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INVESTMENT MANAGEMENT REPORT

NO CFTC REGISTRATION FOR SINGLE FAMILY OFFICES AND BUSINESS DEVELOPMENT COMPANIES

In December 2012 the Division of Swap Dealer and Intermediary Oversight of the U.S. Commodity Futures Trading Commission (the "CFTC") issued no-action relief providing assurances to single family offices[1] and business development companies ("BDCs") employing derivatives strategies that they would not be required to register as commodity pool operators under the Part 4 of the CFTC's Regulations.[2] As amended by Section 721(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Commodity Exchange Act defines a commodity pool operator as any person who solicits, accepts or receives property for the purpose of trading in commodity interests, including futures, options and swaps. Perkins Coie represented the Private Investor Coalition ("PIC"), in its request for no-action relief for single family offices from the CFTC.

Commodity pool operators are generally required to register with the CTFC. However, CFTC Rule 4.13 provides an exemption from registration for "the operators of family, club and small pools...and pools that have limited futures activity or that restrict participation to sophisticated persons." And, CFTC Rule 4.5 provides an exclusion from registration for mutual funds and certain other "otherwise regulated persons." Nonetheless, Rule 4.13 did not make express whether it exempted single family offices, nor did Rule 4.5 make express whether it excluded BDCs, from the CFTC's registration requirements.

Single Family Offices

Prior to February 24, 2012, when the CFTC announced various changes to its registration regime, advisers to private funds excepted from SEC registration also were exempt from CFTC registration Rule 4.13(a)(4). Single family offices also historically relied on Rule 4.13(a)(4) to avoid registering with the CFTC. In advance of the December 31, 2012 effective date of the CFTC's rescission of Rule 4.13(a)(4), the PIC requested relief from the CFTC on the grounds "that family offices are not operations of the type and nature that warrant regulatory oversight by" the CFTC. The PIC, a national organization of family offices that successfully

[1] Single family offices are professional entities that exclusively serve and are wholly owned and controlled by members of one family and provide investment advisory and related wealth management services to the members of that family.

[2] The No-Action Letter regarding single family offices is CFTC Letter No. 12-37, Nov. 29, 2102 and the No-Action Letter regarding BDCs is CFTC Letter No. 12-40, Dec. 4, 2102.

urged the SEC to exclude single family offices from the registration requirements of the Investment Advisers Act of 1940 (the "Advisers Act"), similarly urged the CFTC that "because a family office is comprised of participants with close relationships, and there is a direct relationship between the clients and the adviser, such relationships greatly reduce the need for the customer protections available pursuant to Part 4 of the [CFTC's] Regulations."

In offering no-action relief to single family offices, the CFTC staff noted the significant amount of time and effort spent by the SEC in working with the PIC to finalize Rule 202(a)(11)(G)-1, which exempts family offices from registration under the Advisers Act. The CFTC, the staff wrote, "observes that the fundamental issue of the appropriate application of investor protection standards as required by each respective agency's regulations is substantially similar in the issue at hand...[and] placing both agencies on equal footing with respect to the application of investor protections relevant to this issue will facilitate compliance with both regulatory regimes."

Single family offices intending to rely on the CFTC's no-action letter should note the conditions established by the CFTC, namely that in order to rely on the letter a single family office must:

- perfect its claim to the relief by filing a notice with the CFTC pursuant to the instructions outlined in the no-action letter; and
- confirm by March 31, 2013 that it is, and at all times thereafter continue to be, a single family office within the meaning and intent of Rule 202(a)(11)(G)-1 under the Advisers Act.

Business Development Companies

BDCs are treated somewhat uniquely under the federal securities laws. Unlike mutual funds that are registered as investment companies under the Investment Company Act of 1940 (the "Investment Company Act"), and distinct from private funds that are excluded from the definition of investment company under the Investment Company Act, BDCs are investment companies that may become exempt from registration by filing a notice of election to be treated as a BDC under Section 54 of the Investment Company Act. Accordingly, BDC's do not fit squarely into the language of CFTC Rule 4.5, which excludes "an investment company registered as such under the Investment Company Act" from the requirement to register with the CFTC that would otherwise apply.

BDCs operate in substantially the same manner as registered investment companies, a fact the CFTC staff highlighted in its no-action letter assuring BDCs that the CFTC would not require registration as a commodity pool operator as long as the following conditions are met:

- the BDC has elected to be treated as a BDC under Section 54 of the Investment Company Act and continues to be regulated as a BDC by the SEC;
- the BDC has not and will not market itself to the public "as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options or swaps markets;"
- either (i) the BDC's commodity interest trading is for bona fide hedging purposes and the aggregate initial margin and premiums for any non-hedge commodity interest positions do not exceed 5% of the liquidation value of the BDC's total portfolio; *or* (ii) the aggregate notional value of the BDC's non-hedge commodity interest positions does not exceed 100% of the liquidation value of the BDC's total portfolio; and
- the BDC perfects its claim to the relief by filing a notice with the CFTC pursuant to the instructions outlined in the no-action letter.

In taking its no-action position, the CFTC focused on the regulated nature of BDCs and their similarity to mutual funds that are exempt from CFTC registration under Rule 4.5. "Many BDCs have external advisers and, like advisers to [mutual funds], such external advisers to BDCs must register with the SEC," the CFTC staff wrote, adding that BDCs, like mutual funds are subject to periodic examination by the SEC. The CFTC also reasoned that the additional investor protection of CFTC registration was not necessary given that "almost all BDCs are listed for trading on national securities exchanges and, thus, are subject to exchange rules governing listed companies...must comply with the disclosure and other requirements of the Securities Exchange Act of 1934...[and] must comply with the full panoply of regulations and corporate governance guidelines required under the Sarbanes-Oxley Act of 2002."

