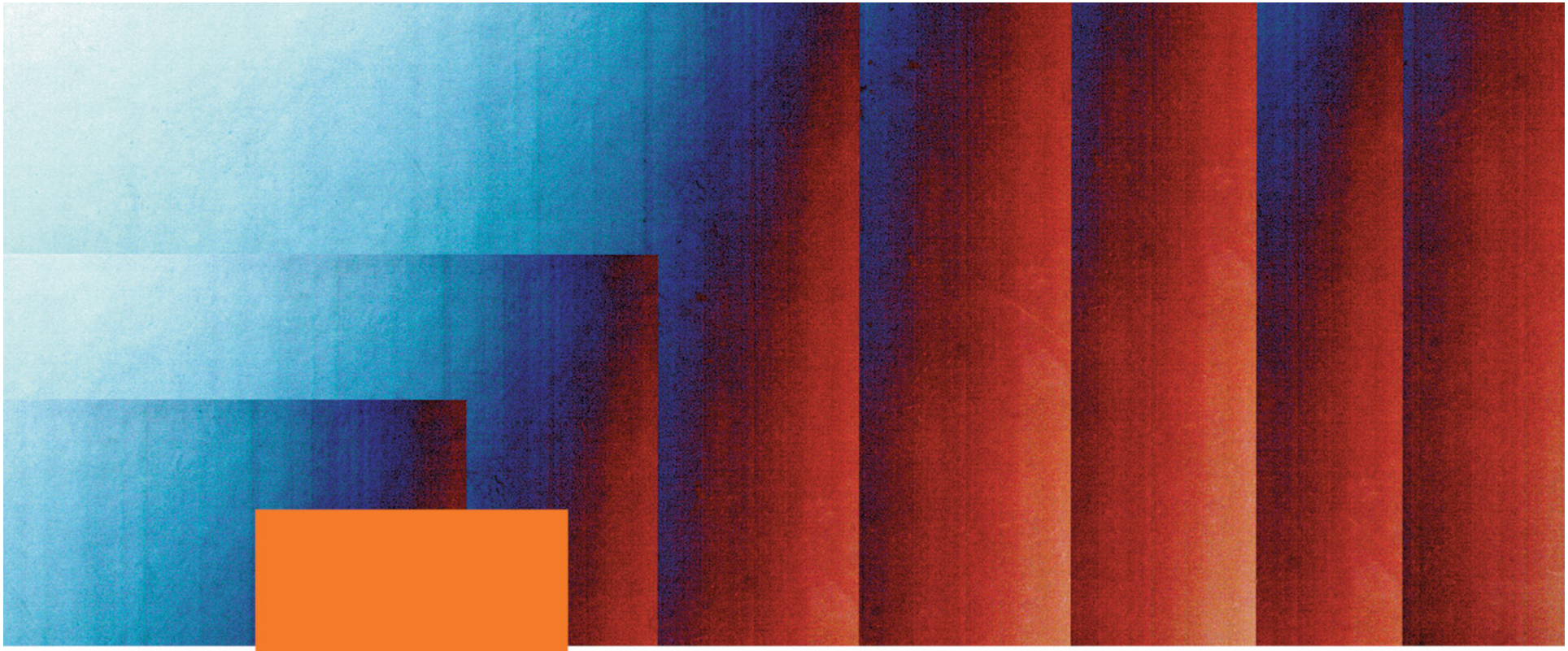

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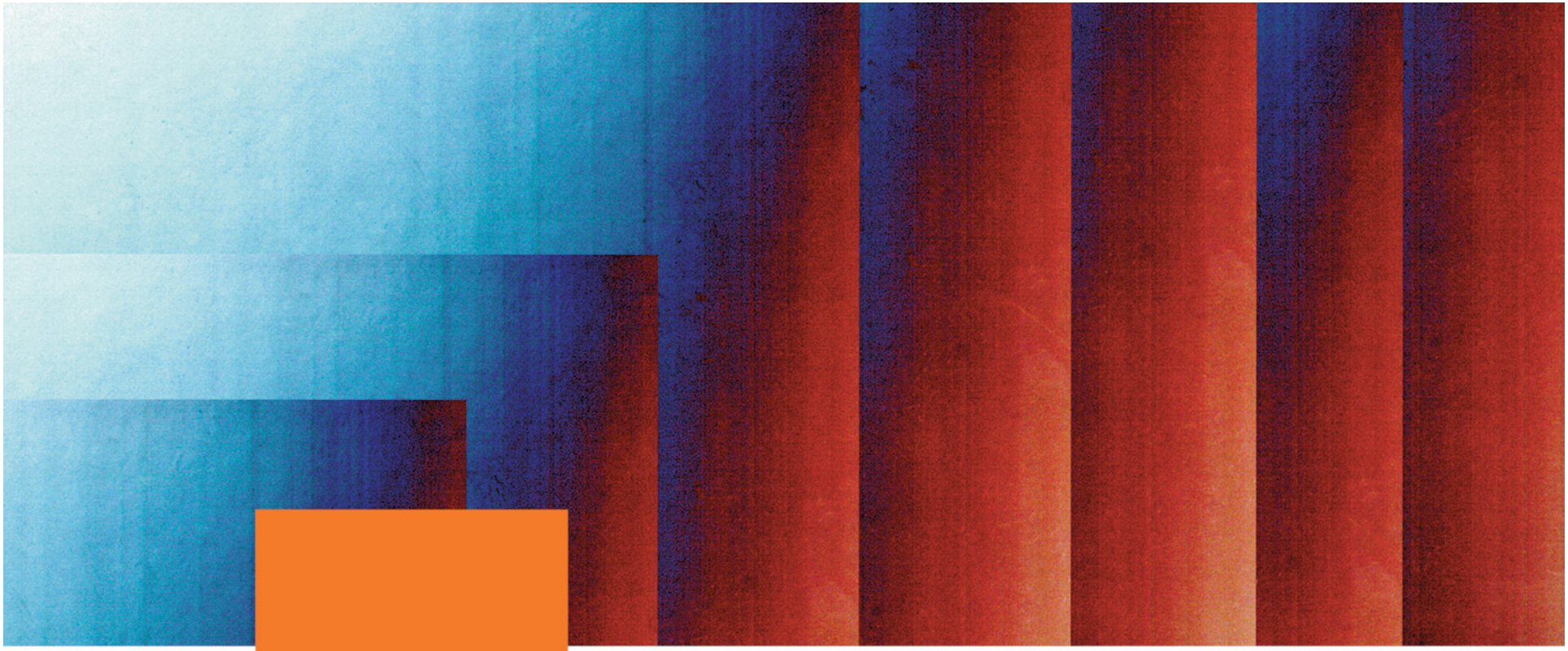

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Barbarians at the *Gartenberg* Gates: A Report from the Front

John W. Rotunno
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CI 9445434 v2

The Nature of the Right of Action Under Section 36(b) of the ICA

- Section 36(b) of the Investment Company Act of 1940 imposes upon an investment adviser a fiduciary duty "with respect to…[its]…receipt of compensation for services, or of payments of a material nature" made by a registered investment company
  - The same section confers upon shareholders a right to sue for a breach of this fiduciary duty, *i.e.,* for recovery of an "excessive fee"
  - A claim may be brought against only an investment adviser or affiliated person receiving such compensation (and therefore not a fund board)
  - Litigation must be brought in federal court (and usually is brought in the state where the relevant fund is organized, or where the adviser is located)

The Nature of the Right of Action Under Section 36(b) of the ICA *(continued)*

- Limitations on the Section 36(b) right of action
  - To have standing to bring suit, a shareholder must be a direct or beneficial owner of shares of the fund paying the fee at issue, *i.e.*, the shareholder must have an economic interest at stake
  - Recoverable damages are limited to the "actual damages resulting from the breach of fiduciary duty," not exceeding the amount of compensation or payments received
  - No damages are recoverable for any period more than one year before the filing of suit
  - No right to a trial by jury (although courts have considered empanelment of "advisory" juries)

Why Section 36(b) Claims Are Attractive to Plaintiffs' Lawyers

- Notwithstanding the historic inability of plaintiffs to satisfy the *Gartenberg* standard, and the endorsement of that standard by the Supreme Court in *Jones*, Section 36(b) cases continued to be filed. Why?
- The Willie Sutton factor
- Section 36(b) cases are high stakes litigation:
  - A fairly simple complaint can put tens or hundreds of millions of dollars at risk
  - The potential adverse impact of a determination that fees are "excessive" exerts enormous pressure on advisers to settle

Why Section 36(b) Claims Are Attractive to Plaintiffs' Lawyers *(continued)*

- Unique procedural attributes of Section 36(b) claims make them particularly attractive to plaintiffs' lawyers:
  - Right of action is in the nature of a derivative claim, but without the demand requirement and related procedural constraints applicable to derivative cases
  - No automatic stay of discovery during the pendency of a motion to dismiss
  - No requirement that settlements be subject to judicial approval; consequently, settlement terms usually are not disclosed publicly

Why Section 36(b) Claims Are Attractive to Plaintiffs' Lawyers *(continued)*

- The *Jones-Gartenberg* standard imposes an open-ended "all relevant circumstances" test, elements of which are not clearly defined
  - Malleability of the *Jones-Gartenberg* standard makes it difficult to dispose of unmeritorious claims early in a case on a motion to dismiss
  - Because fraud is not an element of a Section 36(b) claim, the demanding pleading requirements applicable to securities fraud claims have no application to "excessive fee" claims

Why Section 36(b) Claims Are Attractive to Plaintiffs' Lawyers *(continued)*

- Result is that plaintiffs often are able to proceed to extensive, harassing, and expensive discovery delving into cost accounting issues, profitability, fund performance, separate account relationships, "soft dollars" and board processes, among other things
  - Due to the importance under *Jones-Gartenberg* of the care and conscientiousness of a fund board in approving an investment management agreement, directors/trustees also are a prime target of discovery
  - Extended discovery affords plaintiffs' counsel the opportunity to record thousands of hours of time, providing additional leverage in settlement negotiations and serving as the basis for a fee award if the case should proceed to trial

Why Section 36(b) Claims Are Attractive to Plaintiffs' Lawyers *(continued)*

- Plaintiffs' lawyers have access to a well-known cadre of academic and economic experts prepared to serve as expert witnesses in deposition and at trial
  - Protective orders routinely entered in Section 36(b) cases may enable plaintiffs to shield the opinions and analytical approaches of experts
  - The presence of conflicting expert opinion testimony may afford plaintiffs a measure of protection against an adverse ruling on summary judgment in the late stages of a Section 36(b) case

The Current Landscape: Pending Section 36(b) Litigation

- This is a period of extraordinary activity
- Fifteen cases have been filed since August 2013
  - Two teams of lawyers are responsible for twelve of these fifteen filings
  - Plaintiffs' lawyers are jockeying for position
- Even after taking into account full or partial consolidations, twelve cases are now pending in the district courts—an abnormally high number

The Current Landscape: Pending Section 36(b) Litigation *(continued)*

- Cases now in the district courts:

