Investment Management Regulatory Update

August 24, 2016

SEC Rules and Regulations

SEC Staff Grants No-Action Relief under Section 12(d)(3) of the Investment Company Act to the AFL-CIO Housing Investment Trust to Organize and Acquire the Securities of a Wholly Owned RIA Subsidiary

On August 5, 2016, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to the AFL-CIO Housing Investment Trust ("**HIT**"), an open-end management investment company registered under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), giving relief from Section 12(d)(3) of the Investment Company Act to permit HIT to organize and acquire the securities issued by a wholly owned and controlled subsidiary that will be a registered investment adviser under the Investment Advisers Act of 1940, as amended. The investment adviser subsidiary would initially provide investment advice to a private fund.

According to the incoming letter (the "**Incoming Letter**"), HIT is an internally managed open-end registered investment company that has elected to be treated as a "regulated investment company" ("**RIC**") under the Internal Revenue Code of 1986 (the "**Code**"). The Incoming Letter states that in order to maintain its status as a RIC, HIT must satisfy specified source-of-income requirements (among others), principally by deriving at least 90% of its gross income in each taxable year from dividends, interest, payments with respect to certain securities, loans, gains from the sale of stock or other securities, net income from certain "qualified publicly traded partnerships," or other income derived with respect to its business of investing in securities. HIT's board of directors (the "**Board**") has determined, according to the Incoming Letter, that providing investment advisory services through a wholly owned investment adviser entity would be beneficial to HIT's shareholders since it would (i) allow HIT to shield itself from potential liabilities incurred in connection with such advisory activities and (ii) assist HIT in satisfying the source-of-income requirements under the Code by not directly receiving investment management fee

income. The Incoming Letter further represents that HIT's shareholders have approved the Board's proposal.

In the Incoming Letter, HIT makes certain additional representations about the structure of the proposed investment adviser subsidiary (the "**Adviser Sub**"):

- HIT itself will not have an investment adviser and the determination to enter into the advisory business through the Adviser Sub has been approved by at least a majority of HIT's directors who are not "interested persons" of HIT under Section 2(a)(19) of the Investment Company Act;
- HIT will discuss the Adviser Sub and its activities, and provide an assessment of any associated risks, in its annual reports to shareholders and in its prospectus;
- The Adviser Sub will not make any proprietary investment that HIT itself would be prohibited from making directly (whether under law or HIT's own investment policies);
- HIT will deem the assets, liabilities and indebtedness of the Adviser Sub as its own for purposes of assessing compliance with the asset coverage requirements set forth in Section 18 of the Investment Company Act; and
- The Board will at least annually review the Adviser Sub's business to determine whether it should be continued, including by taking into account (a) the compensation of the officers of HIT and of the Adviser Sub; (b) all investments by and investment opportunities considered for HIT that relate to any investments by or investment opportunities considered for a client of the Adviser Sub; and (c) the allocation of expenses associated with the provision of advisory services between HIT and the Adviser Sub.

Section 12(d)(3) generally provides that it is unlawful for any registered investment company to purchase or otherwise acquire any security issued by any person who is, among other things, an investment adviser of an investment company or a registered investment adviser. According to the Incoming Letter, the concerns of Congress underlying Section 12(d)(3) were to (i) prevent investment companies from exposing their assets to the entrepreneurial risks of securities-related businesses, including those of an investment adviser, and (ii) prevent potential conflicts of interest and situations in which brokers, securities dealers and other financial intermediaries were in a position to dominate investment companies. HIT states in the Incoming Letter that these concerns are not present here, including because the Adviser will be organized as a limited liability company (rather than a general partnership), which will assist in insulating HIT's shareholders from the risks of the Adviser Sub's business. Further, according to the Incoming Letter, the potential for the conflicts of interests that concerned Congress are mitigated here by the following aspects of the proposed structure: (i) HIT will remain internally managed; (ii) HIT will wholly own and control the Adviser Sub and (iii) the Board will oversee the Adviser Sub's advisory business. HIT further stated in the Incoming Letter that HIT could provide these advisory services directly (as opposed to through the Adviser Sub), but is proposing to provide them through the Adviser Sub for *bona fide* tax planning reasons.

According to the Letter, the SEC would not recommend enforcement action under Section 12(d)(3) based on the facts and representations in the Incoming Letter.

