Investment Management Regulatory Update

May 28, 2014

SEC Rules and Regulations

SEC Reopens Commenting Period on Target Date Funds

On April 3, 2014, the SEC announced that it is seeking comment on the recommendations by the Investor Advisory Committee (the "**Committee**") regarding disclosure by target date mutual funds. Please see the ***December 4, 2009 Investment Management Regulatory Update*** for a discussion on a Senate Committee hearing and report on issues associated with target date funds.

Target date funds are savings vehicles that invest in a mix of assets, including stocks, bonds and other instruments, that change over time as the fund approaches a set date in the future—its target date. Generally, a target date fund's asset allocation is marketed as growing more conservative over time. Such funds are popular retirement savings vehicles in light of this asset allocation strategy. In 2010, the SEC proposed a rule requiring each target date fund to include a graphical and/or tabular depiction illustrating changes in such fund's asset allocation over time (known as the fund's "glide path").

In April 2013, the Committee submitted recommendations on the proposed rule. In its recommendations, the Committee strongly supported the proposal to require target date funds to include additional disclosure in marketing materials to improve investors' access to and understanding of the risk portfolio of target date funds. However, the Committee further recommended that the SEC adopt a standard methodology for the glide path illustrations, and that the SEC develop a glide path illustration based on

the standardized measure of fund risk. In its recommendations, the Commission expressed concern that a glide path illustration based solely on asset allocation may introduce bias into the illustration and expose investors to more risks.

In response to the Committee's recommendations, the SEC reopened the comment period to seek comments from the public on whether it should follow the Committee's recommendations and develop a glide path illustration that is based on a standardized measure of fund risk. The SEC is further seeking comments on the degree to which managers of target date funds use measures of risk as part of their investment strategy, how useful and understandable certain quantitative risk measures would be to investors, and the appropriate placement of a risk-based glide path illustration in a fund's marketing materials. The reopened comment period expires on June 9, 2014.

- **See a copy of SEC's 2010 Rule Proposal**
- **See a copy of SEC's Press Release**
- **See a copy of the Committee's Recommendation**

SEC Grants No-Action Relief to 403(b) Plans Investing as Qualified Purchasers

On April 8, 2014, the Staff of the Division of Investment Management of the SEC issued a no-action letter to Invesco Advisers, Inc. ("**Invesco**"). In the letter, the Staff stated that it would not recommend enforcement action under Section 7(a) of the Investment Company Act against insurance company separate accounts ("**Separate Accounts**") that offer and sell group annuity contracts ("**Contracts**") as part of a "generic stable value investment option" managed by Invesco, in the event that sponsors of plans organized under Section 403(b) of the Internal Revenue Code of 1986 ("**Code**") invest in such Separate Accounts.

Section 7(a) of the Investment Company Act generally prohibits an unregistered investment company that is organized under U.S. or state law from, among other things, offering or selling any security (or engaging in certain other activities) "by use of the mails or any means or instrumentality of interstate commerce." Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities are held exclusively by "qualified purchasers" (as defined in Section 2(a)(51) of the Investment Company Act) and that is not making, and does not propose to make, a public offering of its securities.

According to the no-action letter, Invesco advises and provides asset management services to a variety of clients, including sponsors of 403(b) plans. 403(b) plans generally include tax-deferred retirement plans for employees of certain tax-exempt organizations and certain ministers. According to the no-action letter, Invesco has developed a "generic stable value investment option" (the "**Invesco Option**") targeted to 403(b) plans sponsored primarily by large institutions (the "**Plans**"), which would be selected by participants in the Plans ("**Participants**"). According to the no-action letter, under the Invesco Option, Invesco would allocate assets of the Plans to various investments, including Contracts (which offer employees a bundled investment and insurance product) offered and sold by Separate Accounts (which generally rely on the exclusion from the definition of "investment company" under Section 3(c)(7) of the Investment Company Act). Invesco further represented in its incoming letter that Participants generally would not know that they are investing in any particular Separate Account.