Case Name	Filing Date	Venue	Plaintiff's Law Firm
Kasilag v. Hartford Investment Financial Services, LLC	2/25/11	D.N.J.	Zwerling, Schachter / Szaferman, Lakind
Sivolella v. AXA Equitable Life Ins. Co.	7/21/11	D.N.J.	Szaferman, Lakind
*Sanford v. AXA Equitable Funds Management Group, LLC**	1/15/13	D.N.J.	Szaferman, Lakind
*American Chemicals & Equipment, Inc. 401(k) Plan v. Principal Management Corp.***	8/28/13	S.D. Iowa	Schneider, Wallace
Cox v. ING Investments LLC	8/30/13	D. Del.	Robbins, Arroyo
McClure v. Russell Investment Management Co.	10/17/13	D. Mass.	Robbins, Arroyo / Zwerling, Schachter
Curd v. SEI Investments Management Corp.	12/11/13	E.D. Pa.	Robbins, Arroyo
Zehrer v. Harbor Capital Advisors, Inc., et al.	2/4/14	N.D. Ill.	Robbins Arroyo

* Consolidated with *Sivolella v. AXA Equitable Life Ins. Co.* on 1/22/13
** Filed in the Northern District of Alabama and transferred to the Southern District of Iowa on 1/24/14

The Current Landscape: Pending Section 36(b) Litigation *(continued)*

Case Name	Filing Date	Venue	Plaintiff's Law Firm
*Clancy v. BlackRock Investment Management, LLC, et al.**	2/21/14	D.N.J.	Zwerling, Schachter / Szaferman, Lakind
*Kasilag et al. v. Hartford Funds Management Co., LLC***	3/12/14	D.N.J.	Zwerling Schachter / Szaferman Lakind
*Foote v. BlackRock Advisors, LLC, et al.**	3/28/14	D.N.J.	Wollmuth Maher & Deutsch / Robbins Arroyo
*Fox v. BlackRock Advisors, LLC, et al.**	4/3/14	D.N.J.	Wollmuth Maher & Deutsch / Robbins Arroyo
Goodman v. J.P. Morgan Investment Management, Inc.	5/5/14	N.D. Ohio	Zwerling, Schachter
Lynn M. Kennis Trust U/A/ Dtd 10/02/02 v. First Eagle Investment Management, LLC	5/7/14	D. Del.	Zwerling, Schachter
*Davidson v. BlackRock Advisors, LLC, et al.**	5/22/14	D.N.J.	Brualdi Law Firm
*Hebda v. Davis Selected Advisers, L.P., et al.****	6/16/14	S.D.N.Y.	Zwerling, Schachter
*Chill v. Davis Selected Advisers, L.P., et al.****	8/22/14	S.D.N.Y.	Kirby McInerney LLP
Tumpowsky v. Harbor Capital Advisors, Inc., et al.	9/16/14	N.D. Ill.	Zwerling Schachter / Szaferman Lakind

* Consolidated in *In re BlackRock Mutual Funds Advisory Fee Litigation* on 5/6/14
** Consolidated with *Kasilag v. Hartford Investment Financial Services, LLC* for purposes of discovery on 4/3/14
*** Consolidated in *In re Davis New York Venture Fund Fee Litigation* on 9/19/14

The Current Landscape: Pending Section 36(b) Litigation *(continued)*

- What do these cases have in common?
- The pending cases do not demonstrate a strong correlation to fund size, management fee levels or fund performance
  - Some of the funds involved have less than $1 billion in AUM
  - Most have less than $10 billion in AUM
  - Fund performance generally is ignored in the complaints

The Current Landscape: Pending Section 36(b) Litigation *(continued)*

- The defendants in the pending cases do share one attribute in common: sub-advisory relationships
  - Cases fall into two categories: defendants either employ a sub-adviser, or serve as a sub-adviser to other funds employing a similar investment strategy
  - Premise of the complaints is that sub-advisers ostensibly perform all substantial services for a fraction of the advisory fees, assertedly rendering the advisory fees "excessive" in relation to the purportedly inconsequential additional services performed by advisers
  - Current focus on sub-advisory relationships can be traced to the decision in *Curran v. Principal Management Corp.* (S.D. Iowa 2010), holding that allegations that an adviser charged far more in fees than it paid its sub-adviser gave rise to a reasonable inference that advisory fees were excessive
  - The subsequent decision in *Kasilag v. Hartford* (D.N.J. 2012), in which the court accepted plaintiff's allegation that Hartford "pays sub-advisors to perform 'substantially all' of the investment management services that it provides . . . at a fraction of the fee it charges for such services," added fuel to the fire

The Current Landscape: Pending Section 36(b) Litigation *(continued)*

- Another attribute common to recently filed cases is the absence of fee schedule breakpoints, or the presence of breakpoints at levels that allegedly do not adequately share assumed economies of scale with investors
- Again drawing upon the *Hartford* decision, the complaints in recently filed cases circumvent *Jones'* admonitions as to the deference to be afforded to fund board judgment by alleging simply that the board in question could not have acted conscientiously in light of the other "facts" alleged in the complaints

The Current Landscape: Pending Section 36(b) Litigation *(continued)*

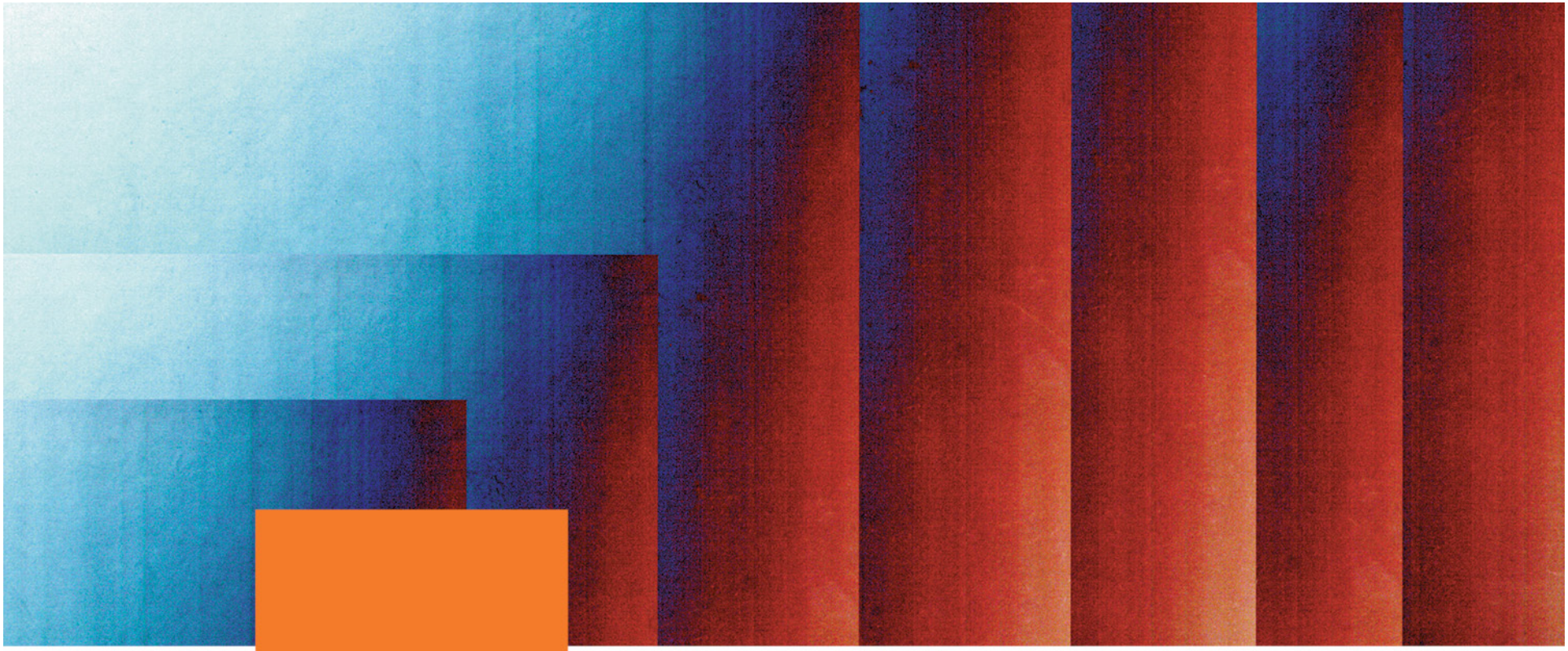
- A number of the recently filed "excessive fee" cases attempt to "piggyback" a Section 47(b) request for rescission on a Section 36(b) claim
  - Only a shareholder may bring a Section 36(b) claim
  - But Section 47(b) is different – it renders a contract violative of the ICA unenforceable by either party to the contract, suggesting that a shareholder request for rescission must be brought in a conventional derivative action, subject to the demand requirement

Recent Rulings

- *Curd v. SEI Investments Management Corp.* (E.D. Pa.)
  - On August 28, 2014, the court granted defendant's motion to dismiss on the ground that the complaint was untimely: plaintiff failed to allege that defendant charged excessive fees at any time during the one year period prior to the filing of the complaint
- *Am. Chemicals & Equipment, Inc. 401(k) Retirement Plan v. Principal Management Corporation, et al.* (S.D. Iowa)
  - On September 10, 2014, the court granted in part and denied in part defendants' motion to dismiss
    - Court found that in Count I, plaintiff had sufficiently pleaded a Section 36(b) claim under the "liberal pleading standard" of Fed. R. Civ. P. 8
    - Court dismissed Count II, which purported to plead a claim for "excess profits from economies of scale," on the ground that "breach of fiduciary duty based only on economies of scale is not an independent cause of action"

What Does The Future Hold?

- The pace of filings strongly suggests that the plaintiffs' bar is not done
- Principal constraints on the number of additional filings are the ability of plaintiffs' firms to identify shareholders willing to serve as plaintiffs and the capacity of plaintiffs' firms to conduct major litigations concurrently in multiple venues
- Capacity issues and "investment risk" may result in greater cooperation among plaintiffs' firms
- The first substantive rulings in pending cases likely will influence the course of others, and of future filings



