Ropes & Gray's Investment Management Update: May 2011

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

SEC Proposes Changes to Advisers Act Definition of "Qualified Client"

On May 10, 2011, the Securities and Exchange Commission (the "SEC") issued proposed rules and a notice of its intention to issue an order increasing the thresholds for qualification as a "Qualified Client" under the *Investment Advisers Act of 1940* (the "Advisers Act"), as required by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"). Under Advisers Act Rule 205-3, the Qualified Client standard must be met in order for a client, or an investor in a private fund, to be charged a performance-based fee.

The Advisers Act prohibits an investment adviser from entering into, extending, renewing or performing any investment advisory contract providing for compensation to the adviser based on a share of capital gains on, or capital appreciation of, client funds unless the client meets the "Qualified Client" standard set forth in Rule 205-3. In its current form, Rule 205-3 permits an investment adviser to enter into such performance fee arrangements if (i) the client has least $750,000 under management with the adviser (the "assets-under-management test") or the adviser reasonably believes that the client has a net worth of more than $1.5 million (the "net worth test"), (ii) the client is a "Qualified Purchaser" under section 2(a)(51)(A) of the *Investment Company Act of 1940* (the "1940 Act"), or (iii) the client is an executive officer, director, trustee, general partner, or knowledgeable employee of the adviser.

As required by Section 418 of the Dodd-Frank Act, the SEC announced its intention to issue an order that will adjust the dollar amount tests in Rule 205-3 to account for the effects of inflation by increasing the assets-under-management test from $750,000 to $1 million and the net worth test from $1.5 million to $2 million. In addition, the SEC proposed the following modifications to Rule 205-3:

- A new provision that will require the SEC to issue orders making future inflation adjustments every five years;
- A revision to the net worth test that excludes the value of a person's primary residence and related mortgage debt that is no greater than the property's current market value from the calculation of a client's net worth; and
- A modification of the Rule's current transition provisions to allow advisers and clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, as well as any such arrangements entered into by an investment adviser at a time when the adviser was exempt from registration with the SEC.

The Dodd-Frank Act requires that the SEC issue an order adjusting the dollar amount tests in Rule 205-3 to account for inflation by July 21, 2011. The SEC is accepting comments on the proposed rules until July 11, 2011.

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FINRA Fines Wells Fargo $1 Million for Late Prospectus Deliveries

In a recent enforcement action, the Financial Industry Regulatory Authority ("FINRA") fined Wells Fargo Advisors, LLC ("Wells Fargo") $1 million for failing to timely deliver prospectuses to approximately 934,000 customers who had purchased mutual funds in 2009, notwithstanding the fact that Wells Fargo had contracted with a third-party service provider to meet these obligations. FINRA found that Wells Fargo was aware of the late deliveries, which in some cases were up to 153 days late, having received quarterly reports and daily notifications regarding the delays from the third-party service provider and that Wells Fargo failed to take corrective action once it learned its delivery obligations were not being met.

This enforcement action underscores the risk of relying solely on contractual provisions with a service provider to satisfy securities law obligations without adequate policies and procedures to monitor compliance with those obligations, particularly when coupled with a failure to take corrective action to ensure compliance when necessary. It also underscores the importance of ensuring that entities with prospectus delivery obligations have the operational capacity to deliver prospectuses within three business days of any sale, as required by the federal securities laws.

FINRA Proposes Revised Amendments to Compensation Disclosure Requirements for Broker-Dealers

FINRA recently issued a revised proposed rule governing the disclosure of cash compensation paid to broker-dealers in connection with the distribution and sale of investment company securities. Proposed FINRA Rule 2341 would replace NASD Rule 2830, on which it is based, and would require point-of-sale disclosure by broker-dealers regarding such cash compensation if adopted.

Rule 2830(l) currently prohibits broker-dealers from accepting any cash compensation from an "offeror" of investment company securities, including the investment company and its investment adviser, administrator, underwriter or any other affiliated person, unless the cash compensation is disclosed in the investment company's current prospectus or statement of additional information ("SAI"). Under the proposed rules, broker-dealers could no longer rely on the disclosure of cash compensation arrangements in an investment company's prospectus or SAI.[1] Instead, a broker-dealer that has received, or has entered into an arrangement to receive, within the previous calendar year any cash compensation from an offeror, other than the sales charges and service fees disclosed in the prospectus fee tables of investment companies sold by such broker-dealer, would be required to: (i) prominently disclose that it has received, or has entered into an arrangement to receive, cash compensation (including revenue sharing, sub-administrative and/or sub-transfer agency fees, if applicable) from investment companies and their affiliates; (ii) prominently disclose that this additional cash compensation may influence the selection of investment company securities that the broker-dealer and its associated persons offer or recommend to investors; and (iii) provide a prominent reference (or hyperlink in the case of electronically delivered documents) to a webpage or toll-free number where the investor could obtain additional information regarding the broker-dealer's cash compensation arrangements. This additional information would include a narrative description of additional cash compensation received (or to be received) from offerors and a description of any services provided (or to be provided) by the broker-dealer in return, a narrative description of any preferred list of investment companies (including the names of the investment companies) that the broker-dealer has adopted as a result of the receipt of additional cash compensation, and the names of offerors that have paid, or entered into an arrangement with

[1] Of course, investment companies will continue to be subject to certain disclosure requirements set forth in Form N-1A regarding payments to financial intermediaries.