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

Industry Update

CFTC Proposes to Amend the Conditions for Exemption from Registration for Certain Foreign Persons

On July 27, 2016, the U.S. Commodity Futures Trading Commission ("**CFTC**") announced its proposal to amend CFTC Rule 3.10(c) (the "**Proposal**"). According to the CFTC, the Proposal would modify the conditions for an exemption from registration for certain non-U.S. persons acting as futures commission merchants, introducing brokers, commodity trading advisors or commodity pool operators (collectively, "**Foreign Intermediaries**") with respect to commodity interest transactions executed solely on behalf of persons located outside the United States or on behalf of certain international financial institutions.

According to the Proposal, CFTC Rule 3.10 sets out the manner in which intermediaries, including Foreign Intermediaries, must apply for registration with the CFTC, and current section (c) thereunder generally exempts from registration Foreign Intermediaries acting solely with respect to persons also located outside the United States if the transactions are submitted for clearing through a registered futures commission merchant. This exemption, however, was difficult to apply in the case of swap transactions, because not all swap transactions must be cleared. As such, the Proposal would eliminate the clearing requirement in the Rule 3.10(c) exemption. In addition, the Proposal would make clear that the Rule 3.10(c) exemption is available to Foreign Intermediaries acting on behalf of certain "international financial institutions" (such as the International Monetary Fund). Both of these aspects of the Proposal would codify prior CFTC staff no-action positions.

The CFTC has requested comments on the Proposal by September 6, 2016. Comments may be submitted through the CFTC's web site (**http://comments.cftc.gov/**), the Federal eRulemaking Portal (**http://www.regulations.gov/**) or by mail or hand delivery to the following address: Christopher Kirkpatrick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581.

- **See a copy of the Proposal**

Litigation

SEC Charges Investment Adviser with Failing to Clearly Disclose Additional Costs to Investors

On July 14, 2016, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against RiverFront Investment Group, LLC (the "**Company**"), a registered investment adviser, for disclosure-related violations of Sections 207 and 204 of the Investment Advisers Act and Rule 204-1(a) thereunder. The SEC alleged that the Company failed to accurately disclose the frequency with which it traded in a manner that resulted in additional transaction costs to its advisory clients.

According to the Order, the Company began serving as a subadviser to advisory clients in wrap fee programs in mid-2008. In a wrap fee program, advisory clients generally pay an annual fee that is intended to cover the cost of several services on an aggregate basis, including trade execution. The practice of sending trades to a non-designated broker-dealer, referred to as "trading away," results in additional costs to the client that are not otherwise covered by fees in the wrap fee program. According to the SEC, the Company disclosed in its Form ADV that it may trade away in an effort to obtain best execution on behalf of its clients, but that it would "generally" execute trades through the designated broker-dealers. The SEC found that, from mid-2008 to March 2009, the Company directed almost all wrap trades to the designated broker-dealer for execution. However, the SEC alleged that, beginning in late

2009, the Company began to substantially increase the amount it was trading away. According to the SEC, after the end of the first quarter of 2009, the Company began to trade away, on a security-type by security-type basis, virtually 100% of its portfolio trades.

According to the Order, even as the Company began to move away from using the designated broker-dealer for wrap fee programs, the Company did not amend its Form ADV to disclose this material change. As a result, the SEC found that, while the Company did not personally profit by trading away, the Company did cause its clients to pay millions of dollars' worth of transaction costs that were not covered by the annual wrap fee.

As a result of its disclosure violations, the SEC alleged that the Company willfully violated Section 207 of the Advisers Act, which generally makes it unlawful for any person to make an untrue statement of a material fact in any registration application or report filed with the Commission. In addition, according to the SEC, the Company willfully violated Section 204(a) of the Advisers Act and Rule 204-1(a) thereunder, which generally require that a firm's Form ADV be amended when information provided in the brochure becomes materially inaccurate.

The Company consented to the SEC's order without admitting or denying the SEC's findings. The SEC ordered the Company to pay a civil money penalty of $300,000. In addition, the Company must post on its website on a quarterly basis the volume of trades by market value executed away from sponsors and the associated transaction costs passed on to clients.

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

State Street Settles Charges Relating to Misleading Custody Clients Regarding Indirect Foreign Currency Exchange Trading

On July 26, 2016, U.S. Attorney Carmen M. Ortiz for the District of Massachusetts, Director Andrew J. Ceresney of the Division of Enforcement for the SEC and Secretary Thomas E. Perez of the U.S. Department of Labor (the "**DOL**"), announced that State Street Bank and Trust Company ("**State Street**"), a Massachusetts-based financial institution, agreed to a settlement of SEC administrative proceedings, Department of Justice ("**DOJ**," and together with the SEC and the DOL, the "**Agencies**") proceedings and DOL proceedings against State Street relating to State Street's alleged misleading of certain of its custody clients when providing indirect foreign currency exchange ("**FX**") services (the "**Announcement**").

