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INVESTMENT MANAGEMENT REPORT

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IMPROPER SOLICITATION CASES ILLUSTRATE BROAD SCOPE OF "BROKER" ACTIVITIES

Investment advisers, particularly smaller advisory shops and private fund managers, should take note of the SEC's March 2013 settlements with a private equity firm (the "PE Settlements")[1] regarding federal broker registration requirements. The PE Settlements serve as an important reminder of the costs of ignoring the registration rules for brokers and other players in the asset management industry. The cases also suggest investment advisers should revisit their policies and procedures to confirm they reflect the breadth of activities encompassed by the SEC's definition of brokerage.

On their face, the requirements of the federal securities laws regarding brokers seem fairly simple.

- **Section 3(a)(4)(A)** of the Securities Exchange Act of 1934 (the "Exchange Act") **defines a "broker" as any person engaged in the business of effecting transactions in securities for the account of others**.
- **Section 15(a)** of the Exchange Act provides, in substance, that with some limited exceptions,[2] **it is unlawful for any person to effect any transactions in, or induce or attempt to induce the purchase or sale of, any securities unless the person is registered as a broker or dealer under the Exchange Act or associated with a registered broker or dealer**.

However, the recent PE Settlements combined with federal court decisions and SEC no-action and other guidance create a complex body of broker/dealer law that casts a wide net around investment advisers and their employees and affiliates.

You Might Be a Broker If...

The primary issue in the PE Settlements was the behavior of a "finder," or sales consultant, hired by a private equity firm. The finder was not registered with the SEC and/or FINRA as a broker, and since the firm was not registered as a broker/dealer, and had in fact only recently registered as an investment adviser, the finder was not affiliated with any broker/dealer registered with the SEC/FINRA. His role was ostensibly limited to "contacting potential

[1] Securities Exchange Act Release Nos. 69090 and 69091 (Mar. 8, 2013); Investment Company Act Release No. 30417 (Mar. 8, 2013); and Investment Advisers Act Release No. 3563 (Mar. 8, 2013).

[2] *See, e.g.*, Rule 3a4-1 under the Exchange Act, which provides a safe harbor from registration for employees, directors, officers and other persons similarly associated with a company issuing securities, and Rule 15a-6 under the Exchange Act, which provides an exemption from registration certain non-U.S. resident persons engaged in business as a broker/dealer entirely outside the United States.

investors to arrange meetings." But according to the SEC, the finder went much further, actually **soliciting investments and engaging in "the business of effecting transactions in securities"** by:

- **providing offering documents to potential investors** – the finder in the PE Settlements repeatedly distributed private placement memoranda, subscription documents and due diligence materials regarding the private funds managed by the private equity firm that compensated him;
- **urging existing or potential investors to consider adjusting portfolio allocations** to accommodate new investments;
- **offering individual analysis of the strategy and performance track record of specific investments;**
- **providing confidential information regarding investments** – the SEC alleged in the PE Settlements that the finder revealed identifying information about the private funds advised by the firm and those funds' existing investors and their capital commitments; and
- perhaps most importantly, **receiving transaction-based compensation** – the PE Settlements finder had a contract with the firm that that entitled him to a fee equal to 1% of all capital commitments made to the private funds by investors he introduced.

Through no-action letters and other interpretive guidance, the SEC has stated in no uncertain **terms that the receipt of transaction-based compensation by a "finder" will make him a "broker" within the meaning of the federal securities laws, as it gives him a "salesman's stake" in the solicitation activities**, which is the exact conflict of interest that the federal securities laws requiring broker registration are designed to protect against.[3] Transaction-based compensation may take many forms, such as a percentage of capital invested due to the finder's efforts, as was the case in the PE Settlements. The federal courts have generally agreed with the SEC that transaction-based compensation is "one of the hallmarks of being a broker-dealer," given **"the underlying concern that transaction-based compensation represents a potential incentive for abusive sales practices that registration is intended to regulate and prevent."**[4]

In its 2008 online ***Guide to Broker-Dealer Registration***,[5] the SEC states that the following activities indicate one's status as a broker required to register with the SEC/FINRA:

- **finding investors or customers for, making referrals to, or splitting commissions** with registered broker/dealers, investment companies (or mutual funds, including hedge funds) or other securities intermediaries, even in a "consultant" capacity;
- **finding investment banking clients** for registered broker/dealers;
- **engaging in, or finding investors for, venture capital or "angel" financings;**
- **finding buyers and sellers of businesses** (*i.e.*, activities relating to mergers and acquisitions where securities are involved);
- **marketing real-estate investment interests that are securities;**
- **acting as a "placement agent"** for private placements of securities; and
- **marketing or effecting transactions in insurance products that are securities.**

Other activities that the courts have found, in the context of specific facts and circumstances, **tantamount to providing brokerage services** include:

- **participating in negotiations** between an issuer of securities and potential investors, **providing valuation information** about investments, **sponsoring seminars and social events** for prospective investors and **distributing gifts and promotional items**;[6]
- **advertising for issuers** of securities and **possessing investors' funds and securities**;[7]
- **publishing investment-related materials promoting specific securities** in exchange for a fee paid by the issuer.[8]

Despite all of this precedent, even the SEC staff concedes that what constitutes "the business of effecting transactions in securities," is not always clear. Speaking to the Trading and Markets Subcommittee of the American Bar Association on April 5, 2013, David W. Blass, Chief Counsel of the SEC's Division of Trading and Markets, noted that **the question of**

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3 *See, e.g., Brumberg, Mackey & Wall*, 2010 SEC No-Act. (available at www.sec.gov/divisions/marketreg/mr-noaction/2010/brumbergmackey051710.pdf), citing Securities Exchange Act Release No. 61884 (April 9, 2010) (Order Exempting the Federal Reserve Bank of New York, Maiden Lane LLC and the Maiden Lane Commercial Mortgage Backed Securities Trust 2008-1 from Broker-Dealer Registration).

4 *See, e.g., Cornhusker Energy Lexington, LLC v. Prospect St. Ventures*, 2006 WL 2620985 (D.Neb.2006).

5 The guide is available at www.sec.gov/divisions/marketreg/bdguide.htm#II.

6 *See, e.g., SEC v. Hansen*, 1984 WL 2413 (S.D.N.Y.1984).

7 *See, e.g., SEC v. Margolin*, 1992 WL 279735 (S.D.N.Y.1992).

8 *See, e.g., SEC v. Corporate Relations Group, Inc.*, 2003 WL 25570113 (M.D.Fla.2003).

when a person is required to register with the SEC as a broker-dealer is "broad and oftentimes tricky."[9]

The Costs of Using Unregistered Brokers

The finder involved in the PE Settlements was **barred from the securities industry**. The private equity firm involved in the case agreed to pay a **$375,000 corporate fine** and the senior executive responsible for the finder's activities was **suspended from serving in a supervisory capacity** within the securities industry for a period of 9 months and agreed to pay a **$75,000 personal fine**. Beyond these easily quantifiable penalties are the **reputational risk** to the firm of the public settlement and **other as of yet intangible consequences**.

There is no doubt that is it expensive, in terms of time and money, to successfully register with the SEC and/or FINRA as a broker or broker/dealer representative. But the costs of violating the rules outweigh the costs of compliance. As the PE Settlements reiterate, **it is very risky for an adviser to use a "business broker" or "finder" instead of a registered broker or broker/dealer representative to find clients and raise new investments**.