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the broker-dealer to pay, additional cash compensation. Broker-dealers would not be required to disclose the dollar amount of additional cash compensation received during the applicable period.

If the rule is adopted, broker-dealers would be required to provide the requisite disclosures to each customer prior to the time that the customer first purchases shares of an investment company through the broker-dealer. The proposed rule would require that broker-dealers provide existing customers with the requisite disclosures by the later of 90 days after the effective date of the proposed rule change or prior to the time the customer first purchases shares of an investment company through the broker-dealer after the effective date (other than purchases through reinvestment of dividends or capital distributions or through automatic investment plans).

Proposed FINRA Rule 2341 would also revise NASD Rule 2830 by making a minor change to the recordkeeping requirements for non-cash compensation, eliminating a condition regarding discounted sales of investment company securities to dealers, codifying past FINRA staff interpretations regarding the purchases and sales of exchange-traded funds, and making certain minor technical revisions.

The SEC is expected to take action on the proposal this summer.

SEC Proposes Rules for Nationally Recognized Statistical Rating Organizations

On May 18, 2011, the SEC proposed rules that would implement certain provisions of the Dodd-Frank Act and enhance existing SEC rules governing nationally recognized statistical rating organizations ("NRSROs") and third-party due diligence services provided in connection with the issuance of asset-backed securities. Following the recent financial crisis, many believed that credit rating agencies were improperly influenced by conflicts of interest and lacked transparency. According to SEC Chairman Mary L. Schapiro, the proposed rules are designed to "strengthen the integrity and improve the transparency of credit ratings."

The SEC's proposed rules and rule amendments applicable to NRSROs would, among other things:

- prevent sales and marketing activities of an NRSRO from influencing ratings issued by the NRSRO and require an NRSRO to take certain actions, including public disclosures, if the NRSRO determines that a rating was influenced by a conflict of interest;
- enhance public disclosure of information on the initial credit ratings determined by the NRSRO for each type of obligor, security, and money market instrument, and any subsequent changes, to better enable users of ratings information to evaluate the accuracy of the NRSRO's ratings and compare the performance of ratings issued by different NRSROs;
- require public disclosure of certain information in the event the NRSRO changes the methodology used by the NRSRO to determine credit ratings; and
- require the NRSRO to publish a form in connection with the publication of a credit rating and a certification from any provider of third-party due diligence services that relates to the credit rating.

The SEC also proposed a new rule and form that would apply to providers of third-party due diligence services for asset-backed securities, and rule amendments and a new rule that would require issuers and underwriters of asset-backed securities to make the findings and conclusions of such third-party due diligence providers publicly available.

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The SEC seeks comment on a number of matters relating to the proposals set forth in the proposing release. The text of the proposed rules can be found here.

Treasury Finalizes TIC Form SLT Reporting Requirements

As part of the system designed by the Department of the Treasury (the "Treasury") to measure portfolio investment into and from the United States, known as the Treasury International Capital ("TIC") reporting system, the Treasury has released final instructions for the reporting requirements of TIC Form SLT ("Form SLT"). Form SLT is a mechanism by which the Treasury can gather information on foreign investor holdings of U.S. securities and U.S. investor holdings of foreign securities, and will require investment advisers to mutual funds, among others, to file reports with the Treasury regarding such holdings. This information is generally used to track capital flow in international capital markets and to construct and formulate international financial and capital market policy.

In general, Form SLT requires that (i) U.S. resident custodians report long-term U.S. securities held by the custodian on behalf of foreign residents and long-term foreign securities held by the custodian on behalf of U.S. residents, (ii) U.S. resident end investors (such as a U.S.-resident investment adviser) report investments in long-term foreign securities for their own portfolios or for the portfolios of their clients that are not held by U.S. resident custodians and (iii) U.S. resident issuers report long-term U.S. securities held by foreign resident investors, in each case where the consolidated total of all reportable long-term U.S. and foreign securities equals or exceeds the exemption level (currently $1 billion) (the "Exemption Level") on the last business day of the reporting month. A long-term security generally includes a debt or an equity security with either no stated maturity or with an original maturity exceeding one year.

Form SLT reports must be filed by financial and non-financial organizations; managers of private and public pension funds, mutual funds and private investment funds or any other similarly pooled, commingled funds; foundations and endowments; and funds and other similar entities that either own shares or units of, or other equity interests in a foreign related or non-related entity (*e.g.*, a U.S.-based feeder fund owning shares of an offshore-based master fund), or has its shares or units, or other equity interests held by foreign related or non-related entities, that hold foreign long-term securities, or that have issued U.S. long-term securities held by foreign residents, that equal or exceed, in the aggregate, the Exemption Level.