According to the no-action letter, the Division would not recommend enforcement action against the Separate Accounts in the event that sponsors of the Plans invest in Contracts offered and sold by Separate Accounts based on the facts and representations described above and Invesco's additional representations that:

- (i) each Plan will own and invest on a discretionary basis at least $25 million in investments, and was not formed for the specific purpose of acquiring the securities offered by any Separate

Account relying on the exclusion from the definition of investment company contained in Section 3(c)(7) of the Investment Company Act;

- (ii) the sponsors of Plans will be subject to the Prudent Man fiduciary standard, either contractually or pursuant to the provisions of the Plans with respect to both the Plan assets invested in the Separate Accounts including the Invesco Option and to selecting a manager that manages an option through which assets would be invested in a Separate Account;
- (iii) the Invesco Option will not be used to facilitate any Participant's individual decision to invest in any particular Separate Account;
- (iv) a Participant's discretion in allocating his or her investments will be limited to choosing investment options with identified generic investment objectives (including the Invesco Option);
- (v) the Invesco Option may invest in the securities of multiple Separate Accounts so long as no more than 50% of the Invesco Option's assets consist of securities of any one Separate Account immediately following the Invesco Option's purchase of a Separate Account's securities; and
- (vi) no representation will be made to Participants regarding the allocation of any of the contributions to or account balances under the Plan (or the Invesco Option) to any particular Separate Account and if a Participant receives information that mentions an investment in a particular Separate Account, it will be accompanied by a disclaimer stating in substance that "no assurances can be given that the Invesco Option will continue to invest its assets, or the same portion of its assets, in the Separate Account."

In granting this no-action relief, the Staff relied on the H.E. Butt Grocery No-Action Letter issued on May 18, 2001. Please see the ***June 15, 2001 Investment Management Regulatory Update*** for a discussion of the H.E. Butt Grocery No-Action Letter.

- **See a copy of the No-Action Letter**

Industry Update

SEC Issues Cybersecurity Initiative Risk Alert

On April 15, 2014, the staff of the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") issued a Risk Alert (the "**Alert**") on its cybersecurity initiative, announcing its plan to conduct examinations of at least 50 registered broker-dealers and registered investment advisers to assess the cybersecurity preparedness in the securities industry. OCIE had previously announced in its 2014 National Exam Program priorities that focusing on technology, including cybersecurity preparedness, would be a priority in 2014. Please see the ***January 27, 2014 Investment Management Regulatory Update*** for a discussion of the 2014 National Exam Priorities.

The Alert followed an SEC roundtable on cybersecurity, where SEC Chair Mary Jo White emphasized the importance of cybersecurity preparedness to ensure the integrity of the market system and that customer data is adequately protected. According to the Alert, the SEC will be focusing on the following areas when it conducts examinations of a broad set of registered broker-dealers and registered investment advisers: (1) cybersecurity governance; (2) identification and assessment of cybersecurity risks; (3) protection of networks and information; (4) risks associated with remote customer access and funds transfer requests; (5) risks associated with vendors and other third parties; (6) detection of unauthorized activity; and (7) experiences with certain cybersecurity threats. To assist compliance professionals in identifying and improving the areas that need attention, the SEC included a sample document request list in the Alert.

This sample document request list focused on the following key areas:

- **Identification of Risks/ Cybersecurity Governance.** OCIE may request information regarding certain practices employed by the firm for managing information security assets. Such information may include the method and frequency of: (1) inventory of software platforms and applications; (2) cataloguing of connections to the firm's network from external sources; and (3) prioritization of resources based on their sensitivity and business value. OCIE may also request information regarding risk assessments conducted by the firm to identify cybersecurity threats and physical security threats that may bear on cybersecurity.
- **Protections of Firm Networks and Information.** OCIE may ask whether the firm relies on any published cybersecurity risk management process standards. OCIE may also request information on the types of practices and controls regarding the protection of the firm's networks and information utilized by the firm, which may include: (1) whether the firm provides written guidance and periodic training on cybersecurity risks; (2) the firm's information security, data destruction and incident response policies; (3) control of user authorization and privileges on the network; and (4) established processes to maintain the safety of the firm's network.
- **Risks Associated with Remote Customer Access and Funds Transfer Requests.** If the firm provides its customers with online access, OCIE may request information on: (1) the identity of the service provider; (2) the measures the firm or the third party take to ensure the safety of customers' access; (3) the permitted functions on the platform; and (4) any supplemental information provided to customers on reducing risks associated with the remote access. OCIE may also request information on the authentication procedures the firm employs before transferring funds pursuant to email requests from customers to transfer funds and on the policy of losses related to cybersecurity breach.
- **Risks Associated with Vendors and Other Third Parties.** OCIE may request information on any cybersecurity risk assessment of vendors and other third parties with access to the firm's sensitive cybersecurity-related information. In addition, if any vendor or other third party conducts remote maintenance of the firm's network and devices, OCIE may request that the firm provide any policies and procedures in place to prevent unauthorized access.
- **Detection of Unauthorized Activity.** OCIE may request information on practices employed by the firm to facilitate detecting unauthorized activity, including the party responsible for such practices. OCIE may request information regarding the following practices: (1) management of the personnel and sources for detecting unauthorized activity; (2) monitoring the firm's network and physical environment to detect unauthorized activity; (3) analysis and evaluation of events related to cybersecurity breach; and (4) conducting relevant tests, such as "penetration tests," "vulnerability scans" and periodic testing of the reliability of event detection processes.

