- the adviser's assessment of the proxy advisory firm's capacity and competency; and
- any material changes at the proxy advisory firm.

Fund Adviser Due Diligence and Oversight of Proxy Advisory Firms
The report notes that fund advisers owe a duty of care and loyalty with respect to services undertaken on behalf of fund clients, including proxy voting, and an adviser with voting authority must adopt and implement policies and procedures reasonably designed to ensure that it votes proxies in the best interest of the fund. The adviser is responsible for proxy voting on behalf of a fund, even if it hires a proxy advisory firm to provide assistance. The scope of oversight will depend on the particular services provided to the fund.

When conducting initial due diligence of a proxy advisory firm, a fund adviser should consider whether the proxy advisory firm has the capacity and competency to assist with the relevant proxy voting functions. An adviser should also consider the anticipated costs and benefits as well as the alternatives to using a proxy advisory firm.

Depending on services to be provided, a fund adviser may consider some of the following as part of the initial and ongoing due diligence review of a proxy advisory firm:

- information about the proxy advisory firm's owners and affiliates, policies and procedures, internal structure and key departments;

- the financial condition of the proxy advisory firm;
- the resources a proxy advisory firm dedicates to proxy research and analysis;
- information about the range of services provided, the terms of the service agreement and the division of responsibilities between the adviser and the proxy advisory firm;
- whether the proxy advisory firm has adequate experience, expertise and resources to provide the requested services;
- recent material events affecting the proxy advisory firm;
- information about the proxy advisory firm's insurance policies;
- summaries of internal audits or other recent reports on the proxy advisory firm's internal controls;
- information about the proxy advisory firm's information/data security resources and controls;
- the proxy advisory firm's legal and regulatory history; and
- reasonableness of fees in light of services provided, and how services and fees compare to those of other proxy advisory firms.

Investment advisers are required to review the adequacy of their proxy voting policies no less than annually. The ICI recommends that a fund adviser evaluate a proxy advisory firm with the same frequency. A fund adviser may schedule recurring reviews or communications with the proxy advisory firms.

Adviser Review of Proxy Voting Guidelines
Subject to board approval, fund advisers may formulate and maintain proxy voting guidelines specifying how they will vote in the best interests of the fund on various kinds of approvals. If considering whether to adopt a proxy advisory firm's standard guidelines, the fund adviser could review the reasoning behind the guidelines, the firm's internal process for reviewing, formulating and revising the guidelines and whether the guidelines are consistent with the fund's best interest. With respect to situations where proxy voting guidelines do not yield an obvious voting decision, a fund adviser may want to inquire about the methodologies that influence the proxy advisory firm's recommendations.

Conflicts of Interest
The report also discusses the extent to which fund advisers may need to evaluate a proxy advisory firm's potential conflicts of interest. This is particularly important for fund advisers that rely on a proxy advisory firm's voting recommendations. The report suggests that a fund adviser should ensure that it understands and evaluates a proxy advisory firm's processes for identifying, mitigating and disclosing potential conflicts of interest and the implementation of those processes.

Disclosure
Funds are required to describe in their registration statements the policies and procedures that they use to determine how to vote proxies. The SEC provided examples of general policies and procedures with respect to which disclosure would be appropriate, including the extent to which the fund delegates its proxy voting decisions to its investment adviser or another third party or relies on recommendations from a third party. Disclosure will vary from fund to fund depending on the nature of services provided by the proxy advisory firms.

Source: Report on Funds' Use of Proxy Advisory Firms, Investment Company Institute (January 2015), available at http://www.ici.org/pdf/pub_15_proxy_advisory_firms.pdf.

SEC Proposal to Require Disclosure of Hedging by Directors and Officers of Closed-End Funds

The SEC has proposed amendments that would require closed-end funds that have shares listed on a national securities exchange (listed closed-end funds) to disclose whether they permit directors and employees (including officers) to hedge the fund's shares. The proposed amendments apply only to directors and employees of the fund itself. Portfolio managers of the fund's adviser are

not covered under the proposed amendment, unless they are officers of the fund. The proposed disclosure is intended to allow the shareholders of a listed closed-end fund whose shares are trading at a discount to know whether the fund's directors and officers, like other fund shareholders, would receive that discounted price upon a sale of the shares without an offset from any hedging transactions.

The rule would require disclosure in proxy or consent solicitation statements and information statements relating to an election of directors of whether a director or officer is permitted to hedge or offset any decrease in the market value of the fund's shares either: (1) granted to the director or officer as part of his or her compensation, or (2) held by the director or officer. Under the proposal, listed closed-end funds would be required to disclose whether any director or officer is permitted to purchase financial instruments such as prepaid variable forward contracts, equity swaps, collars and exchange funds. The fund also would be required to disclose which types of transactions, if any, it permits and which categories of transactions it prohibits.

