GODFREY KAHN S.C.

Focus

Investment Management Legal and Regulatory Update

April 2013

SEC and Former Morgan Keegan Directors Reach Tentative Settlement in Fair Valuation Case

The SEC has reached a tentative settlement agreement with former Morgan Keegan directors relating to charges that they failed to adequately oversee the fair valuation of securities in five Morgan Keegan Funds. The SEC alleged that the directors violated their fair value responsibilities with respect to securities backed by subprime mortgages that plunged in value during the mortgage crisis in 2007. According to the SEC complaint filed in December 2010, the directors failed to specify a fair valuation methodology and failed to continuously review the appropriateness of the methodology used by the valuation committee or to learn how fair values were actually being determined. Instead, the complaint alleges that the directors delegated fair valuation responsibility to a valuation committee without providing any meaningful substantive guidance on how those determinations should be made. *For additional discussion of the charges against the former Morgan Keegan directors, see "SEC Charges Mutual Fund Directors for Failure to Oversee Asset Valuation" in our January 2013 update.* Terms of the settlement were not disclosed and will now be presented to the SEC for consideration.

Sources: *Dave Michaels and Zeke Faux, Ex-Morgan Keegan Fund Directors to Settle SEC Claims, Bloomberg, March 27, 2013; Joe Morris, SEC, Morgan Keegan Directors Reach Settlement, Ignites, March 28, 2013; In the Matter of J. Kenneth Alderman, et. al., SEC Administrative Proceeding File No. 3-15127, December 10, 2012.*

President Obama Nominates Mary Jo White as New SEC Chair

In January, President Obama nominated Mary Jo White to serve as the Chair of the SEC. Ms. White currently is a partner and chair of the litigation department of Debevoise & Plimpton where she has often defended big financial services firms. She previously served as the U.S. attorney for the Southern District of New York where she prosecuted complex white collar crimes and international terrorism cases. There has been speculation that with her history as a prosecutor, Ms. White's appointment may result in an increased focus on enforcement at the SEC.

Ms. White's confirmation hearing was held on March 12, 2013. While she faced no opposition at the hearing, Ms. White was pressed on the importance of completing

Dodd-Frank financial regulation and fighting financial fraud. Additionally, Ms. White suggested that, if confirmed, she would address the issue of money market fund reform. On March 19, 2013, the Senate Banking Committee voted 21-to-1 in favor of sending her nomination to the full Senate for a vote.

Sources: *Peter Ortiz, Former SEC Chair: Mary Jo White 'Excellent' Choice, Ignites, January 24, 2013; Peter Ortiz, Industry Welcomes 'Tough' Prosecutor to Head SEC, Ignites, January 25, 2013; Dina ElBoghdady, Mary Jo White Faces No Opposition at SEC Confirmation Hearing, Washington Post, March 12, 2013; Ben Protess, Dismissing Concerns, Panel Backs White's S.E.C. Nomination, Dealbook, March 19, 2013.*

SEC Sets Examination Priorities for 2013

The SEC's Office of Compliance Inspections and Examinations (OCIE) released its 2013 examination priorities for the National Examination Program (NEP). The NEP-wide examination priorities (that apply to nearly all SEC-regulated entities) are:

- identifying market participants engaged in fraudulent or unethical behavior;
- corporate governance and enterprise risk management, including how firms govern and manage financial, legal, compliance, operational and reputational risks;
- monitoring how registrants mitigate conflicts of interest and disclose such conflicts to investors;
- examining technology controls.

The NEP also identified several ongoing risks, emerging issues and policy topics specific to the Investment Adviser-Investment Company (IA-IC) Exam Program and Broker-Dealer (BD) Exam Program that will be focus areas in 2013.

