Ropes & Gray's Investment Management Update: November/December 2011

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

Regulatory Matters

FINRA Proposes Rule Requiring Investor Disclosure and Notice Filings for Private Placements

The Securities and Exchange Commission ("SEC") recently solicited a second round of comments on the Financial Industry Regulatory Association ("FINRA") proposal imposing new disclosure and filing requirements for private placements. FINRA Rule 5123 (the "Proposed Rule") would (i) require that private placement investors be provided detailed information about the intended use of proceeds and the amount and type of offering expenses and offering compensation; and (ii) require member firms and their associated persons to provide to FINRA information about their private placement activities, including any private placement memorandum ("PPM"), term sheet, or other disclosure document within 15 calendar days after the initial sale of securities, and to file any material amendments to a disclosure document used in an offering within 15 days after the date such document is provided to any investor or prospective investor.

The Proposed Rule would exempt from its obligations several types of private placements based on either the type of purchaser or the type of offering. Exemptions include offerings sold solely to any one or more of the following: institutional accounts, qualified purchasers ("QPs") as defined in Section 2(a)(51)(A) of the *Investment Company Act of 1940* (the "1940 Act"), qualified institutional buyers ("QIBs") as defined in Rule 144A of the *Securities Act of 1933* (the "Securities Act"), investment companies as defined in Section 3 of the 1940 Act, entities composed exclusively of QIBs, banks, and employees and affiliates of the issuer. Additionally, exemptions include offerings made pursuant to Rule 144A or Regulation S under the Securities Act, offerings filed with FINRA under Rules 2310, 5110, 5121, or 5122, and offerings of certain exempt securities, subordinated loans, variable contracts, modified guaranteed annuity contracts, modified guaranteed life insurance policies, non-convertible debt, preferred securities, commodity pool securities, and securities issued in conversions, stock splits, and restructuring transactions with an existing investor for no additional consideration.

FINRA will announce the effective date of Rule 5123 within 90 days of SEC approval. The effective date will be no later than 180 days following SEC approval. The text of the proposed rule is available here and the corresponding SEC release is available here.

SEC Proposes Rule Requiring Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants

As part of its rulemaking efforts under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"), on October 12, 2011, the SEC proposed new Rules 15Fb1-1 through 15Fb6-1 (the "SBS Rules") under the *Securities Exchange Act of 1934* (the "Exchange Act") to provide for the registration of security-based swap dealers and major security-based swap participants (each, an "SBS Entity" and collectively, "SBS Entities"). Forms to facilitate the registration of these entities were also proposed. The proposed SBS Rules establish procedures for registering an SBS Entity with the SEC, and for amending, withdrawing, and cancelling such registration.[1]

The proposed registration process is based on the existing broker-dealer registration regime and avoids unnecessary duplication by allowing SBS Entities to file simplified forms if they are already registered as an intermediary with the SEC or the CFTC. In addition to completing the appropriate registration form, each SBS Entity would be required to provide (i) certification by a senior officer as to the entity's financial, operational, and compliance capabilities; and (ii) certification by the chief compliance officer that none of its associated persons involved in effecting security-based swaps is statutorily disqualified.

The proposed SBS Rules would require SBS Entities to promptly amend their registration to correct any information that is or becomes inaccurate for any reason. All forms are proposed to be submitted electronically, likely through EDGAR. The SEC has requested public comment on the proposal by December 19, 2011. Additional information on the proposed SBS Rules is available here.

SEC Updates Responses to Questions About the Pay to Play Rule

On November 8, 2011, the SEC provided updated responses to questions about Rule 206(4)-5 under the 1940 Act (the "Pay to Play Rule"). The SEC adopted the Pay to Play Rule in July 2010 in order to prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser, certain employees of the adviser, or third-party solicitors make a contribution to certain candidates or elected officials. Responses to questions about the Pay to Play Rule were previously provided in March and April 2011. The updated questions and responses relate to the compliance date for regulated person recordkeeping, affiliated companies as covered associates, employee solicitors' supervisors, and the compliance date of the third-party solicitor ban.