In addition, this sample document request list asked the firm to report incidents related to cybersecurity risks it has experienced since January 1, 2013. The SEC indicated that this sample document request list should not be considered inclusive; in the actual examination, the documents and information request list for each broker-dealer and investment adviser may be tailored to address specific concerns of OCIE.

- **See a copy of the Alert**

SEC Provides Guidance on Investment Company Deregistration

In April 2014, the Division of Investment Management issued an IM Guidance Update regarding deregistration of investment companies registered under the Investment Company Act. Section 8(f) of the Investment Company Act generally allows the SEC to deregister a fund if it determines that such fund is no longer an "investment company." Most companies complete the deregistration process by applying on Form N-8F (the "**Form**")—such requests to deregister are reviewed by the SEC and, if the staff does not identify any deficiencies, the SEC then issues a public notice regarding the application, and issues an order granting the request to deregister unless a hearing on the application has been ordered. According

to the SEC, a "significant number" of the comments it issues regarding deficiencies relate to only a small number of items on the Form.

In light of these frequently noted deficiencies, the IM Guidance Update identifies such items and provides additional guidance on how to respond to these items:

- **The Fund's Name** (Item 2). According to the SEC, the response to Item 2 should provide the fund's name exactly as it appears on EDGAR and should not include the name of any particular series of the fund. Furthermore, the IM Guidance Update notes that the name of the fund set forth in the "Verification" section at the end of the Form must match the name of the fund provided in Item 2 exactly.
- **Applicant's Contact Person** (Item 6). The IM Guidance Update clarifies that applicants are permitted to indicate the email address of the contact person in their response to Item 6 in order to receive any comments via email.
- **The Fund's Adviser** (Item 11). The IM Guidance Update provides that if the fund is a unit investment trust ("**UIT**"), the fund should respond to Item 11 by indicating that it is "not applicable" or by explaining that, as a UIT, the fund does not have an adviser.
- **Approval of the Fund's Board of Directors** (Item 15(a)). If the applicant is a UIT, the IM Guidance Update similarly clarifies that the fund should respond to this item by indicating it is "not applicable" or by explaining that, as a UIT, the fund does not have a board of directors. The SEC further explained that this is the appropriate response even if the applicant is an insurance company separate account organized as a UIT and the board of the insurance company approved the action leading to deregistration. If the applicant is a UIT that is liquidating pursuant to its terms, the SEC stated that the applicant may explain such circumstances in its response.
- **Filing on the Basis of "Abandonment of Registration"** (Item 25). According to the SEC, funds seeking to abandon their registration are generally either (1) registered funds that determined to wind up before offering securities to the public or (2) funds that will remain in operation but now qualify for an exemption from the definition of "investment company" under either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. According to the Guidance Update, funds that have determined to wind up should mark "no" in Item 25 and include the following statement either in Item 12 or Item 25: "Applicant has never made a public offering of its securities and does not propose to make a public offering or engage in business of any kind." If a fund that is currently registered is seeking to abandon its registration based on the second category—that it is becoming a private fund—the IM Guidance Update instructs that such fund should check "yes" in Item 25 and include a statement that "the fund will continue to operate in reliance on Section 3(c)(1) or 3(c)(7) of the Investment Company Act and a brief explanation of the basis for reliance," as well as a representation that "the fund has notified, or promptly will notify, its beneficial owners that certain legal protections afforded to shareholders under the Investment Company Act will no longer apply." If an applicant is an insurance company separate account that will continue to operate as a private fund, it should include a similar statement and representation as a registered fund seeking to become a private fund, as well as certain details regarding contract owners invested in the separate account.

- **See a copy of the IM Guidance Update**

IM Information Update Summarizes 2013 Accomplishments and Provides Key 2014 Agenda Items

In March 2014, the SEC's Division of Investment Management issued an IM Information Update, summarizing its accomplishments in 2013 and providing insight into anticipated actions it will take in 2014.

