Investment Management Regulatory Update

July 14, 2015

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SEC Rules and Regulations

SEC Updates Staff Responses to Questions About Pay-to-Play Rule

On June 25, 2015, the staff of the SEC's Division of Investment Management updated a response in its frequently asked questions ("**FAQs**") regarding Rule 206(4)-5 (the "Pay-to-Play Rule") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**").

Among other things, the Pay-to-Play Rule prohibits an SEC-registered investment adviser, certain advisers exempt from registration (including so-called exempt reporting advisers and foreign private advisers) and their "covered associates" from providing or agreeing to provide, directly or indirectly, a "payment" to a third party (such as a solicitor or placement agent) to "solicit" a "government entity" for investment advisory services on behalf of such adviser, unless such third party is a "regulated person." A "regulated person" is defined in the Pay-to-Play Rule as (i) an SEC-registered investment adviser in compliance with the political contribution restrictions of the Pay-to-Play Rule, (ii) an SEC-registered broker-dealer that is a member of the Financial Industry Regulatory Authority ("**FINRA**") or (iii) a municipal adviser registered with the SEC under Section 15B of the Securities Exchange Act of 1934 (the "**Exchange Act**") that is subject to pay-to-play rules adopted by the Municipal Securities Rulemaking Board ("**MSRB**"), provided that, in the case of clauses (ii) and (iii), the SEC determines by order that FINRA and MSRB have pay-to-play rules that are (A) substantially equivalent or more stringent than the Pay-to-Play Rule and (B) consistent with the objectives of the Pay-to-Play Rule.

On June 25, 2015, the SEC provided notice setting the compliance date for the third-party solicitation ban as July 31, 2015. In its update to the FAQs, the SEC clarified that it would not recommend enforcement action against investment advisers for payments to third-party solicitors under the Pay-to-Play Rule until the later of (i) the effective date of a substantially equivalent or more stringent pay-to-play rule adopted by FINRA, as described above, or (ii) the effective date of a substantially equivalent or more stringent pay-to-play rule adopted by MSRB, as described above.

For more information regarding the Pay-to-Play Rule, please see the **July 14, 2010, April 15, 2011, February 21, 2012, April 19, 2012 and June 19, 2012 Investment Management Regulatory Updates**.

- **See a copy of the FAQs**

SEC Grants No-Action Relief Permitting a Fund of Funds in the Same Group of Investment Companies to Invest a Portion of its Assets in Investments That Might Not Be Securities

On June 29, 2015, the Staff of the Division of Investment Management of the SEC (the "**Division**") issued a letter (the "**Letter**") providing no-action relief to Grant Park Multi Alternative Strategies Fund, a series of Northern Lights Fund Trust (the "**Trust**," and the series, the "**Fund of Funds**"), an open-end management investment company registered under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), that invests in another series of the Trust in the same group of registered investment companies as the Fund of Funds (such other series, the "**Underlying Fund**").

Section 12(d)(1)(A) of the Investment Company Act generally prohibits, among other things, a registered investment company (a "**RIC**") from acquiring securities issued by another RIC if, immediately after the acquisition, the acquiring RIC: (i) would own more than three percent of the outstanding voting stock of the acquired RIC; (ii) would have more than five percent of its total assets invested in the acquired RIC; or (iii) would have more than ten percent of its total assets invested in the acquired RIC and all other RICs. Section 12(d)(1)(B) of the Investment Company Act generally prohibits a RIC from knowingly selling its securities to another RIC if the sale will cause the acquiring RIC to own more than 3% of the acquired RIC's total outstanding voting stock, or if the sale would cause more than 10% of the acquired RIC's total outstanding voting stock to be owned by RICs. According to the Letter, these provisions were designed to prevent potential abuses—including the layering of fees, the pyramiding of control and undue influence and overly complex structures—that could arise from investments by RICs in other RICs.