More information about the Pay to Play Rule is available in Ropes & Gray's alert here. The full list of SEC responses to questions about the Pay to Play Rule can be found here.

FinCEN to Require Investment Advisers to Establish AML Programs

In a speech delivered to the American Bankers Association/American Bar Association Money Laundering Enforcement Conference on November 15, 2011, James H. Freis, Jr., Director of the Financial Crimes Enforcement Network ("FinCEN"), reported that FinCEN is working on a regulatory proposal that would require investment advisers to establish anti-money laundering ("AML") programs and report suspicious activity.

FinCEN proposed rules in 2003 requiring investment advisers to establish AML programs, but it withdrew the proposed rules in November 2008. Since then, there have been significant changes to the regulatory framework for investment advisers and Freis noted that FinCEN was ready to revisit the proposal with recent industry changes in mind.

[1] To avoid potential business disruptions, the proposed SBS Rules provide that SBS Entities would be permitted to file for conditional registration as soon as the final registration rules and forms are adopted by submitting an application for registration to the SEC without the senior officer certification, allowing the SEC to review and comment on the application while the SBS Entity takes steps to comply with the remaining requirements of the SBS Rules. The conditional registration could be converted to an ongoing registration when all requirements are met.

SEC Staff Issues No-Action Letter Clarifying that Compliance with ERISA Rule 404a-5 will Satisfy the Requirements of Rule 482

In a recent no-action letter, the staff (the "Staff") of the SEC's Division of Investment Management agreed to treat information that complies with disclosure requirements set forth in Rule 404a-5 (the "DOL Rule") under the *Employee Retirement Income Security Act of 1974* ("ERISA") as communications that satisfy the requirements of Rule 482 under the Securities Act ("Rule 482").

Rule 482 permits an open-end investment company registered under the 1940 Act to include uniformly calculated performance information in advertisements and other sales materials. For an advertisement to comply with Rule 482, among other things, performance information must be current as of specified timeframes, certain legends must be provided, and the manner of presentation must adhere to certain requirements.

The DOL Rule, issued by the Department of Labor on October 20, 2010, requires plan administrators and their designees of 401(k)s and similar participant-directed individual retirement plans ("Retirement Plans") to disclose plan and investment-related information to participants and beneficiaries on or before the date on which an individual can first direct his or her investments, and at least annually thereafter. This required plan and investment-related information generally includes specific performance, benchmarking, and fee information for each investment option available under the Retirement Plan, including investments in investment companies registered under the 1940 Act.

Although the information required under the DOL Rule differs somewhat from the information required under Rule 482, the Staff indicated that it would treat information provided under the DOL Rule as meeting the requirements of Rule 482. The Staff also stated that such information need not be filed with FINRA or filed with the SEC pursuant to Rule 497 under the Securities Act or Section 24(b) of the 1940 Act.

Recent Judicial and Administrative Decisions

SEC Charges Morgan Stanley Investment Management for Improper Fee Arrangement

On November 16, 2011, Morgan Stanley Investment Management ("MSIM") agreed to pay $3.3 million to settle proceedings involving an improper fee arrangement. The Asset Management Unit of the SEC's Enforcement Division, which has been focused on the investment advisory contract renewal process and fee arrangements for registered funds, brought the proceedings when it learned that The Malaysia Fund, Inc. (the "Malaysia Fund"), a closed-end fund advised by MSIM, was paying fees to a Malaysian-based sub-adviser for certain services, including advice, research, and assistance, that were not actually provided by the sub-adviser. The Malaysia Fund's board of directors annually renewed the sub-advisory contract based on MSIM's false representations regarding the services during the 15(c) process and, as a result, the Fund paid approximately $1.8 million to the sub-adviser between 1996 and 2007 for services MSIM did not receive.

The SEC's order finds that MSIM willfully violated Sections 15(c) and 34(b) of the 1940 Act and Sections 206(2) and (4) of the *Investment Advisers Act of 1940* (the "Advisers Act"), and Rule 206(4)-7 thereunder. Without admitting or denying the SEC's findings, MSIM agreed to a censure and to cease and desist from committing or causing any violations and any future violations of those provisions. MSIM also agreed to (i) repay the fund $1.8 million for the sub-adviser's fees and pay a $1.5 million penalty; and (ii) implement policies and procedures specifically governing the Section 15(c) process and its oversight of service providers.