According to the IM Information Update, the Division is considering potential rules on disclosure by funds. In addition, the Division is finalizing rules relating to the implementation of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act and the 2012 Jumpstart Our Business Startups (JOBS) Act. According to the IM Information Update, the Division further seeks to finalize rules designed to "strengthen the resilience" of money market funds and reduce the risk of runs, thereby promoting stability. For further information about these proposed amendments, please see the June 11, 2013 Davis Polk Client Memorandum, ***SEC Proposes Amendments to Money Market Fund Rules***.

Finally, according to the IM Guidance Update, the Division is continuing to advance the SEC's focus on improving disclosure with regard to variable annuities, an investment product typically sold to seniors and other individuals looking for ways to fund their retirement.

- **See a copy of the Information Update**

Litigation

SEC Charges Financial Services Firm with Improperly Calculating Advisory Fees and Overcharging Clients

On April 3, 2014, the SEC issued an order instituting administrative and cease-and-desist proceedings (the "**Order**") against Transamerica Financial Advisors ("**Transamerica**"), a Florida-based registered investment advisor and broker-dealer, for improperly calculating advisory fees and overcharging clients.

Under Section 206(2) of the Advisers Act, investment advisers are prohibited from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. According to the SEC, Transamerica offered breakpoint discounts and allowed clients to aggregate the funds in their various accounts for the purpose of qualifying for the discounts. The SEC order states that Transamerica did not honor all client aggregation requests and did not provide its representatives with consistent guidelines with regard to the discounts. Consequently, according to the SEC, Transamerica failed to maintain adequate fee calculation policies and neglected to give the breakpoint discounts to certain eligible clients, thereby resulting in a violation of Section 206(2). In addition, Rule 206(4)-7 under the Advisers Act requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. According to the SEC, Transamerica violated Rule 206(4)-7 by failing to ensure it had adequate policies and procedures in place at Transamerica's headquarters to implement the breakpoints policy. Section 207 under the Advisers Act generally prohibits advisers from making material misstatements or omissions in SEC reports or registration applications. According to the SEC, the representations it made in Part III of its Forms ADV filed with the SEC violated Section 207.

Without admitting or denying the SEC's findings, Transamerica settled the proceedings. Transamerica agreed to a censure, and to cease and desist from committing or causing further violations of the federal securities laws. In addition, Transamerica agreed to hire an independent consultant to review its policies. Transamerica also agreed to reimburse clients with refunds and credits totaling $553,624 (including interest) and agreed to pay an additional $553,624 in civil penalties.

- **See a copy of the SEC Order**
- **See a copy of the Press Release**

SEC Charges Investment Adviser for Undisclosed Revenue Sharing Plan

On April 15, 2014, the SEC announced charges against the Total Wealth Management Fund ("**Total Wealth**"), a San Diego-based investment adviser registered with the SEC, its chief executive officer, chief compliance officer and the former chief compliance officer (such employees together, the

"**Respondents**") for misleading investors and breaching their fiduciary duties to their clients. The SEC alleged that Total Wealth and the Respondents entered into undisclosed revenue sharing plans that created conflicts of interest. The SEC also claimed that Total Wealth and its chief executive officer materially misrepresented the amount of diligence they conducted on the investments they recommended to clients.

According to the SEC's order, Total Wealth had revenue sharing plans with several investment funds. Under these plans, when Total Wealth placed an investor's investments in one of these funds, Total Wealth would receive a fee from such investment fund, and Total Wealth would further pay a portion of that revenue sharing fee to the Respondents. Total Wealth disclosed in its Form ADV and other marketing materials that it "may" receive revenue sharing fees. According to the SEC, this disclosure was inadequate because Total Wealth and the Respondents were, in fact, receiving such fees at the time the disclosure was made. The SEC additionally alleged that the Respondents concealed these revenue sharing fees by both characterizing such fees as something other than revenue sharing fees and by funneling such fees through entities created for the sole purpose of collecting such fees.

The SEC charged Total Wealth and the Respondents with a violation of Section 207 of the Advisers Act because of the inadequate disclosure regarding the revenue sharing plans. The SEC also charged Total Wealth and its chief executive officer with violation of Rule 206(4)-8 under the Advisers Act, by leading clients to invest in funds that paid revenue sharing fees without adequate disclosure and intentionally concealing the nature of such fee arrangement.