Ongoing Risks for the IA-IC Program

Safety of Assets. Exams will focus on the measures taken by advisers to protect client assets from loss or theft, the adequacy of audits of private funds and the effectiveness of policies and procedures in this area. The SEC noted that recent exams have found a high frequency of issues relating to compliance with Advisers Act Rule 206(4)-2, the custody rule. *See "SEC Issues Risk Alert and Investor Bulletin on Investment Adviser Custody Rule" in this update.*

Conflicts of Interest Related to Compensation Arrangements. Examiners will review financial and other records to identify undisclosed compensation arrangements and the conflicts of interest they present. Examples of these activities include undisclosed fee or solicitation arrangements, referral arrangements (particularly with affiliated entities) and receipt of payment for services "allegedly provided to third parties."

Marketing/Performance. SEC staff will focus on the accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions or methodology utilized and related disclosures and compliance with record-keeping requirements. The SEC noted that aberrational performance can be an indicator of fraudulent or weak valuation procedures or practices.

Conflicts of Interest Related to Allocation of Investment Opportunities. Where there is side-by-side management of accounts that pay performance-based fees (e.g., hedge funds) and accounts that do not pay performance fees (e.g., mutual funds), examiners will confirm that the adviser has controls in place to monitor investment decisions and conflicts of interest that may arise.

Fund Governance. Staff will confirm that advisers are making full and accurate disclosures to fund boards and that boards are conducting reasonable reviews of such information in connection with contract approvals, oversight of service providers, valuation of fund assets and assessment of expenses or viability.

New and Emerging Issues for the IA-IC Program

Payments for Distribution in Guise. Examiners will focus on payments made by advisers and funds to distributors and intermediaries, the adequacy of disclosure made to fund boards about these payments and boards' oversight of the payments. According to OCIE, "these payments go by many names and are purportedly made for a variety of services, most commonly revenue-sharing, sub-TA, shareholder servicing and conference support." Examiners will assess whether such payments are made in compliance with regulations, including Rule 12b-1, or "whether they are instead payments for distributions and preferential treatment." A sweep to examine these types of payments kicked off in early March. The SEC has indicated it wants to gain a better understanding of what services are provided for the fees paid by advisers and funds.

Newly-Registered Advisers. The SEC intends to launch an examination initiative to establish a meaningful presence with the approximately 2,000 investment advisers that have registered with the SEC since early 2012. The vast majority of these new registrants are advisers to hedge funds and private equity funds. The initiative will have four phases:

- engage with new registrants;
- examine a substantial percentage of the new registrants;
- analyze the examination findings; and
- report observations to the industry.

Dually Registered IA/BD. The IA-IC program will continue to expand coordinated and joint examinations with the BD program of dually registered firms and distinct broker-dealer and investment advisory firms that share common financial professionals. Examiners will review how financial professionals and firms satisfy their suitability obligations when determining whether to recommend brokerage or advisory accounts, the financial incentives for making such recommendations and whether all conflicts of interest are fully and accurately disclosed.

"Alternative" Investment Companies. In light of the growing use of alternative and hedge fund investment strategies in mutual funds, examiners will assess whether:

- leverage, liquidity and valuation policies and practices comply with regulations;
- boards, compliance personnel and back-offices are staffed, funded and empowered to handle the new strategies; and
- the funds are being marketed to investors in compliance with regulations.

Policy Topics for the IA-IC Program

The IA-IC examination program for 2013 also includes several policy topics. Examiners are expected to look at:

- money market funds, specifically whether funds are conducting stress tests to gauge their ability to maintain a stable share price based on hypothetical events;
- compliance with exemptive orders; and
- compliance with the pay-to-play rule that prohibits advisers from obtaining business from government entities in exchange for political contributions.

Ongoing Risks for the BD Program

Sales Practices/Fraud. Exams will focus on sales practices targeting retail investors, including:

- affinity fraud or fraud targeting seniors;
- unsuitable recommendations of higher yield products (e.g., municipal or corporate bonds);
- outside business activities;
- conflicts of interest; and
- certain firms identified as recidivist or high-risk for potential misconduct.