U.S. District Court Rules that Securities Case Against Oppenheimer Funds Can Proceed

On October 24, 2011, Judge Kane at the U.S. District Court for the District of Colorado denied a motion to dismiss in a class action lawsuit, *In re: Oppenheimer Rochester Funds Group Securities Litigation*, brought by shareholders of seven Oppenheimer municipal bond funds against various fund managers, trustees, and distributors for alleged federal securities laws violations. The plaintiffs asserted claims under Sections 11, 12, and 15 of the Securities Act, alleging that Oppenheimer marketed the funds as stable income-seeking investments that focused on preservation of capital, while employing risky investment strategies involving investments in highly-leveraged bond derivatives (i.e., inverse floaters) that were not adequately disclosed. The plaintiffs claimed that significant losses in the funds during the 2008 credit crisis, which were greater than those of similarly rated municipal bond funds during the same period, were directly attributable to these risky investment strategies.

In denying Oppenheimer's motion to dismiss, Judge Kane was not persuaded that the funds' stated investment objective of maximizing income consistent with preservation of capital was consistent with the strategies the funds allegedly pursued, or that the risks of the derivatives utilized by the funds were adequately disclosed. In his decision, Judge Kane cited the plaintiff's allegations that the funds invested heavily in highly-risky inverse floaters while obscuring investment limits and leverage and using imprecise disclosure that understated the risks of those instruments, including language noting that inverse floaters "can be" more volatile than conventional fixed-rate securities, "may" have additional risks, and "tend" to underperform fixed-rate bonds in a rising interest rate environment. Judge Kane concluded that the plaintiff's allegations were sufficient to withstand a motion to dismiss and that the plaintiff should be allowed the opportunity to engage in discovery and present evidence.

Taking a position opposite that of the U.S. District Court for the Southern District of New York in *Yu v. State Street Corporation*, Judge Kane additionally rejected Oppenheimer's argument that there could be no causal connection between a fund's prospectus disclosure and plaintiff's losses because mutual fund values are determined by daily valuations of fund assets and liabilities, noting that the underlying value of a fund's holdings could be diminished by actions or realization of risk about which purchasers of fund shares have been misled.

The case, currently in the discovery period, underscores the importance of alignment between a fund's disclosed objectives and actual investment strategies, and the need for substantive and tailored derivatives disclosure. For the full text of the court's decision on the motion to dismiss, please click here.

SEC Charges Investment Advisers with Compliance Failures

On November 28, 2011, the SEC charged three investment advisers for failing to implement compliance procedures as required by Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. While these cases represent extreme compliance failures, they evidence the SEC's interest in adviser compliance matters.

Each of the three investment advisers charged with compliance failures, OMNI Investment Advisors Inc., Feltl & Company Inc., and Asset Advisors LLC, failed to fully adopt and implement written compliance policies and procedures. Two of the three advisers—OMNI Investment Advisors, Inc. and Asset Advisors LLC—had previously received warnings from SEC examiners about their compliance deficiencies.

According to the SEC, the charges correspond to an initiative within the SEC Enforcement Division's Asset Management Unit "to proactively prevent investor harm by working closely with agency examiners to ensure that viable compliance programs are in place at firms." For more information, please see the SEC's press release, which contains links to the related SEC orders.

Second Circuit Appellate Court Holds that FINRA Lacks Authority to Bring Court Actions to Enforce its Fines

On October 5, 2011, the United States Court of Appeals for the Second Circuit ruled that FINRA does not have authority to bring lawsuits to collect fines imposed in disciplinary proceedings. In *John J. Fiero and Fiero Brothers, Inc. v. FINRA,* the Second Circuit held that neither the federal securities laws nor the FINRA rules empower FINRA to bring court actions to collect disciplinary fines.

