ROPES & GRAY

Ropes & Gray's Investment Management Update: September-October 2010

The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

Financial Stability Oversight Council Proposed Rulemaking for Nonbank Financial Companies

The Financial Stability Oversight Council (the "Council"), which was established by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Act"), has issued an advance notice of proposed rulemaking requesting comments on the criteria that should inform the Council's determination of whether a nonbank financial company should be subject to the supervision of the Federal Reserve Board of Governors (the "Board"). The Act requires that in determining whether a nonbank financial company should be subject to the Board's supervision, the Council consider, among other factors, leverage; off-balance-sheet exposures; transactions and relationships with other significant nonbank financial companies; the importance of the company as a source of credit for households, businesses and local and state governments and as a source of liquidity for the U.S. financial system; the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse; the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; the degree to which the company is already regulated by a financial regulatory agency; the amount and nature of financial assets; the amount and types of liabilities, including the degree of reliance on short-term funding; and other risk-related factors that the Council deems appropriate.

The notice contains 15 detailed questions, including some general questions such as what metrics the Council should use, how quantitative and qualitative considerations should be incorporated, how interconnectedness should be measured, whether certain factors should be weighed more heavily than others and whether the degree of public disclosure and transparency should be a consideration. The notice also requests comments on how the Council should measure and assess the scope, size and scale of nonbank financial companies, including whether a risk-adjusted measure of a company's assets should be used. With respect to pooled investment vehicles such as investment companies, hedge funds and private equity funds, the Council is seeking comments on how it should define and take "managed assets" into consideration. In addition, the Council is requesting comments on whether the type of asset management activity (for example, management of private funds as compared to registered investment companies), should inform its decision. The Council notes that during the recent financial crisis some firms provided support to investment vehicles they sponsored or managed and questions whether the Council should take account of such implicit support in making its determinations.

President's Working Group Reports on Money Market Fund Reform

In October, the President's Working Group on Financial Markets released its report entitled "Money Market Fund Reform Options" (the "Report"). The Report does not make any specific reform recommendations,

but instead requests that the newly-formed Financial Stability Oversight Council (the "Council") consider the various reform options included in the Report and that the SEC move forward with plans to strengthen the money market fund ("MMF") regulatory framework. The Report's Executive Summary further requests that the Council pursue those options that it deems would be "most likely to materially reduce MMFs' susceptibility to runs." According to the Report, the SEC will publish a notice and request for comment in the near future.

The Report begins by providing an introduction to MMFs, describing the nature of MMFs and the products that compete with them. The Report discusses various features of MMFs that make them susceptible to runs, including the fact that share prices of MMFs are rounded to the nearest cent and are generally valued at $1.00. The Report argues that this fosters an expectation that MMF share prices will not fluctuate, increasing an investor's incentive to redeem its shares when there is a perceived risk that prices will fluctuate. The report goes on to discuss the experiences of MMFs during the recent financial crisis, including the responses of funds and investors when the Reserve Primary Fund "broke the buck." Next, the Report presents the SEC's MMF rule changes, stating that the changes were designed primarily to meet the SEC's obligations to protect investors and should mitigate, but not eliminate, systemic risks by reducing MMFs' susceptibility to runs (i.e., large redemptions). The report also argues that further reforms are needed to address MMFs' structural vulnerability to large redemptions.

Finally, the Report discusses seven policy options that may help to reduce the risk of runs on MMFs. These options include floating net asset values ("NAV") for MMFs (which may reduce the likelihood of investors believing that MMFs are risk-free investments); private emergency liquidity facilities for MMFs (noting some of the regulatory problems with this approach); mandatory redemptions in kind (requiring MMFs to distribute large redemptions by institutional investors in kind, rather than in cash); insurance for MMFs (requiring some form of insurance for MMF shareholders to mitigate systemic risks posed by MMFs); a two-tier system of MMFs, with enhanced regulatory restrictions on MMFs that seek to maintain a stable $1.00 NAV (with floating NAV MMFs having somewhat less stringent operational restrictions); a two-tier system with stable NAV MMFs reserved for retail investors; and regulating stable NAV MMFs as special purpose banks, thereby subjecting them to banking oversight and regulation. The Report concedes that while the SEC requested comment on some of these options in connection with its MMF reform proposal, other proposals go beyond the SEC's regulatory authority and would require legislative or other government agency action.

