Ropes & Gray's Investment Management Update: August 2011

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

SEC Adopts Final Rule for Large Trader Reporting System

On July 26, 2011, the Securities and Exchange Commission ("SEC") adopted a large trader reporting system that will require "large traders" to identify themselves to the SEC and provide the SEC with information about their businesses and their affiliates. The new system also imposes recordkeeping, reporting and limited monitoring requirements on broker-dealers that hold accounts for large traders. The large trader system was adopted substantially as it was proposed in April 2010, though we have noted some key differences between the proposed and final rules below. Our more detailed alert on the proposed system, including Rule 13h-1 under the *Securities Exchange Act of 1934* (the "Exchange Act") and new Form 13H, can be found here. The adopting release for the large trader reporting system can be found here.

Very generally, a large trader is a person that "directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts" where the aggregate transactions in NMS securities across such accounts equal or exceed 2 million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month. The adopting release notes that the definition of large trader is designed to focus on the ultimate parent company of entities that employ or otherwise control the individuals that exercise investment discretion. As such, a parent company (to the extent it satisfies the definition of large trader based on the aggregate trading activity of its controlled entities) must comply with the requirements of the large trader reporting system on behalf of its controlled entities, unless its controlled entities collectively comply with the rule's requirements with respect to all of the parent company's direct or indirect accounts.

The rule prohibits a trader from disaggregating accounts and trading activity by effecting trades through multiple broker-dealers, accounts or transactions for purposes of avoiding the large trader identification and reporting requirements. In addition, if two or more traders engage in a coordinated trading strategy with the effect of exercising joint investment discretion over their individual accounts, the rule requires each trader to include all transactions in these joint accounts in their respective activity level calculations. Each large trader will be required to file Form 13H with the SEC at least annually, although updating amendments will be required to be filed no later than the end of any calendar quarter in which any of the information previously filed on the form becomes inaccurate for any reason.

Large traders will be assigned identification numbers by the SEC that must be provided to broker-dealers. Broker-dealers, in turn, generally will be required to maintain records regarding the purchases and sales of NMS securities by large traders and provide information to the SEC about transactions in NMS securities that exceed the minimum reporting activity level established in the rule (generally, any transaction involving 100 or more shares). In addition, although large traders are principally responsible for identifying themselves as large traders, broker-dealers have some responsibility to monitor their customers and identify any person that should have identified itself as a large trader and has not done so (an "Unidentified Large Trader").

The following is a summary of the key differences between the proposed large trader reporting system and the adopted system:

- For the purpose of determining whether a person has engaged in sufficient trading activity to be classified as a large trader, the SEC clarified that the rule focuses on transactions involving investment decisions traditionally associated with trading in NMS securities and added transactions involving business combinations to the list of excluded transactions.

- In order to mitigate the need for traders to actively monitor their trading levels, the SEC will permit persons who expect to meet or exceed the large trader activity level in the future to voluntarily register as large traders on Form 13H.

- Changes were made to final Form 13H for the purpose of decreasing the burden of the filing. Most notably, instead of requiring large traders to provide information about each broker-dealer account through which it or certain of its affiliates trade, as was proposed, the final version of the Form solicits the identity of the broker-dealers at which the large trader (and certain affiliates) has accounts and whether each broker-dealer provides prime broker, executing broker and/or clearing broker services. The SEC indicated in the adopting release that if it needs more specific individual account-level information, the SEC will use the list of broker-dealers provided to make targeted requests for information from those entities. Among other changes from the proposed Form, large traders will be required to disclose only those affiliates who exercise investment discretion over NMS securities, and not affiliates who merely beneficially own NMS securities. Also, in place of the proposed requirement to disclose all affiliates, large traders will be required to attach an organizational chart to help the SEC understand the large trader's corporate structure.

- The SEC clarified that broker-dealers generally will have until the opening of business on the day following a request from the SEC to submit transaction information, except in unusual circumstances where same-day information is requested.

- The SEC clarified that when monitoring for Unidentified Large Traders, as long as the broker-dealer does not have actual knowledge that a person is an Unidentified Large Trader, the broker-dealer need only consider transactions with such broker-dealer and it need not proactively investigate a person's trading activity levels with other broker-dealers.

Large traders will have until December 1, 2011 to identify themselves to the SEC and broker-dealers will have until April 30, 2012 to comply with their recordkeeping, reporting and monitoring obligations under the rule.

