Ropes & Gray's Investment Management Update: July 2011

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

Firm Agrees to Pay $200 Million to Settle Allegations Involving the Valuation of Mortgage-Backed Securities

On June 22, 2011, the Securities and Exchange Commission ("SEC"), state regulators and the Financial Industry Regulatory Authority ("FINRA") announced that a registered investment adviser and its broker-dealer affiliate, plus two employees (collectively, the "respondents"), settled charges stemming from the valuation of mortgage-backed securities held by several registered open- and closed-end funds in 2007. The SEC order can be found here and the FINRA letter of acceptance, waiver and consent can be found here.

According to the settlement, the respondents failed to adhere to board-approved valuation policies and procedures when fair valuing mortgage-backed securities and the broker-dealer used inaccurate sales literature when marketing one of the open-end funds. The adviser and its affiliated broker-dealer agreed to pay $200 million for the benefit of affected investors and undertake other remedial measures. In addition, according to the SEC order, a portfolio manager who significantly influenced valuations and the controller of the broker-dealer/treasurer of the funds, who was responsible for overseeing fund accounting operations, have agreed to pay fines of $500,000 and $50,000, respectively. Moreover, the portfolio manager was indefinitely barred from further association with the securities industry while the controller was suspended for 12 months and indefinitely barred from practicing before the SEC as an accountant. This costly settlement underscores that simply maintaining valuation policies and procedures and compliance policies and procedures is not sufficient. Firms should also take steps to ensure that such policies and procedures are being properly followed. The following summary of the facts that led to the settlement are based on the SEC order.

According to the SEC order, the boards of directors of the funds approved valuation policies and procedures and delegated valuation and pricing responsibilities to the adviser's broker-dealer affiliate, which provided fund accounting services to the funds and also served as the distributor of the open-end funds. A valuation committee primarily consisting of employees of the fund accounting agent, including the funds' treasurer, was responsible for carrying out the funds' policies with respect to fair valuation of portfolio holdings that lacked readily available market quotations. The funds' prospectuses were inaccurate on this point and described that the investment adviser (not its affiliate) would be responsible for fair valuation. Among other requirements, the valuation procedures called for the valuation committee to document how fair value determinations were made and the accuracy of those determinations based on next available reliable market quotations. The valuation procedures required security valuations to be periodically validated through, among other means, comparisons with broker-dealer price confirmations and further specified that (i) overriding a price from a broker-dealer required "a reasonable basis to believe that the price provided [did] not accurately reflect the fair value of the portfolio security" and (ii) price overrides were to be documented and reviewed by the valuation committee.

As described in the SEC order, a senior portfolio manager significantly influenced the valuations assigned to portfolio holdings in ways not contemplated by the board-approved valuation procedures. In summary, the portfolio manager engaged in the following practices, among others:

- actively screened and influenced at least one broker-dealer to change price confirmations provided to the fund accounting group and the funds' independent auditor by inducing the broker-dealer to provide interim price confirmations that were less than the values assigned by the funds but greater than the valuations that the broker-dealer originally intended to provide;
- failed to advise the fund accounting department or the funds' boards of directors of information indicating that valuations of particular holdings should be reduced;
- provided arbitrary "price adjustments" regarding portfolio holdings to fund accounting without providing a reasonable basis for the adjustments or supporting documentation, which were used by fund accounting to calculate fund net asset values;
- determined whether current portfolio values should be used or adjustments were appropriate in instances where broker price confirmations contained prices that varied by more than five percent from a fund's current pricing, and such determinations were generally followed by the fund accounting department when calculating fund net asset values;
- forestalled declines in fund net asset values by, among other practices, recommending value reductions for portfolio holdings in a series of pre-planned steps to bring values to or closer to, but still above, price confirmations received from broker-dealers.