According to the Announcement, the Agencies alleged that State Street told its custody banking clients (which included registered investment companies) that it would use "best" or "market rates" on their FX trades, but instead State Street used rates that were marked up in a predetermined fashion, and did not make efforts to obtain the best possible prices for these clients. Furthermore, according to the Agencies, the information in the trade confirmations and monthly transaction reports for these trades provided to State Street's clients was materially misleading in light of the representations that State Street had made about how it priced FX transactions.

According to the Announcement, the SEC order will find that State Street willfully violated Section 34(b) of the Investment Company Act of 1940 (the "**Investment Company Act**"), which prohibits the making of any untrue statement or omission of a material fact in any document required to be filed or kept under Section 31(a) of the Investment Company Act and Rule 31a-1(b) thereunder, by providing its registered investment company clients with trade confirmations and monthly transaction reports that were materially misleading in light of the conduct described above.

The Announcement states that the SEC's order will be issued only after a federal court approves State Street's proposed settlement with private plaintiffs in a pending securities class action lawsuit regarding its pricing of foreign currency exchange trades. According to the Announcement, State Street has agreed

to pay $167.4 million in disgorgement and penalties to the SEC, a $155 million penalty to the DOJ and at least $60 million to ERISA plan clients in an agreement with the DOL.

- **See a copy of the Announcement**

On a related note, on June 13, 2016, the SEC issued an order instituting administrative and cease-and-desist proceedings against The Bank of New York Mellon ("**BNYM**") as part of an overall agreement announced on March 19, 2015 with federal and state regulators concerning the same alleged conduct as State Street, discussed above (the "**BNYM Order**"). According to the BNYM Order, BNYM violated Section 34(b) of the Act and caused violations of Section 31(a) and Rule 31a-1(b) thereunder. BNYM consented to the BNYM Order and agreed to (i) cease and desist from such violations, (ii) disgorge $133,022,207 (which was satisfied by its payment of this amount under the terms of BNYM's related settlements with the U.S. Department of Justice and the New York Attorney General), (iii) pay a $30 million penalty to the SEC, and (iv) report on its remediation and implementation of compliance measures for the standing instruction and successor programs offered to registered investment company clients.

- **See a copy of the Administrative Summary**
- **See a copy of the BNYM Order**

SEC Bars Adviser over Brokerage Conflicts

On July 27, 2016, the SEC issued an opinion (the "**Opinion**") that upheld an administrative law judge's penalty against Dennis J. Malouf, an investment adviser (the "**Adviser**"), for allegedly directing bond transactions to a broker-dealer formerly owned by him in order to receive payments.

According to the Opinion, the Adviser owned both UASNM, Inc. ("**UASNM**"), a registered investment adviser, and a branch of Raymond James Financial Services, Inc. ("**RJ**"), a broker-dealer, between 2004 and 2007. In 2007, amid concerns from RJ regarding the Adviser's conflicts of interest and supervision risks, the Adviser sold the RJ branch to a friend and former RJ co-worker for a purchase price to be paid monthly over a four-year period, totaling approximately 40% of the RJ branch's revenue. According to the Opinion, the Adviser directed a substantial majority of UASNM clients' bond trades to the RJ branch for execution from 2008 to 2011, which generated significant commissions for the RJ branch, which were used by its owner to pay the Adviser. The SEC also noted that this arrangement was not disclosed on UASNM's Forms ADV filed during such period or its website, which stated that no arrangement existed between the recommended broker and UASNM and that UASNM's advice was free from conflicts of interest. The SEC alleged that, upon his own admission, the Adviser agreed that he traded through the RJ branch "because then he got paid," and that he likely could have received better prices for his clients if he had sought multiple bids from different broker-dealers.

The SEC's Division of Enforcement (the "**Division**") initially brought an administrative proceeding against the Adviser in 2014 before an administrative law judge. The administrative law judge agreed with the Division that the Adviser, by failing to correct the material misstatements in UASNM's Forms ADV and on its website regarding UASNM's independence, violated, and aided and abetted and caused UASNM's violations of, the antifraud provisions of the federal securities laws, including Sections 17(a)(1) and 17(a)(3) of the Securities Act of 1933 (the "**Securities Act**"), Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Rules 10b-5(a) and 10b-5(c) thereunder, and Sections 206(1) and 206(2) of the Advisers Act. The administrative law judge barred the Adviser from the industry for seven-and-a-half years, imposed a civil money penalty of $75,000, but declined to order disgorgement of the $1,068,084 the Adviser received from the owner of the RJ branch.