D.C. Circuit Strikes Down "Proxy Access" Rule

On July 22, 2011, the U.S. Court of Appeals for the District of Columbia Circuit struck down Rule 14a-11 under the Exchange Act, which the SEC adopted last year to broaden "proxy access" for shareholders seeking to place their own nominees to boards of directors on a company's proxy. The text of the court's opinion can be found here.

Rule 14a-11 as adopted would have required companies that are subject to the proxy rules under the Exchange Act (including registered investment companies) to include the names of nominees submitted by qualifying shareholders, or groups of shareholders, on the company's proxy statement and proxy voting card, subject to certain limitations. Generally, under the rule a shareholder (or group of shareholders) could qualify by holding at least 3% of a company's voting stock for at least three years.

The rule was challenged by the Business Roundtable and the U.S. Chamber of Commerce, which argued that the SEC had failed to adequately consider the costs and benefits of the rule. The Court held that the SEC acted arbitrarily and capriciously by failing to adequately assess the economic effects of the new rule. Additionally, the Court specifically discussed investment companies' concern that the shareholder protections provided by the *Investment Company Act of 1940* (the "1940 Act") "reduce the need for, and hence the benefit to be had from, proxy access for shareholders of investment companies," and also that "the rule would impose greater costs upon investment companies by disrupting the structure of their governance." The Court stated that if the SEC intends to apply "a newly justified version of the rule" to investment companies then the SEC should address "the more serious of the concerns posed by investment companies but left unaddressed by the [SEC]."

The Court's ruling seems to indicate a willingness on the part of the D.C. Circuit Court to scrutinize the actions of an agency when it adopts regulations authorized by the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") and those regulations are challenged. This decision might cause regulators to be more apprehensive when adopting rules under the Dodd-Frank Act, which could have broader implications for slowing the pace of financial regulatory action. Additional commentary on the Court's ruling from a Ropes & Gray partner can be found here.

The case is *Business Roundtable and Chamber of Commerce of the U.S. v. Securities and Exchange Commission*, No. 10-1305 (D.C. Cir. Jul. 22, 2011).

FINRA Withdraws Proposed Amendments to Compensation Disclosure Requirements for Broker-Dealers

On August 1, 2011, the Financial Industry Regulatory Authority ("FINRA") withdrew its proposed rule change that would have required new point-of-sale disclosures regarding cash compensation, including revenue sharing payments, paid to broker-dealers in connection with the distribution and sale of investment company securities. As proposed, the change would have replaced existing NASD Rule 2830 with FINRA Rule 2341. FINRA has not publicly announced the reason for its withdrawal of the proposed rule, and it is possible that FINRA could seek approval of this rule or a similar rule in the future. Our prior coverage of the proposed rule change can be found here.

SEC Publishes Redline Comparison to Show Recently Adopted Changes to Form ADV Part 1A

The SEC has posted a redline document online showing recent changes that have been made to Form ADV Part 1A. The redline document can be found here.

The changes to Form ADV Part 1A shown in the redline generally result from the implementation of new regulations adopted in response to the Dodd-Frank Act. Among other changes, revised Form ADV Part 1A now solicits information about an advisory firm's eligibility for federal registration under revised Section 203A of the *Investment Advisers Act of 1940* ("Advisers Act"), contains instructions for calculating regulatory assets under management for purposes of determining eligibility for federal registration or reliance on exemptions from registration, contains reporting requirements for exempt reporting advisers (i.e., investment advisers who are exempt from federal registration under the new "venture capital fund" exemption or the "private fund adviser" exemption) and solicits information about private funds (i.e., any fund that would be an investment company but for Section 3(c)(1) or 3(c)(7) of the 1940 Act) advised by the adviser.

Any investment adviser registered with the SEC on January 1, 2012 will be required to file a new Form ADV Part 1A by March 30, 2012 (regardless of the adviser's fiscal year end). Moreover, exempt reporting advisers who were relying on the "private adviser" exemption in Section 203(b)(3) of the Advisers Act on July 20, 2011 as a basis for not registering with the SEC will need to file new Form ADV Part 1A between January 1, 2012 and March 30, 2012. Our prior coverage of the SEC's rules implementing the Private Fund Investment Advisers Registration Act can be found here.