SEC CHARGES FORMER FUND DIRECTORS WITH FAILURE TO SATISFY STATUTORY FAIR VALUATION OBLIGATIONS

On December 10, 2012, the SEC instituted administrative proceedings against the directors of five registered mutual funds. Each of the funds

primarily invested in below-investment grade, collateralized debt obligations for which market quotations were not readily available. The charges stem from the alleged failure of the directors over an eight-month period in 2007 to adopt and implement meaningful valuation procedures and provide proper oversight, resulting in material misstatements of the funds' NAVs. Fund boards and their valuation committees, as well as fund CCOs, should heed the lessons of these cases.

Fund Valuation Procedures

Each of the funds had in place valuation procedures for pricing securities, and each fund's board of directors had delegated pricing responsibilities to the fund's investment adviser. The funds' procedures for fair-valued securities required that they be valued "in good faith" by the adviser's valuation committee, which was composed of representatives of fund accounting and the adviser. The valuation procedures listed various factors the committee was to consider in making value determinations and required certain written documentation and reports to the funds' directors concerning the value determinations made.

According to the SEC, other than the list of factors, which the SEC noted were taken nearly verbatim from SEC Accounting Series Release No. 118, the funds' valuation procedures "provided no meaningful methodology or other specific direction on how to make fair value determinations for specific portfolio assets." Citing as examples, the SEC noted there was no guidance on how the factors should be interpreted or weighed, what methodology should be used for each type of security or how to evaluate the appropriateness of any methodology, nor was there a mechanism to identify and review securities whose prices had not changed in some time.

Allegations Regarding Actual Valuation Practices

In its order, the SEC alleged that between January 2007 and August 2007:

- fund accounting routinely allowed the funds' portfolio managers to set prices for securities without any explanation of the basis for such prices and did so in a way that postponed the degree of decline in the NAVs of the funds;
- no reasonable analytical method, such as a pricing model or cash flow analysis, was used to make fair value determinations;
- the price of a security was typically not changed from its purchase price unless a sale or price confirmation showed a variance greater than 5%;
- price confirmations were sought for as few as 10% of the funds' fair-valued securities and were not obtained in a timely manner for the prices they were meant to confirm;
- fund accounting was not required to identify or explain instances where price confirmations were ignored or overridden; and
- the valuation committee tasked with overseeing the fair valuation process typically did no more than compare sales prices to previously determined fair values on a monthly basis and failed to perform any additional analysis to confirm the fair values of securities that had not been sold or confirmed.

SEC Charges

Section 2(a)(41)(B) of the Investment Company Act requires that securities for which market quotations are not readily available be valued at fair value as determined in good faith by a fund's board of directors. The SEC has stated that **"directors must determine the method of arriving at the fair value of each such security" and "continuously review the appropriateness of the method used in valuing each issue of security" in the fund's portfolio**.

The SEC alleged that the defendant directors failed to meet their fair valuation responsibilities because, among other things: (i) the directors did not know and did not inquire what methodology was used to value particular securities or types of securities; (ii) the directors never established guidelines for the use of price confirmations, including frequency or selection of broker/dealers, nor did they require identification of those securities for which no confirmations had been obtained for a period of time; (iii) reports provided to the directors did not meet the requirements of the valuation procedures and the directors did not request the required information. In particular, the directors' review of valuations was limited because reports given the directors did not include certain information about fair-valued securities in the funds' portfolios that had not been sold, when less than 25% of the funds' fair-valued securities were sold during the first six months of 2007. "As a result of the directors' causing the funds to fail to adopt and implement reasonable procedures, the NAVs of the funds were materially misstated."

A public hearing on the matter is scheduled to occur on April 2, 2013 before an administrative law judge who will issue an initial decision.

SEC TO RESUME GRANTING CONDITIONAL EXEMPTIVE RELIEF FOR CERTAIN ETFS

Nearly three years after announcing that it had indefinitely deferred consideration of exemptive applications made by actively managed ETFs with significant investments in derivatives, the SEC announced in December that it would begin considering and approving exemptive requests under the Investment Company Act by ***non-leveraged*** **actively managed ETFs investing in derivatives**.

Speaking at the ALI CLE 2012 Conference on Investment Adviser Regulation, Norm Champ, Director of the Division of Investment Management, said the Division would consider exemptive requests under the Investment Company Act relating to actively-managed ETFs that make use of derivatives provided the request included two specific representations:

- that the ETF's board periodically will review and approve the ETF's use of derivatives and how the ETF's investment adviser assesses and manages risk with respect to the ETF's use of derivatives; and
- that the ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant Commission and staff guidance.

Director Champ cautioned that the Division would continue its ongoing review of the use of derivatives by funds. The SEC's moratorium on leveraged actively managed ETFs remains in place.

In early January, the SEC issued the first of what is sure to be many orders affording exemptive relief to, and effectively permitting the registration of, non-leveraged actively managed ETFs intending to invest in derivatives. (See, e.g., IC Release No. 30350, Jan. 15, 2013). And while the order itself does not specifically mention the use of derivatives, the ETF's exemptive application, which was amended following Director Champ's December 6, 2012 speech, contains the explicit representations referred to in the speech. For the time being, this seems to be the magic language for actively managed ETFs seeking exemptive relief.

FINRA ENFORCEMENT CASES UNDERSCORE IMPORT OF PROSPECTUS DELIVERY RULES

During the fourth quarter of 2012, FINRA settled five enforcement cases against well-known broker/dealer firms for failing to properly deliver prospectuses to mutual fund investors. The enforcement actions, which included financial penalties, come as a strong reminder that even in the modern scheme of automated trading and online brokerage services, the prospectus delivery rules established by Congress 80 years ago are as applicable as ever.

