Ropes & Gray's Investment Management Update: September 2011

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

Regulatory Matters

SEC Staff Issues No-Action Letter Concerning Recordkeeping Requirements for "Pay-to-Play" Rule

On September 12, 2011, the staff of the Securities and Exchange Commission ("SEC") issued no-action relief concerning recordkeeping requirements associated with the SEC's "pay to-play" rule. The SEC adopted Rule 206(4)-5 (the "pay-to-play rule") under the *Investment Advisers Act of 1940* (the "Advisers Act") in July 2010 to prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its employees or third-party solicitors make a contribution to certain candidates or elected officials. More information about the pay-to-play rule is available here. In connection with the pay-to-play rule, the SEC also amended Rule 204-2 under the Advisers Act to incorporate new recordkeeping requirements. Rule 204-2(a)(18)(i)(B) under the Advisers Act requires investment advisers to maintain a list of all government entities to which the adviser has provided advisory services, or which are or were investors in any covered investment pool to which the investment adviser provides or has provided investment advisory services in the past five years. The Investment Company Institute's incoming letter to the staff of the SEC observed that government entities may hold shares in covered investment pools through one or more omnibus accounts in such a way that a government entity is wholly unknown to the adviser, and that this lack of transparency impeded the ability of advisers to comply with this requirement. To address this concern, the staff of the SEC agreed not to bring enforcement actions against advisers who make and keep a list or other record that includes:

- Each government entity that invests in a covered investment pool, where the account of such government entity can reasonably be identified as being held in the name of or for the benefit of the government entity on the records of the covered investment pool or its transfer agent;
- Each government entity, the account of which was identified as that of a government entity — at or around the time of the initial investment — to the adviser or one of its client servicing employees, regulated persons or covered associates;
- Each government entity that sponsors or establishes a 529 Plan and has selected a specific covered investment pool as an option to be offered by such 529 Plan; and
- Each government entity that has been solicited to invest in a covered investment pool either (i) by a covered associate or regulated person of the adviser; or (ii) by an intermediary or affiliate of the covered investment pool if a covered associate, regulated person, or client servicing employee of the adviser participated in or was involved in such solicitation, regardless of whether such government entity invested in the covered investment pool.

The text of the no-action letter may be found here.

FINRA Proposes to Streamline Communications Rules

The Financial Industry Regulatory Authority, Inc. ("FINRA") has filed proposed rule changes with the SEC regarding member communications with the public. FINRA's proposal is intended to revise how written communications with the public are categorized for purposes of determining compliance with FINRA's related rules. The proposal would reduce the number of communication categories to three categories based on the intended audience as follows:

- "Institutional communication" would include any written (including electronic) communication that is distributed or made available only to institutional investors. "Institutional investor" generally would have the same definition as under current NASD Rules.
- "Retail communication" would include any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. "Retail investor" would include any person other than an institutional investor, regardless of whether the person has an account with the member.
- "Correspondence" would include any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period.

While the proposed rules would expand filing requirements for and exemptions from certain categories, existing requirements for and exclusions from regulatory requirements for communications will remain largely unchanged following the proposed recategorization. Among other changes, the proposed rules would also expand the filing requirements to include all retail communications concerning closed-end funds, including communications distributed after the fund's initial public offering, as well as communications regarding government securities, collateralized mortgage obligations, and securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency. The text of FINRA's proposal is available here.

SEC Whistleblower Rules Go Into Effect; CFTC Adopts Whistleblower Rules

The SEC opened its Office of the Whistleblower on August 12, 2011. This new office will oversee the implementation of the SEC's new whistleblower compensation rules. More information regarding the new whistleblower rules is available here. In a recent speech, Sean McKessy, Chief of the Office of the Whistleblower, responded to industry skepticism regarding the effects the new SEC rules will have on internal compliance programs and confusion regarding limitations on certain professionals, such as attorneys and external auditors, becoming whistleblowers. The text of Mr. McKessy's speech is available here.

On August 4, 2011, the Commodity Futures Trading Commission ("CFTC") adopted final rules implementing whistleblower incentives and protections pursuant to the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"). Although the CFTC whistleblower rules are substantially similar to the SEC whistleblower rules, certain differences are worthy of note, including:

- Unlike the SEC's rules, the CFTC definition of "independent knowledge" does not exclude information obtained as a result of the whistleblower's employment at a public accounting firm or a firm retained to conduct an inquiry into possible violations of law. However, both the CFTC and SEC exclude from award eligibility company employees whose principal duties involve compliance or internal audit responsibilities.