To be safe, **advisers should proactively examine their policies and procedures**, and update them as necessary, **to prevent against the risks associated with retaining a third party that is not a broker/dealer** or registered representative of a broker/dealer **to solicit investments in any fashion**. In doing so, advisers would be wise to consider the statements of the SEC staff and the federal courts regarding broker status.

NORTHERN LIGHTS CASE EMPHASIZES KEY ROLE OF BOARDS IN FUND COMPLIANCE

In an April 18, 2013 speech, SEC Commissioner Luis A. Aguilar foreshadowed the message delivered by the SEC in its May 2, 2013 settlement with five trustees overseeing the Northern Lights Funds and the Funds' compliance and administrative service providers.[10] In his address to The Regulatory Compliance Association, Aguilar reminded the audience of compliance executives that the SEC views fund and adviser compliance programs as extremely important, a fact that is "underscored by the many Commission actions against investment advisers for failing to have adequate compliance procedures in place." He cited a "particularly egregious" case in which an enforcement action was brought against a firm that had "no compliance program" and whose CCO "apparently lived overseas and had no compliance responsibilities."

The facts of the Northern Lights settlement perhaps do not reveal violations of law as blatant as those described by Commissioner Aguilar, but the case nonetheless offers valuable insight into **the "hands on" role the SEC expects mutual fund trustees to play in their funds' compliance** with the federal securities laws. The Northern Lights case also puts trustees on notice about **the risks of outsourcing key compliance functions and of relying blindly on the representations of third-party compliance and/or administrative service providers**. In a so-called "turnkey arrangement," the more than 70 Northern Lights Funds shared a board of trustees but for the most part had different, unaffiliated investment advisers and sub-advisers.

The Section 15(c) Disclosure Violations

Section 15(c) of the Investment Company Act of 1940 (the "1940 Act") generally imposes a duty on the trustees of a mutual fund to request and evaluate such information as may reasonably be necessary to evaluate the terms of the fund's advisory contract(s). Rule 30e-1 under the 1940 Act requires disclosure regarding the factors considered by a mutual fund's trustees in the annual Section 15(c) process to be included in the fund's next report to shareholders.

As the SEC explained in a press release announcing the Northern Lights settlements, an examination of the Northern Lights Funds revealed that their "shareholder reports either misrepresented material information considered by the trustees or omitted material information about how they evaluated certain factors" in making annual investment advisory contract approvals for the Funds under Section 15(c). This occurred, the SEC alleged, because the shareholder report provided "boilerplate" language regarding the Section 15(c) process that did not accurately reflect the factors considered by the Funds' trustees. For example, the SEC stated, "one disclosure claimed that the trustees had considered peer group information about the advisory fee, however no such data had been provided to the trustees. Other disclosures misleadingly indicated that the fund's advisory fee was not materially higher than its peer group range, when in fact the fee was

[9] Blass's speech, *A Few Observations in the Private Fund Space*, is available at www.sec.gov/news/speech/2013/spch040513dwg.htm.

[10] Aguilar's speech, *Doing the Right Thing: Compliance That Works for Investors*, is available at www.sec.gov/news/speech/2013/spch041813laa.htm. The case cited was *Omni Investment Advisors, Inc. and Gary R. Beynon*, Advisers Act No. 3323 (Nov. 28, 2011).

nearly double the peer group's mean fee or even higher."

The SEC has long viewed the annual investment advisory contract renewal process required by Section 15(c) as a vital means of protecting the interests of fund shareholders. Indeed, George S. Canellos, Co-Director of Enforcement at the SEC has said that the SEC "will aggressively enforce investors' rights to accurate and complete information about the board's processes and decision-making" surrounding the fees and other terms of funds' investment advisory contracts. And as the SEC explained in the Northern Lights settlement, **"boilerplate disclosure of the evaluation process for advisory contracts does not provide meaningful disclosure."**

The Northern Lights Funds' administrative service provider was responsible for preparing the Funds' shareholder reports and accordingly was found to have caused the Funds to violate Sections 30(e) and 31(a) of the Investment Company Act and Rules 30e-1 and 31a-2(a)(6) thereunder. The SEC also found the Northern Lights Funds' trustees to have caused the inadequate and misrepresentative disclosures, as they were based on board meeting minutes approved by the trustees that, like the shareholder report disclosures, "included, among other things, the boilerplate language concerning the material factors and conclusions which formed the basis for the trustees' approval or renewal of the advisory contracts...that was materially untrue or misleading."

In essence, **the SEC deemed the Northern Lights Funds' trustees to have been in the practice of "rubber stamping"** the items placed before them for approval, including the Funds' investment advisory contracts and the related shareholder report disclosure and board meeting minutes. **Such perfunctory review and approval clearly does not satisfy trustees' responsibilities under the 1940 Act in the SEC's eyes.**

To be sure to avoid liability for inaccurate disclosures in fund shareholder reports and other communications, **fund boards at a minimum should take steps to ensure** that their **meeting minutes accurately reflect the information presented, considered and evaluated** during the annual Section 15(c) contract renewal process **and, in turn, that the Section 15(c) shareholder report disclosure conforms to the record created by meting minutes**.

The Rule 38a-1 Violations

As the SEC notes in the Northern Lights settlement order, Rule 38a-1 under the 1940 Act "generally requires fund boards to adopt and implement written policies and procedures reasonably designed to prevent the fund from violating the federal securities laws" and "requires that each fund appoint a CCO who is responsible for administering the fund's policies and procedures as approved by its board." Most mutual fund complexes hire one or more individuals whose sole and dedicated responsibility is to administer the funds' compliance program as their CCO. The Northern Lights Funds, however, employed a third-party compliance service provider to "provide CCO services" and administer the Rule 38a-1 compliance policies and procedures for the Funds, the majority of which did not share an investment adviser.

The SEC found that this "turnkey arrangement," combined with the trustees' unquestioned reliance on representations made by the compliance service provider, resulted in violations of Rule 38a-1. As the order explains, the Northern Lights Funds' outsourced CCO was required "to furnish the trustees with materials upon which the trustees could rely in order to approve the policies and procedures" of each of the Funds' advisers. Such materials, the order states, should have included either (i) copies of each adviser's compliance program for the trustees to review or (ii) a fulsome summary of each adviser's compliance program "that familiarized the trustees with the salient features of the compliance programs and that provided the trustees with a good understanding of how the advisers' compliance programs addressed particularly significant risks." Instead, the SEC found that the outsourced CCO provided only a verbal statement that the advisers' policies and procedures "were adequate" along with a written statement at the end of his compliance review which indicated that the various compliance manuals were "sufficient and in use" and that the code of ethics and proxy voting policies and procedures were "compliant."

Because the Northern Lights Funds' trustees simply took the outsourced CCO at his word and because they did not adhere to the basic requirements of the Funds' compliance program, the SEC found them to have caused the Funds to violate Rule 38a-1. Based on these findings, **it is clear that the SEC expects fund boards to perform independent due diligence, if necessary, to support the representations made to them by fund service providers and to be familiar with and closely follow the provisions of their funds' compliance programs**. As Marshall

S. Sprung, Deputy Chief of Asset Management Enforcement at the SEC stated, the Northern Lights "violations make clear that turnkey mutual fund arrangements can pose significant governance concerns, and **trustees must be vigilant in ensuring that the funds they oversee meet their disclosure, compliance, reporting and recordkeeping obligations**."