Trading. Exam staff intends to address certain trading risk areas, with particular focus on high frequency trading, algorithmic trading, proper controls around the use of technology, alternative trading systems and order routing practices.

AML. The staff will identify firms that appear to have weak anti-money laundering (AML) programs, especially customer identification programs (CIP), suspicious activity identification and reporting deficiencies, and weak due diligence procedures regarding certain accounts.

Policy Topics for the BD Program

JOBS Act. Upon approval of a final rule pursuant to the JOBS Act, which creates a new exemption from registration under the Securities Act for qualified "crowd funding" transactions, the staff intends to conduct reviews of entities participating in the crowd funding business.

Sources: *Examination Priorities for 2013, Office of Compliance Inspections and Examinations, February 21, 2013; Peter Ortiz, SEC Makes Distribution-Fee Exam Priority, Ignites, February 25, 2013; Sarah Lynch, SEC to Examine Fund Fees, Alternative Funds, Reuters, March 8, 2013.*

SEC Issues Risk Alert and Investor Bulletin on Investment Adviser Custody Rule

OCIE issued a risk alert and investor bulletin in March regarding compliance with the SEC custody rule for investment advisers, which is designed to protect advisory clients from theft or misuse of their funds and securities. The alert comes after a review of recent examinations that suggest widespread noncompliance with the custody rule. Examiners found that approximately one third of investment advisers subject to examination had custody-related deficiencies.

One common deficiency noted by the SEC is that advisers often fail to recognize they have custody, such as where:

- the adviser or a related person serves as trustee or has power of attorney for the client accounts;
- the adviser provides bill-paying services for clients and is therefore

authorized to withdraw funds from the client's account;

- the adviser manages portfolios by directly accessing online accounts using a client's personal username and password;
- the adviser acts as a general partner of a limited partnership;
- the adviser is authorized to write or sign checks for clients; or
- the adviser receives checks made out to clients and fails to return them promptly to the sender.

Examiners also noted problems with adherence to the custody rule's surprise exam requirement. Specifically, Form ADV-E was often not filed within 120 days after the exam by the accountant, and exams were often not conducted on a surprise basis but were instead conducted at the same time each year.

Advisers also routinely failed to comply with the custody rule's qualified custodian requirements. Client assets were often held in the adviser's name, but not in an account that was under the adviser's name as agent or trustee for the client and that held only client assets. Instead, advisers often commingled client, proprietary and employee assets in one account. Furthermore, advisers often had no reasonable basis to believe the custodian was sending quarterly account statements to the client. In instances where the adviser opened a custodial account on behalf of a client and sent account statements to the client, the statements often failed to include notification urging clients to compare the account statements from the custodian with those from the adviser.

In addition, for advisers that relied on the audit approach with respect to pooled investment vehicles, the examinations found various deficiencies. Accountants that conducted audits were often not independent, and the audited financial statements were often not prepared in accordance with GAAP. Additionally, advisers failed to demonstrate that:

- the financial statements were distributed to all fund investors and were sent within the required timeframe;
- the auditors used were PCAOB-registered; and
- a final audit was performed on liquidated pooled investment vehicles.

Advisers are encouraged to review their compliance with the custody rule in light of the deficiencies noted in the risk alert. Deficiencies noted in the risk alert have resulted in actions ranging from immediate remediation to litigation.

Sources: *SEC Issues Risk Alert and Investor Bulletin on Investment Adviser Custody Rule, SEC Release No. 2013-33, March 4, 2013; Significant Deficiencies Involving Adviser Custody and Safety of Client Assets, National Exam Program Risk Alert Volume III, Issue 1, March 4, 2013.*

Supreme Court Rules That SEC Can't Extend Fraud Deadline

In a unanimous decision, the Supreme Court rejected the SEC's efforts to extend the deadline for seeking civil penalties in fraud cases. Under the Investment Advisers Act, the SEC is authorized to bring enforcement actions, subject to a five-year statute of limitations for civil penalties. The SEC had alleged that the chief operating officer of Gabelli Funds, LLC (Gabelli) and the former portfolio manager of the Gabelli Global Growth Fund had aided and abetted investor fraud from 1999 to 2002 by allowing one investor to engage in market timing in the fund in exchange for an investment in a hedge fund run by Gabelli. This relationship was allegedly not disclosed by the fund, and other investors were not permitted to engage in market timing.