Section 5(b)(2) of the Securities Act of 1933 (the "Securities Act") sets forth the primary prospectus delivery rule, requiring that every sale of a security be preceded or accompanied by a prospectus that complies with Section 10(a) of the Securities Act. In addition, Rule 10b-10 and Rule 15c6-1(a) under the Securities Exchange Act of 1934 (the "Exchange Act") together require that broker/dealers provide transaction confirmation statements – which must include certain disclosures included in a prospectus – to their customers within three days of the transaction settlement. In practice, broker/dealers must provide a prospectus to a customer within three days of his or her investment in a mutual fund. In several of the enforcement actions, prospectuses were delivered more than a year after the transactions in question.

In the FINRA enforcement actions, the defendant broker/dealer firms were charged with failing to comply with prospectus delivery rules and failing to establish and maintain adequate supervisory systems and written procedures reasonably designed to monitor and ensure compliance with the rules. These lapses, FINRA said, were violations of the federal securities laws and also breaches of the FINRA Manual. NASD Conduct Rules 3010(a)(1) and (b)(1) require that member broker/dealer firms must have in place a working and enforced written system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulation. FINRA asserted that the firms' failures were also in contravention of FINRA Rule 2010, which requires that each member firm "in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

The broker/dealer firms in each of the FINRA cases relied on a service provider to carry out delivery of prospectuses to clients. In the settlement orders, FINRA made clear that broker/dealers could not avoid responsibility for prospectus delivery compliance by delegating the task to a third party. **Broker/dealers must, FINRA, explained, have written supervisory**

procedures that call for review of service providers' performance of their prospectus delivery obligations. And, simply having the procedures on the books is not enough, as several of the firms that settled with FINRA had written supervisory procedures that FINRA found to be inadequate. For example, simply asking registered representatives "annually to confirm his or her understanding of [the firm's] requirements regarding mutual fund prospectus delivery, and accept[ing] the representative's response," was deemed insufficient by FINRA under NASD Conduct Rules 3010(a)(1) and (b)(1). Other specific failures cited by FINRA include improper householding in connection with the annual delivery of mutual fund prospectuses and not regularly updating and monitoring the prospectus mailing list maintained by a third party vendor.

In several of the cases, broker/dealers pointed the finger at mutual funds and their advisers, asserting that "the primary cause of the late deliveries was the failure of certain mutual fund companies to maintain adequate supplies of paper copies of prospectuses." FINRA, however, countered that the broker/dealers should have "taken actions to ensure that all of its customers were receiving prospectuses on time," for instance, by taking advantage of the "print on demand" capability offered by prospectus delivery service providers. This service, FINRA pointed out, would allow a firm to comply with prospectus delivery rules by obtaining an electronic copy of the prospectus from the fund company and then printing hard copies to send to customers. **A mutual fund's compliance program should also include a process for monitoring and ensuring the adequacy of prospectus inventory and overseeing the compliance of its service providers with prospectus delivery requirements**.

FINRA brought the five enforcement actions in connection with its review of mutual fund prospectus delivery during the period from January 1, 2009 to June 30, 2011. The actions involved over 100,000 mutual fund transactions, and follow similar cases in 2011 where FINRA fined Wells Fargo Advisors, LLC $1 million "for its failure to deliver prospectuses in a timely manner...and for delays in reporting material information about its current and former representatives" and fined TD Ameritrade $100,000 in connection with charges that "in 4 percent to 5 percent of the mutual fund transactions the firm conducted, customers were not timely receiving prospectuses." The fines agreed to as part of the five settlements reached in late 2012 range from $40,000 to $400,000.

COLLABORATION AND OTHER SEC PRIORITIES FOR 2013

Investment Management Priorities

Norm Champ, Director of the SEC's Division of Investment Management, laid out his priorities for 2013 at the November 2012 meeting of the Business Law Section of the American Bar Association and at the February 2013 meeting of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. One focus for the year will be on **the new Investment Management Risk and Examination Group** ("REG"), which Director Champ said will monitor industry risk in quantitative and qualitative terms and also address specific investment products, sales practices and firms. Director Champ told the group that REG and the five examiners within the Division of Investment Management would coordinate closely with the SEC's Office of Compliance Inspections and Examinations ("OCIE"). He said that while OCIE's on-site presence exams primarily targeted large adviser and broker/dealer firms with systemic risk factors, REG would begin visiting firms of all types and sizes.

Director Champ noted that REG's main goal was to better leverage the information and data generated by OCIE. For example, Champ explained, members of the Investment Management Division staff would be asked to accompany OCIE staff on presence exams so that the Investment Management staff could get both a "snapshot" view of individual firms and a bird's eye view of industry-wide risks and themes. In addition, Champ said that he would work to establish a formalized communication system between the Division of Investment Management, OCIE and the other divisions of the SEC.

Champ also spoke to the backlog of approximately 60 "shelf projects" at the SEC, including the Rule 12b-1 reform proposed in 2010. He said that the list had been pared down to the following eight top projects:

- a review of the Investment Advisers Act of 1940 in light of the new private adviser registrations;
- a rethinking of reporting on Form N-SAR;
- exemptive and/or no-action relief for certain types of derivative instruments, with a focus on disclosure regarding leverage;
- a potential rule exempting certain categories of ETFs;

- valuation guidance for fund boards of directors;
- books and records reform;
- working with the Financial Stability Oversight Council to use the data provided by private advisers on Form PF to monitor systemic risks; and
- variable annuities reform.

While Champ emphasized that Rule 12b-1 reform and related revenue sharing concerns were not on his list of eight projects, he noted that the Division of Investment Management was continuing to gather data on Rule 12b-1 fees and practices.