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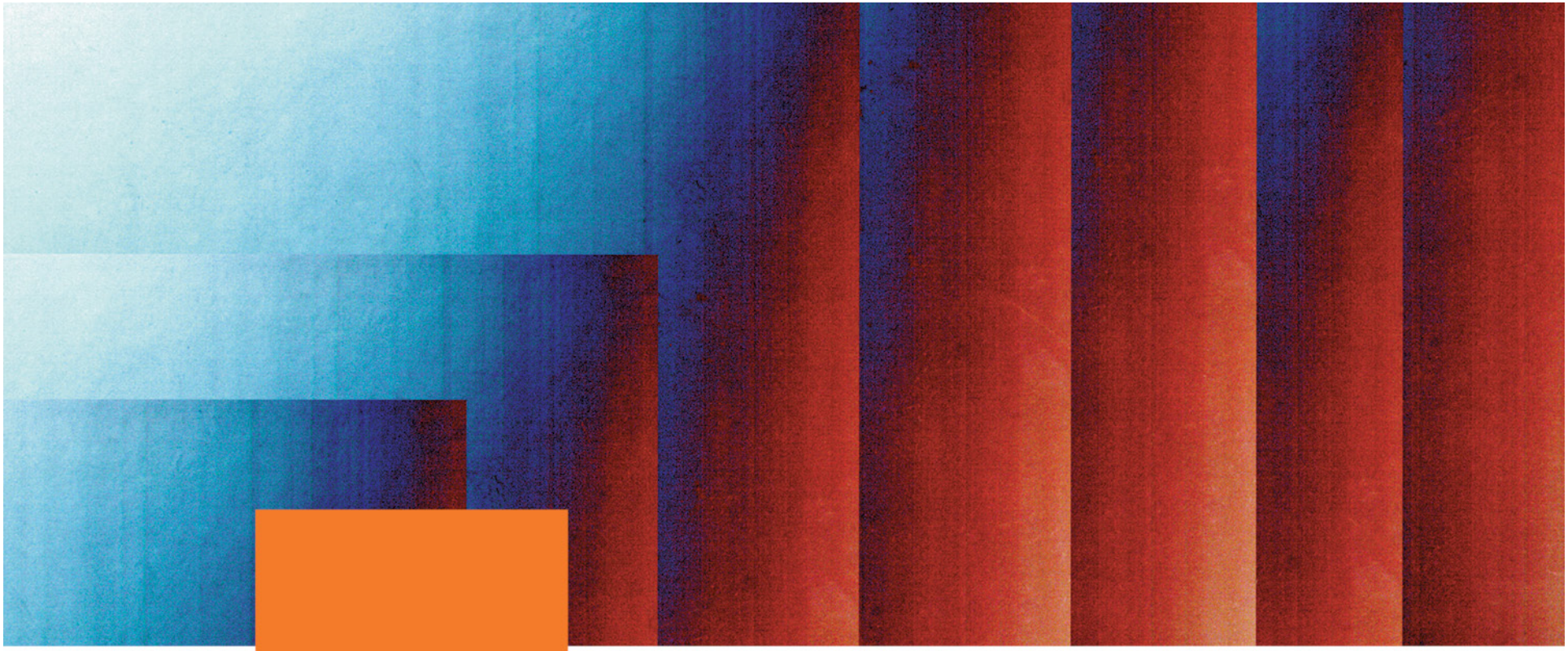

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Commodity/Hedge Fund Developments

Carolyn A. Jayne
Ruth E. Delaney

CI 9445667 v1

Recent CFTC Developments

Third-Party Recordkeeping

- Harmonization rules removed the requirement that records be maintained at the CPO's main business office but limited third-party recordkeepers to specified entities (fund administrators, custodians, distributors, banks and broker-dealers)
- In an exemptive letter dated September 8, 2014, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) recently discarded these categories and permit CPOs to use any third-party as a recordkeeper, so long as:
  - the CPO's timely access to such records is maintained, such that the CPO will satisfy the obligations of the applicable CFTC regulations, particularly with respect to providing such records for inspection; and
  - the CPO timely and completely files the statements required pursuant to CFTC Regulation 4.23(c).

Remaining Recordkeeping Issues:

- CTAs are **not** permitted to delegate recordkeeping duties to any third parties
- Obsolete electronic recordkeeping requirements
- Unnecessary requirement to utilize a technical consultant if only electronic storage media is used for some records
- Potential relief ahead?
  - AIMA/IAA/MFA petitioned for relief this summer
  - In an exemptive letter dated September 8, 2014, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) noted that parties have expressed their concern that certain portions of CFTC Regulation 1.31 may no longer be in keeping with modern data management practices, and stated that the Division intends to perform a review of the requirements of CFTC Regulation 1.31 and their applicability to the current technological environment.

CPO Delegation

- CFTC staff takes the view that the CPO of
  - a corporate fund, is its board members
  - a limited partnership or limited liability company fund is its general partner or managing member/manager
- This position does not apply to registered investment companies
- Under CFTC Staff Letter No. 14-69 (May 12, 2014), delegating CPOs must get individualized no-action relief to delegate the CPO function to the designated CPO (usually the investment manager)
- Staff Letter creates a procedure to get no-action relief

Staff Letter – Conditions

- CPO function and investment management function are delegated to the designated CPO pursuant to a legally binding document
- Delegating CPO does not participate in solicitation or portfolio management activities for the pool (even if registered as an AP of the designated CPO)
- Designated CPO is registered as a CPO
- There must be a business purpose for delegation – not just to avoid registration
- Books and records of the delegating CPO with respect to the commodity pool are maintained by the designated CPO in accordance with CFTC Regulation 1.31

Staff Letter – Conditions *(continued)*

- If delegating and designated CPOs are not natural persons, must be “affiliates”
- Joint and several liability only for delegating CPOs and affiliated natural person delegating CPOs (management directors), but not for independent directors

Staff Letters – Issues

- Management board members cannot be involved in solicitation or portfolio management
- Potential solutions:
  - Reconstitute the Board
  - Apply for no-action relief outside of the Staff Letter
  - Register the natural person directors as CPOs individually
- Delegation of investment management function
- Keeping books and records of the delegating CPO in accordance with CFTC Regulation 1.31
  - Staff indicated recently in a separate letter (CFTC Staff Letter No. 14-114 (Sept. 8, 2014)) that they intend to perform a review of the requirements of Commission Regulation 1.31 and their applicability to the current technological environment

NFA Bylaw 1101

- "Self-policing" mechanism that requires that registered CPOs and CTAs transact business only with persons who are:
  - NFA members (FCMs, introducing brokers ("IBs"), CPOs, CTAs, swap dealers ("SDs"), major swap participants ("MSPs")) or
  - Exempt from registration or not required to be registered
- Impacts fund managers primarily in four ways:
  - Affects their due diligence process with their own investors and/or clients
  - Affects their due diligence process with underlying managers (if a fund of funds)
  - Affects their FCM, IB, and SD relationships
  - Affects their use of solicitors
- CPOs of registered funds do not need to conduct NFA Bylaw 1101 diligence on fund investors

Other Outstanding Issues:

- Funds-of-funds guidance
- CTAs to RICs
- Affiliate Transactions
- NFA promotional material rules and RICs
- Bylaw 1101 guidance to RIC CPOs


Recent Hedge Fund
Developments


JOBS Act

Securities Act of 1933 – General Solicitation

- Regulation D
  - Prohibition on general solicitation and general advertising for offerings conducted under Rule 506 of Regulation D
- "General solicitation" can encompass range of activities

Securities Act of 1933 – General Solicitation

(continued)

JOBS Act Changes:

- Regulation D
  - Permits general solicitation and general advertising (collectively "general solicitation") in securities offerings under new Rule 506(c) of Regulation D provided that all purchasers are "accredited investors" as defined in Rule 501(a) of Regulation D
    - Purchaser in fact comes within one or more enumerated categories of Rule 501(a), or
    - Issuer reasonably believes purchaser comes within an enumerated category
  - Issuer must "take reasonable steps" to verify accredited status of purchasers as a condition of safe harbor exemption in Rule 506(c) in which general solicitation is used (objective, principles-based approach)
  - Verification requirement is in addition to requirement that purchasers be accredited, unless issuer has actual knowledge that purchaser meets requirements

Securities Act of 1933 – General Solicitation
(continued)

- JOBS Act Changes: *(continued)*
  - All terms and conditions of Rule 501 and Rules 502(a) and (d) of Regulation D must be satisfied
    - Qualification and numerical thresholds for accredited investors; rules regarding integration of offerings; and limitation on resales
  - Preserves issuer option to conduct private offering without general solicitation under existing rule, renamed Rule 506(b) – no verification requirement

Securities Act of 1933 – General Solicitation
(continued)

- JOBS Act Changes: *(continued)*
  - Amends Form D to provide Rule 506(b) and Rule 506(c) boxes
  - General solicitation still not defined
  - Availability of CFTC Regulations 4.7(b) and 4.13(a)(13)
    - CFTC Staff Letter 14-116 (Sept. 9, 2014) harmonizes Regulations 4.7(b) and 4.13(a)(3) with Rule 506(c) of Regulation D
    - Relief is not self-executing; notice filing required


Bad Actor

Securities Act of 1933 – Bad Actor

- Issuer is disqualified from relying on Rule 506 exemption if any of its "covered persons":
  - Has an undisclosed "disqualifying event" that occurred prior to 23 September 2013; or
  - Is subject to a "disqualifying event" that occurs on or after 23 September 2013
- Unless:
  - The issuer did not know and could not reasonably know of the "disqualifying event"
  - That is, if the issuer has exercised reasonable care to discover any "disqualifying event" by "covered persons," then the exemption is not lost
- If an issuer cannot rely on Rule 506:
  - For Rule 506(b) offerings, Section 4(a)(2) is potentially available, but
    - Securities are no longer "covered securities" under Section 18(b) of the 1933 Act
    - State law requirements
  - For Rule 506(c) offerings, Section 4(a)(2) is not available
  - If no exemption is available, then possible rescission

Securities Act of 1933 – Bad Actor

(continued)

- Disqualifying Events include:
  - Certain criminal convictions
  - Certain court injunctions and restraining orders
  - Final orders of certain state and federal regulators
  - Certain SEC disciplinary orders
  - Certain SEC cease-and-desist orders
  - SEC stop orders and orders suspending the Regulation A exemption
  - Suspension or expulsion from membership in a self-regulatory organization ("SRO"), such as FINRA, or from association with an SRO member
  - U.S. Postal Service false representation orders
- Many disqualifying events include a look-back period (for example, a court injunction that was issued within the last five years or a regulatory order that was issued within the last ten years)
- The look-back period is measured from the date of the disqualifying event—in the example, the issuance of the injunction or regulatory order—and not the date of the underlying conduct that led to the disqualifying event

Securities Act of 1933 – Bad Actor

(continued)

Covered Persons:

- Issuer and any predecessor of the issuer
- Affiliated issuers
  - Under Rule 506(d), an "affiliated issuer" of the issuer is an affiliate (as defined in Rule 501(b) of Regulation D) of the issuer that is issuing securities in the same offering, including offerings subject to integration pursuant to Rule 502(a) of Regulation D

Securities Act of 1933 – Bad Actor

(continued)

Covered Persons: *(continued)*

- Affiliated issuer – timing of the event
  - Events that occurred prior to the affiliation will not be a "disqualifying event" if the affiliated entity is not:
    - In control of the issuer
    - Under common control of the issuer by a third party that was in control of the issuer at the time of the event
- Directors, general partners, and managing members of the issuer
- Executive officers of the issuer
  - President
  - Vice President in charge of a principal business unit, division, or function
  - Officer who performs a policy-making function or any other person who performs a similar policy-making function

Securities Act of 1933 – Bad Actor

(continued)

Covered Persons: *(continued)*

- Officers of the issuer who participate in the offering
  - President, vice-president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person who routinely performs a corresponding function
  - More than transitory or incidental involvement
  - Could include due diligence activities, preparing disclosure documents and communications with the issuer, prospective investors, and other offering participants

Securities Act of 1933 – Bad Actor

(continued)

Covered Persons: *(continued)*

- 20% beneficial owners — defined as beneficial owners of 20% or more of an issuer's outstanding voting equity securities, calculated on the basis of voting power
  - Analysis would apply to all investors in any fund sold pursuant to Regulation D, including U.S. and non-U.S. persons
  - What is a voting security?
    - Includes the ability to control or significantly influence the management or policies of the issuer through the exercise of voting rights, such as the right to elect or remove directors or the right to approve significant transactions
    - Would not include rights limited solely to approvals or changes to the rights or preferences of a class
  - Who is a beneficial owner?
    - Interpreted the same way as under Rule 13d-3 under the Securities Exchange Act of 1934 ("Exchange Act")
    - Any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, under Exchange Act Rule 13d-3, has or shares, or is deemed to have or share: (1) voting power, which includes the power to vote, or to direct the voting of, such security; and/or (2) investment power, which includes the power to dispose, or to direct the disposition of, such security

Securities Act of 1933 – Bad Actor

(continued)

Covered Persons: *(continued)*

- 20% beneficial owners *(continued)*
  - Because of "look-through," issuers cannot assume that there is no 20% beneficial owner simply because no single investor holds 20% or more of the issuer's outstanding voting securities.
  - Issuers should require each investor to disclose the existence of voting and investment power relationships.
- If any existing investor refuses to provide beneficial ownership and/or Bad Actor representations, consider consulting legal counsel to evaluate Rule 506(d) implications.
- Obtain annual renewal of Bad Actor representations by negative consent.

