Issue 18, February 2014

REGULATORY ADMINISTRATION DIGEST

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The following is a summary of select developments in investment management regulation during the fourth quarter of 2013.

REGULATORY AND ENFORCEMENT DEVELOPMENTS

FINAL RULE LIMITS RELIANCE ON NRSRO CREDIT RATINGS

On December 27, 2013, the Securities and Exchange Commission ("SEC") adopted amendments to Rule 5b-3 ("Rule 5b-3") under the 1940 Act (the "1940 Act") and SEC Forms N-1A, N-2 and N-3 that remove references to credit ratings of nationally recognized statistical rating organizations ("NRSRO"). The amendments were adopted in response to a mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requiring federal agencies to remove such references and substitute standards of credit-worthiness that the agency deems appropriate.

Rule 5b-3. The amendments to Rule 5b-3 eliminate the requirement that repurchase agreement collateral, other than cash or government securities, be rated in the highest category by the requisite NRSROs or be of comparable quality. As a substitute for this requirement, amended Rule 5b-3 will require that such collateral consist of securities that the fund's board of directors (or its delegate) determines are: (i) issued by an issuer that has an exceptionally strong capacity to meet its financial obligations on the securities collateralizing the repurchase agreement; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.

Forms N–1A, N–2, and N–3. The amendments to Forms N–1A, N–2, and N–3 relate to the contents of fund shareholder reports. Funds that choose to use credit quality categorizations in the table, chart, or graph of portfolio holdings required by the applicable form are no longer required to use NRSRO credit ratings. In place of NRSRO credit ratings, those funds may use

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alternative categorizations that are not based on NRSRO credit ratings. In addition, those funds that choose to continue using NRSRO credit ratings will no longer be restricted to using the credit ratings assigned by a single NRSRO and may use ratings provided by credit rating agencies that are not NRSROs. The amendments require funds to describe how the credit quality of the holdings was determined, and if credit ratings are used, a description of how they were identified and selected.

The effective date of the Final Rule is February 7, 2014 and the compliance date is July 7, 2014.

SEC CHARGES ADVISER AND PORTFOLIO MANAGER FOR VIOLATING RULES 2A-7 AND 38A-1

On November 26, 2013, the Securities and Exchange Commission's Enforcement Division initiated administrative and cease-and-desist proceedings against a Detroit-based investment advisory firm and one of its portfolio managers (together, the "Respondents") for fraud and other misconduct in connection with investment advisory services provided to a money market fund series (the "Funds"). In its Order instituting the proceedings, the SEC alleged that the adviser caused the Funds to deviate from the strict operating provisions of Rule 2a-7 under the 40 Act. In addition, the SEC alleged that Respondents caused critical information to be withheld from the Funds' trustee (the "Trustees") and made false and misleading statements to the Trustees regarding the Funds' portfolio holdings and exposure to credit risk. The SEC contends that the Respondents' actions violated Rule 2a-7 under the 1940 Act ("Rule 2a-7") and Rule 38a-1 under the 1940 Act ("Rule 38-1"), in addition to certain antifraud provisions of the 1940 Act.

Among other things, the SEC asserts in the Order that the advisor failed to comply with Rule 2a-7 risk limitations, caused the Funds to exceed the 5% issuer diversification limit, and failed to comply with stress testing provisions. The SEC further asserts that, as a result of these violations, the adviser was not authorized to use the amortized cost method of valuing securities or to characterize the Funds as money market funds. The SEC also alleges that the Respondents violated Rule 38a-1 under the 1940 Act due to their failure to follow compliance procedures

regarding minimal credit risk determinations for securities purchased by the Funds.

According to the SEC's Press Release announcing the proceedings, the action was the result of an ongoing investigation by the Division of Investment Management's Risk Examination Office, which, among other things, sought to identify funds whose performance was consistently different than the rest of the market. In this case, the SEC focused on the gross yield of the Funds as a marker of risk. The SEC stated that "[i]ts ongoing quantitative and qualitative analysis of the asset management industry played a vital role in this enforcement action."

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THREE FUNDS SANCTIONED UNDER SEC COMPLIANCE PROGRAM INITIATIVE

In an October 23, 2013 Press Release, the SEC announced that it had sanctioned three investment advisory firms for repeatedly ignoring problems with their compliance programs. Among the firms' violations identified by the SEC in the respective settlement orders were: (i) including misleading statements in investor brochures and on the adviser's website; (ii) failing to adopt and implement written compliance policies and procedures and to perform annual compliance reviews; and (iii) overbilling and underbilling clients. The offending firms agreed to settlements that include payment of financial penalties and require the hiring of compliance consultants.