Section 12(d)(1)(G) of the Investment Company Act generally provides (among other things) a conditional exemption from the percentage limits in Sections 12(d)(1)(A) and (B) for certain fund of funds arrangements within the same group of RICs. Rule 12d1-2 under the Investment Company Act permits a fund of funds relying on Section 12(d)(1)(G) to invest in, among other things, any types of securities that are consistent with its investment policies.

According to representations made by the Trust in its letter to the Division (the "**Incoming Letter**"), the Fund of Funds and Underlying Funds have the same investment adviser and the Fund of Funds' investment objectives, policies and restrictions allow it to invest in the Underlying Funds as well as in other assets that may or may not be securities under the Investment Company Act. The Trust represented in the Incoming Letter that the Fund of Funds buys shares of the Underlying Funds, and the Underlying Funds sell their shares to the Fund of Funds, in reliance on Section 12(d)(1)(G) and Rule 12d1-2. However, according to the Incoming Letter, Section 12(d)(1)(G) and Rule 12d1-2 do not provide for the Fund of Funds to invest in assets that might not be securities.

According to the Letter, the SEC has issued exemptive orders permitting fund of funds relying on Section 12(d)(1)(G) of the Investment Company Act to make investments in assets that might not qualify as securities under the Investment Company Act. In the Incoming Letter, the Trust argued, on behalf of the Fund of Funds, that its request for no-action relief was consistent with the rationale behind these exemptive orders.

According to the Letter, the Division would not recommend enforcement action against the Fund of Funds or an Underlying Fund under Sections 12(d)(1)(A) and (B) of the Investment Company Act based on the facts and representations described above and in the Incoming Letter if the arrangement meets all of the provisions of Section 12(d)(1)(G) of the Investment Company Act and Rule 12d1-2 thereunder, except for Rule 12d1-2(a)(2) to the extent that it restricts the Fund of Funds from investing in assets that might not be securities under the Investment Company Act.

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

Industry Update

Division of Investment Management Issues Guidance on Personal Securities Transactions Reports by Registered Investment Advisers

In June 2015, the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update (the "**Guidance**") to assist registered investment advisers in determining how to apply Rule 204-1 under the Advisers Act relating to personal securities trading of advisory personnel in the context of certain advisory personnel's trusts and third-party discretionary accounts.

Under Section 204A of the Advisers Act, a registered investment adviser must generally maintain and enforce written policies to prevent the misuse of material nonpublic information, including information about the adviser's securities recommendations and client holdings and transactions. Under Rule 204A-1 under the Advisers Act, the adviser's written code of ethics must generally include (among other things) requirements for the reporting of personal securities holdings and trading activity by certain advisory personnel, including the adviser's directors, officers, partners and supervised persons with access to nonpublic information regarding securities transactions ("**access persons**"). Pursuant to subsection (b)(3)(i) of Rule 204A-1, however, there is an exception to the reporting requirements when an access person has "no direct or indirect influence or control" over the accounts in which the securities are held. As an example, the Division explained that the reporting exception would apply to a blind trust in which a trustee manages funds for the benefit of an access person who has no knowledge of the trustee's specific management actions and has no right to influence the trustee's management.

However, the Division noted that advisers and their access persons have applied the reporting exception where the access person (i) has granted to a third-party trustee management authority over a trust of which the access person is a grantor or beneficiary, and has limited involvement in trust affairs, or (ii) has provided a third-party manager with discretionary investment authority over the access person's personal account. In the Guidance, the SEC clarified that the mere fact that an access person has granted a trustee or third-party manager management or discretionary investment authority over his or her trust or personal account is not, by itself, sufficient for an adviser to rely on the reporting exception. Specifically, the Division noted that granting such authority does not prevent the access person from providing directions or suggestions for investments by the trustee or manager, which could result in direct or indirect influence or control. However, the Division also stated that discussions in which the trustee or manager communicates account activity to an access person without receiving suggestions or directions would not suggest influence or control on the access person's part.