Securities Act of 1933 – Bad Actor

(continued)

Covered Persons: *(continued)*

- Promoters connected with the issuer in any capacity at the time of such sale
- Placement agents – any person that has been or will be paid (directly or indirectly) remuneration for soliciting purchasers and their principals
  - Directors, general partners, managing members, executive officers, and other officers participating in the offering
- Investment manager and principals of a fund
  - Investment advisers and other investment managers of the fund
  - Directors, general partners, managing members, executive officers, and other officers participating in the offering and their respective general partners or managing members


Recent Enforcement Actions
and Compliance Priorities

Substantive Compliance Requirements

- Fiduciary duty (applies to registered and unregistered advisers)
- Anti-fraud
- Advisers Act Rule 206(4)-8
- Compliance policies and procedures
- Chief compliance officer ("CCO")
- Code of ethics

Antifraud Provisions

- Advisers Act Rule 206(4)-8
  - Applies to:
    - Untrue statements of material fact and material omissions
    - Otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative
  - No need to show scienter (intent to deceive, manipulate, or defraud)
  - Applies to pooled investment vehicles: hedge funds, venture capital funds, private equity funds, and registered funds with respect to both investors and prospective investors

Advisers Act Rule 206(4)-7

- Written policies and procedures reasonably designed to prevent violations by the adviser and its supervised persons of the Advisers Act and the rules thereunder
- "Supervised person"
  - Any partner, officer, director, employee of the adviser
  - Or other person who provides investment advice on behalf of the adviser AND the adviser supervises and controls that person
- CCO
  - Competent and knowledgeable regarding the Advisers Act
  - Position of sufficient seniority
  - Authority to develop and enforce the compliance program

Advisers Act Rule 206(4)-7(b)

- Annual Review
  - Must review, at least annually, the **adequacy** of the policies and procedures established pursuant to this rule and the **effectiveness** of their implementation

Investment Adviser Compliance Program

- Compliance Policies and Procedures typically address the following (as applicable to the adviser's business):
  - Portfolio management processes
  - Trading activities – including execution, allocation, and soft dollars
  - Trading of the adviser and its supervised persons
  - Trade error policies
  - Private placement procedures
  - Accuracy of disclosures
  - Advertising – marketing advisory services/solicitation arrangements
  - Social media
  - Electronic communication policies
  - Red flags
  - Calculation of and deduction of advisory fees

Investment Adviser Compliance Program
(continued)

- Compliance Policies and Procedures: *(continued)*
  - Safeguarding of client assets
  - Recordkeeping
  - Valuation process
  - Customer privacy and information security
  - Business continuity plans
  - Conflicts of interest – dealing with affiliates, gifts, and entertainment
  - Pay-to-play
  - OFAC/anti-money laundering
  - Proxy voting procedures
  - Foreign Corrupt Practices Act/gifts and entertainment
  - Outside employment
  - Annual review

Code of Ethics

- Code of Ethics Requirements
  - Rule 204A-1 requires a written code of ethics to include, at a minimum:
    - A standard of business conduct
    - Compliance with applicable federal securities laws – e.g., insider trading
    - Reporting violations of code of ethics and any actions taken against violators
    - Providing supervised persons with a copy of code of ethics
    - Address personal securities transactions
      - Quarterly reporting of personal securities transactions and initial and annual holding reports of "access persons"
      - Pre-approval of certain transactions
  - Recordkeeping for the code of ethics
- Applies to "access persons"

Where Do Enforcement Action Referrals Come From?

- Creation of SEC's Market Abuse Unit
- Referrals from SEC examinations
- Anonymous tips
- Whistleblowers and disgruntled current/former employees:
  - Dodd-Frank bounties – 10-30% of what SEC collects
  - Pequot/Samberg case was built on information obtained from a defendant's ex-wife who received a bounty of $1 million
- SRO surveillance and consolidated data
- Media
- Competitors
- Short sellers/issuers

Themes in Recent Examinations and Enforcement Actions

- Marketing practices and materials
- Conflicts of Interest
- Valuation
- Custody
- Insider Trading

Marketing Practices and Materials

- Misrepresentations or omissions
- Past Performance (hypothetical and back-tested performance, the use and disclosure of composite performance figures)
- Performance recordkeeping requirements
- Compliance oversight of marketing

Conflicts of Interest

- Advisers putting their own interests ahead of their clients in contravention of their fiduciary duty and existing laws, rules, and regulations
- Identify potential conflicts and mitigate them through policies and procedures
- The SEC Examination Priorities 2014:
  - Compensation arrangements for the adviser, with a particular focus on undisclosed compensation arrangements and their effect on recommendations made to clients
  - The allocation of investment opportunities
  - Controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts
  - Risk controls and disclosure, particularly for illiquid investments and leveraged investment products and strategies
  - Higher risk products or strategies targeted to retail (and especially retired or elderly) investors

Valuation

- Failure to have adequate policies addressing valuation
- Failure to follow established policies
- Can result in higher fees to advisers
- Can result in misrepresentation of fund performance

Custody

- The Custody Rule (Rule 206(4)-2) regulates the custody practices of advisers
- The Custody Rule defines custody as “holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them”
- An adviser may have custody through the activities of a related person
- Authority to obtain possession of client funds or securities is custody, even if the adviser does not exercise that authority
- March 2013 “Risk Alert” highlighted four categories of deficiencies:
  - failure by an adviser to recognize that it has “custody” as defined under the custody rule
  - failures to comply with the rule’s “surprise exam” requirement
  - failures to comply with the “qualified custodian” requirements
  - failures to comply with the audit approach for pooled investment vehicles

Insider Trading (Under § 10(B) and Rule 10b-5)

- The **purchase or sale** of a security **on the basis of material nonpublic information** about that security or the issuer **in breach of a duty** of trust or confidence that is owed to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information, **made with scienter**.

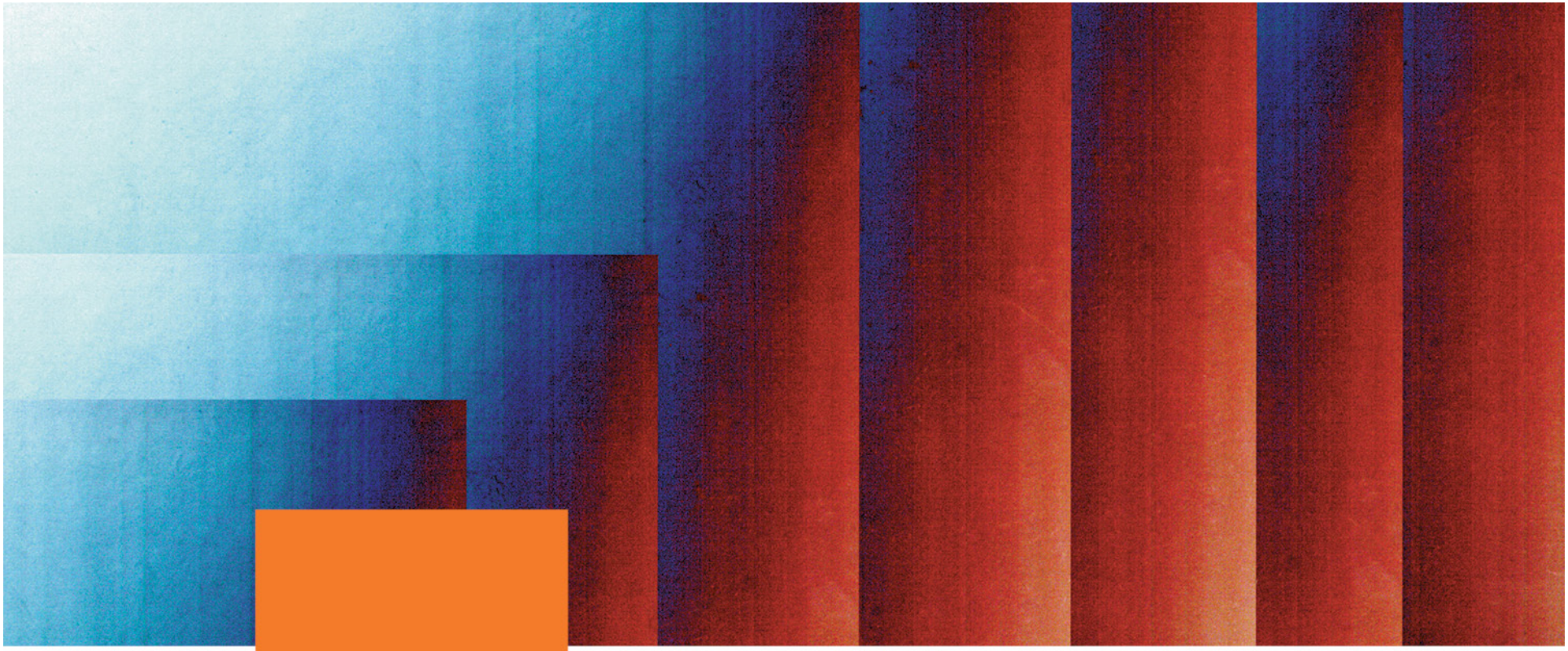
Keys to Understanding Insider Trading

- "On the basis of" – trading while **aware** of inside information (intent not necessary)
- "Material" – substantial likelihood that disclosure would alter the **"total mix"** of information
- "Nonpublic" – Includes information provided with the understanding that it is confidential, or that is embargoed
- "In Breach of a Duty of Trust or Confidence"
  - Duty owed to shareholders **or to person providing information**
  - Includes agreement to maintain confidentiality and history or practice of sharing confidences
- Low bar for a regulator to launch an investigation

Potential Future Examination and Enforcement Focuses

- (More) Insider Trading
- Bad Actor
- General Solicitations Under Rule 506(c)
- Cybersecurity