The SEC sought civil penalties in 2008. The Advisers Act requires that the SEC must file suit within five years from the date when the claim first accrued. The district court dismissed the suit for failure to file within five years. The Second Circuit reversed that decision, holding that the statute of limitations did not begin to run until the SEC discovered or reasonably could have discovered the fraud, also known as the "discovery rule." The Supreme Court reversed the Second Circuit decision and held that the "discovery rule" standard could not be used by government plaintiffs, though it may be permissible for individual victims. According to the Court, unlike individual plaintiffs who have no reason to suspect fraud, "the SEC's very purpose" is to root out fraud, and "it has many legal tools at hand to aid in that pursuit."

Sources: *Joe Morris, Supreme Court: SEC Can't Extend Fraud Deadline, Ignites, February 23, 2013, Marc J. Gabelli and Bruce Alpert v. Securities and Exchange Commission, Supreme Court of the United States, Case No. 11-1274, February 27, 2013.*

SEC Provides Guidance on Social Media Filing Requirements

The SEC recently provided guidance on the filing requirements for interactive content posted in a real-time electronic forum (i.e. chat rooms or other social media). SEC staff noted that out of an abundance of caution, many mutual funds may file materials unnecessarily. Whether a particular communication needs to be filed depends on the content, context and presentation of the communication, including whether the communication was responding to a request or inquiry from a social media user or was forwarding previously-filed content.

The SEC provided the following examples of communications that generally do *not* need to be filed:

- Incidental mentions of a specific investment company not related to a discussion of the investment merits of the fund (e.g., "More than 100 Fund X employees volunteered for our Annual Day of Caring!").
- Incidental use of the word "performance" without specific mention of some or all of the elements of a fund's return (e.g., "We update the performance of our funds every month and publish the results on <website url>").
- A factual introductory statement forwarding or including a hyperlink to a fund prospectus or to information that has been filed with the SEC (e.g., "We launched two new emerging market funds this week. More information about them is available here <website url>").
- An introductory statement not related to the investment merits of a fund that includes a hyperlink to general financial and investment information ("Here's a Q&A with our Portfolio Manager, John Doe, regarding his views on the economy for 2013. <website url>").
- A response to an inquiry by a social media user that provides discrete factual information that is not related to a discussion of the investment merits of the fund and that may direct the social media user to the fund prospectus or information filed with FINRA (e.g., Inquiry: "What are the fees and expenses for ABC Fund?" Response: "Information on the fund's fees and expenses is available at <website url>. Feel free to contact us at 1-800-***-**** for more information.").

The staff also provided examples of communications that *do* need to be filed:

- A discussion of fund performance that provides specific mention of a fund's returns or promotes fund returns.
- A communication initiated by the issuer that discusses the investment merits of the fund (e.g., "Our ABC Fund was included in the list of best new funds recently published by Morningstar. <website url>").

The guidance from the Division of Investment Management is the first in its "IM Guidance Update" series that will offer the staff's views on emerging legal issues. This guidance update was intended to help firms strengthen their compliance efforts by providing real life examples.

