Ropes & Gray's Investment Management Update: March – April 2011

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

SEC Staff Issues No-Action Letters Permitting Registered Investment Companies to Maintain Margin with Clearinghouses or Clearing Members for Certain Credit Default Swaps and Interest Rate Swaps

Through two recent no-action letters, the staff (the "Staff") of the Securities and Exchange Commission's ("SEC") Division of Investment Management has clarified the ability of registered investment companies ("funds") to maintain cash and/or securities in the custody of clearinghouses or their clearing members for purposes of meeting margin requirements for credit default swap contracts or interest rate swap contracts, consistent with the custody requirements of Section 17(f) of the *Investment Company Act of 1940* ("1940 Act"). The no-action relief granted in these letters is similar to relief that was granted to the Chicago Mercantile Exchange on December 3, 2010.

Section 17(f) of the 1940 Act and the rules thereunder govern the safekeeping of fund assets, and generally provide that a fund must place and hold its securities and similar instruments only with certain qualified custodians. If and when specific swap transactions are required to clear through a clearinghouse, the requirement that a fund post cash and/or securities in the custody of the clearinghouse or a clearing member for purposes of meeting margin requirements could potentially violate Section 17(f), absent an analogous exception such as the one that exists for posting margin with futures commission merchants in Rule 17f-6 under the 1940 Act.

In granting no-action relief to ICE Trust U.S. LLC ("ICE") and LCH.Clearnet Limited ("LCH"), the Staff relied on the applicants' representations regarding various protections that would be implemented by the clearinghouses and their members, including segregation of client assets, maintenance of certain books and records, and risk disclosures to clients. The no-action relief provided to ICE and LCH expires on July 16, 2011, by which time the SEC will presumably have adopted rules relating to these issues or will extend the time period of the no-action relief.

SEC Proposes Expansion of Obligations to Contact Lost & Missing Securityholders

On March 18, 2011, the SEC proposed an amendment to Rule 17Ad-17 (the "Rule") of the *Securities Exchange Act of 1934* (the "Exchange Act"), which governs transfer agents' obligations with respect to lost securityholders, that would result in three primary changes to existing practice. First, the proposed amendment would extend the obligation to search for lost securityholders (*i.e.*, securityholders whose mail was returned as undeliverable and who failed to provide a forwarding address) to cover brokers and dealers as well as transfer agents. In the proposing release, the SEC notes its belief that, while the amended Rule would apply to all brokers and dealers, as a practical matter, "the only brokers and dealers that would have obligations under the amended [R]ule would be those that carry securities for the accounts of 'customers' within the meaning of Exchange Act Rule 15c3-3 [which] generally are referred to as 'clearing firms' (as opposed to 'introducing firms') and tend to be the larger brokerage firms."

Second, the amendment would add a new requirement that a "paying agent" notify a "missing securityholder" in writing no later than seven months after the sending of any not yet negotiated check to inform the missing securityholder that such missing securityholder has been sent a check that has not yet been negotiated. A person is considered a missing securityholder if such securityholder has been sent a check that has not yet been negotiated before the earlier of six months or the sending of the next regularly scheduled check. A paying agent is not required to provide notification if the value of the not yet negotiated check is less than $25. The proposed definition of "paying agent" includes any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee or custodian that accepts payments from the issuer of a security and distributes the payments to securityholders. The proposed amendment clarifies that this new requirement has no effect on state escheat laws governing unclaimed property.

Finally, the proposed amendment would extend recordkeeping requirements under the Rule to brokers, dealers and paying agents. The proposed compliance date for the amendment is one year following the date on which the SEC takes final action on the proposal. Comments to the proposed amendment are due on May 9, 2011.

CFTC Releases Swap Recordkeeping and Reporting Requirements

The Commodity Futures Trading Commission ("CFTC") issued new proposed swap recordkeeping and reporting requirements on April 25, 2011.

Recordkeeping for historical swaps

The CFTC proposed rules require all swap users to retain certain records for two groups of swaps: (1) "pre-enactment swaps," which are swaps both entered into prior to and outstanding on July 21, 2010, the enactment date of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") and (2) "transition swaps, " which are swaps entered into on or after July 21, 2010 and before the effective date of the final swap recordkeeping and reporting rules, which will be set in the final rules. The CFTC release refers to these two groups collectively as "historical swaps." Recordkeeping and reporting duties for swaps entered into after the effective date of the final rules are contained in proposed regulations released by the CFTC in December 2010 and are available here.