Questions and Discussion



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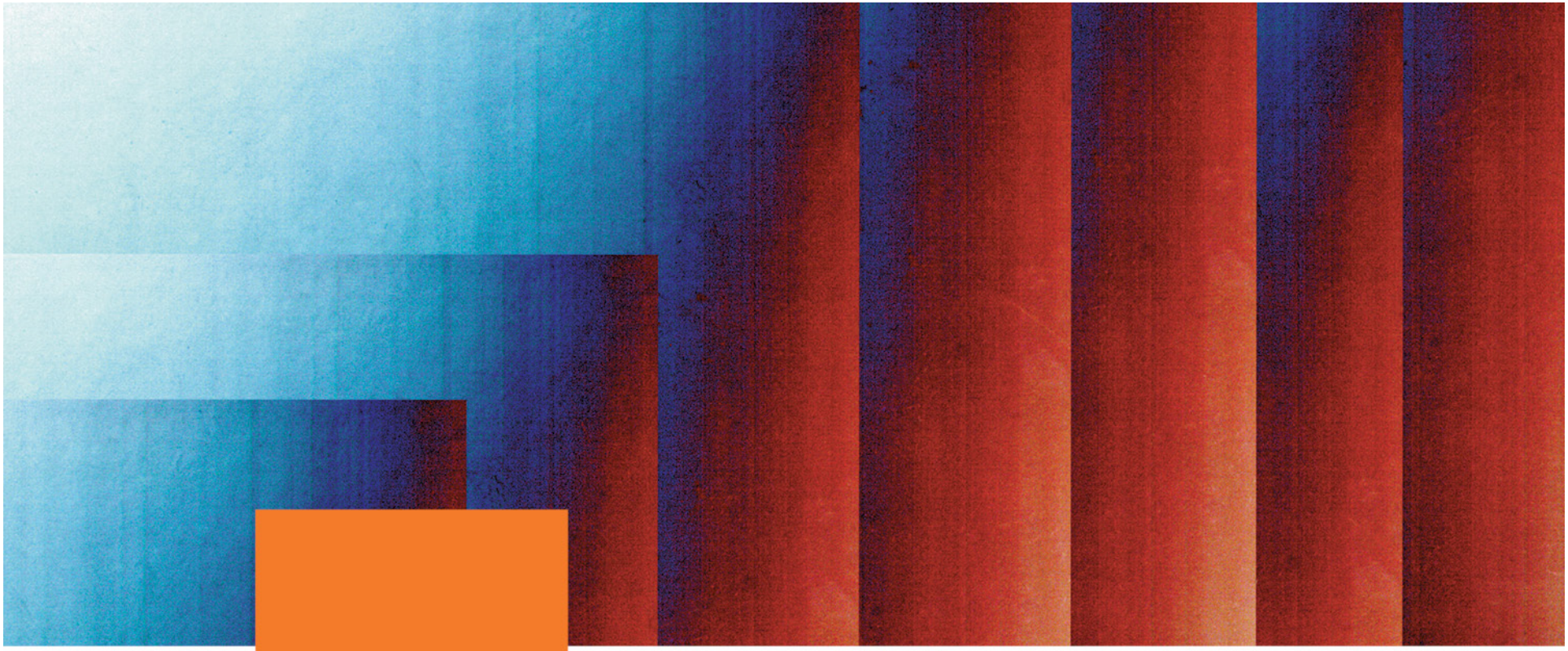

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2014 INVESTMENT MANAGEMENT CONFERENCE

Investment Adviser Issues and Update

Alan Goldberg
Mark Greer

CI 9445745 v1

Updates

Legislative Update

- Death of the Self-Regulatory Organization Proposal
  - Old Proposal: Investment Adviser Oversight Act
    - Would have required investment advisers registered either with the SEC or one or more state securities authorities to become members of a self-regulatory organization ("SRO") funded by membership fees
  - New Proposal: Investment Adviser Examination Improvement Act
    - Would permit the SEC to collect user fees from advisers in order to provide additional funds for OCIE

Regulatory Update

- Shift in SEC Examination Priority
  - 2014 Examination Priority
    - Focus was to be on investment advisers who had never previously been examined, including new private fund adviser
  - 2015 Proposed Examination Priority
    - Entities with a history of disciplinary violations can expect a "laser-like focus" during firm examinations


Cybersecurity

Cybersecurity

- Cybersecurity is a growing threat to the financial industry as a whole, including the investment management industry
  - In 2013, the Identity Theft Resource Center reported 614 data breaches involving 91.9 million compromised records, a 30% increase from 2012
  - A global study from the Verizon RISK Team reported that in 2012, more than 47,000 reported security incidents were reported, of which 621 involved confirmed data disclosures that compromised at least 44 million records
    - Financial organizations were involved in 37% of these 2012 data breaches
- Many investment advisory firms show tremendous interest in addressing cybersecurity:
  - 2014 Compliance Testing Survey results: 75% of respondents identified cybersecurity as a key compliance matter
    - This number is up from 14% in the 2013 Survey

Cybersecurity – Adviser Response

- Despite interest, investment advisory firms are still grappling with how to address online security
  - 2014 IAA Survey shows that a majority still lack cybersecurity controls, policies and procedures:
    - 66% of respondents do not have a standalone cybersecurity policy
    - 80% of respondents have not adopted a formally documented cybersecurity breach incident response plan
    - 42% of respondents do not have a formal policy to conduct due diligence on how key vendors manage cybersecurity
    - 66% of respondents do not have a formal intrusion detection program
    - 80% of respondents do not protect remote access with a second form of authentication
    - 77% of respondents do not have a cybersecurity insurance policy

Cybersecurity – Adviser Response *(continued)*

- Despite interest, investment advisory firms are still grappling with how to address online security
  - 2014 IAA Survey shows that a majority still lack concrete defenses against internal threats:
    - Only 22% of respondents require employees' mobile devices to be encrypted
    - Only 23% of respondents have software on employees' mobile devices to allow the firm to monitor company content on the devices
    - Only 12% of respondents do not permit employees to use their own devices for business purposes
    - Only 19% of respondents restrict the type of devices that employees use
    - 29% of respondents place no restrictions on employees' use of personal devices
    - Only 25% of respondents perform annual cybersecurity awareness training for their employees

Cybersecurity – SEC Views

- Chairman White in March stated:
  - "Cyber threats are of extraordinary and long-term seriousness. They are first on the Division of Intelligence's list of global threats, even surpassing terrorism. And Jim Comey, director of the FBI, has testified that resources devoted to cyber-based threats are expected 'to eclipse' resources devoted to terrorism."
- SEC stated in early 2014 that it would scrutinize investment advisers' policies to protect against third party vendor cybersecurity breaches
  - This indicates that the liability for losses from cybersecurity breaches could remain with the investment adviser
  - Among items that SEC staff may review during an inspection of an investment adviser are:
    - Policies and procedures designed to address computer security
    - Identity theft (red flags)
    - Privacy policies
    - Business continuity plans

Cybersecurity – Regulations

- Current Regulations Impacting Cybersecurity
  - Privacy Regulations
    - SEC enforcement actions often are due to violations of Regulation S-P, which requires SEC-registered investment advisers to adopt written policies and procedures that:
      - address administrative, technical, and physical safeguards for the protection of customer records and information; and
      - must be reasonably designed to:
        - » ensure the security and confidentiality of customer records;
        - » protect against any anticipated threats or hazards to the security or integrity of customer records and information; and
        - » protect against any unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

Cybersecurity – Regulations *(continued)*

- Current Regulations Impacting Cybersecurity
  - Business Continuity
    - The SEC has not adopted a specific regulation requiring a business continuity plan ("BCP").
    - However, it expects an investment adviser's compliance policies and procedures to include a BCP to protect clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services.
    - In 2012, the SEC reviewed various BCPs and issued guidance regarding best practices, which encouraged firms to:
      - Anticipate widespread disruptions in office space, transportation, electricity, and telecommunications
      - Review electricity sources of back-up facilities
      - Incorporate time-sensitive regulatory requirements
      - Contract with multiple telecommunications providers
      - Conduct tests of the BCP at least annually

Cybersecurity – Regulations *(continued)*

- Current Regulations Impacting Cybersecurity
  - Identity Theft Red Flags Regulations (Regulation S-ID)
    - Regulation S-ID requires financial institutions (including investment advisers) that offer one or more covered accounts to develop and maintain programs that detect, prevent and mitigate identity theft.
  - State Data Security Breach/Notification Laws
    - States may issue regulations that provide greater protections than the federal standards under the Gramm-Leach-Bliley Act.
    - More than 45 states have enacted legislation requiring companies to notify individuals in a timely fashion of data security breaches involving personal information.
      - State notification laws generally require that such notification be as soon as possible without unreasonable delay.
      - A minority of states have adopted data security laws that require companies to protect state residents' personal information from data breaches and identity theft.

Cybersecurity – Compliance Matters

- Suggested actions in developing cybersecurity defenses:
  - Review your data privacy and computer security policies and procedures.
    - Consider whether actual practices match the policies and procedures, determining whether the policy or the practice need be amended.
    - Consider if the policies are up to date with the latest technology.
  - Reconsider potential threats to your computer system and the defenses you have in place to protect against those threats.
    - Ensure that such defenses (e.g., firewalls, anti-virus software) are routinely updated.
    - Ensure you have someone responsible for monitoring computer system defenses.
  - Review third-party service providers' privacy and security policies.
    - Review the contracts with those third-party providers to ensure that privacy and computer security issues are addressed.
  - Review and reassess your data breach policy.

Cybersecurity – Compliance Matters *(continued)*

- Suggested actions in developing cybersecurity defenses: *(continued)*
  - Review and reassess your insurance policies.
    - Confirm whether your insurance coverage includes losses and related costs associated with a data breach or loss of client information.
  - Review and reassess your record/data retention policies and destroy unneeded data (if permitted by books and records requirements of applicable statutes and regulations).
  - Review and reassess your employee education/training programs.
    - Consider implementing recurring training sessions for existing employees alongside training for new hires.
  - Review and reassess your company's BCPs (at least annually).
  - Test and retest computer networks and systems.

Social Media

Recap: Social Media And Its Uses

From 2012 SEC National Exam Risk Alert:

"Social media is an umbrella term that encompasses various activities that integrate technology, social interaction and content creation. Social media may use many technologies, including, but not limited to, blogs, microblogs, wikis, photos and video sharing, podcasts, social networking and virtual worlds."

Recap: Social Media And Its Uses

(continued)

- Marketing
- Expanding brand awareness
- Promoting a firm's website
- Building customer loyalty
- Connecting with clients and potential clients
- Educating clients and potential clients
- Servicing clients
- Customer and market research

Recap: Social Media Regulation

Federal Securities Laws and SEC/FINRA Rules Applicable to Investment Advisers, Broker-Dealers and Private Funds

- **Anti-Fraud Provisions:**
  Section 206 of the Investment Advisers Act ("IAA"), Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934 ("Exchange Act"), Section 34(b) of the Investment Company Act ("ICA"), FINRA Rule 2210, CFTC Regulation 180.1, and NFA Compliance Rule 2-29
- **Advertising Rules:**
  Rule 206(4)-1 under the IAA, FINRA Rule 2210, Securities Act Rules 482 and 156, Rule 34b-1 under the ICA, CFTC Regulation 4.41, and NFA Compliance Rule 2-29
- **Compliance/Supervision Rules:**
  Rule 206(4)-7 under the IAA and Rule 38a-1 under the ICA, FINRA Rule 3130, CFTC Regulation 23.602, and NFA Compliance Rule 2-29
- **Recordkeeping Rules:**
  Rule 204-2 under the IAA, Exchange Act Rules 17a-3 and 17a-4, FINRA Rules 2210 and 4511, Section 31 and Rule 31a-2 under the ICA, CFTC Regulations 1.31, 4.7(b), 4.12, 4.23, and 4.33, and NFA Compliance Rule 2-29

Recap: Social Media Regulation

(continued)

General: Rule 206(4)-1

- Advertising is any written communication addressed to more than one person or any notice or announcement in any publication or by radio or television which offers any analysis, report or publication regarding securities; any graph, chart, formula or other device for making securities decisions; or any other investment advisory services regarding securities
  - May include emails, websites or social media posts
- Investment advisers are prohibited from using advertisements that contain "untrue statements of material fact" or are "otherwise misleading"
- Investment advisers are generally prohibited from publishing, distributing or circulating advertisements with:
  - Testimonials
  - Past specific recommendations
  - Graphs, charts and formulas
  - Free reports and services
  - Untrue statements of material fact

Recap: Testimonial Rule

General: Rule 206(4)-1(a)(1)

- It is unlawful for an adviser, directly or indirectly, to publish, circulate, or distribute any advertisement that refers, directly or indirectly, to any testimonial of any kind concerning the adviser or concerning any advice, analysis, report or other service rendered by the adviser.
  - The SEC staff has interpreted the term "testimonial" to include a "statement of a client's experience with, or endorsement of, an investment adviser."
  - Traditionally, testimonials have been prohibited because they may "give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients."
    - Previously, the SEC staff has stated that an investment adviser's publication of an article from an unbiased third party regarding the adviser's performance is not a testimonial, unless it includes a statement of a client's experience with, or endorsement of, the adviser.
    - The SEC staff also has stated that an adviser's advertisement that includes a partial list of the adviser's clients that does no more than identify certain clients of the adviser is not a testimonial.