Sources: *SEC Issues Guidance Update on Social Media Filings by Investment Companies, SEC Release No. 2013-40, March 15, 2013; IM Guidance Update No. 2013-01, Division of Investment Management, March 2013.*

Investment Company Institute Files a Brief in Appeal of Court Decision on Rule 4.5 Challenge

On December 12, 2012, the U.S. District Court for the District of Columbia dismissed a lawsuit brought by the Investment Company Institute (ICI) and the U.S. Chamber of Commerce, which challenged recent amendments to Rule 4.5 promulgated by the CFTC under the Commodity Exchange Act. *For additional discussion of the lawsuit filed by the ICI, see "ICI and U.S. Chamber of Commerce File Lawsuit Regarding CFTC Rule Amendments" in our July 2012 update. For a discussion of the amendments to Rule 4.5, see "CFTC Rescinds and Narrows Regulatory Exemptions for Funds" in our April 2012 update.*

The ICI and U.S. Chamber of Commerce appealed the decision to the U.S. Court of Appeals for the District of Columbia Circuit and filed a motion for expedited consideration of their appeal, which the court granted. Oral argument is scheduled for May 6, 2013.

Sources: *Beagan Wilcox Volz, ICI, Chamber to Appeal Ruling on CFTC Rule, Ignites, December 12, 2012; Order of the United States Court of Appeals for the District of Columbia Circuit, Case No. 12-5413, January 15, 2013; Oral Argument for Appeal of CFTC Rule Decision Scheduled, Mutual Fund Directors Forum, March 4, 2013.*

SEC Staff Meets with IRS to Discuss Tax Implications of a Floating NAV

SEC staff recently met with staff members of the IRS to discuss the tax implications of adopting a floating net asset value (NAV) for money market funds. The discussion centered on the tax treatment of small gains and losses for investors in money market funds, and the IRS reportedly told the SEC there is limited flexibility in interpreting current tax law. A floating NAV could require individual and institutional investors to regard every money market fund transaction as a potentially taxable event.

Investors would have to determine how to match purchases and redemptions for purposes of calculating gains, losses and share cost basis. The SEC reached out to the IRS as it continues to consider measures, including a floating NAV, to enable money market funds to better withstand severe market disruptions.

For additional discussion of money market reform, please see "SEC Debates on Money Market Reforms Continue" in our January 2013 and October 2012 updates.

Sources: *John D. Hawke, Jr., Economic Consequences of Proposals to Require Money Market Funds to 'Float' Their NAV, SEC Comment Letter File No. 4-619, November 2, 2012; Christopher Condon and Dave Michaels, SEC Said to Discuss Floating NAV for Money Funds with IRS, Bloomberg, March 7, 2013; Joe Morris, SEC Sounding Out IRS on Floating NAV, Ignites, March 7, 2013.*

Compliance Staff Concerned with Workload, Compensation

A recent mutual fund industry survey of 159 compliance professionals from 75 firms found that while workloads increased in 2012, firm resources committed to compliance did not. This follows a similar trend from the previous year's survey. The problems of increased workload were exacerbated by concerns over new and pending regulation, particularly CFTC regulation that may require firms to register as commodity pool operators. At the same time, firms have ignored or denied requests for increased compliance resources. This comes at a time where both OCIE and the Division of Enforcement have been more active than in the past.

Compliance professionals identified increased investment in technology as one possibility for addressing the increased workload. The survey results indicated that compliance staff sought technological systems that would weed out routine matters and allow the compliance team to focus on non-routine issues, rather than an increase in personnel.

While the workload of compliance professionals has increased, compensation has largely remained flat. The majority of professionals expected either no increase in their pay, or a slight decrease, with only a small number expecting a significant increase.

Sources: *Danielle Sottosanti, Fund Firms Continue to Underequip Compliance, Ignites, March 4, 2013; Danielle Sottosanti, Compliance Pros Expect Flatlined Pay, Ignites, March 6, 2013; Danielle Sottosanti, Compliance Pros Call for Better Tech Support, Ignites, March 8, 2013.*

SEC Sanctions Investment Adviser for Failure to Adhere to Fund's Stated Investment Objective

The SEC barred a mutual fund manager from the securities industry for failing to follow the investment objectives of the Z Seven Fund (Z7F), a mutual fund managed by Top Fund Management (TFM). TFM was an investment adviser that was registered with the SEC until 2011, and the manager was also its president and control person.