SEC REQUESTS INFORMATION ON UNIFORM FIDUCIARY DUTY

The SEC has requested information relating to alternative approaches to setting standards of conduct and other obligations for broker/dealers and investment advisers as well as the potential costs and benefits that could be derived from such approaches. In the March 1, 2013 information request release, the SEC notes that **while broker/dealers and investment advisers provide many of the same services and engage in many similar activities in connection with providing investment advice to retail customers, they are currently subject to two different regulatory schemes**. The SEC is concerned that this separation in regulatory structure results in "specific regulatory obligations depend[ing] on the statute under which a financial intermediary is registered instead of the services provided."

The SEC says it will use the information provided by commenters responding to the request **to (i) analyze whether to establish a uniform fiduciary standard of conduct** and the form any such standard of conduct would take **and (ii) consider the potential harmonization of certain other aspects of the regulation of broker/dealers and investment advisers**.

Types of Information Requested

The SEC requests information regarding the benefits and costs of three main topics:

- the current standards of conduct applicable to broker/dealers and investment advisers when providing personalized advice to retail customers;
- the potential implementation of a uniform fiduciary standard of conduct; and
- the existing regulatory regimes applicable to investment advisers and broker/dealers.

While the SEC welcomes all relevant information, the release specifically calls for information that is empirical and quantitative in nature and responsive to certain specific categories of information outlined in the release.

Uniform Fiduciary Standard of Conduct

While it has yet to be determined whether the SEC will in fact implement a uniform fiduciary standard of conduct, for the purpose of assisting commenters in providing more useful responses, **the information request release outlines a uniform fiduciary standard of conduct for consideration**. The release also addresses certain assumptions commenters should make when considering the possible uniform standard of conduct.

The uniform standard of conduct suggested by the SEC entails **two key elements: a duty of loyalty and a duty of care**. With respect to the duty of loyalty, the SEC asks commenters to assume, among other things, that any rule would: permit trades on a principal basis with customers; require disclosure of material conflicts of interest that may be in the form of a general relationship guide similar to Form ADV Part 2A; and provide that recommending only proprietary or a limited range of products to retail customers would not, in and of itself, violate a new fiduciary standard.

With respect to the duty of care, the SEC asks commenters to assume that general suitability standards would apply to recommendations made to customers, and, as to certain types of securities, specific suitability and due diligence obligations would apply. Further, any rule would likely include application of existing standards of best execution and reasonable mark-ups to retail customers.

Alternative Approaches

The SEC's information request release also proposes **certain alternative approaches to the uniform fiduciary standard** of conduct for consideration including:

- a uniform requirement for broker/dealers and investment advisers to provide disclosure about the services they offer and material conflicts they may have with retail customers, without imposing a uniform fiduciary standard;
- a uniform standard of conduct that would be applied to both broker/dealers and investment advisers but would not extend to broker-dealers existing guidance and precedent regarding fiduciary duty under the Investment Advisers Act of 1940;
- application of the fiduciary standard discussed in the release only to broker/dealers;
- implementation of certain minimum professional obligations related to an investment adviser's duty of care, without modification of the regulation of broker/dealers; and

- certain models from regulators in other countries.

The full text of the release can be found at www.sec.gov/rules/other/2013/34-69013.pdf. **Responses to the information request are due by July 5, 2013.**

OCIE WARNS AGAINST CUSTODY RULE LAPSES

In early March, the SEC's Office of Compliance Inspections and Examinations ("OCIE") released a Risk Alert regarding certain investment advisers' failure to properly safeguard their clients' assets as required by Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act").[11]

Driven by a lack of compliance with the Custody Rule identified by OCIE staff during the private fund adviser presence exams being conducted as part of the SEC's National Examination Program (the "NEP"), the Risk Alert urges private fund advisers to "review their practices in light of the deficiencies noted in the Risk Alert and their responsibilities under the custody rule to protect client assets." During an April 2013 speech to The Regulatory Compliance Association, **SEC Commissioner Luis A. Aguilar** noted that this "widespread and varied non-compliance with the SEC's Custody Rule" was "troubling" and "simply alarming." He **called the fact that one-third of advisers reviewed by the staff had custody-related deficiencies "unacceptable,"** and indicated that if these advisers continued "to fail to do the right thing...it may be necessary for the SEC to step in."

The Custody Rule

The Custody Rule establishes the conditions a registered investment adviser must adhere to if it has custody of client assets, whether those clients are institutions, individuals, private funds or mutual funds. An adviser has custody of client assets if:

- the adviser *or a related person*;[12]
- holds, directly or indirectly;
- client funds or securities;
- or has any authority to obtain possession of them.

Rule 206(4)-2(d) specifically states that **custody generally includes**:

- **possession of client funds or securities;**
- **any arrangement**, such as a power of attorney, **authorizing an adviser to withdraw client funds or securities** maintained with a third-party custodian; and
- **any capacity that gives** an adviser or any of its supervised persons **legal ownership of, or access to, client funds or securities, for example, serving as the general partner or managing member of a private fund or trustee of a trust**.

As the SEC has explained, the Custody Rule is "designed to enhance the safety of client assets by insulating them from any possible unlawful activities or financial reverses of the investment adviser, including insolvency." To that end, **advisers with custody of client assets generally must**:

- engage a "qualified custodian" to hold those client assets in an appropriately designated separate account;[13]
- notify clients in writing as to where and how their assets are being held, detailing how their assets are being held;
- ensure that the qualified custodian sends account statements to clients on at least a quarterly basis;
- submit to annual surprise audits from an independent public accountant that verifies client funds and securities *or*, where an adviser's only clients are private funds, distribute audited financial statements on an annual basis to the underlying private fund investors; and
- *if* a related person of the adviser, or the adviser itself acts as the qualified custodian, (i) submit to an annual surprise audit by a PCAOB[14]-regulated independent public accountant and (ii) obtain from the accountant an internal controls report relating to the custody of client assets on at least an annual basis (*i.e.*, follow the "audit approach").

In addition to these requirements, advisers maintaining custody of client assets are required to make detailed disclosures regarding their custody arrangements on Form ADV.

As SEC Commissioner Elisse B. Walter has said, "because the safeguarding of assets is central to investor protection, it is critical that investment advisers

[11] The Risk Alert is available at http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf. A related Investor Bulletin is available at http://www.sec.gov/investor/alerts/bulletincustody.htm.

[12] "Related person" for purposes of the Custody Rule means any person, directly or indirectly, controlling or controlled by an adviser, and any person that is under common control with the adviser.

[13] The Custody Rule generally defines a "qualified custodian" as an FDIC-insured bank or a savings association; a registered broker/dealer; a registered futures commission merchant; or a foreign financial institution that customarily holds financial assets for its customers.

[14] The Public Company Accounting Oversight Board.

follow [the SEC's] rules when they maintain custody of their clients' funds."