Sec Guidance: Testimonials

IM Guidance Update 2014-04

- In March, the SEC issued new guidance regarding the publication of third-party commentary from independent social media sites:
  - While publication of commentary that is an explicit or implicit statement of a client's experience with or endorsement of the adviser on the adviser's *own* social media site is prohibited as an improper testimonial, the adviser's publication of the same commentary — but linked from a social media site — on the adviser's own social media site would not violate the rule.
- Under the guidance, an investment adviser may publish commentary from an independent social media site on its own social media site that includes statements of a client's experience with or endorsement of the adviser.
- The rule permits hyperlinking or other electronic publication, not hard-copy advertisements.
- The SEC states that several criteria must be met before an adviser can publish third party social media commentary.

Sec Guidance: Testimonials *(continued)*

- Criteria to permit adviser to publish third party social media commentary:
  - The adviser must not have the ability to affect which public commentary is included or how it is presented on the third party site
  - The commentators' ability to include public commentary must not be restricted
  - The third party site must allow for the viewing of all public commentary and update of new commentary on a real-time basis
  - The independent site must provide content independent of the adviser
  - The adviser must not highlight or give prominence to a subset of testimonials.
  - The adviser must publish all of the unedited comments appearing on the independent site regarding the adviser
    - Note: Independent may have editorial policies that edit or remove public commentary violative of the site's own published content guidelines. An investment adviser's publication of public commentary that has been edited according to such an editorial policy would not call into question the independence of the independent social media site according to the SEC staff.
- Additional Information
  - If an adviser drafts or submits commentary to the independent site, is allowed to suppress publication of, edit, or prioritize the commentary, the Testimonial Rule would be implicated because the adviser would have a "material connection" with the independent site
  - Examples of an adviser's "material connection" include:
    - Having an adviser's supervised persons submit testimonials about the adviser on a Site and using the testimonials in adviser advertisements; and
    - Compensating a client or prospective client (including with discounts or offers of free services) to post commentary on a Site and then publishing the commentary in an adviser advertisement.

Sec Guidance: Other Social Media Use

- <u>Other Permissible Activities</u>
  - The SEC provided guidance on other permissible activities an adviser may engage in related to independent third party sites:
    - An adviser is not prohibited from advertising on an independent site from which it has published commentary as long as it is readily apparent to a reader that the adviser's advertisement is separate from the site's commentary.
    - An adviser may reference in non-social media advertisements the fact that commentary regarding the adviser may be found on an independent social media site (including use of the site's logo in that advertisement).
      - But testimonials from that site may not be published in a newspaper ad.
    - An adviser may list contacts or friends on its own site.
      - However, only if those contacts are not grouped or listed so as to be identified as current or past clients of the adviser, or
      - To otherwise create an inference that the contacts or friends have experienced favorable results from the adviser's services.


Alternative Investments

OCIE Alert: Alternative Investments

- Earlier this year, OCIE staff reviewed adviser due diligence and related investment advisory processes regarding selecting alternative investments.
- OCIE published warning indicators for advisers in conducting due diligence, when an adviser recommends an alternative investment or relies on a manager to select such investments.
  - Such indicators led advisers to conduct additional due diligence analysis, to request that the manager make appropriate changes, or to reject the manager or the alternative investment.
  - **Investment Indicators**
    - Managers unwilling to provide requisite transparency regarding portfolio holdings
    - Performance returns that did not correlate with known factors associated with the manager's strategy
    - Lack of clear research and investment processes
    - Lack of segregation of duties between investment activities and business unit controllers
  - **Risk Management Indicators**
    - Alternative investment portfolio holdings showing high concentration in a single investment position
    - Personnel that appeared insufficiently knowledgeable about a sophisticated strategy they used
    - Investments, as described by the manager, that appeared to be overly complex or opaque
  - **Operational Indicators**
    - Use of an auditor that may not have significant experience auditing alternative investments
    - Concerns identified in audited financial statements such as qualified opinions
    - Insufficient operational infrastructure
    - Lack of a robust fair valuation process

OCIE Alert: Alternative Investments *(continued)*

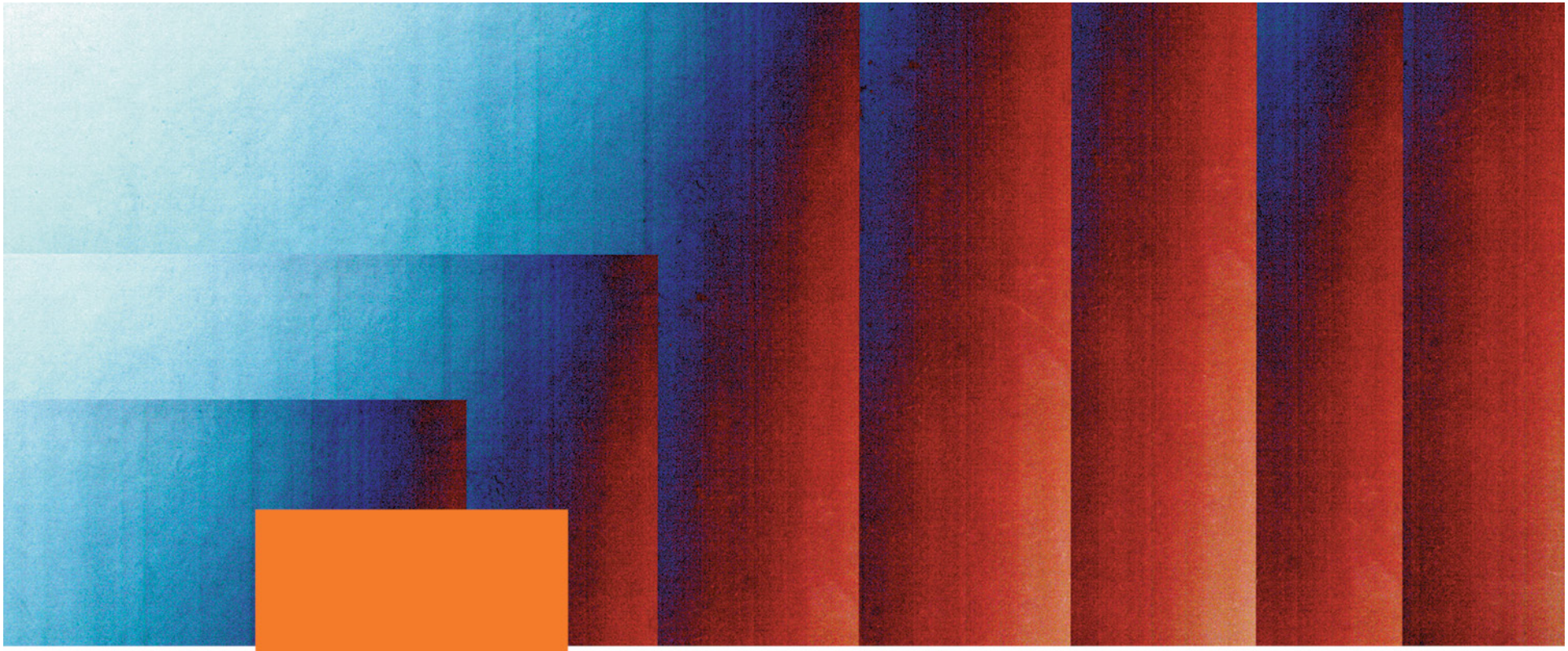
- OCIE also listed certain areas where it observed control weaknesses:
  - Annual Review. Some advisers did not include in their annual review a review of their due diligence policies and procedures for recommending alternative investments.
  - Disclosures Made to Clients. Advisers' disclosures sometimes deviated from actual practices, and that advisers with material deficiencies in their disclosures failed to review disclosures for consistency with fiduciary principles or to describe notable exceptions to the typical due diligence process.
  - Marketing Claims. Some advisers' marketing materials contained information about the scope and depth of the due diligence process that was misleading.
  - Oversight of Service Providers. In some instances, advisers delegated certain responsibilities to third-party service providers and did not conduct periodic reviews of their service providers.
- OCIE also noted issues with certain advisers' code of ethics:
  - Advisers invested in or recommended a limited offering to their clients, while they also permitted access persons to acquire an interest in that same limited offering but with preferential investment terms.
  - Advisers did not maintain a record of any decision, and the reason supporting the decision, to approve the acquisition of securities by access persons.


Dual Registration Matters

Dually Registered: Adviser And B-D

- On March 7, Norm Champ, Director of the SEC's Division of Investment Management, discussed the Staff's concern regarding dually registered B-Ds and investment advisers.
  - He noted the staff's concern regarding "the migration of individual investors from brokerage accounts to advisory accounts."
    - He noted that the SEC will continue to monitor this trend, focusing on evaluating the impact of this migration on investors.
  - OCIE's 2014 National Exam Program included examining "the significant risks to investors presented by dual registrants' conflicts, including risks from migration of accounts for the purpose of generating fees with little benefit to clients."
  - Champ's advice: Dual registrants "should consider whether the recommendation to move from a brokerage account to an advisory account is consistent with fiduciary obligations and whether the move is in the client's best interests."