According to the Press Release, the enforcement actions arose under the SEC's Compliance Program Initiative. Through this program, the SEC targets firms that have been previously warned by SEC examiners about compliance deficiencies, but failed to effectively act upon those warnings. The SEC stated that "[h]ad the problems been addressed, the firms could have prevented their eventual securities law violations."

SEC GUIDANCE AND INITIATIVES

INVESTMENT MANAGEMENT GUIDANCE UPDATES

The SEC recently released the following IM Guidance Updates: (i) *Fund Advisers Serving "At Cost" or For No Compensation*, in which the SEC Staff concludes that investment advisers who provide services

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temporarily "at cost" or for no compensation to particular clients only are not excluded from the definition of "investment adviser" by Section 2(a)(20)(iii) of the 1940 Act; (ii) *Shareholder Notices of the Sources of Fund Distributions - Electronic Delivery*, in which the SEC Staff finds that electronic delivery of the notice required by Rule 19a-1 under the 1940 Act would satisfy the purposes and policies underlying the notice requirement; provided that, the fund complies with SEC guidance on electronic delivery; and (iii) *Fund Names Suggesting Protection From Loss*, in which the SEC Staff encourages funds that expose investors to market, credit, or other risks, and whose name suggests safety or protection from loss (e.g., fund names with terms like "protected" and "guaranteed"), to re-evaluate the name and to consider changing the name to eliminate the potential for investor misunderstanding.

Initiatives in the News

Review of Disclosure Topics and Scope. In a speech *regarding The Path Forward on Disclosure* before the National Association of Corporate Directors, SEC Chairwoman, Mary Jo White, questioned whether "investors need and are optimally served by the detailed and lengthy disclosures about all of the topics that companies currently provide." She warned that the increasing amount of disclosure could lead to "information overload", making it difficult for investors to identify relevant information. She signaled a possible reduction in the number of topics requiring disclosure and the scope and level of detail of required disclosure.

Among other things, Chair White identified questions that should be asked as the SEC continues to refine the disclosure system, including:

- Are there specific disclosure requirements that are simply not necessary for investors or that investors do not want?
- Are changes to our disclosure requirements the only way to improve the quality of disclosure?
- Is there information that appears more than once in a filing, and if so, is that so bad? Or is there a way to avoid repetition in a document?

Chair White stated that the SEC's *Review of Disclosure Requirements in Regulation S-K*, which was mandated under the Jumpstart Our Business

Startups Act, is a first step "for the dialogue and path forward toward a meaningful review of [SEC] disclosure requirements."

SEC Outlines Approach to Important Issues. In *Remarks at the Securities Enforcement Forum*, Chair White focused on the SEC's approach to key issues faced by fund counsel. Among the SEC enforcement initiatives she discussed were:

> ***Striving to be Everywhere****:* Chair White explained that this initiative involves the SEC "finding a way to have a presence that exceeds [its] physical footprint and to be felt and feared in more areas than market participants would normally expect that [SEC] resources would allow." She noted that the SEC is pursuing this goal through the use of tools such as: (i) boots on the ground in the form of the National Enforcement Program; (ii) use of whistleblower authority to give monetary rewards for valuable information about securities law violations; (iii) collaboration with partner agencies such as the U. S. Department of Justice and the Financial Industry Regulatory Authority; and (iv) use of technology to make it easier to spot fraud in the early stages.
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> ***Pursuing Gatekeepers and Operation Broken Gate****:* Chair White stated that the SEC Staff will focus on ensuring that fund boards and auditors appropriately perform their duties. She pushed back against concerns that the SEC's focus on gatekeepers may drive individuals away from those roles, stating that: "being a director . . . is not for the uninitiated or the faint of heart" and the SEC "will not be looking to charge a gatekeeper that did her job by asking the hard questions, demanding answers, looking for red flags and raising her hand." With respect to fund auditors, Chair White described the SEC's *Operation Broken Gate* as an initiative to identify auditors who neglect their duties and the required auditing standards. She stated that the "initiative probes the quality of audits and determines whether the auditors missed or ignored red flags; whether they have proper documentation; and, whether they followed their professional standards."

Chair White underscored the SEC's role as "tough cop" and rejected the notion that the SEC should play a "remedial role", stating that the SEC is "a law enforcement agency, and should be seen by investors to

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be "their cop."" She concluded her remarks by stating that the SEC "will be in more places than ever before" and that it wants to "create an environment where you think [the SEC is] everywhere – using collaborative efforts, whistleblowers and computer technology to expand [its] reach, focusing on gatekeepers to make them think twice about shirking responsibilities, and ensuring that even the small violations face consequences."

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