Director Champ reported that **efforts to harmonize the standard of care applicable to advisers and broker/dealers** in connection with the study required by Section 913 of the Dodd-Frank Act were and ongoing priority for the Division. Current SEC Chairman Elisse Walter echoed Director Champ's statements in mid-February 2013 when she testified to the Senate Backing Committee that the SEC expected to act on the proposal to expand the fiduciary standard "in the next month or two." Chairman Walter reportedly noted that the SEC Commissioners were generally supportive of establishing a unified fiduciary standard for investment advisers and broker/dealers.

Enforcement Priorities

Bruce Karpati, Chief of the Division of Enforcement's Asset Management Unit ("AMU"), speaking at the Private Equity International Conference in New York on January 23, 2013, echoed Champ's statements about the SEC's efforts to strengthen expertise on understanding risks related to the investment management industry, particularly those inherent to the previously unregulated private adviser and private equity segment of the industry. "We want to understand the structure of the industry, the customs and practices, the incentives that exist for managers, and trends and risks that could enable us to more effectively spot or investigate fraud," Karpati said.

To that end, Karpati explained that the AMU was working to create **certain data-based and quantitative method-based "risk analytic initiatives"** that would allow the Division of Enforcement to "proactively detect fraud and identify other problematic industry practices."

Like Champ, Karpati also highlighted plans to foster cross-pollination among the SEC's various divisions. "One significant area of collaboration is with our National Exam Program," Karpati said, where "AMU personnel have helped train examiners and have accompanied them on exams of private equity managers. In return, the National Exam Program ("NEP") has enhanced our understanding of the private equity industry with observations and insights from examinations....We also frequently engage with our Division of Investment Management colleagues on the legal aspects of private equity. IM staff assists us in addressing complex legal and contractual issues that crop up in our investigations."

Karpati noted that as AMU honed its skills, private equity might increasingly be in the SEC's spotlight. Among other things, Karpati said that **AMU's primary concerns about practices in the current private equity industry center on fundraising and capital overhang; the lack of transparency surrounding many private equity products, "especially into the valuation of illiquid assets and the operations of portfolio companies;" and conflicts of interest leading to "misappropriation, deal cherry picking and other forms of misconduct."**

Karpati also spoke about **AMU's Private Equity Initiative** ("PEI"), announced in December 2012, which he explained was a joint project of the Division of Risk, Strategy and Financial Innovation, the Division of Investment Management and OCIE to identify private equity advisers that are at higher risk for certain specific fraudulent behavior. In particular, he said that the PEI **sought to identify "zombie managers"** with relatively illiquid private equity holdings and an inability to raise new funds to establish additional investment vehicles to manage. "Since zombie managers are unable to raise new capital," Karpati said, "their incentives may shift from maintaining good relations with their investors to maximizing their own revenue using the assets that they have." Thus in investigating private funds and advisers targeted by the PEI, Karpati said, the AMU would, among other issues, "look for misappropriation from portfolio companies, fraudulent valuations, lies told about the portfolio in order to cause investors to grant extensions, unusual fees, [and] principal transactions."

In late February 2013, the SEC published its list of NEP priorities for 2013.[3] As Carlo V. di Florio, Director of OCIE reported, the NEP's "market-wide

[3] The full list of OCIE priorities for 2012 is available at http://www.sec.gov/news/press/2013/2013-26.htm.

priorities include fraud detection and prevention, corporate governance and enterprise risk management, conflicts of interest, and technology controls."

OCIE's 2013 priorities for its investment adviser/investment company examination program include:

- **the safety of client** assets and compliance with custody requirements under Advisers Act Rule 206(4)-2;
- **conflicts of interest related to compensation** arrangements such as "undisclosed fee or solicitation arrangements, referral arrangements (particularly to affiliated entities), and receipt of payment for services allegedly provided to third parties;"
- **marketing and performance advertising**, which OCIE characterizes as "an inherently high-risk area due to the highly competitive nature of the investment management industry;"
- conflicts of interest related to **the allocation of investment opportunities** among funds and other products managed by an investment adviser; and
- **fund governance** – "the staff will confirm that advisers are making full and accurate disclosures to fund boards and that fund directors 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."

OCIE reports that during 2013 it will also focus on leverage, liquidity, valuation, compliance and issues associated with hedge funds' and mutual funds' investments in **"alternative investment companies,"** as well as matters related to **Rule 12b-1 compliance** and **revenue sharing**. OCIE will look at "the wide variety of 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 same. 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."

Broker/Dealer Priorities

As the SEC works to respond to the findings of the study of advisers and broker/dealers that was required by Section 913 of the Dodd-Frank Act, which recommended that the SEC propose and adopt "**a uniform fiduciary standard** of conduct for broker/dealers and investment advisers when they provide personalized investment advice about securities to retail investors," it will also coordinate with FINRA to hold **a National Compliance Outreach Program for Broker/Dealers**. The event, which is scheduled for April 9, 2013 in Washington, D.C., is being sponsored by OCIE and the SEC's Division of Trading and Markets as well as FINRA. The conference, says Director di Florio, is intended to "support and enhance the compliance and risk management functions of firms" by providing "a forum for open discussions about effective compliance practices for broker/dealers... on topics of interest to compliance, risk, and audit officers of large broker/dealers with multiple and complex business lines."

On March 1, 2013, **the SEC released an information request asking the industry for "quantitative data and economic analysis** relating to the benefits and costs that could result from various alternative approaches **regarding the standards of conduct and other obligations of broker-dealers and investment advisers."** The SEC intends to use the comments and information it receives to "inform [its] consideration of alternative standards of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers....and of potential harmonization of certain other aspects of the regulation of broker-dealers and investment advisers." Comments are due to the SEC 120 days from publication of the release in the Federal Register – approximately July 1, 2013.

