Ropes & Gray's Investment Management Update: May – June 2010

New Target Date Disclosure Rules Proposed

On June 16, 2010, the SEC proposed amendments to Rules 156 and 482 under the *Securities Act* and Rule 34b-1 under the *Investment Company Act* which are intended to provide enhanced information to investors about target date retirement funds and reduce the potential for investors to be confused or misled regarding such funds and their risk profiles. The proposed amendments to Rule 482 and Rule 34b-1 would: (i) require a target date retirement fund that includes the target date in its name to disclose the fund's intended asset allocation at that target date immediately adjacent to the first use of the fund's name in marketing materials; (ii) require marketing materials for target date retirement funds to include a table, chart, or graph (*e.g.*, a "glidepath") depicting the fund's asset allocation over time, together with a statement highlighting the fund's final asset allocation when it ceases to shift; and (iii) require a statement in marketing materials to the effect that a target date retirement fund should not be selected based solely on age or planned retirement date and is not a guaranteed investment, and that its stated asset allocations may change. The SEC's proposed amendments to Rule 156 would provide additional guidance regarding potentially misleading statements in marketing materials for target date retirement funds and other investment companies. Comments on the proposed amendments are due on or before August 23, 2010.

SEC Staff Responds to Questions About Money Market Fund Reforms

The SEC staff recently issued responses to questions about its February 23, 2010 amendments to the rules governing money market funds. Amended Rule 2a-7 mandates that money market funds must comply with new requirements pertaining to portfolio quality, maturity, liquidity, repurchase agreements, and portfolio stress testing procedures. In its responses, the Staff addressed questions pertaining to, among other things, compliance dates, considerations for implementing the new rules, liquidity determinations, procedures for portfolio stress testing, "know your customer" requirements, portfolio quality requirements, the designation of a fund's Nationally Recognized Statistical Rating Organizations (NRSROs), asset-backed securities, and Web site posting requirements.

The responses pertaining to compliance dates and guidance for implementing the new rules, among other things, clarify that: a fund must meet new average weighted maturity (WAM) and weighted average life (WAL) requirements by June 30, 2010, by selling portfolio securities or otherwise; compliance with daily and weekly liquidity requirements cannot be determined by reference to the maturity-shortening provisions of Rule 2a-7(d)(1)-(8); and funds can amend disclosures to reflect compliance with the new rules through Rule 497 filings, rather than through registration statement amendments. The responses also clarified that a fund investing exclusively in government securities and related repurchase agreements does not need to designate an NRSRO, that a fund should reassess its quality determinations upon designating a new NRSRO, and the timing considerations for designating a new NRSRO under certain circumstances. Lastly, in connection with the new Web site posting rules, the responses addressed compliance dates, the use of Form N-MFP, and the disclosure of a fund's holdings, WAM and WAL. The SEC Staff's responses can be found at http://www.sec.gov/divisions/investment/guidance/mmfreform-imqa.htm.

District Court Dismisses Claims Seeking to Rescind 12b-1 Fee Payments

The United States District Court in the Northern District of California issued an order in the case of *Bradley C. Smith v. Franklin/Templeton Distributors, Inc*., granting the defendants' motion to dismiss a class action in which the plaintiffs asserted a private right of action under Section 47(b) of the *Investment Company Act.* Section 47(b) permits a court to render unenforceable any contract that violates the Investment Company Act.

The plaintiffs' allegations as to how the payment of 12b-1 fees by the funds' distributor to broker-dealers violated the *Investment Company Act* involved several steps. First, the plaintiffs argued that under *Investment Company Act* Rule 38a-1, the Board has a duty to adopt policies and procedures to prevent, detect, and correct violations of the federal securities laws by a fund's service providers. The plaintiffs then asserted that the payment of 12b-1 fees violated the *Investment Advisers Act* because some of these payments were made to broker-dealers who were not also registered as advisers under the *Investment Advisers Act.* The plaintiffs claimed that the 2007 decision of the D.C. Circuit Court of Appeals in *Financial Planning v. SEC*, which invalidated the "broker exception" to the requirement to register as an investment adviser, established the principle that payment of asset-based compensation to a broker-dealer that is not dually registered as an investment adviser is illegal under the *Investment Advisers Act.* Thus, the plaintiffs argued, the funds violated Rule 38a-1 by failing to implement policies and procedures which would have prevented such asset-based compensation from being paid to unregistered investment advisers and therefore the contracts under which the 12b-1 fees were paid should be rescinded.