The Division recommended that advisers seeking to rely on the reporting exception implement policies and procedures to determine whether an access person actually had direct or indirect influence or control over the trust or account. The Division suggested that the following considerations be taken into account in making such determination:

- **Nature of the relationship**. Advisers should gather information about the nature of the relationship between an access person and the trustee and/or third-party manager (i.e., friend or family member, independent professional, etc.).
- **Periodic certifications**. Advisers should obtain periodic certifications by access persons and their trustees or third-party managers with respect to the access persons' influence or control over trusts or accounts. A general certification would be insufficient; rather, advisers should obtain specific certifications using explicit questions on whether the access person exercised influence or control in particular circumstances.
- **Clear explanation**. Advisers should provide access persons with the exact wording of the reporting exception, as well as a clear definition of "no direct or indirect influence or control." Advisers should apply this definition consistently to all access persons.
- **Reports**. Advisers should request, on a sample basis, reports on holdings and/or transactions made in the trust or discretionary account to identify transactions that, without the reporting exception, would have been prohibited under the adviser's code of ethics.
- **See a copy of the IM Guidance Update**

SEC Announces Retirement-Targeted Industry Reviews and Examinations Initiative

On June 22, 2015, the National Examination Program (the "**NEP**"), administered by the SEC's Office of Compliance Inspections and Examinations ("**OCIE**"), launched a multi-year Retirement-Targeted Industry Reviews and Examinations Initiative. The NEP will examine SEC-registered investment advisers and broker-dealers (collectively, "**registrants**") with a focus on areas of the registrants' sales, investment and oversight processes that the NEP identifies as high risk, particularly those activities which may harm retail investors' retirement savings.

According to the announcement, the NEP will identify examinees through the use of data analytics, information from prior examinations and examiner-driven due diligence. The NEP may also consider the activities of the representatives of registrants in its selection process or examinations.

The NEP has identified the following areas of focus:

- **Reasonable Basis for Recommendations**. The NEP will assess registrants' compliance with applicable federal laws and self-regulatory rules when: (i) selecting account types, (ii) performing due diligence on investments, (iii) recommending initial investments and (iv) managing client accounts.
- **Conflicts of Interest**. The NEP will examine whether registrants have instituted compliance programs that identify and address the risks associated with registrants' conflicts of interest and whether material conflicts of interest are disclosed or otherwise addressed. In the announcement, the NEP cited conflicts stemming from the structure of registrants' business or compensation, personal relationships and relationships with service providers.
- **Supervision and Compliance Controls**. The NEP will evaluate the registrants' oversight of and controls, policies and procedures for supervising persons acting on their behalf, as well as registrants' compliance with those policies. Additionally, the NEP may also review registrants with multiple or distant branch offices and their representatives which have other business activities.
- **Marketing and Disclosure**. The NEP will inspect registrants' marketing materials and disclosures to retail investors to determine whether (i) the content of the materials and the representatives' representations contain material misstatements or omissions, (ii) registrants' fee disclosures are complete and accurate and (iii) the registrants' credentials and endorsements are true and comport with any cited standards.

According to the announcement, the NEP may include additional topics for examination beyond these areas of focus based on the findings of the examinations.

- **See a copy of the Announcement**

SEC Commissioners Issue Statements on the Role of CCOs in the Wake of Recent SEC Settlements Charging CCOs with Violations of the Investment Advisers Act

On June 18, 2015, SEC Commissioner Daniel M. Gallagher addressed his reasons for dissenting in two recent enforcement actions involving alleged violations by chief compliance officers ("**CCOs**") of Rule 206(4)-7 ("**Rule 206(4)-7**") promulgated under the Advisers Act. In response to Gallagher's statement and the resulting publicity, SEC Commissioner Luis A. Aguilar made a statement on June 29, 2015.