IRS Temporarily Suspends Issuance of Private Letter Rulings for RICs Indirectly Investing in Commodities

The Internal Revenue Service ("IRS") has recently made known that it has temporarily suspended the issuance of private letter rulings allowing registered funds that are regulated investment companies ("RICs") for U.S. federal income tax purposes to invest indirectly in commodities through (1) wholly owned offshore subsidiaries or (2) certain commodity-linked structured notes. The IRS has previously issued a number of letter rulings to RICs in this area, concluding that such investments generate "qualifying income" for RIC qualification purposes.

The IRS's decision to suspend its issuance of these letter rulings reflects a reassessment of its ruling practice in this area in light of certain recent events, including the Commodity Futures Trading Commission's ("CFTC") examination of whether RICs using commodities subsidiaries should be required to register with the CFTC as "commodity pool operators" (see our prior Alerts from January 2011 and July 2011 for a summary of proposed CFTC rulemaking in this area), the enactment of the *RIC Modernization Act of 2010* and an increase in the number of these ruling requests. It is unclear how much of a role pressure from the CFTC had in the IRS's decision.

The IRS is still accepting new ruling requests from RICs in this area — indeed, we understand that it has suggested applicants continue to file such requests, to "get in line" — but no action will be taken on them while it reassesses its ruling practice. It is unclear how long this suspension will last. The IRS has not indicated that any previously issued rulings in this area will be affected by this suspension.

Unless and until the IRS resumes issuing letter rulings in this area, a RIC that does not already have a letter ruling and wishes to invest indirectly in commodities through the use of a commodity subsidiary or structured notes has one or two alternatives. First, a RIC using a subsidiary can currently repatriate the subsidiary's earnings constructively "brought back" each taxable year under the so-called "Subpart F" rules of the Internal Revenue Code. Second, a RIC seeking to use either a commodity subsidiary or structured notes can seek an opinion of counsel, at a level of confidence sufficient to satisfy the RIC's accountants and board, that the RIC's indirect investment in commodities generates "qualifying income."

SEC Proposes Business Conduct Standards for Certain Security-Based Swap Participants

On June 29, 2011, the SEC issued a set of proposed rules promulgating certain business conduct standards for security-based swap ("SBS") dealers and major SBS participants (together, "SBS Entities").

Summary of the Proposed Rules

Verification. SBS Entities would be required to verify, through reasonable means, that their counterparties meet the definition of an eligible contract participant (an "ECP") before entering into the swap, unless the transaction is entered into on a registered securities exchange.

Disclosure. Prior to entering into an SBS transaction, SBS Entities would be required to disclose to their counterparties (i) information about the material risks and characteristics of the swap and material incentives or conflicts of interest with respect to the swap, and (ii) the counterparty's rights to clear the swap and select the clearinghouse. SBS Entities must also provide to counterparties the "daily mark" of the swap, which the SEC proposes would have an analogous meaning for both cleared and uncleared security-based swaps. For cleared swaps, this daily mark would be the end-of-day settlement price; for uncleared swaps, the daily mark would be the midpoint between the bid and offer prices for the particular uncleared swap as of close of business on the given day.

Recommendations and Fair Dealing. SBS dealers would be required to have a reasonable basis for believing that any recommendation of a swap to a counterparty is suitable for such counterparty. This requirement is analogous to the FINRA rule on suitability and is only triggered when a "recommendation" is being made by the SBS dealer, which requires a "facts and circumstances" analysis. The proposed rule also requires that SBS Entities communicate with their counterparties in a fair and balanced manner with principles of good faith and fair dealing, both prior to entering into the transaction and throughout the term of the swap.

Special Entities. The proposed rule affords special protections to "special entities," which include municipalities, pension plans, endowments and similar entities. If an SBS dealer "acts as an advisor" to a special entity, the dealer is charged with the duty to use reasonable efforts to determine whether the swap is in the best interests of the special entity. SBS Entities acting as counterparties to special entities would be required to have a reasonable basis for their belief that the special entity has an independent representative working in the special entity's best interests. Such an independent representative may be an employee of the special entity.

The proposed rules are available here. Comments to the proposed rules must be received on or before August 29, 2011.