Khuzami Testimony to Senate Judiciary Committee Highlights SEC's Enforcement Activities and Initiatives

On September 22, 2010, Robert Khuzami—Director of Enforcement at the Securities and Exchange Commission—testified before the United States Senate Judiciary Committee. In prepared remarks entitled "Investigating and Prosecuting Fraud after the Fraud Enforcement and Recovery Act," Khuzami focused on several recent accomplishments and developments at the SEC, particularly in light of its recent internal restructuring and the new authority granted to it by the Dodd-Frank Act.

Khuzami noted the Enforcement Division's high level of enforcement activity to date in 2010, as well as its emphasis on "areas relating to the recent financial crisis." At the time of Khuzami's testimony, the SEC had filed 634 enforcement actions in 2010 and had obtained orders for the disgorgement of $1.53 billion in damages and the payment of penalties of $968 million.

Khuzami also highlighted several unit-based initiatives, which center around the five national specialized units created as part of the Enforcement Division's recently completed reorganization. The Market Abuse Unit is developing the capability to systematically search the SEC's "bluesheet" database—the database housing information about individual trades reported to the SEC by clearing firms—for suspicious trading activity, an ability that the SEC has previously lacked. The Asset Management Unit has created several initiatives "targeting disclosure, performance and valuation by funds and their advisers," including a "Bond Fund Initiative" (focused on developing analytics to identify disclosure and valuation issues in mutual fund bond portfolios), a "Problem Adviser Initiative" (focused on the detection of problem investment advisers through risk-based investigation of advisers' representations to investors) and a "Mutual Fund Fee Initiative" (focused on developing analytics to determine whether mutual fund advisers are charging excessive fees to retails investors). Khuzami explained that the Mutual Fund Fee Initiative is "expected to result in examinations and investigations of investment advisers and their boards of directors concerning duties under the Investment Company Act." The SEC's Municipal Securities and Public Pensions Unit is involved in the creation of new rules governing municipal advisers. Additionally, the Structured and New Products Unit is developing initiatives relating to the review of a variety of complex securities products, while the FCPA Unit is coordinating with other law enforcement organizations to pursue significant violations of the Foreign Corrupt Practices Act.

In addition to the unit-based initiatives, Khuzami announced the SEC's "Whistleblower Program," which is intended to generate leads about serious securities law violations by offering substantial rewards to individuals providing information leading to successful enforcement actions. The program is authorized by the Dodd-Frank Act and is being developed by the SEC's Office of Market Intelligence. According to Mr. Khuzami, the Office of Market Intelligence is also working to enhance the SEC's capacity to collect, track and analyze the numerous tips, complaints and referrals it receives.

Proxy Access Rule Challenged

On September 29, 2010, the Business Roundtable and the U.S. Chamber of Commerce (the "petitioners") filed a petition with the U.S Court of Appeals for the D.C. Circuit for review of the recently-amended final SEC rules requiring issuers of securities subject to the SEC's proxy rules to include in their proxy materials certain director nominees put forward by certain shareholders or groups of shareholders (the "Proxy Access Rules"), which were scheduled to become effective on November 15, 2010. On the same date, the petitioners requested the SEC stay the new rules, including the effective date, pending resolution of the litigation in the Court of Appeals. On October 4, 2010, the SEC, without addressing the merits of the petitioners' challenge, issued an order granting the stay with respect to the Proxy Access Rules. The SEC stated that it granted the stay because, among other things, a stay would avoid the potentially unnecessary costs, regulatory uncertainty and disruption that could occur if the rules were to become effective during the pendency of a challenge to their validity.

