

## SEC Recent Developments

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Below is a summary of certain recent guidance from the Securities and Exchange Commission (the “SEC”) that is applicable to investment advisers and broker-dealers, namely: (i) an SEC Risk Alert regarding the Custody Rule applicable to investment advisers; (ii) an SEC Request for Information regarding the standards of care applicable to investment advisers and broker-dealers; and (iii) the SEC’s Examination Priorities for 2013 with respect to investment advisers.

### A. SEC Issues Risk Alert on Custody Rule

On March 4, 2013, the National Examination Program (the “NEP”) of the SEC’s Office of Compliance Inspections and Examinations published a Risk Alert (the “Risk Alert”) in response to “significant deficiencies” in compliance by investment advisers with Rule 206(4)-2 (the “Custody Rule”) of the Investment Advisers Act of 1940, as amended (the “Advisers Act”).<sup>1</sup> The Risk Alert states that the NEP reviewed recent examinations that contained deficiencies and approximately one-third included custody-related issues. Additional information regarding the Custody Rule is available at [http://www.skadden.com/sites/default/files/publications/Publications1988\\_0.pdf](http://www.skadden.com/sites/default/files/publications/Publications1988_0.pdf).

In conjunction with the Risk Alert, on March 4, 2013, the SEC also issued an Investor Bulletin to explain the Custody Rule to investors.<sup>2</sup> The Risk Alert identifies four main categories of Custody Rule non-compliance and includes specific examples of non-compliance within each category.

- 1. Failure by advisers to recognize that they have custody under the Custody Rule.** Examples cited by the SEC include where the adviser has physical possession of client assets and where the adviser serves as the general partner of a pooled investment vehicle that is a limited partnership or holds a comparable position for a different type of pooled investment vehicle. The SEC also noted failures where the adviser or a related person has signatory and check-writing authority for client accounts.
- 2. Failure to comply with surprise examination requirements.** In particular, the SEC cited instances where Form ADV-E was not filed with the SEC within 120 days after the date of the examination and where evidence suggested that examinations were not being conducted on a “surprise” basis (e.g., exams were conducted at the same time each year).
- 3. Failure to comply with qualified custodian requirements.** The SEC noted instances where the adviser, when holding client assets in the adviser’s name, failed to meet the requirements that the assets be held in an account (i) under the adviser’s name as agent or trustee for the client and (ii) that holds only such client’s assets. The SEC also observed instances of commingling by the adviser of client, proprietary and employee assets into one account and instances where the adviser did not have a reasonable basis, after due inquiry, for believing that a qualified custodian was sending quarterly account statements to the client.

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<sup>1</sup> The full text of the Risk Alert is available at <http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>.

<sup>2</sup> The Investor Bulletin is available at <http://www.sec.gov/investor/alerts/bulletincustody.htm>.

**4. Failure to comply with “audit approach” requirements by advisers to pooled investment vehicles.** Examples of such failures included where the accountant that conducted the audit was not “independent” under Regulation S-X or the accountant was not PCAOB-registered and subject to PCAOB inspection. The SEC also observed instances where a final audit was not performed on liquidated pooled investment vehicles. The SEC also noted deficiencies where the audited financial statements were not prepared in accordance with U.S. generally accepted auditing procedures (“U.S. GAAP”) (e.g., organizational expenses were improperly amortized rather than expensed as incurred, resulting in a qualified audit opinion; financial statements were prepared on a federal income tax basis; the adviser could not substantiate fair valuations and the accountant therefore could not issue an unqualified opinion). With respect to advisers subject to the Custody Rule who advise non-U.S. pooled investment vehicles that prepare their financial statements in accordance with International Financial Reporting Standards, the SEC noted deficiencies where (i) the audit was not conducted in accordance with U.S. generally accepted auditing standards and/or (ii) the financial statements did not contain information substantially similar to financial statements prepared in accordance with U.S. GAAP.