In his remarks, Gallagher first discussed how the SEC, in both *In the Matter of Blackrock Advisors, LLC* and *In the Matter of SFX Financial Advisory Management Enterprises, Inc.*, charged CCOs in relation to their failure to implement their respective firms' policies and procedures in violation of Rule 206(4)-7. (For more information on the *SFX* charges, please see the article below, **SEC Charges Registered Investment Adviser and CCO in Connection with Alleged Responsibility for Compliance Failures and Other Violations**. For more information on the *Blackrock* charges, please see the **May 20, 2015 Investment Management Regulatory Update**.) According to Gallagher, however, the requirement to "[a]dopt and implement written policies and procedures reasonably designed to prevent violations" under Rule 206(4)-7 is the responsibility of the adviser, not the CCO, and recent settlements by the SEC have signaled, in Gallagher's opinion, an unfortunate trend toward strict liability for CCOs under this rule. Gallagher highlighted the potential negative effects such a trend could have on the compliance function, including possibly encouraging CCOs to adopt less comprehensive compliance policies and procedures or disincentivizing CCOs from taking ownership of their firm's policies and procedures. According to Gallagher, the central issue lies with Rule 206(4)-7 itself, which by its terms does not offer much clarity regarding the distinction between the role of the CCO and that of the firm in implementing the compliance function. Further, Gallagher highlighted that the SEC has never issued guidance regarding compliance with Rule 206(4)-7. According to Gallagher, the uncertainty regarding Rule 206(4)-7 should not be resolved through enforcement actions, but rather the SEC should review the rule to determine whether SEC guidance, or possibly an amendment, is required.

In his remarks, Aguilar began by noting that Gallagher's statement left the impression among the CCO community that the SEC has taken too harsh a stance against CCOs, which, in Aguilar's opinion, has created an unnecessary and unwarranted fear among CCOs. Aguilar highlighted how few cases the SEC has brought over the past six years directly against CCOs related solely to their compliance functions and that the uptick in recent years coincides with both the growth in the investment advisory industry and the new requirement for many private fund advisers to register as a result of the Dodd-Frank Act. According to Aguilar, enforcement actions against CCOs for violations of Rule 206(4)-7 are rare, and such cases involve CCOs demonstrating egregious conduct, such as failing to conduct an annual review or making a material misstatement in their firm's Form ADV. According to Aguilar, CCOs who carry out their compliance functions competently, diligently and in good faith should not fear the prospect of an SEC enforcement action, as the SEC approaches actions against CCOs very carefully to ensure the right balance is struck between encouraging CCOs to carry out their function diligently and deterring those who otherwise would fail to do so. Finally, Aguilar noted how any effective compliance program is not the responsibility of the CCO alone, but rather necessarily involves the support of a firm's senior leadership.

- **See a copy of Gallagher's statement**
- **See a copy of Aguilar's statement**

Litigation

SEC Charges KKR with Misallocating Broken Deal Expenses

On June 29, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Kohlberg Kravis Roberts & Co. L.P. ("**KKR**") for misallocating $17.4 million in broken deal expenses to its main private equity funds, in breach of its fiduciary duty and in violation of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

The SEC alleged that from 2006 to 2011 (the "**Relevant Period**"), KKR's main "flagship" funds (the "**Flagship Funds**") made investments of $30.2 billion. During the Relevant Period, KKR's dedicated co-investment vehicles and other KKR affiliated investment vehicles (the "**Co-Investors**") invested $4.6 billion, including $750 million from dedicated co-investment vehicles for KKR's executives, certain consultants and others, for whom a certain percentage of every portfolio investment was reserved. During the Relevant Period, the Flagship Funds incurred approximately $338 million in broken deal expenses (principally consisting of diligence, research and other expenses related to unsuccessful buyout opportunities), which KKR allocated to the Flagship Funds based on the geographic region in which the opportunity was located. For example, fees incurred in connection with potential North American investments were allocated to the KKR 2006 Fund L.P., which invested primarily in North America. However, according to the Order, although the Co-Investors participated in and benefited from KKR's sourcing of private equity transactions, KKR did not allocate broken deal expenses to the Co-Investors. The SEC also alleged that KKR failed to expressly disclose in either the limited partnership agreements of its Flagship Funds or in related offering materials that it did not allocate broken deal expenses to Co-Investors. According to the Order, KKR also did not have in place a written compliance policy to govern its fund expense allocation until 2011.