Deficient Safeguarding of Client Assets

In its March 2013 Custody Risk Alert, OCIE explains that the NEP has named **four categories of custody lapses that advisers, particularly newly-registered private fund advisers, should take care to avoid**.

First, advisers reviewed through the NEP **failed to recognize they had custody of client assets within the meaning of Rule 206(4)-2**. An adviser will be deemed to have custody, OCIE states:

- if an employee or related person has been granted **power of attorney, check writing capacity** or similar authority, over client accounts, even if the adviser itself does not have such authority;
- when it **provides bill-paying services for clients**, or "**manages portfolios by directly accessing online accounts** using clients' personal usernames and passwords without restrictions," as either function would allow the adviser to withdraw funds and/or securities from client accounts;
- by **serving as the general partner of a limited partnership, the managing member of a limited liability** company or holding a "comparable position for a different type of pooled investment vehicle;"
- if it has **physical possession of client assets**, such as securities certificates; or
- **has received a check made out to a client and fails to return it promptly to the sender.**

Second, the NEP uncovered certain **technical violations of the Custody Rule's surprise audit requirement**, including (i) the failure of the adviser's chosen accountant to file Form ADV-E, as required, within 120 days of the exam and (ii) evidence suggesting "that examinations were not being conducted on a 'surprise' basis (*e.g.*, exams were conducted at the same time each year)."

Third, OCIE noted that some **advisers failed to meet the Custody Rule's definition of "qualified custodian,"** by:

- holding client assets in the adviser's name, "but not in an account that was under the adviser's name as agent or trustee for the client" and in accounts that comingled client assets with other assets, including proprietary and employee assets;[15]
- placing security certificates at a local bank in a safe deposit box controlled by the adviser such that the bank could not provide account statements to the clients to whom the certificates belonged;
- failing to perform due diligence to support a reasonable belief that the custodian was sending quarterly account statements to clients; and
- not ensuring that client account statements included requisite notifications.

And fourth, **private fund advisers choosing the "audit approach"** to the Custody Rule's requirements regarding annual review by independent accounts, **did not technically comply** with the Rule because:

- **the accountant that conducted the financial statement audit was not "independent" under Regulation S-X;**
- the audited financial statements were not prepared in accordance with Generally Accepted Accounting Principles;
- the adviser failed to demonstrate that the audited financial statements were distributed to all fund investors by making them available only "upon request;"
- the audited financial statements were not sent to private fund investors within 120 days of the fund's fiscal year end; and/or
- the accountants conducting the audit were not PCAOB-registered and subject to PCAOB inspection.

GUIDANCE ON FILING SOCIAL MEDIA COMMUNICATIONS

On March 15, 2013, the staff of the SEC's Division of Investment Management published "a **guidance update**...to clarify the obligations of mutual funds and other investment companies to seek review of materials posted on their social media sites."[16] This document **bolsters the growing body of law that allows funds to use social media to communicate with their existing shareholders and potential investors**. As the SEC's press release explains, the document is the first in the Division's "IM Guidance Update" series, "which will offer the staff's views on emerging legal issues," with the goal of "increasing transparency and enhancing compliance with federal securities laws and regulations."

As a general rule, funds must file their advertising/marketing materials with the SEC or the Financial Regulatory Authority ("FINRA"). Section 24(b) of the Investment Company Act of

[15] As OCIE's Risk Alert states, "Rule 206(4)-2(a)(1) requires the qualified custodian to maintain client assets in a separate account for each client under the client's name or in accounts under the name of the adviser as agent or trustee for the clients (which is permitted only if the accounts contain only clients' funds and securities)."

[16] IM Guidance Update No. 2013-1 is available at http://www.sec.gov/news/press/2013/2013-40.htm.

1940 (the "1940 Act") and/or Rule 497 under the Securities Act of 1933 (the "Securities Act") require funds to file their advertisements with the SEC if they are not otherwise required to file with FINRA under its Rule 2210. Fund promotional materials filed with FINRA are considered to be filed with the SEC. In recent years, it has not been entirely clear whether information conveyed by funds via social media constitutes advertising, and the SEC reports that "out of an abundance of caution, many mutual funds and other investment companies may file materials on their social media sites with FINRA unnecessarily."

In the inaugural IM Guidance Update, the SEC staff states that "certain interactive content need not be filed. **Whether a communication need be filed depends on the content, context, and presentation of the particular communication or set of communications and requires an examination of the underlying substantive information transmitted to the social media user** and consideration of any other facts and circumstances, such as whether the interactive communication is merely a response to a request or inquiry from the social media user or is forwarding previously-filed content."

The following types of communications with investors made through social media, according to the SEC staff, **typically do not trigger advertising filing requirements**:

- References to a specific mutual fund or fund family that does not mention the investment performance or other merits of the fund or fund family. An example provided in the IM Guidance Update: "X Family of Funds invites you to their annual benefit for XYZ Charity."
- Incidental references to "performance" related to a specific mutual fund or fund family that do not explicitly mention some or all of the elements of a fund's return (*e.g.*, 1, 5 and 10 year performance). An example provided in the IM Guidance Update: "When reviewing a mutual fund's historical performance it's important to consider the following: total return; performance against benchmark index; performance against peers; past performance is not a guarantee of future returns."
- Factual statements made in conjunction with the forwarding or inclusion of a hyperlink to a fund prospectus or to other information filed pursuant to Section 24(b) of the 1940 Act or Rule 497 under the Securities Act. An example provided in the IM Guidance Update: "John Doe is the new portfolio manager for ABC fund. <website url>," where the link is to a document filed with FINRA pursuant to Section 24(b) or Rule 497.
- Introductory statements not related to the investment merits of a fund made in conjunction with the forwarding or inclusion of a hyperlink to "general financial and investment information such as discussions of basic investment concepts or commentaries on economic, political or market conditions." An example provided in the IM Guidance Update: "Gold and silver have provided a relatively low correlation to stocks and bonds over the last few years. <website url>," where the link is to a document filed with FINRA pursuant to Section 24(b) or Rule 497.
- Responses to inquiries from social media users that provide "discrete factual information not related to a discussion of the investment merits of the fund. The response may direct the social media user to the fund prospectus or to access information filed with FINRA pursuant to Section 24(b) or Rule 497 or to contact the issuer through a different medium (*e.g.*, phone, e-mail)."

On the other hand, **these types of online communications**, the SEC staff says, **typically must be filed with either the SEC or FINRA as advertising materials**:

- Discussions of fund performance that specifically mention some or all of the elements of a fund's return (*e.g.*, 1, 5 and 10 year performance) or **promote a fund's performance history in any way, even when accompanied by cautionary language**. An example provided in the IM Guidance Update: "Please keep in mind the fund's high double-digit returns were primarily achieved during favorable market conditions."
- **All communications with social media users initiated by the fund that discuss the investment merits of the fund.** An example provided in the IM Guidance Update: "What's your favorite technology to invest in? Read our portfolio manager's views regarding Fund X as an investment opportunity in this space. <website url>," even where the link is to a document filed pursuant to Section 24(b) or Rule 497.

"RED FLAGS" RULE INTENDED TO PREVENT IDENTITY THEFT

On April 10, 2012 the SEC and the CFTC adopted final rules and guidelines to address the risks of identity theft. The new rules require certain financial institutions and creditors to establish a written identity theft prevention program to detect, prevent, and mitigate identity theft in connection with the opening of new accounts and certain existing accounts (an "ID Theft Program"). As the new rules are

substantially similar to the identity theft rules enacted by other regulatory agencies in 2007, the SEC and CFTC believe the entities subject to their final rules are likely already in compliance.