Q & A



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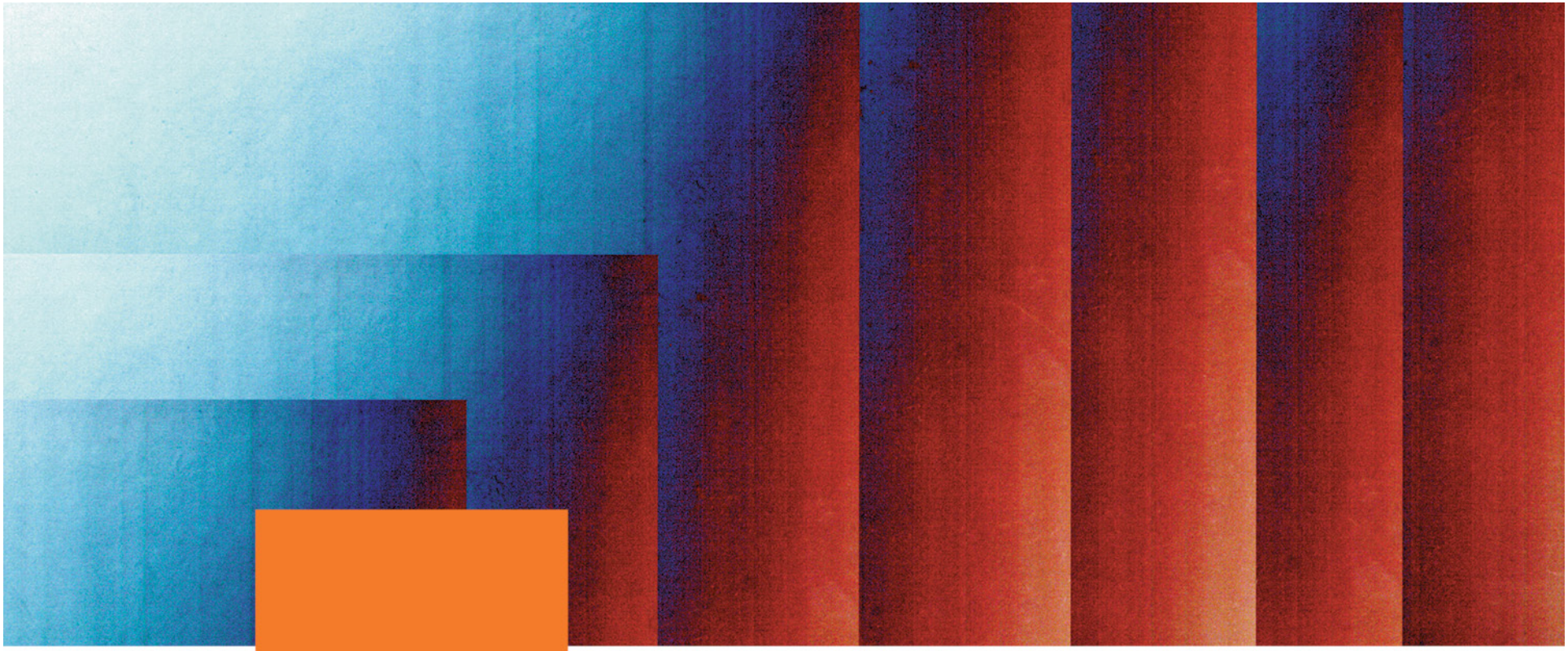

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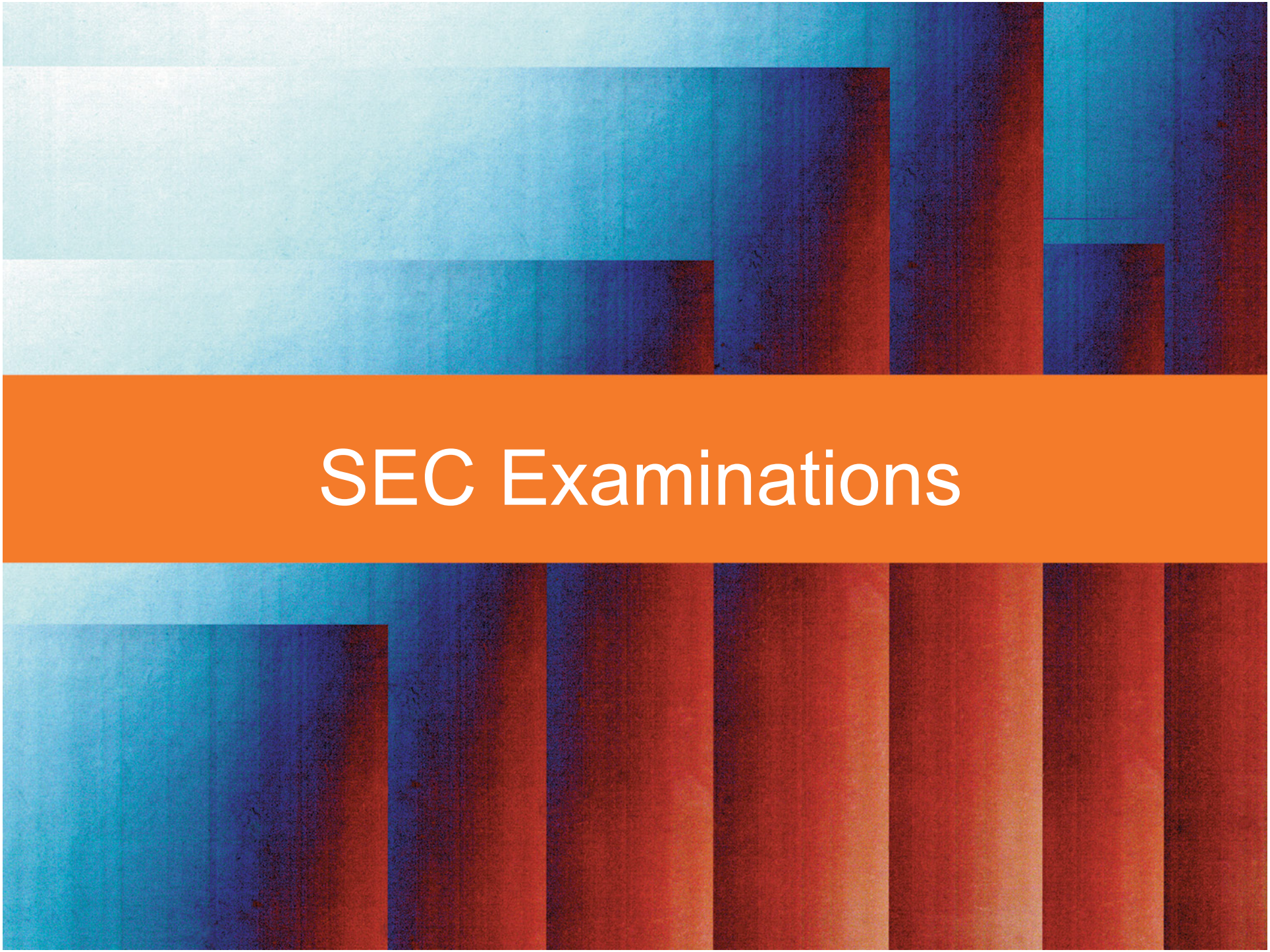
2014 INVESTMENT MANAGEMENT CONFERENCE

SEC Hot Topics and Exam Trends

Alan Goldberg
Anita Gut

CI 9445530 v1


SEC Examinations

Wrap Fee Sweep

- One of the SEC's 2014 examination priorities
- Information Request List includes the following:
  - Copies of disclosures made to clients
  - Internal analysis of account activity
  - Additional transaction fees
  - Number of accounts in each program, dates of inception, identity of participating investment managers or sub-advisers, total value of assets in program and custody arrangements
  - Fees charged by the adviser and sub-adviser
  - Any client complaints or threatened, pending or settled litigation regarding wrap accounts
  - Inactive accounts
  - Whether adviser has conducted any best execution reviews of the wrap trading desk
- Advisers should take a fresh look at their policies and procedures.

2015 Examination Priorities

- In July, an SEC official offered a sneak peek into the SEC's 2015 examination priorities.
- SEC likely to focus on high-cost mutual funds.
- OCIE is concerned with proper disclosure of fees and customer suitability related to L-shares, which are held in variable annuities and have higher upfront costs and a shorter surrender period (often three to four years instead of the typical seven-year period for annuities) than other share classes.
- SEC is expected to release formal list of examination priorities in January 2015.


Legislative Update

Investment Adviser Examination Improvement Act

- Bill sponsored by CA representative Maxine Waters would permit the SEC to collect user fees from advisers in order to provide additional funds for OCIE.
- These user fees would be dedicated to adding staff to OCIE so it is able to provide effective oversight of the advisory profession.
- SEC's Head of the Office of Investor Advocate recently spoke about the bill, noting the low rate of investment adviser examinations (only 9% of RIAs were examined in 2013). He emphasized the urgent need to expand the number of examinations.
  - "Investors have a right to expect that their registered investment advisers will be examined more than once every 11 years."

Investment Adviser Examination Improvement Act *(continued)*

- Number of RIAs has grown 40% over the last decade and their AUMs have more than doubled.
- OCIE has only grown by 10%.
- Various advisory groups, including the Investment Adviser Association, support user fee legislation.
- Another option to improve the OCIE examination rate is third party audits, but the main criticisms of this option are that it will be more expensive than user fees and that there will be a conflict of interest when the auditor is selected and paid for by the firm being audited.

Recent SEC Guidance

SEC Guidance On Proxy Voting

- On June 30, the SEC's Division of Investment Management and Division of Corporation Finance issued guidance addressing proxy voting responsibilities of advisers as well as the availability of certain exemptions from Exchange Act proxy rules for proxy advisory firms.
  - Describes steps that an adviser could take to seek to demonstrate that proxy votes are cast in accordance with clients' best interests and the adviser's proxy voting procedures.
  - Confirms that the Proxy Voting Rule does not require that advisers and clients agree that the adviser will vote all proxies, and that the two parties have flexibility in determining the scope of the adviser's proxy voting obligations.

SEC Guidance On Proxy Voting

(continued)

- Lists considerations that an adviser may wish to take into account if it retains proxy voting responsibilities. The adviser should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues.
- States that an adviser that retains a third party must adopt policies and procedures "reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients."
- Details an adviser's duties concerning the accuracy of the information upon which a proxy advisory firm bases its recommendations – that the firm has the capacity and competency to analyze proxy issues.


No-Action Letters

No-Action Relief For Advisory Fee Rebate Arrangement

- On August 18, the Division of Investment Management issued no-action relief permitting an investment manager to provide rebates on advisory fees for clients with negative performing portfolios.
- The investment manager employs a sub-adviser as an independent investment adviser responsible for asset allocation and investment recommendations.
- The investment manager requested no-action relief to permit offering a 100% quarterly advisory fee rebate (of fees collected in advance) for clients invested in a model portfolio that experienced negative performance for two consecutive quarters in a 12 month period.

No-Action Relief For Advisory Fee Rebate Arrangement *(continued)*

- The investment manager sought assurances that its proposed advisory fee rebate would not violate §205(a)(1) of the Advisers Act, which prohibits compensation "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." This provision prohibits performance fees and is intended to prevent advisers from speculating, overtrading, or taking undue risks with client funds.
- SEC agreed that the proposed rebate for negative performance would not violate §205(a)(1), but the key fact seemed to be that the accounts are being managed in accordance with advice from a *sub-adviser*, thereby mitigating the incentive for the *adviser* to take undue risks with clients' accounts.

No-Action Relief For Immaterial Modification Of Sub-Adviser Fee Arrangement

- On July 28, the Division of Investment Management issued no-action relief to an investment adviser of a fund seeking to amend the terms of a sub-advisory agreement without obtaining shareholder approval.
- Section 15(a) of the 1940 Act provides, in part, that it shall be "unlawful for any person to serve or act as an investment adviser of a registered investment company, except pursuant to a written contract, which … has been approved by a vote of a majority of the outstanding voting securities…"
- The proposed amendments to the sub-advisory agreement would change the sub-adviser's compensation from a fee based on net AUM to a fee based on just the gross AUM.