Under Section 206(2) of the Advisers Act, investment advisers are generally prohibited from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. The SEC alleged that KKR violated Section 206(2) by not disclosing in its funds' limited partnership agreements and related offering materials that KKR did not allocate any broken deal expenses to Co-Investors. According to the SEC, the limited partnership agreements of the KKR Flagship Funds generally provided that such funds would pay all broken deal expenses incurred "by or on behalf of" such funds, but neither such agreements nor the offering materials of such funds provided disclose or stated that KKR did not allocate broken deal expenses to Co-Investors even though such vehicles participated in and benefited from KKR's sourcing of transactions. Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder generally require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. The SEC further alleged that KKR violated Section 206(4) and Rule 206(4)-7 by not adopting and implementing a written compliance policy to govern its broken deal expense allocations during the Relevant Period.

According to the Order, in June 2011, KKR conducted an internal review that recognized the need for a written policy on broken deal expense allocations. Subsequently, KKR drafted a policy setting forth its allocation practices at the time and decided to attribute some share of broken deal expenses to several committed capital co-investment vehicles. In October 2011, according to the SEC, KKR engaged a third-party consultant to review these practices and then revised its allocation policy in 2012 to allocate a share of broken deal expenses to Co-Investors based on a number of factors, including the amount of committed capital and amount of invested capital. In 2013, during an examination of KKR by the SEC's Office of Compliance Inspections and Examinations, KKR refunded to its Flagship Funds a total of $3.26 million in certain broken deal expenses allocated to them from 2009 to 2011.

According to the Order, KKR agreed to settle the charges without admitting or denying the SEC's findings. The SEC ordered KKR to pay over $14 million in disgorgement (not including the $3.26 million that was previously refunded) as well as more than $4.5 million in prejudgment interest and a $10 million

penalty, and to cease and desist from any violations or future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

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

SEC Charges Registered Investment Adviser and CCO in Connection with Alleged Responsibility for Compliance Failures and Other Violations

On June 15, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against SFX Financial Advisory Management Enterprises, Inc. ("**SFX**"), a Washington, D.C.-based registered investment adviser for failing to supervise SFX's former president and failing to adopt policies and procedures reasonably designed to prevent the misappropriation of client assets and failing to implement existing policies, thereby violating Sections 203(e), 203(f) and 203(k) of the Advisers Act. The SEC further charged SFX's CCO with causing certain of these violations. In connection with the Order, the SEC announced fraud charges against the former president of SFX for allegedly stealing client funds.

According to the SEC, from 2006 to 2011, SFX's former president misappropriated at least $670,000 in assets from client accounts. In the Order, the SEC stated that in July 2011, the CCO discovered this misappropriation and ultimately terminated the former president and reported his actions to the criminal authorities. However, according to the SEC, SFX's compliance policies and procedures were not reasonably designed to prevent such misappropriation given the significant risk that individuals, such as the former president, with signatory power over client bank accounts could misappropriate such funds. Although SFX's compliance policy required that the cash flows in client accounts be reviewed, the SEC alleged that this policy was not effectively implemented. Further, SFX's Form ADV, Part 2 brochure disclosed that such cash accounts were "reviewed several times each week by senior management for accuracy and appropriateness," when in fact, according to the SEC, the former president was the only one who reviewed such accounts. In addition, the SEC stated that SFX had no reasonable basis to believe, after due inquiry, that custodians were providing clients with bank statements, in violation of Rule 206(4)-2 promulgated under Section 206(4) of the Advisers Act (the "custody rule").

The SEC also alleged that SFX did not conduct an annual review of its compliance program in 2011, and that the CCO was negligent in such failure.