Additionally, according to the order, the fund accounting agent failed to meet its responsibilities under the valuation procedures by, among other practices, (a) relying with no reasonable basis on the portfolio manager's price adjustments, (b) permitting lower level and untrained employees to make pricing decisions and (c) not reevaluating fair value prices assigned to securities, allowing them to be carried at stale values for months. The order also states that the head of fund accounting knew or was reckless in not knowing of the deficiencies in the implementation of the funds' valuation policies and procedures. The order further states that the fund accounting agent (and distributor of the open-end funds) published daily net asset values that it knew were inaccurate as a result of the failure to adhere to the funds' valuation policies and procedures and sold and redeemed shares at incorrect net asset values. The order provides that as a result of these inaccurate net asset values, the funds' annual and semi-annual reports materially misstated fund performance. Finally, according to the order, the adviser and the fund accounting agent did not have adequate compliance policies and procedures in place to prevent them from knowingly and substantially assisting in the violations described in the order. The SEC's order accordingly found violations of the anti-fraud provisions of the *Investment Advisers Act of 1940* (the "Advisers Act") (Sections 206(1) and 206(2)) and the *Investment Company Act of 1940* (the "1940 Act") (Section 34(b)), as well as the share pricing requirements under the 1940 Act (rule 22c-1) and the compliance program requirements under both the Advisers Act (Section 206(4) and rule 206(4)-7) and the 1940 Act (rule 38a-1).

In addition to the SEC settlement order, FINRA accepted a letter of acceptance, waiver and consent submitted by the broker-dealer to settle alleged violations of NASD Conduct Rules 2110, 2210, 3010(a) and 3010(b). These violations stemmed from the use of sales materials that marketed one of the open-end funds as a relatively safe, investment grade fixed income fund while the fund invested primarily in structured products, including mezzanine and subordinated tranches of structured securities. The FINRA settlement provides that such sales materials contained exaggerated claims, were not fair and balanced, and failed to provide an accurate description of relevant investment risks.

SEC Staff Issues No-Action Letter Permitting Registered Investment Companies to Acquire Shares of Foreign Investment Companies in Excess of the Limits of Section 12(d)(1)(A) of the Investment Company Act of 1940

In a recent no-action letter, the staff (the "Staff") of the SEC Division of Investment Management granted relief to allow U.S. registered investment companies advised by Red Rocks Capital, LLC ("Red Rocks") to invest in certain investment companies organized outside the United States in excess of all of the statutory limits in Section 12(d)(1)(A) of the 1940 Act. The Staff's response to the no-action request can be found here.

Under Section 12(d)(1)(A) of the 1940 Act, a registered investment company (the "acquiring company") generally may not purchase or otherwise acquire any security issued by another investment company (the "acquired company") if it would result in the acquiring company (i) owning more than three percent of the total outstanding voting stock of the acquired company, (ii) having more than five percent of its total assets invested in the acquired company or (iii) having more than ten percent of its total assets invested in the acquired company and all other investment companies. The Section 12(d)(1)(A) limits do not apply to acquisitions of pooled investment vehicles, including those organized outside the United States ("Foreign Funds"), that rely on exemptions from the definition of "investment company" under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, but do apply to acquisitions of Foreign Funds that do not rely on an exclusion from the definition of investment company under the 1940 Act ("non-exempt Foreign Funds") and in which the Red Rocks funds invest (for example, publicly offered Foreign Funds).

The Staff granted the requested relief to permit Red Rocks-advised funds to invest in non-exempt Foreign Funds in excess of all of the statutory limitations of Section 12(d)(1)(A), subject to certain representations, citing in part rationales set forth in the no-action request, including that the SEC has no significant regulatory interest in protecting the non-exempt Foreign Funds from undue influence by an acquiring U.S. registered investment company. The Red Rocks funds had previously invested in non-exempt Foreign Funds in reliance on Section 12(d)(1)(F) of the 1940 Act, which generally exempted the funds from the limits imposed by Section 12(d)(1)(A) but limited investments by each fund and all of its affiliates to not more than three percent of the outstanding voting stock of an acquired non-exempt Foreign Fund. According to the relief, Red Rocks-advised funds will continue to acquire shares of investment companies that are organized in the United States in accordance with Section 12(d)(1)(F).