SEC EXTENDS "LOST SHAREHOLDER" RULE TO BROKER/DEALERS AND PAYING AGENTS

According to research conducted by the Investment Company Institute, approximately 80% of current mutual fund shareholders are invested through a financial intermediary such as a broker/dealer or transfer agent. Congress recognized this trend in drafting Title IX of the Dodd-Frank Act and under Section 929W added a new sub-section to Section 17A[4] of the Exchange Act that directed the SEC to (i) expand Rule 17Ad-17 so that the requirement to search for "lost securityholders" applied to broker/dealers as well as transfer agents and (ii) add a requirement that "paying agents" notify "unresponsive payees" in writing that a check sent to them has not been cashed. On January 16, 2013, the SEC adopted final rule amendments implementing the Section 929W directive. **Fund boards and CCOs should**

[4] Section 17A(g) of the Exchange Act is entitled "Due Diligence for the Delivery of Dividends, Interest, and Other Valuable Property Rights."

be aware of these rules, which are summarized below, and take account of them in developing and implementing their financial intermediary compliance oversight programs.

In addition to extending "lost shareholder" obligations to broker/dealer firms, Rule 17Ad-17, as amended:

- requires broker/dealers and transfer agents "to exercise reasonable care to ascertain the correct addresses of 'lost securityholders,'...and to conduct certain database searches for them."
- defines a "lost securityholder" to mean: (i) a shareholder to whom a broker/dealer or transfer agent has sent an item of correspondence, addressed to the shareholder's address of record, that has been returned as undeliverable, provided that if the intermediary re-sends the correspondence within one month, the shareholder will not be deemed "lost" until such re-sent correspondence is returned as undeliverable; (ii) a shareholder for whom a broker/dealer or transfer agent has not received new address information; and/or (iii) an "unresponsive payee" in that a check sent to the shareholder was not cashed "before the earlier of the paying agent's sending the next regularly scheduled check or the elapsing of six months after the sending of the not yet negotiated check."
- defines "paying agent" to "include any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from an issuer of securities and distributes the payments to the holders of the security."
- includes a de minimus exclusion for uncashed checks of less than $25.
- does not apply if a broker/dealer or transfer agent has an agreement with the "lost shareholder" that unclaimed checks will be deposited directly into his or her account.
- has no impact on state escheatment laws.

In the final rule release (Release No. 34-68668), the SEC explained that the loss of contact between a financial intermediary and its customers can be harmful to investors "because they no longer receive corporate communications or the interest and dividend payments to which they may be entitled." Such loss of contact has various causes, the SEC said, but most frequently results from: "failure of a securityholder to notify the transfer agent of his correct address after relocating...[or] failure of the estate of a deceased securityholder to notify the [intermediary] of the death of the securityholder and the name and address of the trustee/administrator for the estate."

Along with the Rule 17Ad-17 amendments, the SEC also adopted new technical Rule 15b1-6 under the Exchange Act, "which will provide ongoing notice to brokers and dealers of their obligations under Rule 17Ad-17."

The compliance date for amended Rule 17Ad-17 is January 23, 2014.

RECENT SEC ENFORCEMENT ACTIONS

Failure to Disclose Revenue Sharing Tantamount to Fraud

The SEC recently settled charges against an investment adviser based in Portland, OR for failing to disclose revenue sharing agreements and other conflicts of interests to mutual fund shareholders. According to the SEC, the adviser received revenue sharing payments from certain broker/dealers in connection with certain funds that the adviser recommended to its clients, and did not disclose that "the agreement created incentives for [the adviser] to favor a particular category of mutual funds over other investments." The SEC determined that receipt of the compensation without related conflicts of interest disclosure violated Section 206(2) and 207 of the Advisers Act which, respectively, prohibit an investment adviser from "engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client" and from willfully making "any untrue statement of a material fact." The defendant advisory firm agreed to pay a $1.1 million fine to settle the charges, which also included allegations that (i) the adviser violated Section 15(c) of the Investment Company Act by providing misleading fee information to the board of trustees of a mutual fund for which the firm was to serve as a sub-adviser and (ii) violated various provisions of the Advisers Act by voting client proxies in a favor or a proposal in which a related person of the firm had a financial interest.

The Portland adviser's case may be a harbinger of similar enforcement actions to come as the Division of Enforcement's Asset Management Unit, together with the SEC's San Francisco Regional Office, has commenced an enforcement and examination initiative to uncover "arrangements where advisers receive undisclosed compensation and conceal conflicts of interest from investors."

Deviation from Fund Policies into Risky Derivatives Results in Heavy Sanctions

In late December 2012, the SEC settled with an Arizona-based mutual fund portfolio manager for a number of violations of the federal securities laws related to the manager's deviation from a fund's stated investment objective and strategies. As the settlement order details, the fund's prospectus and SAI characterized the fund as pursuing an equity strategy of "investing, under normal market conditions, at least 80% of its total assets in common stocks and securities immediately convertible into common stocks," with an objective of seeking long-term capital appreciation. The fund's use of derivatives was restricted and its prospectus "made no mention of options trading and none of the principal risks involved options." Moreover, the management discussion included in the fund's annual report to shareholders during the period in question stated that options would be used only as part of a hedging program with "the potential to greatly reduce market risk." The fund's portfolio manager, however, "pursued a strategy of buying options for speculative purposes contrary to [the fund's] stated investment policy that was changeable by shareholder vote" in that it was a fundamental investment policy. His investments in options during the period in question ranged from 21% to 75% of the fund's total assets, in clear violation of the fund's 80% equity investment policy.

Over the course of five quarters, the portfolio manager's activities resulted in $3.7 million in losses for the fund (roughly 70% of its total assets) and its eventual liquidation and dissolution. The SEC found the portfolio manager's behavior to be willfully fraudulent and violative of: Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8(a) thereunder; Section 17(a)(3) of the Securities Act; Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; and Sections 34(b) and 13(a)(3) of the Investment Company Act. He was accordingly subject to a number of sanctions, including a non-permanent bar from the investment management industry.