SFX and the CCO agreed to settle the charges without admitting or denying the SEC's findings. The SEC ordered SFX to pay a civil money penalty of $150,000 and the CCO to pay a civil money penalty of $25,000. Further, the SEC censured SFX and the CCO and ordered each to cease and desist from committing or causing and violations or future violations of Sections 206(2), 206(4) and 207 of the Advisers Act and Rules 206(4)-2 and 206(4)-7 thereunder.

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

SEC Charges Registered Investment Adviser with Failure to Conduct Timely Annual Compliance Program Reviews and Other Violations

On June 23, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Pekin Singer Strauss Asset Management Inc. ("**Pekin Singer**"), a Delaware registered investment adviser, for failing to conduct timely annual compliance program reviews in 2009 and 2010 and failing to implement and enforce provisions of its policies and procedures and code of ethics during the same period, thereby violating Sections 206(4) and 204A of the Advisers Act and Rules 206(4)-7 and 204A-1 promulgated thereunder. In addition, the Order instituted and settled proceedings against Ronald L. Strauss ("**R. Strauss**"), Pekin Singer's president at the time, for failing to

dedicate adequate resources to Pekin Singer's compliance program and allowing the firm's Form ADV to include misleading disclosures regarding its code of ethics, thereby violating Section 207 of the Advisers Act. Finally, the Order instituted and settled proceedings against Pekin Singer, William A. Pekin ("**W. Pekin**") and Joshua D. Strauss ("**J. Strauss**") for failing to seek best execution for certain clients and failing to adequately disclose their conflicts of interest in placing and maintaining certain clients who were eligible for a less expensive share class in the more expensive share class of an open-end mutual fund managed by Pekin Singer, thereby violating Sections 206(2) and 207 of the Advisers Act.

According to the SEC, Pekin Singer and R. Strauss failed to dedicate adequate resources to the firm's compliance function, despite repeated requests by the chief compliance officer ("**CCO**") for additional support to fulfill his compliance responsibilities. Further, according to the Order, the CCO had a hybrid role with both research and compliance responsibilities, yet R. Strauss directed the CCO to prioritize his research tasks over his compliance responsibilities. As a result, the SEC found that the CCO was unable to complete timely annual compliance program reviews for the years 2009 and 2010 and thus did not adequately evaluate the effectiveness of Pekin Singer's compliance policies and procedures and code of ethics, which resulted in several violations of the same. In addition, according to the Order, Pekin Singer's code of ethics in effect during 2011 and 2012 included several misleading disclosures, including statements that the firm's employees were required to submit initial and annual securities holdings reports and that employees were prohibited from trading securities prior to transactions for the firm's advisory clients. According to the SEC, Pekin Singer did not collect holdings reports from 2009 until 2012, and certain employees did not follow the personal trading restrictions, yet the firm's Form ADV did not disclose such failures.

According to the Order, Pekin Singer also failed to transfer certain of its qualifying clients invested in its open-end mutual fund ("**Appleseed**") into a new share class with a lower expense ratio. The Order states that Appleseed had a single share class at launch, into which Pekin Singer invested several of its separately-managed account clients. Several years later, according to the Order, Pekin Singer, W. Pekin and J. Strauss launched an additional share class with an expense ratio that was 25 basis points lower than the original class. According to the SEC, the 25-basis-point differential represented an administrative services fee, which Appleseed paid to Pekin Singer. The SEC found that, despite certain clients' eligibility for the new share class with the lower expense ratio, Pekin Singer, W. Pekin and J. Strauss decided not to transfer such clients to the new share class. In addition, according to the Order, Pekin Singer, W. Pekin and J. Strauss decided to convert a small number of clients to the new share class where such conversion simultaneously reduced the firm's platform fees in connection with Appleseed, resulting in a net gain for the firm of five basis points.

Pekin Singer, R. Strauss, J. Strauss and W. Pekin agreed to settle the charges without admitting or denying the SEC's findings. The SEC ordered Pekin Singer to pay a civil money penalty of $150,000 and each of R. Strauss, J. Strauss and W. Pekin to pay a civil money penalty of $45,000. Further, the SEC censured Pekin Singer, W. Pekin and J. Strauss and suspended R. Strauss from acting in a compliance or supervisory capacity in the financial services industry for 12 months.