FIA and ISDA Publish Documentation for Cleared Swaps

On June 17, 2011, the Futures Industry Association ("FIA") and the International Swaps and Derivatives Association ("ISDA") published the FIA-ISDA Cleared Derivatives Execution Agreement. The Agreement is intended to be a template "give up" agreement for over-the-counter derivatives that are intended to be cleared, under which a party can enter into an over-the-counter derivative with another party and then transfer the derivative to its clearing member for clearance. FIA and ISDA member representatives who are swap dealers and buy-side firms assisted with the development of the Agreement.

The Agreement prescribes a procedure for submitting the trade for clearing; clarifies that each party's agreement with its clearing firm will govern once a trade is accepted for clearing; and establishes the rights and obligations of the parties in case a trade is not accepted for clearing. If one of the parties to the Agreement is a dealer, the Agreement gives the dealer broad discretion to determine what will happen if a trade is not accepted for clearing. While this approach is similar to the one used for futures, it is different from the approach often used currently for over-the-counter derivatives prime brokerage arrangements, under which the parties often agree at the time the arrangement is established what will happen if a derivative is not accepted by the derivatives prime broker. Additionally, the Agreement includes optional annexes for parties who agree that the clearing firm of one or both parties will be party to the Agreement.

Use of the Agreement is voluntary. Many provisions in the Agreement are likely to be superseded by new regulatory requirements and the specific rules of individual swap execution facilities and clearing organizations; therefore, the Agreement provides that its terms are subject to applicable law. FIA and ISDA have stated that they believe that the Agreement will be updated over time as the cleared swaps market continues to evolve.

The text of the FIA-ISDA Cleared Derivatives Execution Agreement can be found here.

FASB Drops Proposal That Would Have Caused Transaction Costs to be Included in Funds' Expense Ratios

On June 8, 2011, the Financial Account Standards Board ("FASB") voted 6 to 1 to modify a portion of its May 2010 proposal that generally would have caused investment companies to include portfolio transaction costs in their expense ratios.

A May 2010 FASB Exposure Draft proposed extensive updates to the accounting standards for financial instruments which would have, in part, impacted the treatment of transaction costs and fees (including brokerage expenses) associated with investments. Under the proposal, investment companies would have been required to recognize transaction costs on the purchase and sale of investments as current period operating expenses in their statements of operations and expense ratios, a major departure from the current GAAP treatment, which requires transaction costs to be included in the cost of securities purchased or deducted from the proceeds of sales — i.e., to be treated as a cost of trading the portfolio investment rather than as a recurring operating expense as suggested by the FASB proposal. FASB received many comment letters from industry participants critical of the proposal, citing among other concerns that it would diminish the utility of the expense ratio as a measure of an investment company's recurring operating expenses and introduce serious comparability concerns across investment companies and reporting periods.

FASB's May 2010 Exposure Draft can be found here and the minutes of FASB's June 8th meeting can be found here.

SEC Staff Issues No-Action Letter Clarifying that a Business Development Company May Rely on Rule 32a-4

Through a recent no-action letter, the Staff said that it would not recommend enforcement action against a business development company ("BDC") if the BDC does not submit the selection of its independent public accountant to shareholders for ratification or rejection at the BDC's next succeeding annual meeting of shareholders, provided that the BDC fully complies with rule 32a-4 (the "Rule") under the 1940 Act as if the BDC were a registered investment company. The Staff's response to the no-action request can be found here.

Section 32(a) of the 1940 Act prohibits a fund from filing financial statements signed or certified by an independent public accountant unless the selection of that accountant has been submitted to shareholders. The Rule, however, provides an exemption to the shareholder ratification requirement if the fund's board of directors has established an audit committee composed solely of non-interested members; the audit committee has a charter setting forth the committee's structure, duties, powers, and methods of operation (or those requirements are addressed in the fund's charter or bylaws); and the fund maintains and preserves permanently in an easily accessible place a copy of the audit committee's charter and any modification to the charter. Section 59 of the 1940 Act makes section 32(a) applicable to a BDC to the same extent as if it were a registered closed-end investment company, but the applicant suggested that there was some ambiguity as to whether a BDC can rely on the Rule. This no-action letter clarifies that a BDC that satisfies the requirements of the Rule does not need to submit the selection of its accountant to shareholders.