The petitioners alleged in their petition that the Proxy Access Rules: (i) are arbitrary and capricious; (ii) do not promote efficiency, competition and capital formation; (iii) exceed the SEC's authority; and (iv) violate issuers' rights under the First and Fifth Amendments to the U.S. Constitution. Petitioners also argued in their brief in support of the motion to stay that the SEC erred in covering investment companies under the Proxy Access Rules because investment companies are subject to a range of different statutory requirements than operating companies, and that the SEC gave insufficient attention to the differences in the operation of investment companies and other public companies, including the significant costs that a director elected under the rules would impose on investment companies' unitary and cluster boards.

SEC Proposes Rule Defining "Family Office"

The Dodd-Frank Wall Street Reform and Consumer Protection Act excludes "family offices" (as defined by the SEC) from the definition of investment adviser under the Investment Advisers Act. On October 12, 2010, the SEC proposed a rule to define "family offices" for purposes of this exclusion.

Under proposed Rule 202(a)(11)(G)-1, a family office is a company (including its directors, partners, trustees, and employees acting within the scope of their position or employment) that has only "family clients", is wholly owned and controlled, directly or indirectly, by family members, and does not hold itself out to the public as an investment adviser. A "family client" includes family members, key employees of the family office, charitable entities established and funded exclusively by family members, trusts or estates existing for the sole benefit of family clients, and entities wholly owned or controlled (directly or indirectly) by, and operated for the sole benefit of family clients.

The proposal includes a grandfathering provision, as required by the Dodd- Frank Act, that includes in the definition of family office any person who was not registered or required to be registered as an investment adviser under the Advisers Act on January 1, 2010 solely because the person provided investment advice, and was engaged before January 1, 2010 in providing investment advice, to certain natural persons and entities associated with a family office. A person that is a family office solely because of the grandfathering provision remains subject to the antifraud provisions of the Advisers Act. Family offices that qualify for the exclusion from the definition of an investment adviser at the federal level would not be subject to registration as investment advisers under state securities laws. Comments on the proposed rule are due on or before November 18, 2010.

IRS Finalizes Cost Basis Reporting Regulations

On October 18, 2010, the IRS finalized regulations that require brokers and mutual funds to report cost basis to their customers and to the IRS. For the sale of stock that is acquired on or after January 1, 2011, brokers must report adjusted cost basis (and whether the gain or loss on the sale is long-term or short-term). Effective for shares acquired on or after January 1, 2012, mutual funds must provide the same reports on sales. Historically, brokers and mutual funds have only reported gross proceeds on the sale of securities (on Form 1099-B).

To determine the adjusted basis of securities that are sold, the proper lot (or lots) of the securities must be determined. Customers may use a variety of conventions to determine the lot of securities that are sold, including first-in, first out, average cost, or specific identification. The final regulations specify how and when the customer and broker will establish the conventions to be used to determine basis. The final regulations afford customers many choices and, in many instances, permit customers to change their choice without the consent of the IRS.

The regulations generally require customers and brokers to use the same conventions to determine gains and losses. However, in some circumstances, customers and brokers may report different amounts of gains and losses. For example, customers, but not brokers, are required to apply the straddle tax rules to determine gains and losses. In addition, customers must consider all of their holdings to apply the wash sale tax rules, while brokers need only consider the securities within an account in which the stock was sold.

The IRS is revising Form 1099-B to allow for the reporting of the new basis information and is revising the schedule D of the Form 1040 to require taxpayers to reconcile differences in the gains and losses that they report on their income tax returns and the gains and losses that have been reported on the brokers' information returns.

As noted above, mutual funds have an extra year to implement cost basis reporting. However, mutual funds also face special challenges. For example, many funds currently report gains and losses using average cost basis. These funds may elect to consolidate their existing reporting with their new reporting of sales of mutual fund shares, but the funds must notify their customers of the single-account election, and their customers must agree to use the average cost basis method for the mutual fund shares subject to the election.

