Ropes & Gray's Investment Management Update: September – October 2009

SEC Proposes Flash Order Ban

The SEC recently proposed an amendment to Rule 602 of Regulation NMS that would eliminate an exception for the use of "flash orders" by equity and options exchanges. Flash orders generally are bids or offers executed immediately after communication or bids or offers that are cancelled or withdrawn if not executed immediately after communication. Rule 602 currently excludes flash orders from the requirement that national securities exchanges make their best bids and best offers in U.S.-listed securities available in the consolidated quotation that is distributed to the public.

The exception for flash orders that was included in the predecessor to Rule 602 in 1978 initially was intended to assist manual trading in the crowd on exchange floors by excluding "ephemeral" quotations as they were not practical to include in the consolidated quotation data. The proposed amendment is the SEC 's response to current concerns that the widespread use of the flash order exception may be separating the market into two tiers—one tier in which the public does not have access, through consolidated quotation data feeds, to information about the best available prices for U.S.-listed securities, and another tier in which this information is available to a limited number of sophisticated market participants through private data channels. Comments on the proposed amendment to Rule 602 are due on or before November 23, 2009.

Temporary Money Market Portfolio Holdings Disclosure Requirements Implemented

The Treasury Department's Money Market Guarantee Program (the "Guarantee Program"), ended on September 18, 2009 and on that day the SEC voted to approve a new interim final temporary Rule 30b1-6T. Under this rule, money market funds must submit to the Commission a schedule of portfolio holdings and related information when the fund's market-based NAV (or "shadow price") falls below $0.9975. Once this occurs, the fund's portfolio holdings schedule must be submitted by the next business day, and thereafter on the last business day of each week (by the second business day of the following week) until the market-based NAV rises above $0.9975. All data submissions are confidential. Ropes & Gray has confirmed with the staff of the Division of Investment Management that a fund may include the value of any capital support agreements in its shadow pricing for purposes of the Rule.

Rule 30b1-6T is, in essence, an extension of a similar requirement under the Guarantee Program which ended on the same day, though the new rule applies to all money market funds and not just participants in the Guarantee Program. The rule was issued with immediate effectiveness for an initial term through September 17, 2010. The SEC has requested comments on, among other issues, the data items required in the schedule and whether the $0.9975 level is the appropriate reporting trigger. Under existing rules the frequency with which shadow pricing is conducted is left to the discretion of the fund's Board of Directors. Because Rule 30b1-6T does not purport to change these existing rules for funds with a market-based NAV above $0.9975, daily shadow pricing is not required.

The SEC maintains that the new rule will facilitate continued industry monitoring; however, at any given time it is likely to provide the Commission with information on only a few funds. By contrast, the portfolio holdings reporting requirement proposed as part of the SEC's money market reform initiative in June would mandate monthly reporting for all money market funds and so would appear to be better tailored to broad systemic monitoring.

Bank Custodian Pays Penalty for Customer's Failure to Disclose Excessive Mutual Fund Sales Fees

In a settlement reached with the SEC, Regions Bank (Regions) agreed to pay a fine in a case alleging that Region's customer, U.S. Pension Trust Corp. and U.S. College Trust Corp. (collectively "USPT"), defrauded approximately 14,000 investors by charging excessive, undisclosed commissions and fees in connection with the sale of mutual funds available from well-known U.S. fund companies. USPT offers and sells these mutual funds to investors primarily residing in Latin America through a series of retirement and college investment plans, allowing investors to make investments either in one lump-sum or through annual contributions. USPT employed U.S. banks to serve as trustees of the investment plans, with a bank entering into an individual trust agreement with each investor.

As a primary selling point of its plans, USPT assured investors that their investments would be safe because of this direct trust relationship with a U.S. bank. Until March of 2006, USPT did not disclose to new investors that it took up to 85% of an investor's annual contributions, and up to 18% of lump-sum contributions, in fees and commissions. USPT used these fees to pay profits to itself, sales commissions to its agents and insurance premiums to a company owned by USPT principals (the plans also included an insurance component). Until 2006, USPT did not disclose in any of its materials the fees and commissions that it charged to investors. While USPT revised its materials in 2006 to disclose the existence of these fees, it did not provide this new disclosure to existing investors that continued to make contributions under the plans.

Beginning in 2001, Regions (or its predecessor) served as trustee of several USPT plans, entering into thousands of trust agreements with investors. Pursuant to a master agreement between USPT and Regions, Regions would receive contributions from investors, deposit these funds into a Regions account, and forward to USPT, per USPT's instructions, the amounts representing the undisclosed fees, commissions and profits. The master agreement was written in English and was not provided to investors. After the transactions were processed, Regions would send a signed certificate to each investor acknowledging the creation of a trust account and confirming the total amount of the investor's contribution. The certificate, however, did not disclose the amount of the contribution that was used to pay USPT's fees and costs.