### **B. SEC Seeks Information to Assess Standards of Conduct and Other Obligations of Broker-Dealers and Investment Advisers**

On March 1, 2013, the SEC published a request for information to determine whether a more uniform standard of care should be applied to broker-dealers and investment advisers who provide securities advice to retail customers (the “Request for Information”).<sup>3</sup> While investment advisers have a fiduciary duty under the Advisers Act to act in the best interests of their clients, broker-dealers are not uniformly considered fiduciaries with respect to their customers. Broker-dealers are, however, subject to regulation under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and the rules of each self-regulatory organization to which they belong.

The SEC noted that since the enactment of the Advisers Act and the Exchange Act, the line between the services provided by investment advisers and broker-dealers has blurred, raising a concern that regulatory obligations are being determined based on the agency or organization of registration instead of on the services being provided.

In addition, the SEC is concerned about retail customer confusion regarding standards of conduct. “Studies have shown that few investors realize that the standard of care they receive depends on the type of investment professional they use. And often investors do not know which type of financial professional they are relying on,” said SEC Chairman Elisse B. Walter. “This request for information will help us in our ongoing consideration of alternative standards of conduct for certain broker-dealers and investment advisers, as well as potential harmonization of other aspects of regulation in this area.”

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act gives the SEC the authority, in its discretion, to adopt rules establishing a uniform fiduciary standard of conduct for all investment advisers and broker-dealers when providing personalized investment advice about securities to retail customers, which standard would be no less stringent than the fiduciary duty currently applicable to investment advisers.

The SEC is requesting information to assist it in determining whether to engage in rulemaking, and if so, what the nature of such rulemaking ought to be. The SEC is particularly interested in qualitative data and economic analysis regarding potential costs and benefits to the industry and investors associated with changing existing standards. The Request for Information also includes several alternatives to a uni-

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<sup>3</sup> The full text of the Request for Information is available at <http://www.sec.gov/rules/other/2013/34-69013.pdf>.

form fiduciary standard of conduct and requests information regarding whether any of the alternatives meets the goal of enhancing retail customer protection and decreasing retail customer confusion. The SEC also will use the information provided to determine whether other aspects of the regulation of investment advisers and broker-dealers can be harmonized.

Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to perform a study regarding the effectiveness of the existing standards and provide recommendations regarding any identified shortcomings. In this study, which was completed in January 2011, the Staff recommended that the SEC (i) establish a uniform fiduciary standard of conduct for all investment advisers and broker-dealers when providing personalized investment advice about securities to retail customers and (ii) harmonize the regulatory requirements of broker-dealers and investment advisers to the extent this would enhance investor protection. In conjunction with this study, the Staff requested comments regarding the benefits and costs associated with changing the existing standards and received very few comments in response.

The Request for Information was published in the Federal Register on March 7, 2013, and the SEC will collect responses until July 5, 2013.

### C. The SEC's Examination Priorities for 2013

On February 21, 2013, the NEP published its examination priorities for 2013 (the "2013 Examination Priorities"). The 2013 Examination Priorities include market-wide initiatives as well as specific priorities for each of the NEP's four program areas: (i) investment advisers and investment companies, (ii) broker-dealers, (iii) clearing and transfer agents, and (iv) self-regulatory organizations. The following overview summarizes the market-wide initiatives, the specific initiatives applicable to investment advisers and investment companies, and the specific initiatives applicable to broker-dealers.<sup>4</sup>

**Market-Wide Initiatives.** The NEP identified the following initiatives for 2013 that will apply to nearly all registrants:

#### *Fraud Detection and Prevention*

- The Staff will continue to seek to identify fraudulent or unethical behavior and will encourage "tips, complaints and referrals from investors, registrants and other parties."

#### *Corporate Governance and Enterprise Risk Management*

- The Staff will continue to focus on the management of enterprise, financial, legal, compliance, operational and reputational risk, including the "tone at the top."
- The Staff will continue to engage in "discovery" reviews and joint monitoring efforts with other regulators, such as the Federal Reserve in monitoring tri-party repurchase agreements.