DOL Says CFTC Business Conduct Standards May Not Cause Swap Counterparties to Lose Eligibility to Rely on the Counterparty Exception to ERISA Fiduciary Status

On April 28, 2011, a senior official at the Department of Labor ("DOL") provided a letter to the CFTC addressing concerns regarding whether the business conduct standards under Dodd-Frank and related proposed CFTC rules for swap dealers and major swap participants could cause a counterparty to a swap with a plan covered by the Employee Retirement Income Security Act of 1974 ("ERISA") to become a fiduciary to the plan. The issue was addressed in the context of the DOL's proposed expanded definition of fiduciary investment adviser, which we have previously covered here and here. The DOL's proposed rule change can be found here.

The letter addressed the fact that there is some question about whether a swap dealer or major swap participant could become a fiduciary by virtue of providing a plan with information regarding a swap's value, risk characteristics or other information material to the transaction as required by the proposed CFTC business conduct rules. The letter also noted that there may be some concern about whether in light of the business conduct standards a swap counterparty can successfully assert that its interests are sufficiently "adverse" so as to permit reliance on the proposed exception from the definition of fiduciary investment adviser for adverse counterparties.

The letter addressed these concerns by stating that, "[i]n DOL's view, a swap dealer or major swap participant that is acting as a plan's counterparty in an arm's length bilateral transaction with a plan represented by a knowledgeable independent fiduciary would not fail to meet the terms of the counterparty exception solely because it complied with the business conduct standards set forth in the CFTC's proposed regulation." The letter also stated that, "[e]ven if the plan's swap counterparty complies with the business conduct standards, it is not 'undertaking to provide impartial investment advice' within the meaning of the DOL regulation when it engages in a bilateral arm's length transaction with a plan."

In a welcome and potentially significant clarification, the letter also indicated that a swap dealer or major swap participant that is acting as both an advisor and a counterparty to an ERISA plan under the business conduct rules can rely on the counterparty exception under the proposed DOL regulation. The letter stated that, "[a]s the CFTC recognized in the preamble to the proposed business conduct standards, 'a swap dealer has an inherent conflict of interest when it acts as both an advisor and as a counterparty to a Special Entity.' For example, under the business conduct standards, swap dealers can both recommend and enter into swaps with plans and, when the swaps move against the plans, the dealers can keep the resulting profits. Accordingly, the parties' interests are 'adverse' within the meaning of the DOL's proposed regulation." (internal citation omitted).

As a related note, in its proposing release for business conduct standards for certain security-based swap participants discussed immediately above, the SEC cited the DOL letter stating that the staffs of the SEC, DOL and CFTC are coordinating with one another to address similar concerns under the SEC's proposed rules.

The DOL letter can be found here.

SEC Increases "Qualified Client" Dollar-Amount Thresholds for Performance Fee Rule

On July 12, 2011, the SEC issued an order increasing the dollar-amount thresholds used to determine whether an advisory client, or an investor in a private fund, is a "qualified client" that may be charged a performance fee by its investment adviser under Rule 205-3 under the Advisers Act. The order can be found here.

Under the revised thresholds, a client/investor will satisfy the dollar-amount threshold to be a "qualified client" if the client/investor has at least $1 million under management with the adviser immediately after entering into the advisory contract or the adviser reasonably believes that the client/investor has a net worth of more than $2 million immediately prior to entering into the advisory contract. These increases from the current thresholds of $750,000 and $1.5 million, respectively, were adopted as a result of the Dodd-Frank Act's requirement that the SEC adjust these dollar-amount thresholds for inflation every five years beginning no later than July 21, 2011. Other provisions of Rule 205-3 that provide other means of satisfying the qualified client definition — i.e., "qualified purchasers" under the 1940 Act and persons with specified relationships with an adviser — are unaffected by the order.

Advisers should update their client and investor questionnaires in light of these threshold changes, which become effective September 19, 2011.

As we previously reported here, on May 10, 2011 the SEC proposed other changes to Rule 205-3 that, very generally, would exclude the value of a person's primary residence (and related mortgage debt) from the calculation of a client's net worth and provide a transition rule for existing performance fee arrangements that do not satisfy the new thresholds but (i) were permissible at the time the advisory contracts were entered into or (ii) were entered into by an investment adviser at a time when it was exempt from registration with the SEC. In its July 12, 2011 press release announcing the dollar threshold changes (which can be found here), the SEC staff indicated that these proposed amendments to Rule 205-3 are "currently under consideration."

