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Investment Management Legal and Regulatory Update - October 2013

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SEC Issues Guidance Update for Investment Companies that Invest in Commodity Interests and Announces New Risk and Examinations Office

The staff of the Division of Investment Management has issued a Guidance Update that summarizes the views of the Division regarding disclosure and compliance matters relevant to funds that invest in commodity interests. The staff also announced the creation of a Risk and Examinations Office within the Division of Investment Management that will accompany the SEC's Office of Compliance Inspections and Examinations (OCIE) on exam visits.

Disclosure of Derivatives and Associated Risks. Any principal investment strategies disclosure related to derivatives should be tailored specifically to how a fund expects to be managed and should address those strategies that the fund expects to be the most important means of achieving its objectives and that it also anticipates will have a significant effect on its performance. In determining the appropriate disclosure, a fund should consider the degree of economic exposure the derivatives create, in addition to the amount invested in the derivatives strategy. This disclosure also should describe the purpose that the derivatives are intended to serve in the portfolio (e.g., hedging, speculation, or as a substitute for investing in conventional securities), and the extent to which derivatives are expected to be used. Additionally, the disclosure concerning the principal risks of the fund should similarly be tailored to the types of derivatives used by the fund, the extent of their use, and the purpose for using derivatives transactions.

Prior Performance Presentation. A newly registered fund that invests in commodity interests and that includes in its registration statement information concerning the performance of private accounts or other funds managed by the fund's adviser is responsible for ensuring that such information is not materially misleading. Specifically, a fund that includes the performance of other funds or private accounts should generally include the performance of all other funds and private accounts that have investment objectives, policies, and strategies substantially similar to those of the fund.

Legend Requirement. Rule 481 under the Securities Act requires a fund to provide a legend on the outside front cover page that indicates that the SEC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus and that any contrary representation is a criminal offense. The staff will not object if a fund that invests in commodity interests includes in the legend language that also indicates that the CFTC has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus.

Compliance and Risk Management. Day-to-day responsibility for managing a fund's portfolio, including any commodity interests and their associated risks, rests with the fund's investment adviser. In addition, the fund's board generally oversees the adviser's risk management activities as part of the board's oversight of the adviser's management of the fund. The staff expects that funds and their advisers would adopt policies and procedures that address, among other things, consistency of fund portfolio management with disclosed investment objectives and policies, strategies, and risks.

Each fund should have in place policies and procedures that are sufficient to address the accuracy of disclosures made about the fund's use of derivatives, including commodity interests, and associated risks, as well as consistency of the fund's investments in these derivatives with the fund's investment objectives. For example, these policies and procedures should be reasonably designed to prevent material misstatements about a fund's use of derivatives, including commodity interests, and the associated risks.

New Risk and Examinations Office. The update notes that a Risk and Examinations Office has recently been created within the Division of Investment Management to analyze and monitor the risk management activities of investment advisers, investment companies, the investment management industry and new products. The group will work closely with OCIE to make onsite visits to investment management firms.

Source: *SEC Division of Investment Management Guidance, August 2013, 2013-05.*

SEC Approves Registration Rules for Municipal Advisors

State and local governments that issue municipal bonds frequently rely on advisors to help them decide how and when to issue the securities and how to invest proceeds from the sales. Prior to passage of the Dodd-Frank Act in 2010, municipal advisors were not required to register with the SEC. This left many municipalities relying on advice from unregulated advisors. After the Dodd-Frank Act became law, the SEC established a temporary registration regime for municipal advisors that prohibited any municipal advisor from providing advice to, or soliciting, municipal entities or other covered persons without being registered. More than 1,100 municipal advisors have since registered with the SEC. The SEC recently adopted final rules that establish a permanent registration regime for municipal advisors.

Registered municipal advisors will also likely be subject to additional new regulation from the Municipal Securities Rulemaking Board (MSRB). In September 2011, the MSRB withdrew several rule proposals pertaining to municipal advisors pending adoption by the SEC of a permanent registration regime for municipal advisors. Among the proposals was a rule regulating political contributions by municipal advisors. The MSRB had previously indicated that it would resubmit the withdrawn rule proposals once a final definition of the term "municipal advisor" was adopted by the SEC.