For historical swaps that are outstanding on or after April 25, 2011, swap users must keep records of the "minimum primary economic terms" of the swaps, which essentially are the terms matched by the counterparties in confirming the swap. The minimum terms that must be retained are listed in an appendix to the proposed rules and vary by swap category: interest rate swaps, credit and equity swaps, currency swaps and other commodity swaps. Examples of the minimum terms that must be retained are: trade date, effective date, and termination date; notional amount; and fixed and floating rate reset dates and calculation periods. Swap users also must retain a copy of a historical swap's legal confirmation and any related master agreement and credit support agreement if such documents are in the swap user's possession on or after April 25, 2011. For historical swaps that expired prior to April 25, 2011, swap users must retain the information and documents relating to the terms of the transaction in their possession either on or after October 14, 2010 for pre-enactment swaps or on or after December 17, 2010 for transition swaps.[1]

[1] These 2010 dates are the publication dates of currently-effective CFTC interim final rules regarding reporting pre-enactment swaps and transition swaps. In each of these rules, swap users were advised to retain information and documents relating to the terms of historical swaps. Copies of these rules are available here.

These records must be maintained throughout the life of a historical swap and for five years after its termination. For non-swap dealers and non-major swap participants, these records must be retrievable within 3 business days throughout the retention period. The records are subject to inspection by the CFTC, the SEC, the Department of Justice, and certain federal banking regulators.

Reporting for historical swaps

In addition, the CFTC proposed rules require the reporting of certain swap data for historical swaps to swap data repositories or the CFTC. The obligation to report will generally fall on swap dealers and major swap participants, although non-swap dealers and non-major swap participants facing each other on a swap or facing a non-U.S. counterparty could bear this obligation. The data to be reported includes all of the terms of the confirmation that are recorded in the automated systems of the reporting counterparty, and at a minimum the primary economic terms of the historical swap as described above, as well as market performance data for the swap throughout its life. Such reporting will be required starting on a date to be set in the final reporting rules. Finally, the proposed rules stipulate that, within 180 days after the effective date of the final version of the swap reporting rules, non-reporting swap users must also obtain a "Unique Counterparty Identifier" and report that Unique Counterparty Identifier to the swap data repositories that received data regarding the swap users' historical swaps.

The deadline in the CFTC proposed rules for submitting comments is June 9, 2011. On April 27, 2011 the CFTC voted to reopen or extend the public comment period for most of its proposed regulations under the Dodd-Frank Act for an additional 30 days following the Federal Register publication date of the public comment reopening or extension notice, which is expected shortly.

SEC Pursues Enforcement Action against CCO for Violations of Regulation S-P

The SEC recently took enforcement action against the chief compliance officer ("CCO") of a broker-dealer firm for failing to protect confidential customer information, in violation of Rule 30(a) of Regulation S-P (the "Safeguards Rule"). The Safeguards Rule requires that every broker, dealer, investment company, and registered investment adviser ("Covered Institutions") adopt written policies and procedures reasonably designed to protect customer information from unauthorized access and use. This enforcement action, along with two other related enforcement actions brought by the SEC against other executives of the broker-dealer, marks the first time that the SEC has assessed financial penalties against individuals charged solely with violations of Regulation S-P.

In this matter, the broker-dealer experienced multiple data breaches over a two year period, including three stolen laptops containing customer information and the misappropriation of computer credentials whereby a terminated employee gained access to and monitored an employee's email, including e-mails exchanged with customers. The SEC found that the CCO willfully aided, abetted and caused the firm's violations of the Safeguards Rule by failing to implement and maintain adequate written policies and procedures for safeguarding customer information. Specifically, the SEC found that the firm's written procedures for safeguarding such information simply recited language from the Safeguards Rule and lacked instructions to ensure compliance or implement procedures for preventing or addressing security breaches. The SEC also found that once aware of the breaches, the CCO failed to direct the firm to: (i) properly assess the risk that these breaches posed to customers, (ii) adopt additional written policies and procedures to protect customer information in accordance with the Safeguards Rule, and (iii) take remedial steps recommended by employees, such as contacting law enforcement authorities or affected customers. The SEC noted that the data breaches and the firm's limited response to them highlighted the inadequacy of the firm's written policies and procedures for safeguarding information, and that in failing to direct the firm to revise or supplement these policies and procedures, the CCO caused the Firm to violate the Safeguards Rule.