The SEC argued that USPT violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which prohibits any person from obtaining money by means of an untrue statement or material omission in the offer or sale of securities, and any course of business which would operate as a fraud upon actual or potential purchasers. Furthermore, the SEC argued that USPT violated Section 15(a)(1) of the Exchange Act, which prohibits any broker or dealer from using interstate commerce to induce the purchase or sale of any security unless the broker or dealer is registered in accordance with Section 15(b) of the Exchange Act. The SEC alleged that Regions knew, or should have known, that the excessive fees were not disclosed in USPT's marketing materials or any other materials provided to investors. Under Section 8A of the Securities Act and Section 21C of the Exchange Act, the SEC may issue a cease-and-desist order against a person that is the cause of another person's violation due to an act or omission that the person knew or should have known would have contributed to the violation. The SEC alleged that Regions was a cause of USPT's violations, and Regions agreed to settle the charges by consenting to the entry of the cease-and-desist order and payment of a $1 million penalty.

SEC Moves Forward With Credit Rating Agency Reforms

The SEC, continuing its efforts to tighten the regulation of rating agencies, has issued four releases addressing a number of the SEC rules that deal with security credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs). One of the releases, issued October 5, 2009, amended Rules 5b-3 and 10f-3 under the Investment Company Act. Rule 5b-3 permits an investment company to look through refunded securities to the underlying government securities held in escrow for purposes of determining diversification so long as certain conditions are met. One condition is that an independent certified public accountant must certify to the escrow agent that the escrowed securities will satisfy all scheduled principal, interest and premium payments on the refunded securities. Previously, Rule 5b-3 waived the certification requirement for refunded securities rated in the highest category by an NRSRO. The amendment to Rule 5b-3 eliminates this waiver. Effective November 12, 2009, all refunded securities will require an accountant's certification regardless of credit rating, or investment companies will not be permitted to look through to the underlying escrowed securities.

Rule 10f-3 under the Investment Company Act provides an exemption, subject to certain conditions, to the general prohibition in Section 10(f) of the Investment Company Act on an investment company acquiring securities for which an affiliate of the investment company is acting as a principal underwriter. Certain municipal securities with an NRSRO investment grade rating were previously included in the exemption. The SEC has amended the rule to replace the NRSRO rating requirement with certain credit and liquidity risk assessments as determined by the investment company's board of directors.

In another release issued the same day, the SEC deferred consideration of action and solicited additional comments on several rule changes it has been considering, including proposed amendments to Rules 2a-7 and 3a-7 under the Investment Company Act, additional amendments to Rule 5b-3 under the Investment Company Act, and proposed amendments to Rule 206(3)-3T under the Investment Advisers Act.

The proposed amendments to Rule 2a-7 would remove references to NRSRO ratings in determining which valuation and pricing methods a money market fund is permitted to use. Rule 3a-7, which excludes a structured finance vehicle from the definition of investment company if, among other conditions, it receives a certain rating from an NRSRO, may be amended to eliminate references to NRSRO ratings in connection with another proposal regarding the offer and sale of asset-backed securities. In addition to the amendment to Rule 5b-3 noted above, the SEC is considering further amendments to eliminate the role of NRSRO credit ratings from the determination of whether a repurchase agreement is fully collateralized for purposes of treating the repurchase agreement as an investment in the underlying collateral.

Finally, the SEC sought additional comments on a proposal to amend Advisers Act Rule 206(3)-3T. Section 206(3) of the Advisers Act generally prohibits an investment adviser from entering into a securities transaction as a principal with a client unless the investment adviser first discloses to the client in writing the capacity in which it is acting and obtains the client's consent. Rule 206(3)-3T provides certain steps that an adviser can take to satisfy the requirements of Section 206(3), but it excludes transactions in securities that are issued or underwritten by the investment adviser or any "control persons" of the investment adviser. The rule provides an exception to this general exclusion for non-convertible debt securities underwritten by the investment adviser or a "control person" if such securities are investment grade, meaning that they are rated in one of the four highest rating categories by at least two NRSROs.

The SEC proposed last year to amend Rule 206(3)-3T to require an investment adviser to make an individualized assessment of whether a security is investment grade for purposes of the rule, rather than permitting the investment adviser to rely exclusively on NRSRO ratings. In the latest release, the SEC stated that it is considering broader action than was originally proposed with respect to Rule 206(3)-3T, but it provided no details on the expected future proposal. Comments on the proposals above are due December 8, 2009.

In a separate but related release, the SEC proposed amendments to certain rules to require disclosure regarding the use of credit ratings in connection with the offering of securities by issuers, including closed-end funds. Under current rules, an issuer is not required to disclose in its prospectus credit ratings that may be used in the marketing of the securities. The SEC proposes to amend Form N-2 (and Regulation S-K and other registration statement forms, but not Form N-1A) to require an issuer to disclose in its registration statement any credit ratings used by the registrant, the underwriter, or certain other parties in connection with marketing the issuer's securities in a registered offering. This proposal would not require such disclosure if no credit ratings are used in marketing the offering.