The SEC proposal would apply to listed closed-end funds and public companies. The SEC is not proposing to impose the requirement on open-end funds, closed-end funds that are not listed on an exchange or exchange-traded funds, although the release did request comment on whether the requirements of the proposed rule should apply to those funds. SEC Commissioners Gallagher and Piwowar issued a joint statement on the proposed rule, in which they noted that they would not have included listed closed-end funds within the scope of the rule. Comments on the rule proposal were due April 20.

Sources: Disclosure of Hedging By Employees, Officers and Directors, Securities and Exchange Commission Release No. 33-9723 (February 9, 2015), available at https://www.sec.gov/rules/proposed/2015/33-9723.pdf; Letter to Closed-End Investment Company Members No. 3-15, Independent Directors Council (February 13, 2015); Commissioners Daniel M. Gallagher and Michael S. Piwowar, Joint Statement on the Commission's Proposed Rule on Hedging Disclosures (Feb. 9, 2015), available at http://www.sec.gov/news/statement/020912ps-cdmg-cmsp.html#.VN0PaChnCg0.

ICI Responds to Financial Stability Oversight Council's Request for Comment on Asset Management Products and Activities

The Financial Stability Oversight Council (FSOC) was established to identify risks to the financial stability of the United States, promote market discipline and respond to emerging threats to the stability of the U.S. financial system. In December 2014, FSOC sought public comment on whether asset management products and activities may pose potential risks to the U.S. financial system in the areas of liquidity and redemptions, leverage, operational functions and resolution.

The ICI recently responded to the notice seeking comment. In its response, the ICI stated that the four areas of concern discussed in the FSOC notice have all been subject to extensive regulatory oversight and that SEC Chair Mary Jo White has announced a robust rulemaking agenda for the SEC to make potential enhancements in all four areas. In the event that FSOC concludes that funds do present risks to U.S. financial stability, ICI urged FSOC to recognize that the SEC, as the primary regulator of the asset management industry, is best positioned to address any such risks through enhancements to its existing regulatory program.

Below is a discussion of the specific areas of comment solicited by FSOC and ICI's response to those requests for comment.

Liquidity and Redemptions

FSOC sought comment on whether investments through pooled investment vehicles that provide redemption rights, as well as their management of liquidity and redemptions, could potentially influence investor behavior in a way that could affect U.S. financial stability differently than direct investment in stocks and bonds. The ICI noted that daily redeemability is a defining feature of mutual funds and that 85% of a fund's portfolio must be invested in liquid securities that can be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the instrument on its books. The ICI also responded to FSOC's concern that, in times of stress, liquidity risk may be concentrated on investors that choose to remain invested in a fund by presenting empirical data that in times of falling securities prices, the share of a portfolio invested in cash and liquid assets will rise. Fund managers can use some of those assets to meet redemptions and maintain a relatively constant allocation to cash and liquid securities. The ICI response also presents empirical data showing that funds actually create liquidity by routinely operating in markets buying and selling securities and that growth in funds focused on investing in less liquid assets has not increased the tendency of investors to redeem during periods of market stress.

Leverage
FSOC sought comment on whether leverage by investment vehicles could increase the potential for forced asset sales, or expose lenders or other counterparties to losses or unanticipated market risks, and the extent to which these risks have implications for U.S. financial stability. The ICI concurs with FSOC's focus on leverage as an investment practice that could have implications for financial stability but notes that regulated funds are subject to the Investment Company Act requirement to maintain asset coverage of at least 300% for all borrowing. The ICI notes that regulated funds through their long positions in debt and equity instruments primarily act as providers of capital and act as bearers of counterparty risk rather than sources of such risk. With respect to securities lending, the ICI notes that a regulated fund must receive from a borrower at least 100% of the value of the loaned securities and that the collateral must be marked to market daily to ensure that at least 100% collateral is maintained at all times.

Operational Risk
FSOC sought comment in two areas: (1) risks that may be associated with the transfer of significant levels of client accounts or assets from one asset manager to another, and (2) risks that may arise when multiple asset managers rely on one or a limited number of third parties to provide important services. With respect to fund service providers, the ICI response focuses on the role of fund boards in approving and overseeing the compliance policies and procedures of the fund and its primary service providers. Additionally, the ICI notes that at least annually, a mutual fund CCO will provide a written report to the board regarding the operation of the compliance procedures of the fund and its service providers and each material compliance matter that occurred since the last report.