- The CFTC rules permit a whistleblower to receive an award from both the CFTC and the SEC for providing the same information if he or she recovers from the SEC first. The SEC rules do not allow recovery if the whistleblower has already been granted an award from the CFTC.
- In contrast to the SEC rules, which only permit a whistleblower to appeal whether, and to whom, an award is made, a whistleblower may also appeal the amount of the award under the CFTC rules.
- The statute of limitations for a retaliation claim under the CFTC rules is two years from the date of the employer's retaliatory act, while the SEC rules allow for six years from the date of the violation or three years from when the material facts of the claim were known or should have been known.

The CFTC rules take effect on October 31, 2011.

Money Market Funds: A Recap of Regulatory Proposals under Consideration by the SEC

The money market fund industry has come under heightened scrutiny since 2008 amid ongoing concerns that the current stable-NAV model for money market funds exposes funds to potential mass redemptions and poses significant systemic risk. The SEC adopted amendments to Rule 2a-7 under the *Investment Company Act of 1940*, as amended ("1940 Act"), effective May 2010 to require more conservative investment parameters related to credit quality, maturity and liquidity, as well as enhanced guidelines around risk oversight and transparency to investors. Additional money market reform proposals remain under active consideration by the SEC. It is unclear, however, what form any future regulation will take and whether the SEC will be able to successfully implement the money market proposals under consideration.

Industry commentators, including Andrew "Buddy" Donohue, the former head of the Division of Investment Management for the SEC, have suggested that the SEC may favor adopting a proposal in line with the so-called Squam Lake proposal. The Squam Lake Group, a group of 14 economists, has proposed to require money market funds to create capital buffers equal to between 1 and 3 percent of assets by establishing segregated accounts holding cash or cash equivalents. This plan would involve selling bonds or subordinated shares to a separate group of investors (such as the fund's investment manager) who would lose money if the fund were to draw upon the capital buffer to cover investment losses. The proposed buffer is intended to lower the risk of destructive runs by significantly lowering the risk that a money market fund could "break the buck." The Squam Lake Group has suggested that this plan will also better align the incentives of fund managers with the interests of the public in reducing systemic risk.

The SEC is also considering whether to impose a floating NAV on money market funds. Proponents of the floating NAV believe that pricing to market would reduce the incentive to redeem in the event of a loss and thereby lower the risk of a run on the fund. Opponents of the proposal believe that a floating NAV will lead to a significant reduction in the supply of short-term credit, an increase in systemic risks to the financial system because institutional investors will seek investment opportunities in alternative investments that are not similarly regulated, and adverse tax consequences. In her August 26, 2011 response to a recent letter from House Financial Services Committee Chairman Spencer Bachus and Subcommittee Chairman Scott Garrett that questioned the potential negative impact of a floating NAV on the long term viability of the money market mutual fund industry, SEC Chairman Mary Schapiro stated that the SEC continues to actively consider a floating NAV proposal. Chairman Schapiro's letter can be found here.

Other proposals under consideration include a plan introduced by Fidelity, pursuant to which money market funds would build up a capital buffer over time by withholding a small portion of the income paid to shareholders, and a plan proposed by Paul Volcker, which would require money market funds to reorganize

as special-purpose banks and be subject to bank regulatory and capital requirements. Under the Dodd-Frank Act, the Financial Stability Oversight Committee could also designate money market funds to be systemically important financial institutions ("SIFIs"), although this may prove unlikely until there is greater consensus on the appropriate criteria for SIFI designations.

The timing and form of possible new money market fund regulations remain uncertain. Some sources have suggested that the SEC could release a proposed rule for public comment as early as October. However, recent challenges to SEC rulemaking have increased scrutiny on the SEC's cost-benefit analysis associated with rulemaking. Each of the proposals discussed above is likely to have significant associated costs, challenging the SEC's ability to successfully implement these proposals absent a thorough cost-benefit analysis.

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

On July 29, 2011, the staff of the SEC's Division of Investment Management issued four no-action letters (the "Letters") extending to registered investment companies (each a "Fund") temporary relief from Section 17(f) enforcement actions if a Fund or a Fund custodian places assets in the custody of certain derivatives clearing organizations or certain of their members for purposes of meeting margin requirements for interest rate or credit default swap contracts. Specifically, the Letters permit Funds or their custodians to place and maintain assets in the custody of the Chicago Mercantile Exchange ("CME"), ICE Clear Credit LLC ("ICE") and LCH Clearnet Limited ("LCH"), each a derivatives clearing organization registered with the CFTC, in addition to certain clearing members associated with each of CME, ICE and LCH that are registered as futures commission merchants with the CFTC. The staff had previously issued no-action letters on the same grounds, which had expired on July 16, 2011; the Letters extend the relief through December 31, 2011. A discussion of the original relief granted can be found here.