The court rejected the plaintiffs' theory, holding that Section 47(b) only provides a private right of action when another section of the *Investment Company Act* has been violated, and that a violation of Rule 38a-1 does not give rise to any private right of action. According to the court, Rule 38a-1 does not require funds to ensure that broker-dealers comply with applicable registration requirements. The court also distinguished the *Financial Planning* decision by noting that the ruling in that case applies to fees for investment advice and is irrelevant to the payment of distribution (12b-1) fees.

Open-end Fund Manager Charged With Insider Trading

On May 11, 2010, the SEC filed an order instituting administrative and cease and desist proceedings against a municipal bond fund portfolio manager in connection with redemptions of shares by the members of the portfolio manager's family from one of the portfolio manager's funds. The SEC order states that, in September 2008, the funds experienced heavy redemptions, and the portfolio manager was instructed by his superiors to maintain high levels of cash in one of the funds to meet anticipated redemption requests. The order alleges that, at this time, the portfolio manager contacted a family member and suggested that she "really should consider [her] inclination to sell [shares in of one of the funds]," and told her to tell the same thing to another family member. Shortly thereafter, the family members redeemed, or attempted to redeem, their shares in one of the funds. The SEC alleged that the portfolio manager's conduct violated certain securities laws, including insider trading prohibitions under Rule 10b-5, on the grounds that the portfolio manager owed the fund's sponsor and the fund a fiduciary duty and breached that duty when he advised the family member and, through her, another family member, to "sell their shares" while in possession of material non-public information regarding the fund. The SEC asserted that this conduct violated 10b-5 even though the transactions in question were redemptions by the issuer of its own securities at the fund's NAV, as opposed to a "sale" of shares through a market transaction at a "market price," and therefore the redeeming shareholder did not have any greater information than the other party to the transaction (*i.e.,* the fund).

Closed-End Funds Permitted to Use Rule 486(b) to Amend Registration Statements

On April 23, 2010, the SEC staff granted no-action relief allowing certain closed-end funds managed by Tortoise Energy Infrastructure Corporation and Tortoise Energy Capital Corporation (Tortoise Funds) to utilize Rule 486(b) under the *Securities Act* to file post-effective amendments to the Funds' Form N-2 registration statements. Rule 486(b) generally provides that a post-effective amendment to a registration statement may be filed by a registered closed-end fund that makes periodic repurchase offers pursuant to Rule 23c-3 under the *Investment Company Act* (an "Interval Fund").

The Tortoise Funds had not been able to utilize Rule 486(b) because they are not Interval Funds and, historically, their registration statements have not been effective for significant portions of each year due to the post-effective amendment process currently required to update the Funds' financial statements. Citing the adopting release for Rule 486, the applicant argued that the SEC "recognized that closed-end interval funds may need continuously effective registration statements and would benefit if certain filings could become effective automatically" and asserted that this line of reasoning should be extended to its closed-end funds that are conducting offerings pursuant to Rule 415(a)(1)(x).

The SEC staff granted the requested no action relief on condition that the Tortoise Funds comply with the provisions of Rule 486(b) (other than the requirement to be an Interval Fund) as well as with the undertakings currently found in the Tortoise Funds' registration statements, which are: (i) to file a post-effective amendment containing a prospectus pursuant to Section 8(c) of the *Securities Act* prior to any offering pursuant to the issuance of rights to subscribe for shares below net asset value; and (ii) to file a post-effective amendment containing a prospectus pursuant to Section 8(c) of the *Securities Act* prior to any offering below net asset value if the net dilutive effect of such offering (as calculated in the manner set forth in the dilution table contained in the prospectus), together with the net dilutive effect of any prior offerings made pursuant to the post-effective amendment (as calculated in the manner set forth in the dilution table contained in the prospectus), exceeds 15%.