In addition, the SEC alleged that Total Wealth and its chief executive officer misrepresented to their clients the extent of due diligence they conducted on the investment products they recommended. According to the SEC, Total Wealth's chief executive officer represented to investors that Total Wealth's due diligence efforts included "on-site manager visits and in-depth qualitative and quantitative due diligence," while, according to the SEC, word of mouth was the chief executive officer's main method of identifying the investment products.

Based on the alleged fraudulent conduct and deceptive nature of their communications with the clients, the SEC charged Total Wealth and its chief executive officer with violating Sections 206(1), 206(2), and 206(4) of the Advisers Act.

- **See a copy of the SEC Order**
- **See a copy of the Press Release**

Notes from Europe: European Regulatory Developments

UK Financial Conduct Authority Fines Fund Manager 18.6 Million Pounds

On April 28, 2014, the UK Financial Conduct Authority ("**FCA**") published a decision dated April 24, 2014, in which it fined two UK fund management companies, Invesco Asset Management Limited and Invesco Fund Managers Limited, a total of £18,643,000 for placing investors at levels of risk that were greater than they had been led to expect. The two fund managers were operating under the trade name "Invesco Perpetual." The FCA found that Invesco Perpetual had, for a four-and-a-half-year period from May 2008 through November 2012, failed to comply with their regulatory obligations towards investors. Investco Perpetual had failed in three ways:

- it invested some of its funds in breach of investment limits, which resulted in losses;
- it introduced leverage without making proper disclosure to the investors about the risks that were involved in some funds; and
- it was found to have inadequate systems and controls in place, as a result of which funds were not valued accurately and trades were not allocated fairly between funds.

In conclusion, the FCA found that investors were exposed to a greater level of risk than they might have expected. Invesco Perpetual were ultimately found to have breached Principal 3 (which relates to management and control) and Principal 7 (which relates to communications with clients) of the FCA's Principals for Business. FCA further found that Invesco Perpetual had breached certain specific rules in the FCA Handbook. The fine was calculated based on the level of revenue that Invesco Perpetual derived from managing investors' money. Invesco Perpetual also compensated the funds a total of approximately £5.3 million, the amount of the damages caused by the breach of investment limits.

- **See a copy of the FCA's final notice**

UK: FCA Publishes Findings on Retail Fund Charges

On May 13, 2014, the FCA published a report setting out its findings in its thematic review of the clarity of fund charges in relation to retail funds. In conducting its thematic review, the FCA assessed eleven UK firms, including asset managers, banks, insurers and wealth managers who operate funds that are sold to UK retail investors. While some firms were found to have provided a consistent and clear description of charges across their different marketing documents, the FCA found that this was not the case for all of the firms. The FCA highlighted two main points as a result of its thematic review:

- some firms were using the term "annual management charge" in some places in their marketing literature and the term "ongoing charges figure" ("**OCF**") in other places, which the FCA found might confuse investors and inhibit their ability to compare charges accurately; and
- in the case of UCITS funds, the use of the term OCF across all marketing literature would likely help investors understand and compare charges.

The FCA expects all fund managers to review their arrangements in light of the FCA findings. The FCA further expects senior management of fund managers to satisfy themselves that their firm's practices in connection with the clarity of charge information and fund governance are in line with the FCA's expectations (the FCA's report sets out examples of good and poor practice). The FCA will continue to work with firms on the clarity of charges through its routine supervision of firms.

- **See a copy of the FCA's thematic review report**

UK: FCA Publishes Policy Statement regarding Soft Dollar Commissions

On May 8, 2014, the FCA published a policy statement on the use of dealing commission rules for investment managers (PS 14/7). The policy statement builds on the FCA's consultation paper originally published on November 25, 2013 on the use of dealing commission rules for investment managers. For a discussion of the previously published consultation paper, please see the ***December 20, 2013 Investment Management Regulatory Update***. In the policy statement, the FCA responded to the feedback it has received on its original proposals set out in its consultation paper. In light of the feedback, the FCA made some minor adjustments to the final rules and issued related guidance. The FCA published together with the policy statement a related instrument amending Chapter 11.6 of the Code of Business Source book ("**COBS**") of the FCA Handbook of Rules and Guidance on the use of dealing commission by investment managers. These changes to Chapter 11.6 of COBS will come into force on June 2, 2014.

- **See a copy of the FCA's policy statement dated May 8, 2014**
- **See a copy of the Conduct of Business Source Book (Use of Dealing Commission) (Amendment Number 2) Instrument 2014 (FCA 2014/29)**
- **See a copy of the FCA's November 2013 consultation paper.**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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