In the wake of Hurricane Sandy, the Staff is examining issues with respect to business continuity plans.

#### *Conflicts of Interest*

- The Staff will focus on a firm's mitigation of conflicts, conflicts disclosure and the overall risk governance framework.

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<sup>4</sup> The full text of the 2013 Examination Priorities is available at <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>.

### *Technology*

- The Staff may review IT governance, supervision, capability and security, including risks that may adversely affect investor confidence.

**Initiatives Specific to Investment Advisers and Investment Companies.** Although the scope of an exam will vary from registrant to registrant, the 2013 Examination Priorities highlight certain predominant issues in the investment adviser/investment company space that the Investment Adviser–Investment Company Program will focus on in 2013.

### *Safety of Assets*

- The Staff will review steps taken to protect client assets from loss or theft, the adequacy of audits and the effectiveness of related policies and procedures.
- The Staff will focus on whether advisers are recognizing when they have custody under the Custody Rule, complying with the rule’s “surprise exam” requirement, satisfying the rule’s “qualified custodian” provision and following the terms of the exception to the independent verification requirements for pooled investment vehicles.

### *Conflicts of Interest Related to Compensation Arrangements*

- The Staff will look for undisclosed compensation arrangements that may cause a conflict of interest, such as “undisclosed fee or solicitation arrangements, referral arrangements (particularly to affiliated entities), and receipt of payment for services allegedly provided to third parties.”
- For example, if an adviser places client assets with a fund or fund platform and in return is paid “client servicing fees” by such fund or fund platform, such arrangement presents a conflict and must be disclosed.

### *Marketing/Performance*

- The Staff will look for aberrational performance, which can indicate fraudulent or weak valuation procedures.
- The Staff also will focus on “the accuracy of advertised performance, including hypothetical and back-tested performance, the assumptions or methodology utilized, and related disclosures and compliance with record keeping requirements.”
- The Staff also will review changes in advertising due to the JOBS Act, which will require modification of the general solicitation rules.

### *Conflicts of Interest Related to Allocation of Investment Opportunities*

- In reviewing advisers that manage, side by side, accounts that do and do not pay performance-based fees, the Staff will confirm that the registrant has controls in place to monitor the side-by-side management, particularly where the same portfolio manager is making investment decisions for both kinds of accounts.

### *Fund Governance*

- The Staff will confirm “that advisers are making full and accurate disclosures to fund boards and that fund directors are conducting reasonable reviews of such information in connection with contract approvals, oversight of service providers, valuation of fund assets, and assessment of expenses or viability.”

### *New Registrants*

- The NEP intends to launch a two-year coordinated national examination initiative with four phases: (i) engaging with new registrants, (ii) examining a substantial percentage of new registrants, (iii) analyzing examination findings and (iv) reporting observations to the industry.
- The SEC will prioritize examinations of private fund advisers where the Staff’s analytics indicate higher risks to investors or where there is an indication of fraud or serious wrongdoing.

### *Dually Registered IA/BD*

- The NEP will continue joint examinations with the B-D Program of dually registered firms and of broker-dealers and investment advisers that share common financial professionals.
- Among other things, the Staff will review “how financial professionals and firms satisfy their suitability obligations when determining whether to recommend brokerage or advisory accounts, the financial incentives for making such recommendations, and whether all conflicts of interest are fully and accurately disclosed.”
- In the case of dually registered firms, the Staff also will review policies and procedures for guidelines concerning when a financial professional makes a securities recommendation to a broker-dealer account versus an investment adviser account.

### *“Alternative” Investment Companies*

- With respect to the use of alternative and hedge fund investment strategies in open-end funds, exchange-traded funds (“ETFs”) and variable annuity structures, the Staff will assess whether: “(i) leverage, liquidity and valuation policies and practices comply with regulations; (ii) boards, compliance personnel and back-offices are staffed, funded, and empowered to handle the new strategies; and (iii) the funds are being marketed to investors in compliance with regulations.”