If the disclosure requirement is triggered, then the following information must be disclosed with regard to the credit rating, to inform investors so that they can understand the scope or meaning of ratings being used to market securities, to identify potential conflicts of interest faced by credit rating agencies, and to indicate situations in which an issuer may have engaged in "ratings shopping:"

- Key elements of the credit rating, including the scope of the rating and any limitations;
- Certain relationships between the agency providing the credit rating and the registrant or its affiliates; and
- Any preliminary credit ratings obtained from agencies other than the rating agency that provided the final rating.

The SEC is also proposing to require current disclosure of changes in credit ratings that were previously disclosed in a prospectus. Amendments to Rules 13a-11 and 15d-11 would require closed-end funds to report on Form 8-K certain changes in credit ratings previously disclosed on Form N-2.

The SEC also issued a concept release requesting comment on whether to rescind Securities Act Rule 436(g), which operates to exempt certain credit ratings provided by NRSROs (but not credit ratings provided by other credit rating agencies) from Sections 7 and 11 of the Securities Act. Under Rule 436(g), credit ratings assigned by an NRSRO to a class of debt securities, a class of convertible debt securities, or a class of preferred stock are not considered a part of a registration statement prepared or certified by a person (an expert) for purposes of Section 7, and the NRSRO is not subject to liability under Section 11 even if the rating is disclosed in a registration statement. The SEC noted the disparate treatment afforded ratings agencies designated as NRSROs and those not so designated. Among other things, the release states that investors rely on credit rating agencies as experts and that, for this and other reasons, it may now be appropriate to hold NRSROs and other credit rating agencies to the same standard of liability as other experts under Section 11. Comments on this proposal are due December 14, 2009.

Lehman Bankruptcy Court Cuts Derivative Counterparty's Rights under ISDA Master

The U.S. Bankruptcy Court for the Southern District of New York has ordered Metavante Corporation to pay to Lehman Brothers Special Financing from amounts it had withheld under a swap agreement that had not been terminated by Metavante following Lehman's Chapter 11 filing. The swap was governed by a standard ISDA Master Agreement, which grants a non-defaulting party an option to terminate an ISDA Master Agreement (and all derivatives trades under the contract) upon its counterparty's default as well as a right to withhold future payments on all transactions under the ISDA Master Agreement upon a default by its counterparty.

The presiding judge's order reached several conclusions that are potentially significant to holders of derivatives contracts. First, the order suggested that Metavante had waived its right to terminate the swap by failing to exercise that right for eleven months after the right arose, notwithstanding that Section 9(f) of the standard ISDA that says that the delay in exercising any right will not be presumed to operate as a waiver of that right. Furthermore, the order concluded that the bankruptcy "safe-harbor" for exercising remedies under a derivatives contract covers some ISDA contractual rights (such as liquidating, terminating, or accelerating derivatives transactions) but does not include the right to withhold future payments under section 2(a)(iii) of the ISDA Master. This ruling may conflict with orders entered in bankruptcy proceedings outside of the United States with regard to the administration of Lehman Brothers International (Europe). A 2003 Australian decision (Enron Australia v. TXU Electricity Ltd,) upheld a counterparty's right to withhold payment indefinitely under section 2(a)(iii).

New York State Bar Association Issues Report on Internal Revenue Code Section 457A and Deferred Compensation Relating to Investment Funds and Other Service Recipients

Section 457A of the Internal Revenue Code was enacted last year as a part of Emergency Economic Stabilization Act of 2008 (commonly referred to as the "recovery" or "bailout" legislation enacted on October 3, 2008). Section 457A follows Section 409A, which several years ago became the first comprehensive codification of the rules governing the federal income-taxation of nonqualified deferred compensation. The Code section is directed at reining in substantial deferrals of compensation paid to managers of hedge funds (and certain other private funds). As ultimately enacted, Section 457A is broader in scope and potentially covers certain non-U.S. operating companies and domestic investment funds, among others.

On October 2, 2009, the Tax Section of the New York State Bar Association filed with the U.S. Department of the Treasury, the Internal Revenue Service, and Congress an extremely comprehensive Report on Section 457A, which highlights a number of issues, interpretive matters, pitfalls, and other matters relating to the statute. You may access the Report, which may well become a primary point of reference for many tax advisors dealing with Section 457A, by clicking here. Reflecting our commitment to items of such critical importance to the investment community as well as our other clients, a Ropes & Gray partner is one of the two co-authors of this Report.

Other Developments

Since the last issue of our IM Update we have also published the following separate Client Alert(s) of interest to the investment management industry:

SEC Enforcement Action under Regulation S-P for Data Intrusion October 8, 2009

For further information, please contact the Ropes & Gray attorney who normally advises you.