Proposed Rule

In 2010, the SEC proposed a rule governing the permanent registration process. The proposal defined "municipal advisor" broadly and would have required municipal advisor registration of appointed board members of municipalities and people providing investment advice on all public funds. The SEC received more than 1,000 comment letters on the proposal, most of which raised concerns about the broad reach of the proposal.

Final Rule

The final rule requires a municipal advisor to register with the SEC if it:

- provides advice on the issuance of municipal securities or about certain "investment strategies" or municipal derivatives; or
- undertakes a solicitation of a municipal entity or obligated person.

The rule clarifies who is and is not a "municipal advisor" and offers guidance on when a person is providing "advice" for purposes of the municipal advisor definition. The rule exempts employees and appointed officials of municipal entities from registration and limits the type of "investment strategies" that will result in municipal advisor status. Additionally, instead of the proposed approach that would have required individuals associated with registered municipal advisory firms to register separately, the final rule requires firms to furnish information about these individuals.

Defined Terms

Advice. A person is providing "advice" to a municipal entity or an "obligated person" based on all of the relevant facts and circumstances, including whether the advice:

- involves a recommendation to a municipal entity;
- is particularized to the specific needs of a municipal entity; or
- relates to municipal financial products or the issuance of municipal securities.

Advice, however, does not include providing certain general information.

An "obligated person" is an entity such as a non-profit university or non-profit hospital that borrows the proceeds from a municipal securities offering and is obligated by contract or other arrangement to repay all or some portion of the amount borrowed.

Investment Strategies. A person providing advice to a municipal entity or an "obligated person" with respect to "investment strategies" only has to register if such advice relates to:

- the investment of proceeds of municipal securities;
- the investment of municipal escrow funds; or

- municipal derivatives.

Exemptions from the Municipal Advisor Definition

The following persons conducting the specified activities would not be required to register as a municipal advisor:

Registered Investment Advisers. Registered investment advisers and associated persons do not have to register if they provide investment advice in their capacities as registered investment advisers, such as providing advice regarding the investment of the proceeds of municipal securities or municipal escrow investments.

This exemption does not apply to advice on the structure, timing, and terms of issues of municipal securities or municipal derivatives. The SEC considers advice in these areas as outside the focus of investment adviser regulation.

Independent Registered Municipal Advisor. Persons who provide advice in circumstances in which a municipal entity has an independent registered municipal advisor with respect to the same aspects of a municipal financial product or issuance of municipal securities do not have to register, provided that certain requirements are met and certain disclosures are made.

Banks. Banks do not have to register to the extent they provide advice on certain identified banking products and services, such as investments held in deposit accounts, extensions of credit, funds held in a sweep account or investments made by a bank acting in the capacity of bond indenture trustee or similar capacity.

This exemption does not apply to banks that engage in other municipal advisory activities, such as providing advice on the issuance of municipal securities or municipal derivatives, in part because municipal derivatives were a source of significant losses by municipalities in the financial crisis.

Underwriters. Brokers, dealers and municipal securities dealers serving as underwriters do not have to register if their advisory activities involve the structure, timing and terms of a particular issue of municipal securities.

Registered Commodity Trading Advisor. Registered commodity trading advisors and their associated persons do not have to register if the advice they provide relates to swaps.

Swap Dealers. Registered swap dealers do not have to register as municipal advisors if they provide advice with respect to swaps in circumstances in which a municipal entity is represented by an independent advisor.

Public Officials and Employees. Public officials do not have to register to the extent that they are acting within the scope of their official capacity. This exemption addresses an unintended consequence of the proposed rule that generated significant public comment and created the impression that public officials and municipal employees would be covered if they provided "internal" advice.

This exemption covers persons serving as members of a governing body, an advisory board, a committee, or acting in a similar official capacity as an official of a municipal entity or an obligated

person. For instance, it covers:

- members of a city council, whether elected or appointed, who act in their official capacity; and
- members of a board of trustees of a public or private non-profit university acting in their official capacity, where the university is an obligated person by virtue of borrowing proceeds of municipal bonds issued by a state governmental educational authority.

Similarly, this exemption covers employees of a municipal entity or an obligated person to the extent that they act within the scope of their employment.