### *Payments for Distribution in Guise*

- The Staff will focus on various payments made by advisers and funds to distributors and intermediaries, such as payments for revenue sharing, sub-TA, shareholder servicing, and conference support services, with particular attention to whether adequate disclosure has been made to fund boards about such payments and board oversight of such payments.
- The Staff will assess whether such payments comply with regulations, including Investment Company Act Rule 12b-1, or whether they are payments for distribution and preferential treatment.

### *Money Market Funds*

- Investment Company Act Rule 2a-7 requires money market funds to periodically stress test their ability to maintain a stable share price based on hypothetical events. The Staff will review whether firms are conducting stress tests, what factors are considered in testing and test results.

### *Compliance with Exemptive Orders*

- The Staff will focus on compliance with any previously granted exemptive orders.

### *Compliance with the Pay-to-Play Rule*

- The Staff will review whether firms are in compliance with the SEC’s recently adopted Pay-to-Play rule.

**Initiatives Specific to Broker-Dealers.** Although the scope of an exam will vary from registrant to registrant, the 2013 Examination Priorities highlight certain predominant issues that the Broker-Dealer Program will focus on in 2013.

#### *Sales Practices/Fraud*

- The Staff frequently finds fraud in connection with sales practices regarding retail investors, including: affinity fraud; unsuitable recommendations, improper supervision and inadequate due diligence with respect to higher yield products; activities and products on the periphery of registered entities; conflicts of interest that are not appropriately mitigated or disclosed; and recidivist or other firms with a high risk for misconduct.

#### *Trading*

- The Staff intends to address certain trading risk areas, “with particular focus on high frequency trading, algorithmic trading, proper controls around the use of technology, alternative trading systems and order routing practices.”

#### *Capital*

- The Staff intends to examine clearing firms engaging in high-frequency/high-volume trading, focusing on management of intraday liquidity risk and assessments of intraday net capital.

#### *Anti-Money Laundering*

- The Staff will identify clearing and introducing firms that have weak AML programs, especially customer identification, suspicious activity identification and reporting deficiencies.
- The Staff will focus on how a firm’s AML program addresses the risks related to its business practices, including risks associated with taking on the accounts of failed or expelled firms.

*Compliance with Exchange Act Rule 15c3-5 (the “Market Access Rule”)*, with particular attention to the following:

- **Master/Sub-Accounts.** This structure is particularly susceptible to “money laundering, market manipulation, unregistered broker-dealers, excessive margin, and inadequate minimum equity for pattern day traders,” and consequently the Staff will pay particular attention to the adequacy of books and records maintained by broker-dealers that provide market access.
- **Proprietary Trading.** The Market Access Rule requires capital thresholds on proprietary trading, including error accounts, that must include a method for accounting for open quotes, taking into account quotes associated with market making activities.
- **Supervision of Registrants’ Technology System Controls and Governance.** The Staff has observed a series of technology system problems, both at the exchange level and at multiple broker-dealers, that have caused significant losses, eroded customer confidence and raised questions as to the effectiveness of controls and oversight over technology systems, supervision of personnel, adequacy of firms’ protocols to address problems and risk management procedures.
- **Dual Registrants – Regulatory Coordination.** The Staff will focus in this area on coordination with the Commodity Futures Trading Commission.



*Exchange-Traded Funds*

- The Staff will focus on issues risks relating to ETFs, such as fails to deliver, compliance with Regulation SHO and the suitability of recommendations of leveraged or inverse ETFs to retail investors.

*JOBS Act*

- Upon approval of a final rule that creates a new exemption from registration under the Securities Act for qualified “crowd funding” transactions, the Staff intends to review entities participating in the crowd funding business.

*Other Regulatory Requirements*

- Pending the adoption of final rules, the Staff intends to assess compliance with (i) new registration and related rules applicable to municipal advisors (ii) new rules regarding incentive compensation and (ii) new rules applicable to Security-Based Swap Dealers.