This enforcement action highlights the risks to Covered Institutions for failing to craft policies and procedures under the Safeguards Rule to address security threats to computers, networks and information storage systems, and underscores that the SEC will pay particular attention to the sophistication and implementation of written policies and procedures, including how a firm responds to breaches. It is noteworthy that this enforcement action follows the March 2008 proposed amendments to the Safeguards Rule, which set forth more specific requirements for implementing written policies and procedures, safeguarding information and responding to information security breaches. In proposing more stringent requirements under the Safeguards Rule, the SEC indicated that it was concerned that many Covered Institutions were not regularly evaluating and updating their written policies and procedures to address more regular and advanced threats against consumer records and information. Although the proposed amendments to the Safeguards Rule have not been finalized, this enforcement action suggests that information security will continue to be an area of focus of the SEC in the future, and that the SEC will treat perceived compliance deficiencies as severely as direct violations of substantive legal requirements.

Proposed "Limit Up – Limit Down" Plan to Address Extraordinary Market Volatility

On April 5, 2011, the national securities exchanges and Financial Industry Regulatory Authority filed a proposal with the SEC to establish a "limit up – limit down" mechanism to address extraordinary market volatility in U.S. equity markets. The proposed plan would prevent trades in listed equity securities, including exchange-traded funds ("ETFs"), from occurring outside of a specified price band, which would be set at a percentage level above and below the average price of the security over the preceding five minutes.

The limit up – limit down plan would replace the existing single stock circuit breaker pilot that was approved shortly after the Dow Jones Industrial Average dropped nearly 1,000 points on May 6, 2010 (the so-called "flash crash") and that has been criticized for halting trading due to erroneous trades. For equity securities currently subject to the circuit breaker pilot (i.e., securities in the S&P 500 Index and Russell 1000 Index, as well as over 300 ETFs), the price band would be set at 5% above and below the average price of the security over the immediately preceding five-minute period; for equity securities not subject to the pilot, the band would be set at 10%. Price bands would be doubled during the opening and closing periods, and broader bands would apply to stocks priced below $1.00. If trading for a security is unable to occur within its price band for more than 15 seconds, there would be a five minute trading pause on the trading of that security. Although no trades would take place during this pause, all bids and offers would be displayed.

Trading centers, such as exchanges and broker-dealers that execute internally, would be required to establish, maintain and enforce written policies and procedures that are reasonably designed to comply with the limit up – limit down plan, including policies and procedures that are reasonably designed to prevent trades at prices that are outside of the price band for a particular equity security.

The SEC will determine whether to approve the proposed limit up – limit down plan following the plan's publication in the Federal Register for a 21-day public comment period.

SEC Issues Exemptive Relief to Actively Managed ETFs

The SEC recently issued exemptive relief to two investment management firms seeking to operate actively managed ETFs. These ETFs will use an active management strategy to achieve their investment objectives, instead of tracking the performance of a benchmark index. Although these are not the first active ETFs to receive exemptive relief, this SEC action is notable because no orders permitting the operation of newlycreated active ETFs had been granted since March 2010, in the wake of an SEC announcement that the staff of the SEC would be conducting a review to evaluate the use of derivatives by mutual funds, ETFs and other investment companies. These exemptive orders could signal that the SEC is now ready to move forward with similar applications. However, it is important to note that the recent applications granted by the SEC included representations that the ETFs would not invest in options contracts, futures contracts or swap agreements. These representations typically do not exist in the applications that apply to the vast majority of existing ETFs, and thus there continues to be a significant regulatory barrier that prevents firms from entering the ETF market on the same terms that apply to existing providers.

