ROPES & GRAY

Ropes & Gray's Investment Management Update: November 2010 – February 2011

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

Federal Reserve Board Proposes Amendments Relating to the Designation of Systemically Important Nonbank Financial Companies

On February 9, 2011, the Federal Reserve Board (the "Board") proposed amendments to Regulation Y that establish the criteria for determining whether a company is "predominantly engaged in financial activities," a "significant nonbank financial company" or a "significant bank holding company" for purposes of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"). The proposal is closely related to a rule proposed by the Financial Stability Oversight Council (the "FSOC") on January 18, 2011. The Board's proposal is one more step in establishing standards under which the FSOC may exercise its authority to subject a nonbank financial company to supervision by the Board. Such Board supervision of a nonbank company will be possible only if the FSOC determines that the nonbank company could pose a threat to the financial stability of the United States. Transactions and relationships with "significant nonbank financial companies" and "significant bank holding companies" will be one basis for such a game-changing determination.

The proposed amendments would establish two methods by which a nonbank company could be determined to be predominantly engaged in financial activities. Under the first method, a company generally can be designated as predominantly engaged in financial activities if its consolidated gross financial revenues in either of the two previous fiscal years were at least 85% of the company's consolidated gross annual revenues, or if its consolidated total financial assets at the end of either of the two previous fiscal years were at least 85% of its consolidated total assets. Under the second method, a company can be designated as predominantly engaged in financial activities if at least 85% of the company's consolidated gross revenues are, at the time of evaluation, from activities that are financial in nature or from the ownership, control or activities of an insured depository institution or its subsidiary or are related to such activities. The second method presumably would allow the Board and the FSOC to respond more quickly than the first if a company's activities changed (such as through a merger or acquisition).

The proposed amendments also would define the terms "significant nonbank financial company" and "significant bank holding company." As proposed, a company would be considered "significant" if it had $50 billion or more in total consolidated assets or had been designated by the FSOC as systemically important. A designation of a company as a significant nonbank financial company or significant bank holding company would not, in and of itself, subject the designated company to stricter supervision. However, as noted above, the FSOC may subject to Board supervision one or more large nonbank companies with which the designated company has transactions and/or relationships. In any event, those transactions and relationships will also be subject to greater governmental information-gathering.

Compliance Date Extended for Form ADV, Part 2B (Brochure Supplement)

On July 28, 2010, the Securities and Exchange Commission (the "SEC") adopted amendments to Part 2 of Form ADV to require registered investment advisers to provide each client with a brochure and brochure supplement written in plain English. The brochure is designed to contain information about the advisory firm, while the brochure supplement is designed to contain information about the specific firm personnel on whom the client relies for investment advice. The SEC has since extended the compliance dates applicable to the brochure supplement for certain investment advisers in order to provide them additional time to design, test and implement their systems and controls. The revised compliance dates are as follows:

For Existing Registered Investment Advisers. All investment advisers registered with the SEC as of December 31, 2010 that have a fiscal year ending on a date between December 31, 2010 and April 30, 2011 have until July 31, 2011 to begin delivering brochure supplements to new and prospective clients, and until September 30, 2011 to begin delivering brochure supplements to existing clients.

Newly-Registered Investment Advisers. All newly-registered investment advisers filing their applications for registration between January 1, 2011 and April 30, 2011 have until May 1, 2011 to begin delivering brochure supplements to new and prospective clients, and until July 1, 2011 to begin delivering brochure supplements to existing clients.

The SEC did not change the compliance dates for existing registered investment advisers with fiscal years ending after April 30, 2011 or for newly-registered investment advisers filing applications for registration after April 30, 2011.

No-Action Relief Granted from Custody Rule's Private Fund Auditor Qualification Requirements

Advisers of private funds are exempt from certain safekeeping requirements under the *Investment Advisers Act*'s "Custody Rule" if the private funds obtain annual audits that fulfill the requirements of Rule 206(4)-2(b)(4) (the "Annual Audit Provision"). In order to qualify for this exemption, the audit must be conducted by "an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the Public Company Accounting Oversight Board [(the 'PCAOB')] in accordance with its rules."

According to a recent request for no-action relief, many private funds have engaged auditors that audit brokers or dealers but not public companies. Currently, the PCAOB is not authorized to inspect auditors of brokers or dealers that are not public companies. Although the *Dodd-Frank Wall Street Reform and Consumer Protection Act* grants the PCAOB authority to adopt rules related to the inspection of auditors of brokers and dealers, the PCAOB's proposed rules concerning such inspections (the "PCAOB Inspection Rules") have not yet been approved by the SEC. In the interim, if an adviser of private funds engages an auditor that inspects brokers or dealers but not public companies, the audit would not satisfy the Annual Audit Provision.

After consideration, the SEC staff determined that it will not recommend enforcement action to the SEC under the Custody Rule if an adviser's private funds engage an auditor that is not yet subject to PCAOB inspection because it audits brokers or dealers (but not public companies) to conduct an audit that otherwise complies with the Annual Audit Provision, so long as:

(a) the auditor was engaged to audit the financial statements of one or more of the private funds for the most recently completed fiscal year;

(b) the auditor was registered with the PCAOB and engaged to audit the financial statements of a broker or a dealer on July 21, 2010 and is registered with the PCAOB and engaged to audit the financial statements of a broker or a dealer as of the issuance of audited financial statements used to satisfy the Annual Audit Provision; and

(c) the adviser provides written notice to each investor in each relevant private fund prior to distributing the financial statements that the private fund's auditor is not subject to regular inspection by the PCAOB.