Attorneys. Attorneys do not have to register if they are providing legal advice or traditional legal services with respect to the issuance of municipal securities or municipal financial products.

This exemption does not apply to advice that is primarily financial in nature or to an attorney representing himself or herself as a financial advisor or financial expert on municipal advisory activities.

Accountants. Accountants do not have to register if they are providing accounting services that include audit or other attest services, preparation of financial statements, or issuance of letters for underwriters.

Registration Forms

The final rule requires municipal advisory firms to file the following through EDGAR:

- Form MA to register as a municipal advisor; and
- Form MA-I for each individual associated with the firm who engages in municipal advisory activities.

The temporary registration regime will remain in place until December 31, 2014. The new rule requires municipal advisors to register on a staggered basis beginning July 1, 2014. The expiration date of the temporary rules will be extended in order to allow municipal advisors to continue to remain temporarily registered during the staggered compliance period.

Sources: *SEC Approves Registration Rules for Municipal Advisors, SEC Press Release 2013-185 (September 18, 2013); Registration of Municipal Advisors, SEC Release No. 34-70462 (September 18, 2013).*

SEC Eliminates the Prohibition on General Solicitation and General Advertising in Certain Private Offerings to Accredited Investors

As we reported in our July Client Alert, the SEC amended Regulation D to implement a Jumpstart Our Business Startups Act (JOBS Act) requirement to lift the ban on general solicitation and general advertising for certain private offerings.

JOBS Act

Congress passed the JOBS Act in 2012, which directed the SEC to remove the prohibition against general solicitation and general advertising for securities offerings relying on Rule 506, provided that sales are limited to accredited investors and an issuer takes reasonable steps to verify that all purchasers are accredited investors.

While issuers will be able to widely solicit and advertise for potential investors, the JOBS Act required the SEC to adopt rules that "require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission." In other words, there is no restriction on who an issuer can solicit, but an issuer faces restrictions on who is permitted to purchase its securities.

Rule 506(c)

The addition of 506(c) to the existing Rule 506 permits issuers, including hedge funds and other private funds, to use general solicitation and general advertising to offer their securities provided that:

- all purchasers of the securities are accredited investors (as defined in Rule 501);
- the issuer takes reasonable steps to verify that the investors are accredited investors;
- all other conditions of the Rule 506 exemption are met; and
- Form D is completed and the box is checked indicating that Rule 506(c) is being relied upon.

Verification of Accredited Investor Status

Under the new rules, the issuer will need to take reasonable steps to verify that each investor is accredited. Whether the steps taken are "reasonable" will be a principles-based determination by the issuer, in the context of the particular facts and circumstances of each purchaser and transaction. The SEC noted that the issuer should consider the nature of the purchaser and the amount and type of information that the issuer has about the purchaser; the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering; and the terms of the offering, such as a minimum investment amount.

In response to comments received with respect to the SEC's original rule proposal, the amendment to Rule 506 also includes a non-exclusive list of methods that issuers may use to verify that purchasers are accredited investors. The methods described in the final rule include the following:

- **Verification of Income.** Review IRS forms filed for last two years and obtain a written representation of expected income for the current year.
- **Verification of Net Worth.** Review documentation related to assets (bank and brokerage statements, CDs and independent appraisal reports) and liabilities (credit reports).
- **Third Party Verification.** Obtain a written confirmation that a person is an accredited investor from a broker-dealer, investment adviser, attorney or CPA.
- **Existing Accredited Security Holder.** For any investor who invested in an issuer's prior Rule 506 offering as an accredited investor and remains an investor, obtain a written certification

(at the time of a Rule 506(c) sale) that he or she still qualifies as an accredited investor.

Preservation of Existing Rule

The existing provisions of Rule 506 as a separate exemption are not affected by the final rule. Issuers conducting Rule 506 offerings without the use of general solicitation or general advertising can continue to conduct securities offerings in the same manner and aren't subject to the new verification rule.

Form D

In connection with these changes, Form D has been amended to require issuers to indicate whether they are relying on 506(c), which permits general solicitation and advertising in a Rule 506 offering.

The rule amendments became effective September 23, 2013.