Controversial Shield Law Provisions of Dodd-Frank Act Repealed

On October 4, 2010, President Obama signed into law a bill amending Section 929I of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Act"). As originally enacted, section 929I provided expansive protections from public disclosure of information produced to the Securities and Exchange Commission (the "SEC") by regulated entities. Specifically, Section 929I protected documents and information produced to the SEC in connection with its examination and surveillance functions in furtherance of, among other things, its regulatory and oversight actions. After Section 929I of the Act was enacted, lawmakers became concerned that the provision could be read broadly enough to shield documents and information acquired by the SEC in many contexts.

The amended law removes the broad authority of the SEC to keep confidential information it obtains pursuant to its regulatory oversight activities. The amended law does, however, extend some level of FOIA protections for documents related to examining, operating or conditions reports prepared by, on behalf of or for the use of an agency responsible for the regulation or supervision of "financial institutions." Such documents are exempted from public disclosure under FOIA, and the amended Section 929I expressly defines the SEC as an agency responsible for the regulation or supervision of financial institutions, and further defines any entity that the SEC is responsible for regulating, supervising or examining as a financial institution. Importantly, however, the amended law eliminated Section 31(c) of the Investment Company Act of 1940 (the "1940 Act"), apparently because it was considered superfluous with the addition of Section 929I. Section 31(c) had afforded investment companies additional protections with respect to information provided to the SEC for the purposes of the SEC's surveillance, risk assessment, and other regulatory and oversight activities. However, when Congress amended Section 929I, it did not reinstate Section 31(c), theoretically leaving investment companies with fewer protections than they had before the enactment of the Act. The Investment Company Institute is currently working with Congress to restore Section 31(c) to provide additional protections for records given to the SEC pursuant to the 1940 Act. In the meantime, the fund industry may still rely on the FOIA exemption regarding protections for documents related to examining, operations or conditions reports obtained by the SEC. Entities such as registered broker-dealers and investment advisers have long held the view, and the courts have agreed with the view, that the exemption applies to them. Because the amended law only applies to the FOIA exemption for examining, operating or conditions reports, many other documents that are collected during an examination may be subject to public disclosure. Furthermore, the SEC has taken the position that it may disclose documents that are covered by the FOIA exemption in situations where the need for confidentiality is outweighed by the public's interest in accountability and transparency.

IRS Signals Change in Policy on Participation in Group Trusts by Certain Puerto Rico Plans

Tax-exempt group trusts cannot have certain Puerto Rico plans as participants, according to the position taken by an IRS official in a letter to Senator Arlen Specter dated September 14, 2010. Although a trust funding a plan for Puerto Rico residents that is tax-qualified in Puerto Rico (a "Puerto Rico-only" plan) may be exempt from U.S. tax under a special ERISA rule (Section 1022(i)(1) of ERISA), the letter states that Puerto Rico-only plans "are not among the qualified plans or similar arrangements that are permitted to invest in group trusts on a tax-favored basis" and that "such plans cannot pool their trust assets for investment purposes without jeopardizing the tax-favored status of all of the other plans participating in the group trust."

No formal guidance has been issued, but the apparent change in IRS policy (the IRS had previously issued contrary guidance in private letter rulings) presents a challenge for sponsors of group trusts that are exempt from tax under IRS Revenue Ruling 81-100 and related guidance and for the advisors and managers of "401(k)" or other U.S. qualified plan assets participating in group trusts. Some group trusts already have Puerto Rico-only plans as participants. Others may have as participants plans that are currently qualified under both U.S. and Puerto Rico tax rules ("dual-qualified" plans) but that are in the process of making a transfer to a Puerto Rico-only plan by December 31, 2010 to take advantage of tax relief provided by the IRS in a 2008 ruling.

The IRS is reportedly being asked to reconsider its Puerto Rico plan/group trust analysis, but as of November 10, 2010 no formal guidance has been provided.

The IRS letter can be found here.

Custody Rule FAQ Clarifications Updated by SEC Staff

The SEC Staff has been periodically updating and adding to its FAQs regarding the Custody Rule, which are available here. On September 9th, the Staff added responses to four questions dealing with the requirements relating to an advisor's ability to direct a qualified custodian to make payments to the client, to direct a qualified custodian to change a client's address, and AICPA standards applicable to audits.