Pursuant to the Dodd-Frank Act, the SEC is expected to codify this relief before it expires on December 31, 2011.

European Nations Issue Temporary Bans on Short Selling

Several European regulatory authorities have imposed temporary bans on short selling in their respective countries. In particular, Greece introduced a ban on short selling effective August 8, 2011, and Belgium, France, Italy and Spain implemented bans on short selling or short positions effective August 12, 2011. Greece's ban will remain in force until October 7, 2011 and Belgium's rules will apply for an indefinite period. France, Italy and Spain originally imposed 15-day bans, which were extended until September 30, 2011 for Italy and Spain and until November 11, 2011 for France. The European Securities and Markets Authority ("ESMA") reported that the measures are intended to restrict the benefits that can be achieved from spreading false rumors and to achieve a regulatory level playing field. ESMA also stated that these regulations have been aligned to the extent possible in the absence of a common EU legal framework in the area of short selling. More information regarding the temporary bans is available here.

SEC Open Meeting; Concept Release on Funds' Use of Derivatives

The SEC held an open meeting on August 31, 2011 to announce the publication of a concept release (the "Concept Release") on the use of derivatives by investment companies under the 1940 Act. The Concept Release requests data and comments regarding the types of derivatives used by mutual funds and other investment companies, the purposes for which funds use derivatives, and whether funds' use of derivatives has undergone or may be undergoing changes. The Concept Release represents the latest step in the SEC's ongoing review of the use of derivatives by funds. More information and certain preliminary observations regarding the Concept Release are available in Ropes & Gray's alert here.

At the August 31, 2011 open meeting, the SEC also voted to request public comment on the treatment of asset-backed issuers as well as real estate investment trusts and other mortgage-related pools under the 1940 Act. The SEC is seeking public comment regarding possible amendments to Rule 3a-7 under the 1940 Act, which excludes certain issuers of asset-backed securities from having to comply with the requirements of the 1940 Act. In a separate concept release, the SEC is seeking public comment on interpretive issues relating to some REITs and other mortgage-related pools that rely on Section 3(c)(5)(C) of the 1940 Act. More information regarding the SEC's proposals is available here.

Recent Judicial and Administrative Decisions

Ninth Circuit Decides Excessive-Fee Lawsuit in Favor of Capital Research and Management Co.

On August 24, 2011, the U.S. Court of Appeals for the Ninth Circuit upheld the district court's ruling in favor of Capital Research and Management Co. ("Capital Research") in the case *Jelinek v. Capital Research and Management Co.*, finding that the plaintiffs failed to prove that Capital Research breached its fiduciary duty under Section 36(b) of the 1940 Act. The decision in this excessive-fee lawsuit may indicate how lower courts will interpret and apply the Supreme Court's recent decision in *Jones v. Harris*.

In affirming the district court's decision in *Jelinek*, the Ninth Circuit rejected the plaintiffs' claim that *Jones* had expanded the standard set forth in the seminal case *Gartenberg v. Merrill Lynch Asset Management, Inc.* to allow plaintiffs to prevail if they could show a flawed board approval process. The Ninth Circuit reasoned that the 1940 Act, *Jones* and *Gartenberg* "all require the court to calibrate the degree of deference afforded the independent directors' expertise based on the case and the conscientiousness with which they performed their duties" and found that the district court had "meticulously" applied the proper standard to the case. The Ninth Circuit noted that, in light of the flaws the district court identified in the independent directors' fee approval process, the district court gave the directors' fee approval less deference than it otherwise would have, but correctly concluded that "overall the conduct of the directors met the *Gartenberg* standard."

The Ninth Circuit's decision reinforces the view that *Jones* upheld *Gartenberg* as the standard for evaluating mutual fund adviser compensation and rejects the argument that *Gartenberg* does not apply in cases where plaintiffs can provide evidence of a flawed board approval process. The *Jelinek* decision also affirms the role of independent directors in setting advisory fees and the degree of deference that courts continue to afford to independent fund boards.

AXA to Face New Breed of Excessive-Fee Lawsuit

On July 21, 2011, plaintiffs filed a multimillion-dollar lawsuit against AXA Equitable Life Insurance Company, et al. ("AXA") alleging that AXA received excessive fees for its work managing eight subadvised variable annuity funds. This lawsuit goes a step beyond prior excessive-fee lawsuits such as *Jones v. Harris*, in which only the investment manager was involved and subadvisory fees were not at issue. Further, prior cases such as *Jones v. Harris* considered whether a management fee, in its totality, was "so disproportionately large that it [bore] no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." In contrast, the AXA case, as well as others such as *Southworth v. Hartford Investment Financial Services, LLC,* represents a new type of excessive-fee case which challenges whether the investment manager has breached its fiduciary duty under Section 36(b) of the 1940 Act with respect to the *portion* of the management fee charged to a fund that the investment manager retains. Plaintiffs in the AXA case claim that "despite delegating all or substantially all of its investment management duties to subadvisors and performing little, if any additional work, [AXA] retains up to 94% of the investment management fees, resulting in exorbitant profits." Where a fund does not separately pay a fee to a subadviser (because the investment manager, not the Fund, compensates the subadviser from its management fee), it remains to be seen whether courts will consider an investment manager's profitability with respect to the portion of the management fee retained, or whether courts will consider only whether the total compensation received by the investment manager is so disproportionately large that it bears no reasonable relationship to the totality of services rendered. The complaint against AXA is available here.