Sources: *SEC Approves JOBS Act Requirement to Lift General Solicitation Ban, Commission Also Adopts Rule to Disqualify Bad Actors from Certain Offerings and Proposes Rules to Enable SEC to Monitor New Market and Bolster Investor Protections, SEC Press Release 2013-124 (July 10, 2013); Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release No. IA-3624 (July 10, 2013).*

SEC Adopts Rule to Disqualify "Bad Actors" from Rule 506 Offerings

The SEC recently approved amendments to Rule 506 to set forth the "bad actor" (commonly known as "bad boy") provisions that could disqualify issuers from relying on the rule. The Dodd-Frank Act directed the SEC to adopt the amendments in order to prevent issuers from relying on the Rule 506 safe harbor if certain "bad actors" were involved in the offering.

As required by the Dodd-Frank Act, the SEC approved disqualifications under Rule 506 that are substantially similar to the disqualifications found in other securities regulations. Persons covered by the bad boy provisions include: issuers; directors, executive officers, other officers participating in the offering, general partners or managing members of issuers; beneficial owners of 20% or more of the issuer's voting equity securities; investment managers to an issuer that is a pooled investment fund and directors, executive officers, other officers participating in the offering, general partners or managing members of the investment manager; promoters connected with the issuer; persons compensated for soliciting investors as well as the directors, officers, general partners or managing members of any compensated solicitor. The disqualifying events include:

- securities-related criminal convictions;
- securities-related court injunctions and restraining orders;
- final orders of a state securities commission, state insurance commission, state or federal bank, savings association or credit union regulator or the CFTC barring an individual from association with regulated entities or from engaging in securities, insurance or banking business or finding a violation of any law pertaining to fraudulent, manipulative or deceptive conduct;

- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers and investment companies and their associated persons;
- SEC cease-and-desist orders related to violations of certain anti-fraud provisions and registration requirements of the federal securities laws;
- suspension or expulsion from membership in, or suspension or bar from associating with a member of, a securities self-regulatory organization; and
- SEC stop orders pertaining to the filing of a registration statement or the suspension of an exemption.

Reasonable Care Exception. Under this exception, an issuer would not lose the benefit of the Rule 506 safe harbor if it can show that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering.

Disclosure of Pre-Existing Disqualifying Events. Disqualification applies only for disqualifying events that occur after September 23, 2013, the effective date of this rule. Matters that existed before the effective date of the rule and would otherwise be disqualifying are subject to a mandatory disclosure requirement to investors.

Sources: *SEC Approves JOBS Act Requirement to Lift General Solicitation Ban, Commission Also Adopts Rule to Disqualify Bad Actors from Certain Offerings and Proposes Rules to Enable SEC to Monitor New Market and Bolster Investor Protections, SEC Press Release 2013-124 (July 10, 2013); Disqualification of Felons and Other Bad Actors from Rule 506 Offerings, SEC Release No. 33-9414 (July 10, 2013).*

SEC Proposes Amendments to Private Offering Rules (Regulation D and Form D)

In partial response to the many comments that the SEC received with respect to its proposed JOBS Act amendments to Rule 506, the SEC recently proposed the following amendments to the private offering rules.

Advance Notice of Sale. Under the proposal, issuers that intend to engage in general solicitation as part of a Rule 506 offering would be required to file the Form D at least 15 calendar days before engaging in general solicitation for the offering. Also, within 30 days of completing an offering, issuers would be required to update the information contained in the Form D and indicate that the offering has ended.

Additional Information about the Issuer and the Offering. Under the proposal, issuers would be required to provide additional information such as:

- types of general solicitation used;
- methods used to verify accredited investor status;
- publicly available website;
- controlling persons;

- industry group;
- asset size;
- breakdown of investor types (accredited/non-accredited and natural person/entity) and amounts invested; and
- breakdown of use of proceeds.

Disqualification. Under the proposal, an issuer would be disqualified from using the Rule 506 exemption in any new offering if the issuer or its affiliates did not comply with the Form D filing requirements in a Rule 506 offering.

Legends and Disclosures. Under the proposal, issuers would be required to include certain legends or cautionary statements in any written general solicitation materials used in a Rule 506 offering. The legends would be intended to inform potential investors that the offering is limited to accredited investors and that certain potential risks may be associated with such offerings.