In a similar case also settled in late December 2012, two Midwestern investment advisers and their portfolio managers were charged with failing "to adequately inform investors about the fund's risky derivative strategies that contributed to its collapse during the financial crisis." The close-end fund at issue in the case had a principal investment strategy of investing in equity securities and writing covered call options on a substantial portion of those equities. The fund's registration statement disclosed this strategy as well as the fact that the fund intended to utilize a variety of derivative strategies generally, including put and call options, futures contracts, swaps, caps, floors and collars. During the one and a half year period leading up to the 2008 financial crisis, however, the fund's advisers "implemented two new derivative strategies to supplement the fund's existing covered call investment strategy," both of which "exposed the fund to substantial losses in the event of a steep market decline or spikes in market volatility." Such declines and volatility, of course, materialized in the fall of 2008 and the fund realized a loss of approximately $45 million (or 45% of its net assets). It was liquidated in 2009 after losing $70 million total (72% of its net assets).

Many funds suffered such losses during the 2008 financial collapse, but if their registration statement disclosed the risks of such losses, their advisers were generally protected from liability. But, the advisers and portfolio managers involved in the SEC settlement failed to properly disclose the significant risks associated with the new derivatives strategies they began employing in April 2007. The registration statement in effect for the fund during the period in question did not disclose the implementation of the new strategies – writing out-of-the-money put options and shorting variance swaps – as principal investment strategies nor did it describe the substantial risks to the fund of using these types of derivatives, particularly given the high percentage of fund assets that were being devoted to them by the fund's portfolio managers. The strategies, the SEC found, became an integral part of how the fund's portfolio managers sought to achieve its investment objective. Still, the fund's reports to shareholders from the period did not address written put options or variance swaps. Rather the shareholder reports asserted that the fund's covered call strategy "had the potential to protect the fund in a downward trending market." As the SEC explained in one of the settlement orders, the fund's advisers "never disclosed that put options and variance swaps were primary drivers of fund performance, or that the use of those products might alter the fund's risk profile by exposing the fund to significant losses."

One adviser involved in the case agreed to settle with the SEC for a fine of approximately $2 million for willful violations of Section 34(b) of the Investment Company Act and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

The other adviser charged by the SEC agreed to reimburse $45 million to shareholders impacted during the period in question. That adviser was charged with willfully violating Section 34(b) of the Investment Company Act and causing violations of Rule 8b-16 thereunder. The fund's two portfolio managers during the period were each alleged by the SEC to have violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; and Section 34(b) of the Investment Company Act Rule 8b-16 thereunder. A public hearing to determine the sanctions against the portfolio managers will be held during the first quarter of 2013.

INS AND OUTS AT THE SEC

In November 2012, **Mary L. Schapiro**, announced her resignation as Chairman of the SEC, effective December 14, 2012. Schapiro served at the SEC for nearly four years during a period of substantial regulatory overhaul, including the enactment and implementation of the Dodd-Frank Act following the 2008 economic crisis. Schapiro's departure followed the summer 2012 resignations of Ricardo Delfin, one of her closest advisors, and Robert Plaze, Deputy Director of the Division of Investment Management. President Obama designated **Elisse B. Walter**, an existing SEC Commissioner, to temporarily serve in Schapiro's place. In late January 2013, the President nominated **Mary Jo White**, a private attorney, to serve as the permanent SEC Chair. Chairman Walter will continue to serve until Ms. White is confirmed by the Senate.

Meredith B. Cross announced her resignation as Director of the SEC's Division of Corporation Finance in late 2012. Director Cross was a part of Chairman Schapiro's senior leadership team.

Robert Khuzami, who served as the Director of the SEC's Division of Enforcement for four years, announced in early January 2013 that he would step down. During Director Khuzami's tenure, the SEC tried over 150 cases tied to the financial crisis, including those related to the federal insider trading probe, and prosecuted more than 700 enforcement actions in each of 2011 and 2012. Director Khuzami endorsed his deputy, **George S. Canellos** to take his position, and the SEC formally named Canellos as Acting Director of the Enforcement Division effective February 8, 2013. Canellos has served as the Deputy Director of the Division of Enforcement since June 2012, and was previously the Director of the SEC's New York Regional Office. **David P. Bergers**, former Director of the SEC's Boston Regional Office, has been named Acting Deputy Director of the Enforcement Division, also effective February 8, 2013.

Robert W. Cook, Director of the Division of Trading and Markets at the SEC, announced his intention to leave the agency in late 2012. During his three years at the SEC, Cook oversaw the implementation of significant rulemaking and other responsibilities assigned to the Division of Trading and Markets under the Dodd-Frank Act and the Jumpstart Our Business Startups ("JOBS") Act. **John Ramsay**, the current Deputy Director of the Division of Trading and Markets, has been named to serve as the Acting Director of the Division.

Mark D. Cahn, who served as General Counsel at the SEC for two years, announced his departure effective December 31, 2012. Mr. Cahn was replaced by Chairman Walter with **Geoffrey F. Aronow**, a private attorney. Mr. Aronow previously served as the Director of the Division of Enforcement at the CFTC.

David Grim, a long-time SEC staffer, was appointed Deputy Director of the SEC's Division of Investment Management on Jan. 15, 2013. As the SEC reported, "Mr. Grim has worked in the division for 17 years, most recently as Assistant Chief Counsel in its Office of Chief Counsel, and has received several awards for his legal and managerial work."