FINRA Requests Comments on Account Opening Disclosure Proposal

FINRA is seeking comment on a concept proposal, released on October 28, 2010, to require member firms, at the time of or prior to commencing a business relationship with a retail customer, to provide a written statement to the customer describing the types of accounts and services it provides, as well as conflicts associated with such services and any limitations on the duties the firm otherwise owes to retail customers. FINRA requested comments on, among other things, the scope of the proposal, the delivery method, the form and content of the disclosures and the timing of the disclosures to be made. The concept release can be found here.

Comments are due by December 27, 2010.

SEC Issues Guidance Regarding Board Determinations Required by Rules 10f-3, 17a-7 and 17e-1 under the 1940 Act

On November 2, 2010, the SEC staff issued a letter to the Independent Directors Council and Mutual Fund Directors Forum clarifying its views regarding the responsibilities of a registered investment company's board of directors in respect of its review of transactions effected in reliance on Rule 10f-3 (permitting a fund to purchase securities from an affiliated syndicate under certain conditions), Rule 17a-7(exempting certain purchase or sale transactions between a fund and certain of its affiliated persons from the prohibitions in Section 17(a)) and Rule 17e-1 (providing when a commission, fee or other remuneration will not be deemed to exceed the usual and customary broker's commission) under the Investment Company Act of 1940, as amended (the "Rules"). A fund's board must determine that any transaction effected pursuant to one of the Rules during the previous quarter was done so in compliance with the fund's relevant procedures. The guidance from the Staff indicates that the Staff believes a fund's board may, where consistent with the prudent discharge of its fiduciary duties, make the determinations required by the Rules in reliance on summary quarterly reports of the transactions effected in reliance on one or all of those rules. The letter suggests that the summary quarterly reports could be prepared by the fund's chief compliance officer or, under appropriate circumstances, a combination of fund counsel, counsel to the independent directors, investment adviser personnel, and/or independent third parties. The Staff also cautions that even if boards rely on the chief compliance officer or others to provide them summary quarterly reports of the transactions, boards "still retain ultimate responsibility for making the quarterly determinations required by these three rules, and boards cannot delegate such responsibility." The Staff's letter also stresses that boards must remain "vigilant to ensure that they have sufficient information to be alerted to issues raised" by transactions effected in reliance on the Rules. The SEC's letter is available here.

DOL Issues Investment Advice Regulations

The US Department of Labor (the "DOL") has proposed highly anticipated amended regulations relating to when a service provider to an employee benefit plan is a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"). The amendments would change the rules governing when services involve "investment advice" so as to constitute fiduciary services. Generally, under ERISA, a party can be a fiduciary to a plan by providing certain discretionary services regarding plan investment or administration, or by providing investment advice. There have been indications that the DOL has become increasingly concerned that the existing regulatory definition is too narrow, thus allowing various consulting and other services to escape characterization as fiduciary services where the application of ERISA's fiduciary rules might be appropriate. Recently, the DOL and the SEC have coordinated efforts regarding these matters. Then, over the summer of 2010, the DOL indicated that it would reexamine the investment-advice regulations, with an eye towards amending them. The DOL has now proposed those amendments.

The proposed rules would broaden the types of advice that could be fiduciary advice substantially, and those who provide management, advice, valuation, appraisal and fairness-opinion services are among those who may want to examine the proposal carefully. It remains to be seen how the financial community, plan representatives and other interested parties will react, and the DOL has requested comments in connection with its efforts to finalize these important regulations.

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:

New ERISA Rules Impose Participant Fee Disclosure Requirements - October 20, 2010

Ropes & Gray's Hedge Fund Update: October 2010 - October 26, 2010

SEC Proposes Rules on "Say on Pay" for Public Companies and Rules on Proxy Vote Reporting for Institutional Investment Managers - October 29, 2010

SEC Proposes Rules on Whistleblower Provisions of Dodd-Frank Act - November 9, 2010

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