No-Action Relief For Immaterial Modification Of Sub-Adviser Fee Arrangement *(continued)*

- This proposed fee arrangement resulted in a slight increase in the sub-adviser's fees and a slight decrease in the adviser's earnings, but no overall increase in fees.
- The fund's board (including a majority of independent directors) had approved the changes.
- The SEC said that it would not recommend enforcement action based on the following representations made by the adviser:
  - the overall advisory fees charged to the fund would not be increased;
  - the quality and nature of services would be unchanged;
  - the agreement would be amended otherwise in accordance with §15(a); and
  - the fund would provide prospective and existing shareholders with notice of the change.


SEC Enforcement Actions

Wells Fargo Advisors Admits Failing To Maintain Adequate Insider Trading Controls

- On September 22, the SEC charged Wells Fargo Advisors with:
  - failing to maintain adequate controls to prevent one of its employees from insider trading based on a customer's non-public information,
  - unreasonably delaying its production of documents during the SEC's investigation, and
  - for providing an altered internal document related to a compliance review of the broker's trading.
- These charges are the first ones ever brought against a broker-dealer for allegedly failing to protect a customer's material non-public information.

Wells Fargo Advisors Admits Failing To Maintain Adequate Insider Trading Controls *(continued)*

- The SEC's allegations were that:
  - a Wells Fargo broker learned confidentially from his customer that Burger King was being acquired by a NY-based private equity firm. He then traded on that non-public information. He was charged with insider trading and is subject to an asset freeze;
  - multiple groups responsible for compliance or supervision within Wells Fargo received indications that the broker was misusing customer information, but they lacked coordination or any assigned responsibilities, and they failed to act on these indications; and
  - during the investigation, Wells Fargo unreasonably delayed producing documents and even provided an altered compliance document to the SEC.

Wells Fargo Advisors Admits Failing To Maintain Adequate Insider Trading Controls *(continued)*

- Federal law requires broker-dealers and investment advisers to establish, maintain, and enforce policies and procedures to prevent misuse of material non-public information. It also requires broker-dealers and investment advisers to promptly produce accurate books and records to the SEC.
- Wells Fargo has agreed to pay a $5 million penalty to settle the charges and to retain an independent consultant to review its policies and procedures.

Adviser Duped Customers Into Wrap Arrangement

- In August 2014, a sole owner/principal of a registered investment adviser was found by a federal jury to have misled his former brokerage clients into a wrap fee arrangement to induce them to hire his new investment advisory firm.
- The representative had quit his brokerage firm in 2005 to begin his own advisory venture and sent a letter to his former brokerage customers making false and materially misleading representations.
- This verdict, coupled with the recent SEC wrap program examination initiative, underscores the SEC's focus on wrap fee programs.

CCO Fails To Prevent, Detect Or Respond To Insider Trading

- On June 11, the SEC instituted a settled administrative proceeding charging the former President and CCO of an investment adviser with failing to implement adequate insider trading policies and procedures, failing to investigate when possible insider trading was brought to his attention and failing to ensure the effectiveness of the company's procedures.
- The SEC alleged:
  - CCO failed to require employees to submit annual holdings reports.
  - CCO failed to collect the Vice President's required personal financial holdings reports, despite knowing the Vice President was a beneficial owner of an investment club account.

CCO Fails To Prevent, Detect Or Respond To Insider Trading

(continued)

- Even after the adviser amended its policies and procedures to comply with an SEC deficiency letter, the CCO failed to comply with amended procedures.
- Despite knowing that the Vice President's father was on the board of a publicly-traded company, CCO failed to maintain required restricted and watch lists of that or any other security.
- The Vice President eventually did engage in insider trading, but the CCO never followed policies and procedures to investigate the suspicious trading, despite being aware of an SEC investigation.
- CCO never annually assessed the adequacy or effectiveness of policies and procedures, and never addressed the adviser's unique insider trading risk.

- CCO was censured, barred and fined.

RIA Charged With Failing To Disclose Conflicts Of Interest To Clients

- Between 2007 and 2010, the adviser, a former president of an investment advisory firm, failed to disclose to his clients material conflicts of interest in connection with multiple client investments.
- He was charged with intentionally and recklessly:
  - failing to tell clients that he obtained more than $2 million for a loan from a private fund in which those clients were invested;
  - recommending that clients approve a transaction involving another private fund without disclosing that he expected to receive compensation as a result of the transaction;
  - buying stock in client accounts without advising clients of the personal benefit he stood to obtain from doing so; and
  - soliciting clients to participate in a large private equity investment without disclosing conflicts arising from his relationships with the other parties of the transactions.

RIA Charged With Failing To Disclose Conflicts Of Interest To Clients *(continued)*

- SEC alleged that he willfully violated §206(1) of the Advisers Act, which prohibits an investment adviser from employing any device, scheme, or artifice to defraud a client, and §206(2) of the Advisers Act, which prohibits an adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.
- The Adviser was ordered to cease and desist from violating §206(1) and (2), was barred from the industry with the right to reapply after five years, and was fined $100,000.

Improper Calculation of Advisory Fees for Retail Clients

- Transamerica Financial Advisors was charged with failing to consistently provide breakpoint discounts on fees charged retail clients in certain of its asset allocation programs.
- Programs provided fee breakpoint discounts based on AUM in a client's accounts and permitted the aggregation of certain related accounts for purposes of applying the breakpoints.
- Significant to the charges was that the adviser had allegedly failed to adequately correct its policies and procedures after an earlier SEC examination had uncovered the problems.
- SEC found that the Adviser did not have sufficient policies and procedures to assure that the related accounts were properly aggregated.


Whistleblower Program Update

Whistleblower Program

- Program, which began in 2012, rewards high-quality, original information that results in an enforcement action with sanctions exceeding $1 million. Whistleblower awards can range from 10% to 30% of the money collected in a case. The SEC must protect the confidentiality of whistleblowers and cannot disclose any information that might reveal a whistleblower's identity.
  - On July 31, the SEC awarded more than $400,000 for a whistleblower who reported a fraud after the advisory firm failed to address the issue internally. The whistleblower provided the SEC with specific, timely and credible information that allowed for a more rapid investigation than would have otherwise been possible.
  - On August 29, the SEC awarded more than $300,000 to an employee who performed audit and compliance functions and reported wrongdoing after the company failed to take action when the employee reported certain issues internally. This is the first award for a whistleblower with an audit or compliance function at a company.

SEC Announces Largest Ever Whistleblower Award

- On September 22, the SEC announced an award of more than $30 million to a whistleblower who produced key information that would have been difficult to detect and that led to an enforcement action.
- This is the largest award made by the SEC's whistleblower program to date and the fourth award to a whistleblower living in a foreign country.
  - Office of the Whistleblower: "This award of more than $30 million shows the international breadth of our whistleblower program as we effectively utilize valuable tips from anyone, anywhere to bring wrongdoers to justice. Whistleblowers from all over the world should feel similarly incentivized to come forward with credible information about potential violations of the U.S. securities laws."
- The previous high for an SEC whistleblower award was $14 million, which was announced in October 2013.

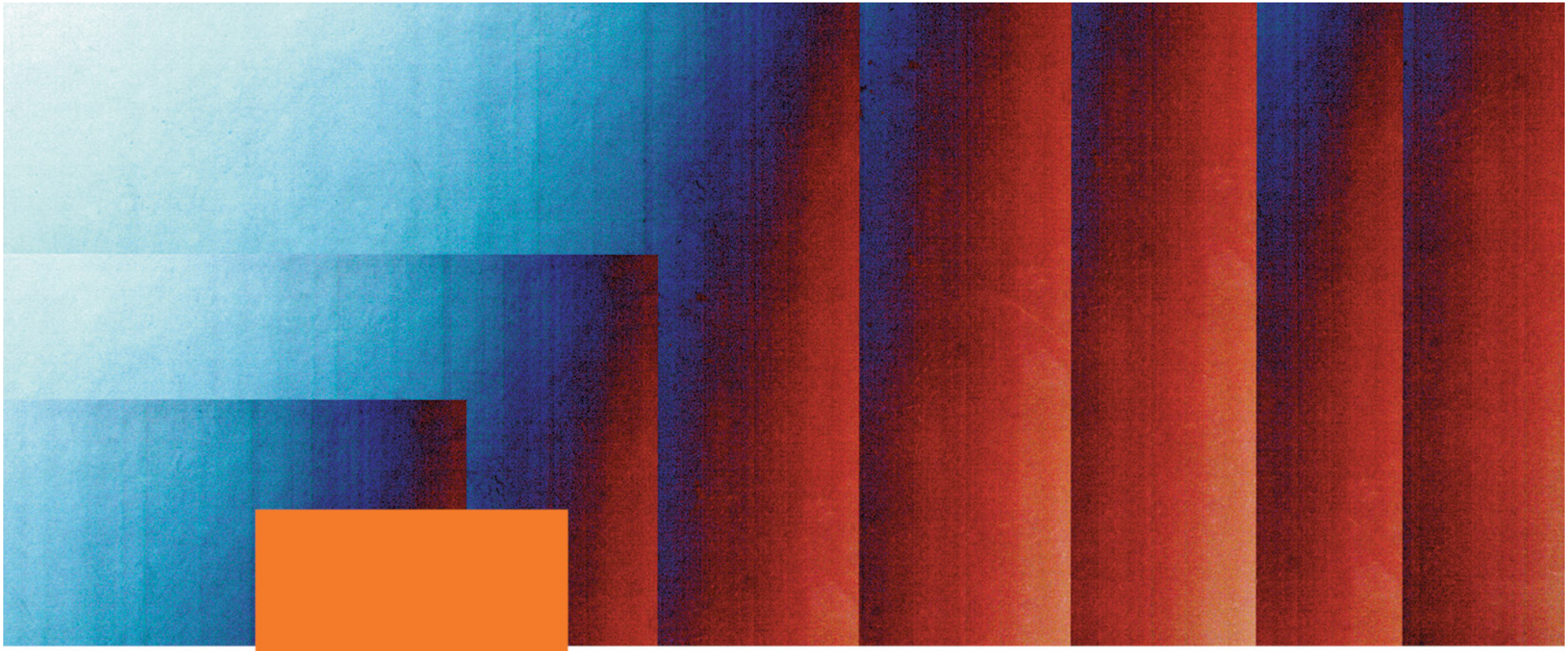
First Whistleblower Retaliation Action

- In June, the SEC settled an administrative proceeding with Paradigm Capital Management, a NY-based hedge fund advisory firm, and its owner. The order alleged that Paradigm engaged in prohibited principal transactions and then retaliated against an employee who had reported the activity to the SEC.
- Retaliatory actions, which led to the employee's resignation, included:
  - removal of employee from trading desk and directing him to work offsite.
  - when the employee returned to the office, Paradigm refused to permit him to return to his duties at the trading desk.
  - provided employee with more than 1,900 pages of trading data to review to identify specific conduct that could substantiate his claims.
  - tasked the employee with enhancing Paradigm's trading policies and procedures.

First Whistleblower Retaliation Action *(continued)*

- The SEC anti-retaliation protections prohibit an employer from discriminating against an employee who provides information to the SEC relating to possible violations of securities laws, and applies regardless of whether a whistleblower qualifies for an award under the whistleblower program.
- Paradigm and its owner agreed to pay penalties in excess of $2 million and agreed to retain an independent compliance consultant.
- This is the first time the SEC has used its authority to bring enforcement actions arising from retaliation against whistleblowers.


Any Questions?



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