Resolution
Lastly, FSOC sought comment on whether there are specific financial interconnections that could present risks if an asset manager, investment vehicle, or affiliate were to become insolvent, declare bankruptcy, or announce an intent to close and liquidate. The ICI response argues that mutual funds do not experience disorderly failure because while a fund's NAV per share may decline, it is virtually impossible for a fund's liabilities to exceed its assets. Additionally, the ICI provides data showing that large numbers of stock and bond mutual funds and fund sponsors have left the business each year without causing market instability. For example, in 2014 alone, 362 funds were merged or liquidated and 25 fund sponsors left the business without broadly affecting the investing public, market participants, or financial markets.

Sources: Notice Seeking Comment on Asset Management Products and Activities, Financial Stability Oversight Council, Docket No. FSOC-2014-0001 (December 2014), available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf; Letter to Financial Stability Oversight Council, Paul Schott Stevens, Investment Company Institute (March 25, 2015), available at http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf.

MSRB to Amend Rules to Create Professional Qualifications for Municipal Advisors

The Municipal Securities Rulemaking Board (MSRB) received approval from the SEC to amend several MSRB rules to establish professional qualification requirements for municipal advisors and their representatives. The amendments create two new registration classifications for municipal advisors – municipal advisor representatives and municipal advisor principals. A municipal advisor representative is a person who engages in municipal advisory activities on behalf of a municipal advisor. A municipal advisor principal is a person who is qualified as a municipal advisor representative and is directly engaged in the management, direction or supervision of the municipal advisory activities of the municipal advisor and its associated persons. To qualify as a municipal advisor representative or municipal advisor principal, an individual will be required to pass the new Series 50 examination.

The Series 50 examination will commence with a pilot test which the MSRB plans to deliver in the fall of 2015. Individuals who pass the pilot test will be qualified to act as municipal advisor representatives or principals as if they had passed the permanent test. Individuals interested in taking the pilot test may subscribe to an email distribution list on the MSRB's website to learn more about the test. The pilot test will be used to establish a passing grade for the test. Once a passing grade is established, the MSRB will announce the effective date of the permanent test. Individuals who engage in or supervise municipal advisory activities will have one year from the effective date to pass the test. During the grace period, municipal advisor professionals may continue to engage in or supervise municipal advisory activities.

Source: MSRB to Amend Rules to Create Professional Qualification Standards for Municipal Advisors, Municipal Securities Rulemaking Board Notice No. 2015-04 (March 2, 2015), available at http://www.msrb.org/~/media/Files/Regulatory-Notices/Announcements/2015-04.ashx.

Litigation and SEC Enforcement Actions

SEC Charges Mutual Fund Adviser for Improper Handling of Fund Assets

The SEC instituted an enforcement action against Water Island Capital LLC, an investment adviser to several alternative mutual funds, for maintaining millions of dollars of the funds' cash collateral at broker-dealer counterparties instead of with the funds' custodian. Without admitting or denying the findings, the adviser agreed to pay $50,000 to settle the SEC charges.

The Investment Company Act generally requires that if an investment company maintains its securities in the custody of a qualified bank, the cash proceeds from the sale of such securities and other assets must likewise be kept in the custody of such bank.

From January to September 2012, the adviser allegedly did not ensure that certain assets of the funds were maintained in the custody of the funds' custodial bank and instead allowed broker-dealer counterparties to hold $247 million in cash collateral. The adviser caused the funds to post contractually required cash collateral relating to swaps but did not ensure the transfer of those assets to the funds' bank. Alternatively, the cash collateral could have been maintained with the funds' custodial bank subject to a tripartite agreement between the custodial bank, the broker-dealer counterparty and the funds, which the SEC notes is standard industry practice.

"Mutual funds must ensure that all fund assets are properly protected," said Andrew M. Calamari, Director of the SEC's New York Regional Office. "Water Island Capital failed to implement the required policies and procedures to ensure all cash collateral was held in the custody of the funds' bank."

In addition to violations of the custody requirements of the Investment Company Act, the SEC alleged that the adviser failed to implement the funds' directed brokerage policies and procedures. The Investment Company Act permits a fund to direct fund portfolio transactions to brokers that sell fund shares only if the fund or adviser has implemented policies and procedures reasonably designed to ensure the selection of brokers is not influenced by considerations about the sale of shares of the fund. Although the adviser adopted policies that required the firm to create and maintain an approved list of executing brokers for the funds and monitor the funds' compliance with the directed brokerage requirements, the SEC found that the policies and procedures were not implemented.