IRS Issues Regulations Addressing Tax Uncertainty Surrounding Assignment of Derivative Contracts Required by the Dodd-Frank Act

As a result of the Dodd-Frank Act, dealers and clearinghouses may be required to assign or otherwise transfer large numbers of derivatives contracts. For example, some dealers who are U.S. banks are expected to move their derivatives businesses to affiliated entities to comply with provisions of the Dodd-Frank Act that prohibit U.S. banks from entering into certain types of derivatives transactions.

Many such derivatives contracts provide that the non-assigning counterparty needs to consent to any assignment or similar transfer. On July 21, 2011, the IRS issued temporary Treasury Regulation § 1.1001-4 under Section 1001 of the Internal Revenue Code (the "Temporary Regulations") generally providing that the assignment or other transfer of a covered derivative contract among dealers or clearinghouses will not result in a tax realization event for the non-assigning counterparty (e.g., a fund that has entered into a derivative contract with a dealer), even if the non-assigning counterparty is required to consent to the assignment.

Moreover, the Temporary Regulations expand the previous version of this rule to cover derivatives beyond "notional principal contracts" (generally, swaps), to also include, among other derivative positions, options and forwards. The Temporary Regulations currently appear to exclude commodities swaps from their reach, even though they were expressly covered by the prior rule. We understand that this exclusion was inadvertent and will be the subject of a future technical correction.

The Temporary Regulations became effective on July 22, 2011 and can be found here.

GAO Issues Report on Mutual Fund Advertising

As required by Section 918 of the Dodd-Frank Act, the U.S. Government Accountability Office ("GAO") has issued a report on its review of mutual fund advertising, focusing on the advertising of past performance information. The report examined: (i) what is known about the impact of fund advertisements on investors; (ii) the extent to which performance information is included in advertisements; and (iii) the regulatory requirements for fund advertisements and how they are administered and enforced. In preparing its report, the GAO reviewed existing and proposed SEC and FINRA rules, conducted a literature review of studies related to the impact of mutual fund advertising on investors and reviewed a random sample of 300 fund advertisements. The GAO's report can be found here.

The GAO noted that some academic studies and representatives of investor protection organizations have expressed concerns that investors could be influenced to make inappropriate investment decisions by advertisements that emphasize past performance, but found that the evidence that investors are harmed by these advertisements is mixed. Among its observations, the GAO noted that surveys show that investors are increasingly relying on information from financial advisors and other sources and use a variety of information other than performance information when making their investment decisions. The GAO also noted that the potential for investor harm may be limited because advertising materials for mutual funds largely focus on information other than performance. The GAO estimated that from 2006 through 2010, only 9 percent of mutual fund advertisements intended to be seen by the public primarily focused on fund performance and only 35 percent of all advertisements submitted to FINRA contained some performance information.

The GAO also indicated that the regulatory review process for fund advertising appears to limit the potential for misleading advertisements, but noted that there are concerns about the consistency of FINRA's comments on advertising materials. The GAO also indicated that FINRA's mechanisms for communicating new rule interpretations to the industry could be improved.

With respect to inconsistency of FINRA comments, the GAO noted that one key factor may be that the standards in FINRA's advertising rules are subjective and different FINRA analysts may interpret these standards differently from one another. The GAO noted, however, that FINRA maintains several processes that are designed to improve the consistency of comments provided on advertising materials.

The GAO also noted that FINRA lacks sufficient mechanisms for ensuring that new interpretations of existing rules are communicated evenly to all mutual fund complexes when they are provided in comment letters. For example, the GAO gave the example of FINRA changing its position on the use of hypothetical back-tested data in fund advertisements. When FINRA changed its interpretation of its advertising rules as applied to this practice, FINRA did not publicly disseminate any written guidance. Instead, FINRA alerted fund complexes of its new position through individual comment letters on advertising materials submitted for review. The GAO noted that disseminating changes in interpretive positions through this method leads to the uneven application of FINRA's interpretations where one firm continues to use previously approved advertisements while other firms that are submitting advertisements for review are told not to use advertisements that follow the same practice. To address this specific concern, the GAO recommended that the SEC take steps to ensure that FINRA develops sufficient mechanisms to notify all fund companies about changes in rule interpretations for fund advertising. Both the SEC and FINRA agreed with the recommendation.

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:

Broker-Dealer/Adviser Sanctioned for Inadequate Insider Trading Procedures
July 14, 2011

DOL Sets Final Effective Dates for ERISA Fee Disclosure Rules
July 14, 2011

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