Of particular note to U.S. investment advisers and fund managers is the requirement that such entities must report investments in foreign securities for their own account or for the account of their clients that are not held (and therefore reported) by a U.S.-resident custodian. In addition, to the extent such an investment adviser or fund manager is required to file Form SLT in any month, it will be required to include a report of the covered holdings and issuances of all U.S resident parts of its own organization and of all U.S. resident entities (including funds) that it advises/manages, on a consolidated basis. Reporting obligations under Form SLT are placed on custodians and/or investment advisers of mutual funds, exchange-traded funds, and other pooled, commingled funds, and such funds are not independently obligated to file reports.

Form SLT will go into effect on September 30, 2011. Form SLT is available here and the Instructions to Form SLT are available here.

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CTFC Provides Relief to Commodity Pool Operators of Commodity ETFs from Certain Disclosure Requirements

On May 18, 2011, the Commodity Futures Trading Commission ("CFTC") published final rule amendments that provide relief from certain disclosure, reporting and recordkeeping requirements for certain commodity pool operators ("CPOs") of pools whose interests are traded on a national securities exchange ("Commodity ETFs"), and from the CPO registration requirement for certain independent directors or trustees of Commodity ETFs. These amendments codify relief that the CFTC staff previously issued to CPOs of Commodity ETFs through no-action relief.

Specifically, a new paragraph (c) is added to CFTC Regulation 4.12 that, subject to certain conditions, would permit the CPO of a Commodity ETF to claim relief from the specific Disclosure Document delivery and acknowledgment requirements of Regulation 4.21, the monthly Account Statement delivery requirement of Regulation 4.22, and the requirement to keep the CPO's books and records at its main business address in Regulation 4.23.

In addition, a new paragraph (a)(5) has been added to Regulation 4.13. This new provision exempts from CPO registration, subject to certain conditions, an independent director or trustee of a Commodity ETF if that person was required to serve as a director or trustee solely for purposes of constituting and maintaining the audit committee required for actively-managed public companies under provisions of the Sarbanes-Oxley Act and SEC rules and exchange listing requirements adopted pursuant thereto. The amendments are effective June 17, 2011.

Massachusetts Proposes Tax Guidance for Professionally Managed Funds

The Massachusetts Department of Revenue ("DOR") has issued a discussion draft of a Directive to give professionally managed funds (other than mutual funds) rules for determining "trader" versus "investor" status. The distinction can be important in Massachusetts, which denies a personal income tax deduction for some investment-related federally deductible items (*e.g.*, investment interest) unless they are incurred in a trade or business.

The draft Directive offers a general test for trader status and some numerical tests expressed as safe harbors. The general test contains six factors, all of which must be satisfied for a trader fund; they include references to trade frequency, the existence of third-party investors, a demonstrated primary objective of achieving short-term income or profit, restrictions on any long-term buy-and-hold investment strategies, the absence of certain redemption restrictions, and the absence of disclosure or documentation inconsistent with trader status. Under the two proposed safe harbors, a fund would be treated as having a primary objective of achieving short-term income or profit if (i) the average holding period of the fund's assets, based on average fair market value during the tax year, is 45 days or less for the tax year, or (ii) at least 80% of the fund's assets, based on average fair market value during the tax year, have holding periods of 30 days or less.

The draft Directive would also permit a portion of a fund to be treated as a trader fund under an apportionment rule if the fund satisfies the other general-test requirements and if its shorter-term investments (holding period of one year or less) constitute a "sufficiently material" portion of its activities. Where apportionment is available, the DOR would accept as a reasonable apportionment of trader expenses the percentage determined by the ratio that the fund's investments with holding periods of 45 days or less bear to the fund's total investments. Other apportionment approaches may be possible.

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The Directive also provides guidance concerning the Massachusetts personal income tax treatment of management fees in a fund-of-funds structure.

The DOR has requested comments on the draft Directive by June 20, 2011.

Note Regarding Implementation of the Dodd-Frank Act

The Dodd-Frank Act requires that all final rules under its over-the-counter derivatives provisions be published by July 2011 and become effective no earlier than 60 days after they are published. Most rules have now been proposed, although almost none are in final form. A bill has been proposed in the U.S. House of Representatives that would delay the effectiveness of most of the derivatives provisions of the Dodd-Frank Act until December 2012. Reports indicate that it is unlikely that the bill will pass in the Democrat-controlled Senate.

Other Developments

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

California FPPC Issues New Interpretive Guidance On Placement Agent Legislation
April 29, 2011

U.S. Treasury Proposal Excludes Certain Foreign Exchange Derivatives from "Swap" Definition
May 2, 2011

DOL Proposes Coordinated Effective Dates for ERISA Fee Disclosure Rules
June 1, 2011

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