Reminder — Brochure Supplements Need to be Ready for Distribution by July 31

Advisers who were registered with the SEC on December 31, 2010 and whose most recent fiscal year ended between December 31, 2010 and April 30, 2011 must begin delivering brochure supplements to new and prospective clients on July 31, 2011 and to existing clients on September 30, 2011. The compliance dates for existing registered investment advisers with fiscal years ending after April 30, 2011 remain unchanged: once these advisers have filed their annual updating amendment to Form ADV, they are required to provide brochure supplements to new or prospective clients before or at the time that a supervised person begins to provide advisory services to the client, and to existing clients within 60 days of filing the annual updating amendment. The compliance date for investment advisers applying for registration after April 30, 2011 is unchanged: these advisers must begin providing brochure supplements to clients upon registering.

The Amendments to Form ADV adopting release can be found here and the Amendments to Form ADV; Extension of Compliance Date release can be found here.

Reminder — September Pay-to-Play Deadline

Advisers are reminded of the following deadlines for compliance with the pay-to-play rule (rule 206(4)-5 under the Advisers Act) and related rule requirements:

- Advisers to registered investment companies that are covered investment pools (i.e., an investment option for a participant-directed government plan or program) must comply with rule 206(4)-5 and the related recordkeeping requirements of rule 204-2 by September 13, 2011. In the absence of guidance from the SEC delaying the compliance date, this means that advisers to investment companies whose shares are held through an intermediary and advisers who are sub-advisers to an investment company need to make arrangements with the intermediary and/or adviser to get information as to whether any investors in the fund are government entities. FINRA sent a notice to its members in early June encouraging them to make "reasonable efforts to cooperate" with advisers seeking information for these purposes, "[t]o the extent the information requested is readily available." The Political Contributions by Certain Investment Advisers adopting release can be found here.
- The SEC has extended the date by which investment advisers may no longer use third parties to solicit government business except in compliance with rule 206(4)-5 from September 13, 2011 to June 13, 2012. The extension and related rule amendments were described in our recent alert which can be found here.

Regulators Keeping Their Eyes on Regulation S-P

Regulators continue to show their appetite for enforcing Regulation S-P against firms subject to Regulation S-P (registered investment advisers, broker-dealers, and mutual funds) and their employees. FINRA recently accepted a letter of acceptance, waiver and consent submitted by an employee of a member firm in connection with allegations that the employee improperly sent non-public personal information regarding customers to a non-affiliated third party member firm. The letter states that the employee knew, or should have known, that Regulation S-P prohibits such disclosure and that the employee acted contrary to the firm's written policies and procedures without its authorization and knowledge, causing his firm to violate Regulation S-P. FINRA fined the employee $5,000 and suspended him from association with any FINRA member in any capacity for 15 days.

This disciplinary action, coupled with similar actions by the SEC and FINRA earlier this year, suggests that privacy and information security continue to be an area of focus for enforcement officials. Firms should periodically review their Regulation S-P policies — both with respect to Regulation S-P's privacy requirements and its information security requirements — and should remind employees of the steps they need to take when handling non-public personal information in order to remain in compliance with such policies.

The FINRA letter of acceptance, waiver and consent can be found here.

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:

Update on Commodity Pool Operator Registration Exemptions
July 7, 2011

SEC Adopts Final Rule Defining Family Offices Exempt From SEC Registration
June 24, 2011

SEC Adopts Rules to Implement the Private Fund Investment Advisers Registration Act
June 23, 2011

FBAR Filing Deadline Extended To November 1, 2011 For Certain Individuals With Signature Authority
June 16, 2011

CFTC Proposes Temporary Exemptions From Certain New OTC Swap Laws
June 15, 2011

Supreme Court Forecloses Primary Liability for Secondary Actors in Securities Offerings
June 13, 2011

Ropes & Gray's Hedge Fund Update: June 2011
June 13, 2011