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REGULATORY AND OTHER COMPLIANCE CONCERNS

Failure to Supervise Liability

Commissioner Daniel M. Gallagher, speaking at the National Society of Compliance Professionals National Meeting in October 2012, reminded compliance officers that the Advisers Act authorizes sanctions against compliance officers of investment advisers for failing to reasonably supervise an employee or other associated person of the adviser, if that person commits a violation of the federal securities laws and he or she was subject to the compliance officer's supervision. This **failure to supervise liability has the potential to make compliance officers responsible for the illegal activity of other people** and is a hazy area of the law. As such, Commissioner Gallagher explained that "in recognition of the complexity of the subject and the resulting need for flexibility…we should be cognizant of the limitations of establishing a rigid set of expectations based on bright-line rules." He did offer some guidance, however, noting that "optimal supervision requires a framework that encourages in-house legal and compliance officers to depart, when necessary, from the safety of black and white categorizations of who is and who is not a supervisor as well as what a supervisor is expected to do."

An October 2012 FINRA settlement provides a concrete example of when failure to supervise liability will attach to a CCO.[5] The former CCO of a brokerage firm was responsible for supervising the firm's president and for reviewing the firm's transaction for any irregular activity, including potentially suspicious trades. The CCO did not identify or otherwise act upon a large number of red flags that, had they been investigated, would have revealed that the firm's president was engaged in an intricate cherry-picking scheme in which he reallocated trades for his own profit. The former CCO was found by FINRA to have failed to supervise the firm's president, and was suspended from serving in any capacity at a FINRA member firm for a period three months.

Private Adviser Presence Exams

The SEC's Office of Compliance Inspections and Examinations ("OCIE") is charged with protecting the investing public by conducting exams and inspections of SEC-registered entities, including investment advisers, investment companies, broker/dealers, transfer agents, and exchanges. In October 2012, OCIE announced that as part of its National Exam Program ("NEP"), it was launching a two-year "initiative to conduct focused, risk-based examinations of investment advisers to private funds that recently registered with the Commission ("Presence Exams")." The announcement was communicated through a letter distributed to senior executives of private advisers that were required to register with the SEC in connection with the amendments to Section 203 of the Advisers Act required by the Dodd-Frank Act. The Presence Exams are intended to assess whether these newly registered advisers are operating in a manner that is consistent with the federal securities laws.

OCIE will conduct the Presence Exams in three primary phases. During the first phase, in which OCIE will endeavor to reach out to private adviser CCOs other senior executives, OCIE's stated goal is "to inform newly registered firms about their obligations under the Advisers Act and related rules." To this end, OCIE "has published compliance outreach materials, staff letters, risk alerts, special studies, speeches, and other documents" through the SEC website and will hold regional meetings and national seminars as part of the SEC's Compliance Outreach Program, which is designed to provide a forum for CCOs to discuss compliance issues with the SEC staff and learn about effective compliance practices.

The second phase, in which OCIE will review the business and operations of

[5] FINRA Letter of Acceptance, Waiver and Consent No. 2010024116901.

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private advisers selected for an exam, will require much more action on the part of private adviser CCOs. During the examination phase, OCIE will visit private advisers' offices and will request records relating to the adviser's "higher-risk areas," including marketing, portfolio management, conflicts of interest, safety of client assets and valuation. As the introductory letter issued by OCIE explains, "after the completion of the on-site portion of the examination, NEP staff may send [the adviser] a letter indicating that the examination has concluded without findings or a letter that describes the deficiencies identified and asks [the] firm to undertake corrective action. If serious deficiencies are found, in addition to sending an examination summary letter, NEP staff may refer the problems to the Division of Enforcement, or to a self-regulatory organization, state regulatory agency, or other regulator for possible action."

Once the intensive examination phase of the Presence Exams project is complete, OCIE plans to report its findings and observations to the SEC and the public, which "may include common practices identified in the higher-risk focus areas, industry trends, and significant issues." The goal of the reporting, OCIE has stated, will be "to encourage firms to review compliance in these areas and to promote improvements in investment adviser compliance programs."

CCOs at all registered investment advisers should review their firm's policies and procedures to ensure that they cover the "higher-risk" topics identified by OCIE.

- One focus of the Presence Exams will be on **truth in advertising**. "NEP staff will review marketing materials to evaluate whether the investment adviser has made false or misleading statements about its business or performance record; made any untrue statement of a material fact; omitted material facts; made any statement that is otherwise misleading; or engaged in any manipulative, fraudulent, or deceptive activities."
- Not surprisingly, the Presence Exams will also focus on **portfolio management and conflicts of interest**. Advisers have an obligation to act in the best interests of their clients and "to identify, mitigate, and disclose any material conflict of interest. NEP staff will review and evaluate investment advisers' portfolio decision-making practices, including the allocation of investment opportunities and whether advisers' practices are consistent with disclosures provided to investors."
- As with traditional exams of registered advisers, with the Presence Exams OCIE will look at private advisers' **compliance controls**. Each on-site exam will include a review of the procedures and controls that the adviser uses "to identify, mitigate, and manage certain conflicts of interest within [the firm]. Some areas of the conflicts of interest that NEP staff will review include: allocation of investments, fees, and expenses; sources of revenue; payments made by private funds to advisers and related persons; employees' outside business activities and personal securities trading; and transactions by advisers with affiliated parties."
- The Presence Exams will inquire about private advisers' **custody practices** in keeping with the enhanced items on Form ADV regarding safekeeping of client assets. "NEP staff will review advisers' compliance with the relevant provisions of the Advisers Act and related rules that are designed to prevent the loss or theft of client assets. When obtained, NEP staff also will review independent audits of private funds for consistency with the Advisers Act custody rule."
- And, as the SEC is generally focused on **valuation matters**, the Presence Exams will address private advisers' valuation policies and procedures. "NEP staff will review advisers' valuation policies and procedures, including their methodology for fair valuing illiquid or difficult to value instruments. NEP staff also will review advisers' procedures for calculating management and performance fees, and allocation of expenses to private funds."