Both the Division and the Adviser appealed. According to the Opinion, the Adviser argued that in order to prove its claims under the antifraud provisions, the Division was required to establish that he made a material misrepresentation or omission, which he had not made since the primary responsibility for such filings and public disclosures had been delegated to another officer of UASNM. The SEC disagreed,

however, and noted that although the Adviser may not have personally "made" the material misstatements in UASNM's Forms ADV and on its website, he failed to promptly correct the material omissions despite having a fiduciary duty to do so. Further, the SEC found that the Adviser acted deceptively in failing to correct the misstatements, thereby leaving his clients with the false impression that UASNM had no arrangements with broker-dealers. As such, the SEC concluded that the Adviser employed a deceptive device with, at a minimum, extreme recklessness, and was thus liable under the antifraud provisions of the Securities Act, the Exchange Act and the Advisers Act. The SEC also found that the Adviser violated Sections 206(1) and 206(2) of the Advisers Act by failing to seek best execution for his clients.

In addition, the SEC disagreed with the administrative law judge that the Adviser's proceeds from the owner of the RJ branch were "legal profits" and ordered the Adviser to disgorge the full $1,068,084 he received, minus amounts he has already paid to UASNM clients in connection with a prior litigation in state court, resulting in a disgorgement order of $562,001.26 plus judgment interest. Finally, the SEC extended the Adviser's industry bar to one without time limitations.

- **See a copy of the Opinion**

SEC Charges Two Unrelated Investment Advisers for Failing to Disclose Loans from Broker-Dealers

On July 18, 2016, the SEC issued two orders (the "**Orders**") instituting and settling administrative and cease-and-desist proceedings under Sections 203(e) and 203(k) of the Advisers Act against Advantage Investment Management, LLC ("**AIM**") and Washington Wealth Management, LLC ("**WWM**"), each a registered investment adviser, relating to each adviser's failure to disclose a loan from a broker-dealer whom the adviser had engaged to provide services to its clients.

According to the Order relating to AIM, in 2012, AIM entered into an agreement with a third-party broker-dealer to provide execution, trading, custody and reporting services for AIM's clients. In connection with this agreement, the SEC stated that the broker-dealer issued a forgivable loan of approximately $3 million, which was to be forgiven over a five-year period so long as AIM's relationship with the broker-dealer continued. According to the SEC, although AIM's Form ADV from 2015 contained disclosure that acknowledged the possibility that an AIM investment adviser representative who had recently become associated with AIM "may" receive payments from the broker-dealer pursuant to a forgivable loan arrangement, it did not address the existence, nature and magnitude of the loan actually received in 2012. Nor did AIM explain the resulting conflicts of interest with AIM's continued use and recommendation of the broker-dealer for execution of client trades, custody of client assets, and reporting and research services, or how AIM addressed such conflicts.

According to the Order relating to WWM, in 2012, WWM entered into an agreement with a newly engaged broker-dealer to provide execution, trading, custody and reporting services for WWM's clients. In connection with this agreement, the broker-dealer made loans totaling approximately $1.8 million, $1.1 million of which was to be forgiven over a five-year period so long as WWM's relationship with the broker-dealer continued and WWM maintained certain asset levels on the broker-dealer's custodial platforms. According to the SEC, WWM did not disclose the existence, nature or magnitude of these loans from the broker-dealer to its clients, either in its Form ADV or otherwise, until October 16, 2013, in response to an examination by the SEC's Office of Compliance Inspections and Examinations. By the end of 2013, the SEC stated that WWM terminated its relationship with the broker-dealer and repaid all of the loans.

The SEC concluded that, based on the conduct described above, each of AIM and WWM willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice, or course of business that operates as a fraud upon any client or prospective client, as well as Section 207 of the Advisers Act, which makes it unlawful for any person to make any untrue statement of any material fact or omit any material fact in any report filed with the SEC.

Each of AIM and WWM consented to its respective Order without admitting or denying the SEC's findings. The SEC also ordered AIM and WWM to cease and desist from further violations and to pay a civil penalty of $60,000 and $50,000, respectively.

- **See a copy of the Order Relating to AIM**
- **See a copy of the Order Relating to WWM**

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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