In addition, if the issuer is a private fund and includes information about past performance in its written general solicitation materials, it would be required to provide additional information in the materials to highlight the limitations on the usefulness of this type of information. The issuer also would need to highlight the difficulty of comparing this information with past performance information of other funds. The proposal also requests public comment on whether other manner and content restrictions should apply to written general solicitation materials used by private funds.

Submission of Written General Solicitation Materials to the SEC. Under the proposal, issuers would be required to submit written general solicitation materials to the SEC through an intake page on the SEC website. Materials submitted in this manner would not be available to the general public. As proposed, this requirement would be temporary, expiring after two years.

Guidance to Private Funds about Misleading Statements. In its current form, Rule 156 under the Securities Act provides guidance on when information in mutual fund sales literature could be fraudulent or misleading for purposes of the federal securities laws. Under the proposal, the rule would be amended to apply to the sales literature of private funds.

Comments on the proposal originally were due on September 23, 2013. However, "in light of the public interest," the SEC re-opened the comment period until October 30, 2013.

Sources: *SEC Approves JOBS Act Requirement to Lift General Solicitation Ban, Commission Also Adopts Rule to Disqualify Bad Actors from Certain Offerings and Proposes Rules to Enable SEC to Monitor New Market and Bolster Investor Protections, SEC Press Release 2013-124 (July 10, 2013); Amendments to Regulation D, Form D and Rule 156, SEC Release No. IC-30595 (July 10, 2013).*

SEC Charges Investment Adviser for Misleading Fund Board About Algorithmic Trading Ability

The SEC charged an investment adviser and its former owner for misleading a mutual fund's board of directors about the firm's ability to conduct algorithmic currency trading so the board would approve the adviser's contract to manage the fund.

The case arises out of an initiative by the SEC Enforcement Division's Asset Management Unit to focus on the "15(c) process" - a reference to Section 15(c) of the Investment Company Act that requires a fund's board to annually evaluate the fund's advisory agreements. Advisers must provide the board with truthful information necessary to make that evaluation.

"It is critical that investment advisers provide truthful information to the directors of the registered funds they advise," said Julie M. Riewe, Co-Chief of SEC Enforcement Division's Asset Management Unit. "Both boards and advisers have fiduciary duties that must be fulfilled to ensure that a fund's investors are not harmed."

The SEC's Enforcement Division alleged that Chariot Advisors LLC and Elliott L. Shifman misled the fund's board about the nature, extent, and quality of services that the firm could provide. In two presentations before the board, Shifman misrepresented that his firm would implement the fund's investment strategy by using a portion of the fund's assets to engage in algorithmic currency trading. Chariot fund's initial investment objective was to achieve absolute positive returns in all market cycles by investing approximately 80% of the fund's assets under management in short-term fixed income securities, and using the remaining 20% to engage in algorithmic currency trading.

According to the SEC's order instituting administrative proceedings, Chariot Advisors did not have an algorithm capable of conducting such currency trading. This was particularly significant because in the absence of an operating history the directors focused instead on Chariot Advisors' reliance on models when the board evaluated the advisory contract. Even though Shifman believed that the fund's currency trading needed to achieve a 25 to 30% return to succeed, Shifman allegedly did not disclose to the board that Chariot Advisors had no algorithm or model capable of achieving such a return.

The SEC alleges that for at least the first two months after the fund was launched, Chariot Advisors did not use an algorithm model to perform the fund's currency trading as represented to the board, but instead hired an individual trader who was allowed to use discretion on trade selection and execution. According to the order, the trader used a technical analysis, rules-based approach for trading that combined market indicators with her own intuition.

The SEC further alleges that the misconduct by Shifman and Chariot Advisors caused misrepresentations and omissions in the Chariot fund's registration statement and prospectus filed with the SEC and viewed by investors.

A hearing will be scheduled before an administrative law judge to determine whether the allegations contained in the order are true and whether any remedial sanctions are appropriate.

Sources: *SEC Charges North Carolina-Based Investment Adviser for Misleading Fund Board About Algorithmic Trading Ability, SEC Press Release 2013-162 (August 21, 2013); In the Matter of Chariot Advisors, LLC and Elliott L. Shifman, Investment Company Act Release No. 30655 (August 21, 2013).*

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