Entities Required to Have an ID Theft Program

- *Financial Institutions and Creditors*. Any "financial institution" or "creditor" subject to the enforcement authority of the SEC or CFTC is covered under the final rules. A financial institution includes banks and credit unions and "any other person that, directly or indirectly, holds a transaction account for an individual." The SEC provided the following examples of entities that could be classified as a financial institution: (i) a broker-dealer that offers custodial accounts; (ii) a registered investment company that enables investors to make wire transfers to other parties or that offers check-writing privileges; and (iii) an investment adviser that directly or indirectly holds transaction accounts and that is permitted to direct payments or transfers out of those accounts to third parties. The CFTC highlighted futures commission merchants, retail foreign exchange dealers, commodity trading advisors, commodity pool operators, introducing brokers, swap dealers and major swap participants as entities falling within the definition of a financial institution.

  Creditors could include lenders such as broker-dealers offering margin accounts, securities lending services and short selling services.

- *Offer or Maintenance of Covered Accounts*. Financial institutions and creditors must establish an ID Theft Program if they offer or maintain "covered accounts." Generally, a covered account is (i) any account primarily for personal, family or household purposes that permits multiple payments or transactions, and (ii) any other account for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft. Specific examples of covered accounts set forth in the adopting release include a margin account, a brokerage account, or an account maintained by a mutual fund or its agent that permits wire transfers or other payments to third parties.

- *Periodic Review*. Under the rules, each financial institution and creditor is required to periodically determine whether it offers or maintains covered accounts and to conduct a risk assessment that considers methods it provides to open and access accounts and prior experiences with identity theft. Thus, even if a financial institution or creditor initially determines it does not need an ID Theft Program, it must periodically reassess its determination and adopt an ID Theft Program if circumstances change with respect to the accounts it offers.

Required Elements and Administration of an ID Theft Program

The final rules outline four basic elements that must be included in an ID Theft Program. An ID Theft Program must have reasonable policies and procedures to:

- identify relevant red flags for covered accounts and incorporate those red flags in the ID Theft Program;
- detect the red flags the ID Theft Program incorporates;
- respond appropriately to any red flags detected; and
- periodically update the ID Theft Program to reflect changes in risks to customers and the safety and soundness of the financial institution or creditor from identity theft.

Similarly, the rules outline four requirements for the administration of an ID Theft Program:

- the ID Theft Program must be approved by the financial institution's or creditor's board of directors, appropriate committee of the board, or if there is no board, a designated senior management employee;
- the board, committee or senior management employee must be involved in the oversight, development, implementation and administration of the ID Theft Program;
- staff must be trained, as necessary, to effectively implement the ID Theft Program; and
- there must be appropriate and effective oversight of any service provider arrangements.

The full text of the adopting release and the guidelines issued to assist financial institutions and creditors with compliance with the rules, can be found at https://www.federalregister.gov/articles/2013/04/19/2013-08830/identity-theft-red-flags-rules. The rules became effective May 20 and the compliance deadline is November 20, 2013.

SEC CHAIR FOCUSED ON INTERNATIONAL REGULATORY COOPERATION

In her first public speech since becoming Chair of the SEC, Mary Jo White highlighted how the SEC interacts with the increasingly global financial system to protect investors, maintain fair, orderly and efficient

markets and facilitate the flow of capital to businesses.[17] **"An exclusively, or even largely, domestically-focused regulatory approach,"** White urged, **"is no longer acceptable or effective."**

Addressing the Investment Company Institute's General Membership Meeting on May 1, 2012, White emphasized that international awareness and collaboration serve the SEC's core domestic duties and mission. The interconnected global marketplace needs "protection, consistency and stability," **and the SEC, White said, must "maintain a regulatory structure that accommodates jurisdictional differences without lowering standards."**

White identified a variety of **ways in which the SEC's regulatory and enforcement priorities interact with the global financial system**, and described how the SEC works with foreign authorities.

- **Conflicts of Law.** Regarding the often contradictory or overlapping rules applicable to swaps transactions conducted across national borders, White discussed a proposal that would follow a "substituted compliance" approach to reconciling U.S. and foreign regulations by allowing market participants to comply with their home country's laws as long as the regulatory outcome is comparable with what it would be if U.S. law were applied.
- **Global Enforcement.** In addition to cross-border regulatory collaboration, White explained, an effective international enforcement mechanism is needed to establish a healthy global financial system. White said that her vision of a global examination and enforcement regime is slowly taking shape in the form of the SEC's 35 bilateral agreements that facilitate enforcement cooperation and technical assistance, as well as the International Organization of Securities Commissions' Multilateral Memorandum of Understanding, which was updated in 2012. This document, which White reported has 94 signatories, "creates a seamless web of securities authorities that are empowered to use their respective enforcement tools on each other's behalf."
- **Fraud and Insider Trading Deterrence.** Cooperation between securities authorities from different nations has led to quick action against fraud and insider trading. As White discussed, assistance from foreign regulators has helped the SEC act on insider trading law violations, and the SEC has developed and applied analytic techniques to assist foreign jurisdiction in confronting perpetrators of securities fraud.
- **The Foreign Corrupt Practices Act ("FCPA") Training.** At its core, the FCPA prohibits U.S. companies from bribing foreign officials. Acknowledging that "misrepresentations and other unlawful actions travel in both directions across borders," White described the SEC's efforts to combat overseas bribery by U.S. companies through education, enforcement and international cooperation. "Successful FCPA cases," White said, "increasingly require assistance from foreign law enforcement authorities. That is why we recently partnered with the DOJ and FBI in conducting a foreign bribery training program that provided intensive training to 130 foreign investigators and prosecutors from 30 countries, many on which the SEC staff relies for mutual legal assistance in FCPA cases."
- **Accounting Standards.** White identified the SEC's challenge of ensuring that accounting standards enable access to accurate, timely and comparable financial data regardless of a company's location. One way to do this, she noted, was to "accommodate different but equally legitimate financial reporting standards," such as the SEC's acceptance of the International Reporting Standards for foreign private issuers filing financial statements without U.S. GAAP reconciliations. White also highlighted several examples of the SEC's efforts to establish global accounting standards, in particular its work with the International Accounting Standards Board.

SPECULATION ON THE FUTURE OF MONEY MARKET FUNDS

The SEC has scheduled a meeting for June 5, 2013 to vote on proposing money market fund reforms. A 500 page draft money market fund reform package that would require institutional prime funds to "float" their daily net asset value ("NAV") has reportedly been circulated internally at the SEC. This latest development in the money market reform saga comes nearly five years after the $62.5 billion Reserve Primary Fund "broke the buck" when its NAV dipped below $1 per share. It comes on the heels of the reform recommendations proposed by the Financial Stability Oversight Council ("FSOC") in November 2012 after the initial rule changes proposed under former SEC Chair Mary L. Schapiro failed to secure a majority vote of SEC Commissioners. Handicappers expect that the Commission will approve proposing the rules, but allow for a lengthy comment period.