SEC Staff Further Updates Responses to Questions About the Custody Rule

On May 20, 2010, the SEC staff released another update to its responses to questions about Rule 206(4)-2 under the *Advisers Act.* The updated SEC staff responses provided additional information in respect of the following categories: (1) definition of "custody" and scope of the custody rule, (2) fee deductions, and (3) pooled investment vehicles.

Of particular note in the updated responses is Question II.10 under definition of "custody" and scope of the custody rule, which appears to require that collateral posted by an adviser on behalf of a client in connection with a swap agreement be held by a qualified custodian. In light of the significant change in market practice that this interpretation would require, we have contacted the SEC staff to confirm the staff's intention with respect to its response. We anticipate receiving a response from the staff shortly, and will provide further details as more information becomes available.

SEC Circuit Breaker Approval

On June 10, 2010, the SEC approved circuit breaker rules that will require the exchanges and FINRA to halt trading in certain individual stocks experiencing high volatility. The circuit breaker rules were implemented on June 11. The circuit breaker is a pilot program that would pause trading across U.S. equity markets in certain individual stocks in the Standard & Poor's 500 stock index for five minutes if the price of the stock moves 10%

or more in a five-minute period. The new rules will be in effect through December 10, 2010. This pilot period will be used to make appropriate adjustments to the circuit breakers and to expand the scope to securities beyond the S&P 500. The pilot program follows a drop of nearly 1,000 points in the Dow Jones Industrial Average on May 6. The SEC and CFTC have been studying the causes of this drop and ways to prevent a recurrence.

SEC Adopts "Pay to Play" Rule

On June 30th, the SEC Commissioners voted unanimously to adopt rules designed to curtail the influence of "pay to play" practices. The new rules are designed to prohibit advisers from seeking to influence the award of advisory contracts by public entities by making or soliciting political contributions to or for officials who are in a position to influence the awards. Although the new rules have not been published, according to the SEC's press release, the new rules have three key elements:

- Investment advisers will be prohibited from providing advisory services with regard to public employee pension plan assets and similar government investment accounts for compensation—either directly or through a pooled investment vehicle—for two years, if the adviser or certain of its executives or employees make a political contribution to an elected official who is in a position to influence the selection of the adviser with respect to the investment account.

- Investment advisers and certain of their executives and employees will be prohibited from soliciting or coordinating campaign contributions from others—a practice referred to as "bundling"—for an elected official who is in a position to influence the selection of the adviser. The new rules will also prohibit solicitation and coordination of payments to political parties in the state or locality where the adviser is seeking business.

- Third parties, such as a solicitor or placement agent, cannot be paid for soliciting a government client on behalf of the investment adviser, unless that third party is an SEC-registered investment adviser or broker-dealer subject to similar pay to play restrictions.

Other Developments

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

Preparing for Financial Reform: Derivatives
May 27, 2010

Preparing for Financial Reform: Investment Adviser Registration
May 27, 2010

Preparing for Financial Reform: Investment Companies and Investment Advisers
May 27, 2010

Proposed Legislation Would Increase Tax on Carried Interest, Target Perceived Tax Abuses, and Renew Tax Incentives
May 25, 2010

SEC Proposes Large Trader Reporting System
May 3, 2010

Hedge Fund Update
June 15, 2010

Supreme Court Agrees to Clarify Scope of "Primary" Liability Under the Federal Securities Laws
June 29, 2010

Supreme Court Strikes Down "Good Cause" Removal Restrictions on PCAOB, But Leaves Sarbanes-Oxley Intact
June 29, 2010

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