Z7F operated as a non-diversified, open-end investment company. The Z7F prospectuses and statements of additional information described the fund's investment objective as long-term capital appreciation and its principal investment strategy as investing, under normal market conditions, at least 80% of its total assets in common stocks and securities immediately convertible into common stocks of domestic and foreign issuers. The principal investment strategy made no mention of options, and none of the principal risks involved options. Furthermore, the fund had a fundamental policy that the fund could not purchase options other than for hedging purposes.

The SEC's order instituting settled administrative proceedings against the manager and TFM noted that TFM and the manager committed a large amount of the fund's assets to purchases of put options on stock index ETFs or stock index futures as high as 75% of net assets in 2010. The Z7F's options trading allegedly "went well beyond hedging and amounted to speculation because the quantity of put options purchased was incompatible with a hedging strategy when considering the size of the Z7F's equity portfolio." The SEC's order found that the manager and TFM willfully violated the antifraud provisions of the Securities Act, the Securities Exchange Act and the Advisers Act. The order also found that the manager and the Z7F violated Section 34(b) of the 1940 Act, which prohibits any person from making untrue statements of material fact in any prospectus or SAI.

Source: *In the Matter of Top Fund Management, Inc. and Barry C. Ziskin, SEC Administrative Proceeding File No. 3-15154, December 21, 2012.*

FINRA Appeals Schwab Class-Action Ban Ruling

FINRA is appealing a FINRA hearing panel decision which ruled that a class-action ban in a customer agreement with a brokerage firm is consistent with federal law and recent Supreme Court interpretations of the Federal Arbitration Act (Act).

In October 2011, Charles Schwab amended its customer account agreement to include a provision requiring customers to waive their rights to bring or participate in class actions against the firm (class-action waiver). The amended agreement also included a provision requiring customers to agree that arbitrators in arbitration proceedings would not have the authority to consolidate more than one party's claims (consolidation language). FINRA charged that both provisions violated FINRA rules concerning language or conditions that firms may place in customer agreements.

In February 2013, a FINRA hearing panel concluded that the class-action waiver violated FINRA rules designed to preserve judicial class actions as an alternative to arbitration, even when there is a pre-dispute arbitration agreement. However, the panel concluded that the FINRA rules may not be enforced. The panel held that enforcement is foreclosed by the Act and Supreme Court decisions that held adjudicators must enforce agreements to go to arbitration to resolve disputes and must reject any public policy exception that disfavors arbitration, unless Congress itself has indicated an exception to the Act.

If not overturned, the panel's decision may lead other broker-dealers to amend their brokerage contracts to prohibit customers from participating in class-action lawsuits. FINRA could respond to the panel's decision by requiring broker-dealers to abide by "fair play" rules that include access to courts if they wish to remain members of FINRA.

In the same hearing, FINRA did prevail in one of its actions against Schwab. The panel concluded that the consolidation language violated FINRA rules by attempting to limit and contradict a FINRA arbitration rule that specifies circumstances in which arbitrators may arbitrate consolidated claims. The panel further concluded that the Act does not bar enforcement of these rules because the Act does not dictate how an arbitration forum should be governed and operated or prohibit the consolidation of individual claims. The panel fined Schwab $500,000 and ordered it to take corrective action to remove the consolidation language from its agreements.

Sources: *Jed Horowitz, Schwab Gets OK to Ban Client Class-Action Suits, Reuters, February 21, 2013; Maureen Brody, FINRA Lets Schwab's Ban on Class Actions Stand, Ignites, February 22, 2013; Department of Enforcement v. Charles Schwab & Company, Inc., FINRA Disciplinary Proceeding No. 2011029760201, February 21, 2013; Caitlin Nish, FINRA to Appeal Ruling on Schwab Class-Action Ban, February 26, 2013.*

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