[17] White's speech, *Regulation in a Global Financial System*, is available at www.sec.gov/news/speech/2013/spch050313mjw.htm.

Under the Investment Company Act of 1940 ("the 1940 Act"), all money market funds are currently required to maintain a daily NAV of at least $1 per share. Under the draft rule proposal, government and retail money market funds would continue to maintain a stable $1 NAV. Institutional prime funds, on the other hand, could allow their NAVs to drop below $1 per share under the proposal.[18] A key question will be how the SEC will define "institutional" and "retail" funds.

Bloomberg news service has reported that the most recent reform proposal would apply to approximately 37% of the United States' institutional prime funds, or approximately $939 billion in money market fund assets. The Wall Street Journal, however, reports that the floating NAV rules would apply to more than 50% of the money market industry. It is clear that, at this time, there is significant **uncertainty surrounding the draft money market reform proposal being proposed by the SEC and the final outcome of the debate**.

But while we may not know what the future holds for money market funds, we do know a little bit about who's saying what right now:

- **SEC Chair Mary Jo White**, speaking at the Investment Company Institute ("ICI") General Membership Meeting in Washington, D.C. on May 1, 2013, said that "While the U.S. has been the focus of much of the policy debate surrounding **money market funds**, these funds **are global investors and are an area of focus for international regulators as well**. As regulation moves forward on several parallel paths, I am hopeful that we can build upon the SEC's past coordination with global regulators to develop approaches that are consistent, workable, and effective. As the SEC works to develop and propose meaningful money market fund reform, **our goal is to preserve the economic benefits of the product while addressing potential redemption pressures and the susceptibility of these funds to runs** – runs in which retail investors are especially likely to suffer losses."
- **Commissioner Luis A. Aguilar** has publicly said that he would likely vote to approve the proposal, but it would not be surprising if revisions were made to the draft currently under review at the SEC.
- **Commissioner Daniel M. Gallagher has said in the past that he would likely vote in favor of floating the NAV for all money market funds** but that any rule proposal should also address the tax implications of a floating NAV for shareholders.
- **The ICI has long insisted that any money market reform beyond the amendments to Rule 2a-7 under the 1940 Act that were adopted by the SEC in 2010 should apply only to institutional prime funds.** "Given the nature of their investments—and their recent experience in times of financial turmoil—Treasury, government, and tax-exempt money market funds simply don't require further substantial reforms," the ICI has opined.

  But that does not mean that the ICI is in favor of floating the NAV for institutional prime funds. The 2010 amendments to Rule 2a-7, the ICI says, "significantly strengthened the maturity, credit risk and liquidity requirements for money market fund holdings" and "ultimately enhanced financial stability." Calling the floating NAV proposal "inappropriate," the ICI argues that "in 2011, prime money market funds made it through market stresses without experiencing any problems meeting redemptions or disrupting short-term funding markets because they had higher liquidity and increased transparency." **Any additional reforms, the ICI believes should be in the form of:** (i) temporary redemption restrictions or objective **"liquidity gates"** that would be triggered if the liquidity levels of a fund fell to specified levels and would "provide time for that fund to restore liquidity or achieve an orderly liquidation;" (ii) **liquidity fees** that, "if determined appropriate by a fund's board, would allow redeeming shareholders access to liquidity if they need it, but would impose a fee to compensate the fund and remaining investors for the potential cost to the fund of the withdrawal and to protect remaining shareholders;" and (iii) **enhanced disclosure** that "would allow investors and regulators to frequently monitor funds' mark-to-market prices and liquidity levels [and] would encourage an even higher level of conservative portfolio management."[19]
- **A panel of industry experts at the April 2013 meeting of the Business Law Section of the American Bar Association generally agreed with the ICI's position.** Panel members noted the systemic importance of money market funds and expressed the view that a constant NAV was the "principal utility" of money market funds. They suggested that a "capital cushion" requirement might be beneficial but worried that implementing a floating NAV requirement would be "insanely complex" in terms of tax reporting and would require a "wholesale restructuring" of the international

[18] Generally speaking, institutional prime funds are large money market funds that invest heavily in short-term corporate debt.

[19] *See* www.ici.org/viewpoints/view_13_mmfs_reid_prime.

money market. Panelists also cited concerns that the adoption of a floating NAV could spur runs on money market funds, the very risk that money market reform aims to prevent.

- **The concept of a floating NAV for money market funds has been supported by the Federal Reserve and FSOC.** Over the three years it has been in operation since it was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act, FSOC has consistently identified money market funds as systemically risky to the U.S. economy. In its November 2012 recommendations to the SEC, **FSOC proposed three alternatives for money market reform** that "are not necessarily mutually exclusive but could be implemented in combination to address the structural vulnerabilities that result in money market funds' susceptibility to runs."

  First, money market funds could be required to have a floating NAV "by removing the special exemption that currently allows [them] to utilize amortized cost accounting and/or penny rounding to maintain a stable NAV. The value of money market funds' shares would not be fixed at $1.00 and would reflect the actual market value of the underlying portfolio holdings, consistent with the requirements that apply to all other mutual funds." **Second, money market funds could be required to maintain "a NAV buffer with a tailored amount of assets of up to 1%** to absorb day-to-day fluctuations in the value of the funds' portfolio securities **and allow the funds to maintain a stable NAV**." **Third, money market funds could be required to "have a risk-based NAV buffer of 3%** to provide explicit loss-absorption capacity that could be combined with other measures to enhance the effectiveness of the buffer and potentially increase the resiliency of money market funds." **Other measures proposed by FSOC include** "a requirement that 3% of a money market fund shareholder's highest account value in excess of $100,000 during the previous 30 days be made available for redemption on a delayed basis" as well **"more stringent investment diversification requirements, increased minimum liquidity levels and more robust disclosure requirements."**

NEW LEADERSHIP AT THE SEC

- **Mary Jo White** was sworn in as the **Chair of the SEC** on April 10, 2013, taking the reins from Elisse B. Walter who was named acting chair upon the resignation of former Chair Mary L. Schapiro in November 2012. White was nominated by President Obama and confirmed by the U.S. Senate. She comes to the SEC most immediately from private securities litigation practice, and has federal prosecutorial experience spanning four decades, having served as the U.S. Attorney for the Southern District of New York from 1993 to 2002, the First Assistant U.S. Attorney and later Acting U.S. Attorney for the Eastern District of New York from 1990 to 1993, and Assistant U.S. Attorney for the Southern District of New York from 1978 to 1981. White also previously served as a director of The NASDAQ Stock Exchange. She is currently a member of the Council on Foreign Relations, a nonpartisan foreign policy think tank.

- **George Canellos** and **Andrew Ceresney** were named **Co-Directors** of the SEC's **Division of Enforcement** on April 22, 2013. Director Canellos has served as the Division of Enforcement's Deputy and/or Acting Director since June 2012, and prior to that served as Director of the SEC's New York Regional Office. He began serving as the Assistant U.S. Attorney in the Southern District of New York in 1994 and in that capacity also served as Chief of the Major Crimes Unit, Senior Trial Counsel of the Securities and Commodities Fraud Task Force and Deputy Chief Appellate Attorney. Director Ceresney most recently maintained a private corporate and white collar crime practice. He previously served as Deputy Chief Appellate Attorney in the United States Attorney's Office for the Southern District of New York, where he also was a member of the Securities and Commodities Fraud Task Force and the Major Crimes Unit.