The SEC staff's position is applicable only to financial statements issued prior to the SEC's approval of the PCAOB Inspection Rules or July 21, 2011, whichever date is earlier.

State Law Control Share Voting Limitations May Violate Investment Company Act

On November 15, 2010, the SEC staff issued a letter in response to a request for interpretive guidance from the Boulder Total Return Fund, Inc. (the "Fund"), a closed-end registered investment company organized as a Maryland corporation approximately 40% of which is owned by the Horejsi family, well-known activist investors in closed-end funds. The staff's response clarified its views regarding the implications of section 18(i) of the *Investment Company Act* relative to the Fund's consideration of whether to opt in to the provisions of the *Maryland Control Share Acquisition Act* (the "MCSAA"), a state anti-takeover statute. The staff addressed only the MCSAA, but noted that its analysis may also be applicable to other states' anti-takeover laws.

The MCSAA permits certain issuers to restrict the ability of certain shareholders to vote "control shares" (generally, shares in excess of 10% of the outstanding common shares of the issuer). Closed-end funds may opt in to the defensive provisions of the MCSAA. In its letter, the staff concluded that the use of the MCSAA by the Fund would be inconsistent with the fundamental requirements of section 18(i) that every share of stock issued by the Fund be "voting stock" and have "equal voting rights" with every other outstanding share because use of the MCSAA would discriminate against certain shareholders by denying important voting rights.

State Pension Funds and Private Firms Dispute Foreign Currency Pricing

In February 2011, a number of state pension funds and private firms disputed the foreign currency trade pricing provided to them by custodial banks. According to recent media reports, a leading investment advisory firm uncovered currency pricing issues during a due diligence review it performed in connection with its recent purchase of another adviser. The acquired adviser apparently had received better prices for foreign currency trades than had the acquiring adviser, leading some at the acquiring adviser to believe that its custodial bank may not have provided it with favorable pricing. While media reports suggest that the acquiring adviser does not believe the alleged overcharging breached any contracts, other advisers and state attorneys general have reached opposite conclusions.

The State of Washington, for example, recovered $11.7 million from a custodial bank in a dispute over foreign exchange trade costs in October 2010. Currently, attorneys general in three states have filed or joined currency pricing lawsuits, and an Arkansas pension fund with approximately $11 billion in assets filed a similar suit on February 10, 2011. Articles suggest that advisers may seek to negotiate for more disclosure,

such as disclosure of trade time-stamps, to invest in analytical tools to monitor custodial bank pricing more closely, or to move foreign currency transactions in house.

Investment Advisory Firm Sanctioned for IPO Allocation Practices

On February 7, 2011, the SEC, pursuant to a settlement order, sanctioned a registered investment adviser and its chief executive officer for practices related to its allocation of IPO shares among its mutual fund clients. According to the order, during a two-year period, the adviser caused its two smallest mutual fund clients to participate in a disproportionate number of IPOs relative to the adviser's other mutual fund clients. The funds' sale of shares obtained in those IPOs contributed materially and favorably to the funds' returns.

According to the order, the adviser failed to disclose the extent to which the two funds participated in IPOs or the material positive effect that IPO share trading had on the funds' performance to the funds' board of trustees or to investors. Specifically, the SEC took issue with the adviser's failure to disclose the funds' strategy of IPO trading, the material effect that strategy had on the funds' performance and the risks of short-term IPO trading. Also according to the order, the adviser's practices violated its compliance policies and procedures and its Form ADV disclosure related to IPO allocations and to the disclosure of performance information because it allocated IPO shares on a non-pro rata basis based in part on the size of the funds. The order also noted the adviser's failure to commit resources to its compliance program that were adequate to permit implementation of its policies and procedures.

Other Developments

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

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

The SEC's Insider Trading Case Against a Clinical Trial Physician: Lessons For Physicians, Investors, And Public Companies
November 15, 2010

SEC Proposes Rules to Implement the Private Fund Investment Advisers Registration Act
November 22, 2010

"Expert Networks" Under Investigation: Insider Trading Probe Into The Use of Consultants May "Ensnare" Hedge Funds, Mutual Funds, and Investment Bankers Across the Country
November 22, 2010

Protecting Customer Margin for Cleared and Uncleared Swaps
November 30, 2010

CFTC and SEC Exclude Most Non-Dealers from OTC Swap Registration Requirement
December 14, 2010

House and Senate Pass RIC Modernization Act of 2010; Bill Clears for President's Signature
December 15, 2010

Commodity Futures Trading Commission Proposes to Rescind Registration Exemptions
January 28, 2011

SEC Proposes Reporting Obligations for Advisers to Private Funds on New Form PF
January 28, 2011

Re-Learning the Lessons of Watergate: The Cover-Up Is Worse Than the Crime
February 9, 2011

Effective Date Deferred until 2012 for New ERISA Regulations on Fee Disclosure
February 14, 2011

Fed Adopts Final Rule for Conformity with the Volcker Rule
February 15, 2011

We also hosted a webinar – *The Next Generation of Form ADV: What Investment Advisers Should Know in Preparing Brochures and Brochure Supplements* – on February 15, 2011.

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