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

Investment Adviser and Mutual Fund Board Charged with Failures in Advisory Contract Approval Process

On June 17, 2015, the SEC issued an order (the "**Order**") instituting administrative and cease-and-desist proceedings against Commonwealth Capital Management, LLC ("**Commonwealth**"), a mutual fund adviser, its principal and three mutual fund board members (one of whom was an interested board member) for failing to satisfy their obligations under Section 15(c) of the Investment Company Act relating to the evaluation and approval of advisory contracts. The SEC charged Commonwealth for providing incomplete or inaccurate information to the boards of the mutual funds it advised, its principal for causing

such violations and the board members for approving an advisory contract without the information the board had requested as reasonably necessary to its decision.

Section 15(c) of the Investment Company Act generally makes it unlawful for a registered investment company to enter or renew an advisory contract without the approval of a majority of disinterested directors. According to the SEC, Section 15(c) imposes a duty on the fund's directors to request and review such information that may be reasonably necessary to evaluate the terms of an advisory contract, and further requires investment advisers to provide such requested information.

The Second Circuit addressed what factors an investment company board should consider when evaluating an advisory contract in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 930 (2d Cir. 1982). The factors, referred to as the "*Gartenberg* Factors," include: (i) the adviser's cost to provide the services; (ii) the nature and quality of the services; (iii) the extent to which the adviser realizes economies of scale as the fund grows; (iv) the profitability of the fund to the adviser; (v) the fee structures of comparable funds; (vi) fall-out benefits for the adviser or its affiliates and (vii) the independence, expertise, care and conscientiousness of the fund board. The SEC notes in the Order that the SEC has specified similar factors in Item 27(d)(7)(i) of Form N-1A (a fund's shareholder report).

Commonwealth served as investment adviser to various mutual funds in the World Funds Trust ("**WFT**") and World Funds Inc. ("**WFI**") complexes. In the course of the initial approval and subsequent reapproval processes of Commonwealth's advisory contracts, the boards of WFT and WFI requested information from Commonwealth regarding the fees and expenses paid and the nature and quality of the services provided. The boards also requested that Commonwealth provide fee information for comparable funds.

According to the Order, Commonwealth failed to provide the WFT board of trustees with any of the comparative fee information that it requested. Furthermore, Commonwealth disclosed only limited information about the nature and quality of the services it provided to the funds. The SEC found that the board members then approved the advisory contract despite having never received all of the information the board had requested. Additionally, the SEC found that the comparable advisory fee information Commonwealth provided to WFI's board contained numerous invalid comparisons because Commonwealth did not remove incomparable share classes of other funds, incongruous fund types and funds with different fee structures. Certain fee information was also allegedly missing, incomplete or inaccurate. Furthermore, Commonwealth allegedly failed to provide the financial statements requested by the WFI board. Additionally, Commonwealth incorrectly stated, according to the Order, that no advisory fees were waived under an expense limitation agreement, even though it had waived a portion of the fee, and stated that breakpoints had been provided in its contract, when the breakpoints had been omitted from its proposal.

The SEC found that Commonwealth violated Section 15(c) of the Investment Company Act by failing to provide the boards with all the necessary information requested and for providing inaccurate information to the boards. It further found that the board members had violated Section 15(c) by approving the initial advisory contracts for the WFT funds without receiving all the information the board had requested. According to the Order, Commonwealth and the board members agreed to settle the charges without admitting or denying the SEC's findings. The SEC ordered Commonwealth and its principal to jointly and severally pay a civil money penalty of $50,000, the board members each to pay a civil money penalty of $3,250 and for Commonwealth, its principal and the board members to cease and desist from any violations or future violations of Section 15(c).

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

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.

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Yukako Kawata	**212 450 4896**	**yukako.kawata@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Beth M. Bates	**212 450 4062**	**beth.bates@davispolk.com**

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