- **Anne K. Small** was named to serve as the SEC's **General Counsel** on April 23, 2013, after having served in the White House Counsel's Office as Special Assistant to the President and Associate Counsel to the President since October 2011. Ms. Small previously served as Deputy General Counsel for Litigation and Adjudication at the SEC. In her new role at the SEC, she is taking over for former SEC General Counsel, **Geoffrey Aronow**, who has been named **Senior Counsel to the Chair**.

- On May 2, 2103, the SEC announced that **Carlo V. Di Florio**, who has served as the Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE") and National Exam Program ("NEP") for over three years **resigned to accept a position as the head of FINRA's new risk and strategy division**. As the SEC stated, "di Florio led a comprehensive restructuring of the National Exam Program to strengthen the program's strategy, structure, expertise, processes, and technology…under [his] stewardship, the collaborative restructuring of OCIE into a National Exam Program implemented a broad spectrum of improvements and best practices." **Andrew J. Boden will replace di Florio as the Director of OCIE and head of**

the NEP. Bowden's service at the SEC began in November 2011 when he left the private sector to serve as the National Associate Director for OCIE's Investment Adviser/Investment Company Examination Program. He was appointed Deputy Director of OCIE in September 2012.

- **Bruce Karpati has resigned from his role as Chief of the Asset Management Unit within the SEC's Division of Enforcement.** The SEC announced Karpati's departure on May 9, 2013. Until a permanent replacement is named, current Deputy Chiefs Julie Riewe and Marshall Sprung will lead the Asset Management Unit.
- **Lona Nallengara** has been named the **Chief of Staff of the SEC**. Nallengara comes to the position from the SEC's Division of Corporation Finance where he served as Deputy Director for Legal and Regulatory Policy from March 2011 through December 2012, when he was named Acting Director of the Division of Corporation Finance. In its press release regarding the appointment, the SEC notes that "Mr. Nallengara has led a series of complex rulemakings by the Division of Corporation Finance stemming from the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Jumpstart Our Business Startups (JOBS) Act." To fill Nallengara's spot, the SEC has named **Keith F. Higgins** to serve as **Director of the Division of Corporation Finance** at the SEC. Higgins joins the SEC from private practice.
- On May 24, 2013, **President Obama nominated Kara M. Stein to succeed Elisse B. Walter** as an SEC Commissioner and **nominated Michael S. Piwowar to succeed Troy A. Paredes** as an SEC Commissioner. Commissioner Paredes's term expires at the end of June, and Commissioner Walter's expires at the end of the year. Ms. Stein currently serves as legal counsel and senior policy advisor to a member of the Senate Banking Committee. Mr. Piwowar has previously served as an economist on the SEC's staff and currently works as chief economist for the Senate Banking Committee.

CCO Corner

SEC Inspections, Investigations and Enforcement Inquiries

CCOs of registered investment advisers, and of the funds they advise, should be prepared to respond to inspections, investigations and enforcement inquiries from the SEC. The SEC has made clear that ensuring compliance with the federal securities laws is one of its top priorities, as the National Exam Program being administered by the SEC's Office of Compliance and Inspections and Examinations ("OCIE") illustrates. In addition, OCIE has recently commenced a program of "presence" examinations directed at certain newly registered investment advisers and a series of "sweep" exams covering fund distribution payments.

The following is the first of two articles that will discuss concepts that CCOs should keep in mind upon receipt of an SEC inspection or investigation notice or an enforcement inquiry. This article addresses handling an SEC investigation or enforcement inquiry and offers tips on responding to them. Our next edition will discuss handling an SEC inspection and cautionary advice on how to avoid ending up in an enforcement proceeding.

Handling an SEC Investigation

A formal investigation is initiated by the SEC by the issuance of a formal order of investigation. The text of the order will identify the possible statutory violations and will designate specific SEC employees who are authorized to issue subpoenas, take testimony, and otherwise conduct the investigation. Informal investigations are conducted without the issuance of a formal order of investigation; that is, the SEC has not authorized subpoena enforcement authority and the SEC staff lawyers must rely upon voluntary cooperation. All investigations are "non-public." This means that the SEC keeps the existence of a pending investigation confidential. Generally, there is no duty to disclose the existence of an SEC non-public investigation in any applicable prospectus or other disclosure document maintained by the investment adviser, like its "brochure," or to issue a press release. Once the SEC has authorized the institution of enforcement proceedings, a duty to disclose may arise.

Investment companies and investment advisers must be particularly concerned about an SEC investigation in light of the draconian impact Sections 9(a) and (b) of the Investment Company Act of 1940 Act ("1940 Act") and Section 203(e) of the Investment Advisers Act of 1940 ("Advisers Act") will have upon their continuing ability to remain in business.

In brief, Sections 9(a) and 9(b) of the 1940 Act expressly prohibit persons who have been enjoined by reason of certain enumerated forms of misconduct from acting as, among other matters, an employee, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company. This in theory would require such a person to resign their position, which could cause considerable harm to a fund if its investment adviser were to become disqualified. In fact, advisers are often able to obtain relief from this provision, if they are able to obtain an exemptive order from the Commission allowing them to continue to serve despite the provisions of Section 9(a).

Section 203(e) of the Advisers Act provides that "the Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any investment adviser if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such investment adviser, or any person associated with such investment adviser, whether prior to or subsequent to becoming so associated – [has committed the same improper actions listed in Section 9 of the 1940 Act]."

In light of the statutory ability of the SEC under Section 203(e) of the Advisers Act and Section 9 of the 1940 Act to punish an investment adviser which has made serious

mistakes, **a careful response to an SEC investigation should include**:

- **Familiarity with the SEC's Rules Relating to Investigations.**[20]
- **A determination of proper legal representation of each affected party at the earliest possible time.** This is particularly important in light of Rule 7(b) of the SEC's Rules Relating to Investigations,[21] which provides:

  "Any person compelled to appear, or who appears by request or permission of the Commission, in person at a formal investigative proceeding may be accompanied, represented and advised by counsel, as defined in §201.101(a) [of the Commission's Rules of Practice]; provided, however, that all witnesses shall be sequestered, and unless permitted in the discretion of the officer conducting the investigation no witness or the counsel accompanying any such witness shall be permitted to be present during the examination of any other witness called in such proceeding."

  The SEC staff has often sought to use Rule 7(b) to prevent the same counsel from representing more than one witness in an investigative proceeding. The SEC staff will also be concerned about potential conflicts of interest in determining whether counsel may represent more than one witness.
- **A determination early on as to whether it is in the client's interest to be cooperative.** In light of the provisions of Section 203(e) of the Advisers Act and Section 9 of the 1940 Act, there is a strong incentive to cooperate in order to have some measure of control over the outcome.
- **A request for transcripts of each witness' testimony.** A witness in an SEC investigation is entitled to a copy of the transcript of his testimony unless, in the case of a nonpublic formal investigative proceeding, "for good cause" the Commission denies his request for a transcript.[22] A witness has a right to inspect the transcript of his testimony, but if he orders a copy it may be discoverable in third party litigation. If third party litigation is highly likely, it may be more prudent to protect the privacy of the witnesses' testimony by leaving the transcript in the hands of the SEC staff so long as the investigation and any related enforcement proceeding is pending.
- **Consideration of whether to file a statement with the SEC.** Any person who is to be named in an SEC enforcement proceeding is entitled to make a so-called "Wells Submission."[23] A Wells Submission allows persons under investigation by the SEC to file a brief arguing their positions to the Commission before the SEC actually authorizes institution of an enforcement proceeding. A well-prepared Wells Submission can be extremely effective in attacking the merits, fairness, or the weaknesses of an enforcement recommendation by the SEC staff, and can provide the Commission with a more balanced perspective as to the culpability and defenses of a target. Because a Wells Submission can signal the principal defenses intended to be raised in any subsequent, formal enforcement proceeding, this must be weighed against the potential benefits derived from a Wells Submission.