The plaintiffs in the case are a New York penny-stock brokerage firm and its owner, John J. Fiero, both FINRA members, who were sanctioned by the National Association of Securities Dealers (FINRA's predecessor) in 2000 for manipulative and fraudulent selling practices (specifically, naked short selling) in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA conduct rules. Based on these violations, the plaintiff brokerage firm was expelled from membership in FINRA, Fiero was barred from associating with any FINRA members, and they were fined jointly and severally $1 million plus costs. When the plaintiffs refused to pay the fine, FINRA sued to collect it in the New York Supreme Court. The Second Circuit appellate court reviewed the legality of FINRA's judicial action to collect the fine based on FINRA's authority under the Exchange Act and concluded that while FINRA has disciplinary powers over its membership, including the ability to impose sanctions, it does not have authority to bring court proceedings to enforce its fines.

Other Developments

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

Proposed Rules and Guidance Regarding Federal Reserve Oversight of Nonbank Financial Companies
October 20, 2011

Proposed Volcker Rule and the Effect on Private Fund Sponsors and Investors
October 20, 2011

SEC Adopts Reporting Obligations for Advisers to Private Funds on New Form PF
November 1, 2011

Expanding the Market Abuse Regime for European Securities and Investments - What Impact for Investment Managers?
November 2, 2011

[Recent Enforcement Actions by SEC's Asset Management Unit Highlight New Proactive, Analytical Approach]
December 14, 2011

[FINRA Increases Private Placement Scrutiny and Enforcement]
December 20, 2011

Circular 230 Disclosure: To ensure compliance with Treasury Department regulations, we inform you that any U.S. tax advice contained in this communication (including attachments) was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. tax-related penalties or promoting, marketing or recommending to another party any tax-related matters addressed herein.

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.

Alyssa Albertelli
Washington, DC
+1 202 508 4667
alyssa.albertelli@ropesgray.com

Jason E. Brown
Boston, MA
+1 617 951 7942
jebrown@ropesgray.com

Rajib Chanda
Washington, DC
+1 202 508 4671
rajib.chanda@ropesgray.com

Bryan Chegwidden
New York, NY
+1 212 497 3636
bryan.chegwidden@ropesgray.com

Gregory C. Davis
San Francisco, CA
+1 415 315 6327
gregory.davis@ropesgray.com

Timothy W. Diggins
Boston, MA
+1 617 951 7389
timothy.diggins@ropesgray.com

Michael G. Doherty
New York, NY
+1 212 497 3612
michael.doherty@ropesgray.com

John W. Gerstmayr
Boston, MA
+1 617 951 7393
john.gerstmayr@ropesgray.com

Thomas R. Hiller
Boston, MA
+1 617 951 7439
thomas.hiller@ropesgray.com

Christopher A. Klem
Boston, MA
+1 617 951 7410
christopher.klem@ropesgray.com

John M. Loder
Boston, MA
+1 617 951 7405
john.loder@ropesgray.com

Richard D. Marshall
New York, NY
+1 212 596 9006
richard.marshall@ropesgray.com

Brian D. McCabe
Boston, MA
+1 617 951 7801
brian.mccabe@ropesgray.com

Mark V. Nuccio
Boston, MA
+1 617 951 7368
mark.nuccio@ropesgray.com

Alan G. Priest
Washington, DC
+1 202 508 4625
alan.priest@ropesgray.com

Dwight W. Quayle
Boston, MA
+1 617 951 7406
dwight.quayle@ropesgray.com

George B. Raine
Boston, MA
+1 617 951 7556
george.raine@ropesgray.com

Elizabeth J. Reza
Boston, MA
+1 617 951 7919
elizabeth.reza@ropesgray.com

Gregory D. Sheehan
Boston, MA
+1 617 951 7621
gregory.sheehan@ropesgray.com

Jeremy C. Smith
Washington, DC
+1 202 508 4632
jeremy.smith@ropesgray.com

David C. Sullivan
Boston, MA
+1 617 951 7362
david.sullivan@ropesgray.com

James E. Thomas
Boston, MA
+1 617 951 7367
james.thomas@ropesgray.com