U.S. District Court Rules in Favor of Eaton Vance in 12b-1 Derivative Suit

On March 30, 2011, the U.S. District Court for the District of Massachusetts dismissed claims made against the Distributor and Trustees of the Eaton Vance Municipals Trust (the "Trust") regarding "unlawful" Rule 12b-1 distribution payments. In *Wiener v. Eaton Vance Distributors, Inc.*, the Plaintiff alleged, among other claims, that the Trust's asset-based 12b-1 compensation to Eaton Vance Distributors ("Distributors") and individual broker-dealers violated the *Investment Advisers Act of 1940* (the "Advisers Act"). The Plaintiff argued that these 12b-1 payments constituted "special compensation" for advisory services, which disqualified recipient broker-dealers from using the broker-dealer exemption to avoid registering as investment advisers under the Advisers Act. In ruling that the asset-based 12b-1 fees had not been shown to constitute "special compensation" that would prevent reliance upon the exemption, the Court noted that the form of the compensation (*i.e.*, asset-based versus transactional) was not dispositive; rather, the analysis turned on whether the 12b-1 payments were made in exchange for investment advice, for which there was no evidence in this case. Furthermore, the Court observed that even if receipt of such payments disqualified the broker-dealers from relying on the exemption, the broker-dealers would be the entities that had an obligation to register; the Trust's payments of 12b-1 fees would not directly violate the Advisers Act.

The Court further denied the Plaintiff's contention that the distribution agreement between the Trust and Distributor could be voided under federal law in light of Sections 36(a) and 47(b) of the 1940 Act and Rule 38a-1 thereunder. Although Section 47(b) of the 1940 Act provides that shareholders can sue to rescind a contract made in violation of the 1940 Act or any rules or regulations thereunder, the Court held that the Plaintiff failed to establish any such violations. Section 36(a), by its terms, only authorizes the SEC to bring actions against mutual fund directors and trustees, among others, for breaches of fiduciary duty, and the Court was unwilling to create a private right of action in this case under Section 36(a), either alone or in conjunction with Section 47(b). Furthermore, the Court found that the Plaintiff failed to allege any violations under Rule 38a-1, which prescribes mandatory compliance procedures and practices for investment companies.

The Court's decision in this case marks further validation of traditional 12b-1 distribution payment practices at a time when similar 12b-1 derivative suits have been waged against Franklin/Templeton and OppenheimerFunds. The U.S. District Court for the Northern District of California dismissed claims against Franklin/Templeton in two separate rulings last year (cited favorably by the *Eaton Vance* Court), and OppenheimerFunds has its own motion for dismissal pending in the U.S. District Court for the District of Colorado. The Court's decision is not binding precedent, however, outside of Massachusetts.

Update on Proposed Regulations Relating to the Definition of "Fiduciary" under Section 3(21) of ERISA

The *Employee Retirement Income Security Act* ("ERISA") imposes comprehensive duties on fiduciaries of pension and other employee benefit plans subject to ERISA. In general terms, a person can be considered a fiduciary by having discretion of the investment or administration of a plan, or by providing "investment advice" with respect to plan assets. Longstanding regulations have specified what is considered "investment advice" for these purposes.

As previously reported in a Ropes & Gray Investment Management Update available here, the U.S. Department of Labor (the "DOL") has proposed controversial regulations relating to the definition of "fiduciary" under Section 3(21) of ERISA. Under the regulations as proposed, the reach of the concept of "fiduciary" for purposes of ERISA could be expanded substantially. The DOL concluded two-day hearings on the regulations in Washington, D.C. on March 2, 2011 and has indicated an intention to issue final regulations by the end of the year. The regulations could have broad impact, and we are closely monitoring the process.

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:

Regulators Propose Minimum Margin Requirements for Uncleared Swaps
April 15, 2011

Potential Extension of Compliance Date for Private Fund Investment Adviser Registration
April 8, 2011

Federal Court Rejects Mutual Fund Prospectus Liability Claims
April 1, 2011

SEC Proposes Incentive-Based Compensation Rules
March 15, 2011

SEC Proposes to Remove Credit Ratings References from Money Market Fund Rule
March 7, 2011

Government Issues Final Rules on FBAR Filing Requirements
March 3, 2011