In an investment company context, prompt settlement of enforcement proceedings is extremely important both from a disclosure perspective and to avoid the broadest impact of Section 203(e) of the Advisers Act or Section 9 of the 1940 Act. Thus, it is common to initiate "pre-institution of proceedings" settlement discussions. Pre-institution settlement negotiations often result in the public announcement of the institution of formal enforcement proceedings simultaneously with the settlement of those same proceedings.

Handling an SEC Enforcement Inquiry

An investment adviser which becomes the subject of an enforcement inquiry should develop an action plan to assist it in efficiently and effectively handling all aspects of a material non-compliance or enforcement matter.

First, inform senior management of the investment adviser and, if applicable, the board of directors

[20] 17 C.F.R. §203.351 et seq., Fed. Sec. L. Rep. (CCH) ¶66,351 et seq.

[21] 17 C.F.R. §203.7.

[22] Rule 6 of the SEC's Rules Relating to Investigations, 17 C.F.R. §203.6.

[23] *See* Securities Act Release Nos. 5310 (September 27, 1972) and 5320 (October 12, 1972); 17 C.F.R. §202.5(c).

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of any client that is a registered investment company. Where there is a client that is a registered investment company, a committee of independent directors may wish to launch a separate inquiry or investigation. If a separate inquiry or investigation is considered appropriate, the independent directors should consider whether to retain a law firm or an accounting firm to assist them in conducting their own independent investigation. The disinterested directors should also consider whether the investment adviser's internal auditor should report directly to them to coordinate and supervise appropriate aspects of their independent inquiry. The investment adviser needs to consider seriously the degree to which it is willing to cooperate with any such separate inquiry or investigation.

Second, in a material enforcement inquiry, each party in interest should have adequate, independent legal representation. If regular counsel to the registered investment company represents both the investment adviser and the investment company, then special counsel for the independent directors is probably essential. If regular counsel to the registered investment company does not represent the investment adviser, such counsel may represent the independent directors, depending upon the circumstances. If particular officers, directors, or employees of the investment adviser or officers or directors of the mutual fund are also subjects of the enforcement inquiry, consideration should be given as to whether they should have separate legal representation.

Third, if a major regulatory crisis or legal problem has been encountered or discovered, one of the first issues is whether and when the SEC should be informed. Some lawyers believe it is often the better course to come forward voluntarily and inform the SEC staff at the earliest practicable date of the existence of a major regulatory problem. It is usually preferable to explain the problem to the SEC staff than for them to learn of it from a third party source.

With respect to investment company clients, if a prospectus needs to be supplemented it may be prudent to discuss the "sticker" with the SEC staff before submitting it; if a suspension of redemptions is necessary, the SEC staff must be contacted. If it is appropriate to contact the SEC staff, a pro-active plan is the best offense and defense. Every effort should be made to bring all relevant known facts to the SEC staff's attention. It is important to leave the impression that you are being totally forthcoming. A pro-active plan may facilitate handling both direct statutory responsibilities to the SEC staff and possible ancillary civil litigation at the same time.

For investment company clients, if the SEC staff can be convinced that the independent directors are functioning effectively and independently and have the assistance of able legal counsel and independent public accountants, this may forestall the institution of any formal SEC enforcement action while your pro-active plan is unfolding. Where the investment adviser itself is the sole focus of the enforcement inquiry, it is more difficult to forestall any formal SEC enforcement action unless the SEC staff can be convinced that outside counsel has the matter under control.

Fourth, if it is concluded that there may be material contingent or unrecorded liabilities or if any advisory client has suffered material losses, it should be determined whether the investment adviser is at fault in any way and is willing and able to indemnify the advisory client. The investment adviser's willingness and ability to make the advisory client whole will be an important fact in shaping the early discussions with the SEC staff. If the investment adviser is not both willing and able to provide indemnification, counsel should promptly determine whether there are valid claims which the advisory client may assert against the investment adviser. The possible existence of a valid claim against the investment adviser may trigger the need to file a claim under applicable E&O insurance or fidelity bond policies or otherwise put those insurers on notice of the existence of a potential claim.

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Fifth, a material compliance failure will usually raise questions about the accuracy of the investment adviser's accounting records. Advisory clients wishing to remove their assets from the investment adviser may dispute the value ascribed to the assets in their account. If the advisory clients include an investment company, the question will be whether its shares can be accurately priced consistent with the requirements of Rule 2a-4 (or Rule 2a-7) under the Investment Company Act of 1940 Act. **If the problems are serious enough, it may be appropriate to consider suspending the sale of shares of the investment company.** In this regard, the following issues should be considered: (i) does the investment company's prospectus now contain any material misstatements or omissions?; (ii) did the investment company already sell its securities in violation of federal or state securities laws in a manner that would subject the investment company to possible rescission rights or liability for damages?; (iii) would a "sticker" to the investment company's prospectus "cure" any existing disclosure problems?; (iv) if sales must be suspended, can dividends be reinvested?; (v) if an accurate net asset value per share cannot be calculated with respect to an investment company client, what should be done about redemptions?

Sixth, a material compliance matter may require an amendment to the investment adviser's Form ADV, may require changes to the investment adviser's "brochure," and may require that an investment company client's prospectus be "stickered." It may also be appropriate to send a written communication to all advisory clients or shareholders of an investment company client explaining the circumstances.

Seventh, if appropriate, a claim under the fidelity bond should be filed promptly. Fidelity bonds have varying exclusions and limitations which must be reviewed by counsel at the earliest possible date. Most fidelity bonds require prompt notice of loss. If appropriate, notice of a claim under any E&O or D&O policy should be promptly submitted. Counsel should promptly review all E&O and D&O policies and become familiar with their terms and requirements. It is possible that the facts in a material enforcement matter can give rise to a claim under both the fidelity bond and an E&O policy. Certain common exclusions and limitations may pose difficult issues which must be considered promptly. Examples would be: (i) exclusions in the policy for losses caused by fraud, embezzlement, or dishonest conduct; and (ii) an exclusion for claims made by one insured against another insured. There may be possible claims against third parties. If so, prompt attention should be given to perfecting such claims. Any claim made against the investment adviser's or a registered investment company's independent public accountants is likely to cause them to conclude that they must resign their existing auditing engagement.

Finally, there is always the issue of who is to pay expenses incurred in seeking to recover losses must be faced promptly. The question is often affected by the state law and provisions in the investment adviser's governing documents (*i.e.*, charter or bylaws).