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Since OCIE's announcement, private advisers have reported that **the examination phase of the Presence Exam initiative is underway**. In addition to the topics referenced in OCIE's October 2012 letter, NEP staff has also asked for information about:

- distribution fees and alternative investment companies;
- "selling away" by adviser brokerage affiliates;
- risk assessment methods;
- oversight of third party service providers;
- audited financial statements for the past three years;
- limited partnership and operating agreements; and
- carried interest and claw backs paid by private funds.

Andrew J. Bowden, Deputy Director of OCIE, has stated that in addition to NEP staff, enforcement attorneys and economic advisers may visit adviser offices in connection with the Presence Exams.

Bruce Karpati, Chief of the Division of Enforcement's Asset Management Unit, speaking at the Private Equity International Conference in New York on January 23, 2013, offered **advice to the CCOs of private adviser firms in approaching life as a regulated entities**. Karpati emphasized that the oversight role of a private adviser CCO was especially important because certain long held industry practices – such as "the offering of co-investment opportunities only to certain favored clients" – may be viewed as putting the adviser's interests ahead of investor interests in violation of the Advisers Act.

As such, Karpati said, many private advisers need to make efforts to better establish and implement tailored compliance policies and procedures and to integrate compliance risk into their overall risk management processes. Private adviser firms, just like investment management shops that have been registered with the SEC for many years, must ensure that their "CCOs and other risk managers are able to proactively spot and correct situations where conflicts of interest may arise." Indeed, speaking at the February 2013 meeting of the Corporation, Finance and Securities Law Section of the District of Columbia Bar, Director of the SEC's Division of Investment Management, Norm Champ, reported that the primary issues arising from the NEP presence exams that OCIE had reported to his Division involved conflicts of interest inherent to the way private advisers operated prior to being required to register with the SEC.

Karpati also noted, "given the transactional focus of most private equity shops, it may make sense to assign an experienced deal professional who has some understanding of compliance issues to help review and implement some of these procedures… **CCOs should be part of the firm's important decision making processes and should act as investor advocates**," including by making sure that valuations are fairly represented and that investors are accurately informed of the status of their investment."

Karpati urged private advisers to embrace their regulated and/or registered status and "be alert and prepared for exam inquiries. It is important **to be cooperative with exam staff** while an examination takes place. It is also important to **implement any necessary corrective steps if the SEC staff identifies deficiencies or possible violations**." Taking these steps, Karpati said, would "help the examination process to proceed more efficiently and reduce the likelihood of more formal inquiries" in the future.

Private advisers who have been operating as unregistered advisers should understand that their existing policies and procedures may not conform with the expectations of examination staff on such matters as: investor letters and offering documents that provide past specific performance information but do not list all prior investments; treatment of soft dollars and research; record-keeping; and custody relationships.

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Mutual Fund Distribution and Sub-Transfer Agency Arrangements

The SEC has embarked on a targeted examination sweep of mutual fund distribution arrangements "with a view towards ensuring that, as broker/dealers experience declining revenue streams, they not look to increase their sub-TA fees to compensate them for distribution expenses." The sweep comes approximately two years after the SEC's stymied Rule 12b-1 reform proposal and as the mutual fund industry begins tackling transparency and other issues related to oversight of financial intermediaries selling and servicing fund shares through omnibus platforms. **Mutual fund CCOs should be aware of the operational areas identified in the distribution sweep exam and make sure that their funds can produce the information requested**. As evidenced by exam letters received from OCIE's Denver and Boston regional offices, among other information, the sweep exam solicits the following documentation going back as far as October 2009:

- All agreements with third party financial intermediaries – such as broker/dealers, financial planners, insurance agents, retirement planners, and investment advisers – regarding "a relationship that attracts assets to the fund," pursuant to which the fund pays any form of remuneration. A relationship that attracts assets to a fund could be in any form, including "arrangements involving sales, distribution, directed brokerage, shelf space, sub-transfer agency, shareholder servicing, marketing support, 12b-1 plans, or exposure to a third party's sales force or customers."
- The purpose of the compensation payable under each third party agreement, the basis for each category of compensation and the total amount paid to the financial intermediary during the examination period.
- Methods for tracking third party intermediary remuneration.
- Any analysis conducted as part of the negotiation process with third party intermediaries and a list of intermediary firms considered but rejected as distribution partners.
- The disclosed Rule 12b-1 fee percentage applicable to each distribution arrangement and any changes thereto; the dollar value of that percentage for each year; and a detailed accounting of the amount actually expended each year.
- All policies and procedures related to third party distributor remuneration.
- The most recent risk ratings for each third party involved with distributor remuneration; the most recent "Contract Analysis" and "Market Analysis" performed by the firm's finance department surrounding distributor remuneration; and any internal audit report related to distributor remuneration for the funds' principal underwriter or any of its affiliates.
- Any attribution analysis performed on fund flows.
- Board materials and minutes related to fund distribution during the examination period.
- Revenue sharing payments made by the funds' principal underwriter, presented by sales channel in dollars and in basis points.
- Omnibus and network fees paid by the fund and its principal underwriter, presented by sales channel in dollars and in basis points.
- Expense allocations by fund and by share class for sub-accounting fees, Rule 12b-1 fees, management fees, and redemption fees paid pursuant to Rule 22c-2 under the Investment Company Act.
- Policies and procedures regarding Rule 22c-2 compliance, breakpoint discounts and anti-money laundering.
- With respect to omnibus accounts invested in a fund: all contracts between the fund's principal underwriter and the relevant financial intermediary; all compliance exception reports related to Rule 22c-2 compliance generated during the examination period; all requests for underlying beneficial shareholder investor information related to Rule 22c-2 compliance made during the examination period; and any warnings, restrictions, or bans issued to shareholders during the review period.