Sources: SEC Charges Mutual Fund Adviser in Connection With Improper Handling of Fund Assets, SEC Press Release No. 2015-31 (February 12, 2015), available at http://www.sec.gov/news/pressrelease/2015-31.html; In the Matter of Water Island Capital LLC, Administrative Proceeding File No. 3-16385 (February 12, 2015), available at https://www.sec.gov/litigation/admin/2015/ic-31455.pdf.

Supreme Court Hears Arguments in 401(k) Fee Case

The Supreme Court heard oral arguments in *Tibble v. Edison*, the first 401(k) excessive fee suit to reach the high court. The ruling in the case will likely have implications for similar cases being litigated in lower courts and for how plan sponsors manage plans. The Supreme Court is expected to issue a decision by the end of June.

Plaintiffs in the case were participants in a 401(k) plan sponsored by Edison International, a California-based electric utility. The plan originally provided employees six possible investment options. In 1999, the plan grew to include 40 retail-class mutual fund options. In 2002, three additional retail-class mutual fund options were added. Plaintiffs argued that Edison violated its fiduciary duty to plan participants by selecting higher fee retail-class mutual funds when identical institutional-class mutual funds were available with lower fees.

The district court and appellate court both rejected the plaintiffs' argument that, as a rule, a plan should never include retail-class investment options, noting that a fiduciary may choose funds with higher fees for a number of reasons such as a potential for higher return or management flexibility. However, both courts held that with respect to the three mutual funds added in 2002, Edison had

violated its fiduciary duty by failing to investigate the possibility of institutional-share class alternatives. Specifically, each of the funds offered institutional-class options that were 24 to 40 basis points cheaper than the retail-class shares being offered and there were no differences in the investment quality or management between the share classes. Edison had relied on its service provider, Hewitt Financial Services, for advice about which mutual fund share classes should be selected for the 401(k) plan. Both the district and appellate courts held that fiduciaries cannot blindly rely on service providers to select investment opportunities for a 401(k). There was no evidence that either Edison or Hewitt had considered institutional-class shares or whether Edison had asked any questions with respect to, or evaluated, Hewitt's investment recommendations.

The district court ordered Edison to pay $370,000 in damages in connection with the three funds added in 2002. The technical argument before the Supreme Court relates to the statute of limitations for bringing claims under ERISA, specifically whether the plaintiffs can bring claims that Edison breached its fiduciary duty with respect to the funds that were added to the plan in 1999, more than six years before the case was filed. Plaintiffs argued that fiduciary responsibility for plan choices is ongoing and therefore they should not be banned from bringing claims that Edison violated its fiduciary duty with respect to adding the retail funds, rather than lower cost institutional funds, in 1999. Edison argued that there were no significant changes in circumstances after the funds were added in 1999 which would warrant a closer review of the investments after they were initially selected.

Sources: Tibble v. Edison, 729 F.3d 1110 (2013); Supremes Grapple with Scope of Plan Sponsors' 401(k) Duties, Ignites, Beagan Wilcoz Volz (February 25, 2015).

Lockheed Settles $62 Million 401(k) Suit

In a related case, Lockheed Martin agreed to a $62 million settlement in another 401(k) excessive fee case. Lockheed's plan is the fifth largest 401(k) plan in the country with more than 100,000 participants and over $27 billion in assets. Plaintiffs argued that Lockheed breached its fiduciary duty by allowing for overcharges from service providers and mismanaging the plan's investment menu. Plaintiffs' lawyers had argued for over $1.3 billion in damages.

Plaintiffs claimed that Lockheed had violated its fiduciary duties by selecting investment options with unreasonably high fees for the services and management received. Plaintiffs also argued that one of the funds selected by the plan made imprudent investment selections resulting in significant underperformance. The fund in question was a stable value fund. Plaintiffs asserted it should have had no more than 5% of its assets invested in money market funds as opposed to the 50% to 99% actually invested. Plaintiffs also alleged there was a breach of fiduciary duty with respect to company stock funds offered as an investment option in the plan. The company stock funds held cash and Lockheed stock. Plaintiffs argued that the company stock funds repeatedly exceeded the level of cash holdings the fund disclosed it could hold and, as a result, the fund significantly trailed the performance of actual Lockheed stock. Lockheed denied all of the allegations and contended it complied in all respects with the law.

Sources: Abbot v. Lockheed Martin, Order and Memorandum, Case: 3-06-cv-00701-MJR-DGW (March 31, 2009); Abbot v. Lockheed Martin, Plaintiffs' Second Amended Complaint for Breach of Fiduciary Duty, Case: 3-06-cv-00701-MJR-DGW (October 12, 2011); Record $62M Settlement in Lockheed 401(k) Suit, Ignites, Joe Morris (February 23, 2015).

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.