CA District Court Issues First Order Interpreting Supreme Court's *Janus* Decision

On August 1, 2011, in the case of *SEC v. Daifotis*, the District Court for the Northern District of California issued an order in response to the defendants' motion for reconsideration of their earlier motions to dismiss and strike in light of the June 2011 Supreme Court decision in *Janus Capital Group, Inc. v. First Derivative Traders*. The order in this case is noteworthy because it is among the first to consider the recent *Janus* decision. The SEC's complaint in this case focused on events during the market crisis in 2007 and 2008 regarding Schwab YieldPlus Fund and alleged that Kimon Daifotis, the former lead portfolio manager for the Fund, and Randall Merk, an Executive Vice President at Charles Schwab & Co., made a series of misstatements in connection with the operation of the Fund and that Mr. Daifotis aided and abetted the Fund's deviation from disclosed concentration policies.

The court found, among other things, that certain alleged misstatements were sufficiently pleaded under *Janus*, while others failed to sufficiently plead that the defendants "made" the misstatements for purposes of liability under Rule 10b-5 under the *Securities Exchange Act of 1934*. Separately, the court declined to broadly apply the *Janus* decision to limit the SEC's claims regarding alleged misstatements under Section 17(a) of the *Securities Act of 1933* and Section 34(b) of the 1940 Act, finding that the *Janus* decision was limited to claims of primary violations of Rule 10b-5. The court noted that the word "make," which was the central focus of the *Janus* decision, is absent from Section 17(a). The court also observed that, while Section 34(b) does include the word "make," the *Janus* decision's stringent reading of the word "make" followed from the Supreme Court's prior decisions limiting the scope of implied private rights of action under Rule 10b-5; the court thus determined that the same rationale does not apply to Section 34(b) because there is no implied private right of action for Section 34(b) claims. The court's order is available here.

SEC Opinion Clarifies SEC's Position Regarding Burden of Proof Under Section 17(e)(1)

On August 5, 2011, the SEC issued an opinion in the case of a mutual fund trader accused of accepting gifts from brokerage firms with whom he regularly placed orders. The SEC upheld an administrative law judge's decision that Robert Burns, an equity trader who was an affiliated person of an investment adviser, willfully violated Section 17(e)(1) of the 1940 Act by accepting compensation from brokerage firms to which he transmitted orders to buy and sell securities on behalf of certain mutual funds that were clients of the adviser. The opinion is significant in that it sets forth the SEC's views as to the requirements for liability under Section 17(e)(1). The text of the opinion is available here.

Section 17(e)(1), in relevant part, prohibits the receipt (i) by an affiliated person of an investment company, (ii) acting as agent, (iii) of compensation from any other source (iv) for the purchase or sale of the investment company's property. Finding that the first three prongs of the statute were met in Mr. Burns' case, the SEC focused on the fourth requirement for liability: that the compensation be received "for the purchase or sale of any property to or for" a registered investment company. The SEC stated that this provision does not require the SEC to prove that the compensation was given and received with the intent to influence; rather, the SEC must simply establish that, in accepting such compensation, a conflict existed between the trader together with his employing investment adviser and the mutual funds being advised. The opinion explains that once the SEC has made a prima facie showing that a conflict existed, the burden of proof shifts to the defendant to prove that none of the gifts he received were in exchange for the brokerage business he distributed. Furthermore, the SEC took the position that regardless of the detriment to the mutual funds, the trader must prove that he did not violate his fiduciary duty. This case represents a clear statement by the SEC that a mutual fund trader who accepts gifts from brokerage firms will bear the burden of proving that none of the gifts violated the trust placed in the trader by a mutual fund and its shareholders.

Other Developments

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

Massachusetts Adopts New Regulation on the Use of Expert Network Services
August 24, 2011

Ropes & Gray's Hedge Fund Update: August 2011
August 26, 2011

If you would like to learn more about the developments discussed in this update, please contact the Ropes & Gray attorney with whom you regularly work or any partner in the Ropes & Gray Investment Management group, listed below.

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