Ropes & Gray's Investment Management Update: December 2011/January 2012

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

Third Party Pricing of Level 2 Securities a Topic of SEC Focus

In December 2011, in remarks before the American Institute of Certified Public Accountants National Conference on Current SEC and PCAOB Developments, Jason K. Plourde from the SEC's Office of the Chief Accountant, reported that Investment Management Division staff may ask questions in the comment letter process about registered investment companies' use of third party pricing service information.

The FASB's Accounting Standards establish a fair value hierarchy in which Level 2 inputs are defined as "inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly."[1] Mr. Plourde explained that Level 2 securities "may range from bonds for which quoted prices in active markets are observable for similar instruments to collateralized debt obligations for which the only similar observable transactions are not in active markets."

As Mr. Plourde reported, going forward, SEC staff requests for information through the comment letter process may include questions regarding issuers' and funds' use of third party services to price Level 2 securities. The questions are designed to help the SEC staff evaluate management's compliance with the accounting and disclosure requirements in the financial statements, MD&A disclosure, management's assessment of internal control over financial reporting and the maintenance of books and records. The Division of Corporation Finance stated that staff comments in this area include: (a) how does the company evaluate the accuracy and completeness of the data used by the pricing service; (b) how does the company determine that the pricing service uses appropriate models, assumptions and inputs; and (c) what are the issuer's internal controls over the information received from pricing services.

Mr. Plourde suggested that, in order to respond to these comments, management may need to obtain information about valuation techniques, inputs and assumptions from its third party pricing service. This inquiry may include how the service developed the assumptions and models it uses, and may lead management to monitor those assumptions and any changes to them. Additional controls include "pricing challenge" processes. Independent auditor reports on the internal controls of pricing services may also be useful to management in meeting its responsibilities. As Mr. Plourde noted, the individual facts and circumstances of the company will affect the controls it puts into place.

Asset Manager Fined for Improper Valuation of Illiquid Securities

On January 17, 2012, the SEC announced that it had settled enforcement proceedings involving allegedly improper valuations of certain illiquid fixed income securities, including collateralized debt obligations and mortgage- and asset-backed securities. The securities in question were held by three mutual funds and were originally purchased for an aggregate price of $22 million. Soon after these assets were purchased by the funds, the values of the securities were changed based on valuations provided by a third-party pricing service that obtained pricing information from broker-dealers. The values provided through the third party pricing service were substantially in excess of the purchase price paid by the funds to acquire the securities. Although

[1] CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Fair Value Measurements, § 820 (Am. Inst. of Certified Pub. Accountants 1972). Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.

the higher valuations immediately generated exception reports to the funds' investment adviser, the adviser did not fair value the securities for a period of two weeks. According to the SEC, the failure of the adviser to fair value the securities caused the funds' NAVs to be overvalued for a period of "several days."

The SEC's order alleges that the funds violated Rule 22c-1 under the *Investment Company Act*, which prohibits selling, redeeming, or repurchasing any redeemable security except at a price based on the current net asset value of such security, and Rule 38a-1 under the *Investment Company Act*, which requires funds to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws by the funds. Without admitting or denying the SEC's findings, the funds' adviser agreed to a censure and to pay a $300,000 fine. The SEC's Order concerning this case can be found here.

Delay of Investment Adviser SRO Legislation

Legislation aimed at creating a self-regulatory organization for investment advisers has been pushed back until spring, according to aides to House Financial Services Committee Chairman Spencer Bachus (R-Ala.). The proposed bill was introduced at a mid-September 2011 hearing by Representative Bachus. The legislation would give the investment adviser SRO, or SROs, broad rule-making authority, subject to SEC approval, as well as responsibility for conducting examinations.

Representative Bachus developed the proposed SRO legislation in response to an SEC study in January 2011 that said that the SEC lacked the resources to adequately examine the almost 12,000 registered advisers. (This number has likely increased since then.) The study offered three options for increasing adviser examinations: (1) allowing the SEC to charge user fees, (2) establish one or more SROs, and (3) expand FINRA's reach to include investment advisers. The bill does not state a preference for a new SRO, leaving open the possibility that the job could fall to FINRA.

Delay of New Rule Imposing a Fiduciary Duty on Brokers

The SEC recently announced that it has delayed proposing a new rule imposing a fiduciary duty on brokerage firms, in order to take more time to perform a cost-benefit analysis. The rule, authorized (but not required) by Dodd-Frank, would establish a uniform fiduciary standard for investment advisers and brokers with respect to retail investors. The SEC planned to issue a proposed rule with respect to a uniform standard in 2011. SEC staff is currently drafting a request to the public for more data to analyze the costs and benefits of the new rule. The anticipated request could delay the SEC's release of a proposal until at least mid-2012.

New DOL Rule Allows Retirement Plan Administrators to Provide Investment Advice

Under a new Department of Labor ("DOL") rule, sponsors and fiduciaries of participant-directed retirement plans, such as 401(k)s and IRAs, may provide certain investment advice to plan participants. The rule applies to transactions occurring on or after December 27, 2011.

In order to protect plan participants from conflicts of interest, the *Employee Retirement Income Security Act* ("ERISA") generally prohibits a fiduciary investment adviser from recommending investment options within a retirement plan if the adviser receives additional fees from the investment provider. The new rule, however, implements an exemption that Congress enacted in the *Pension Protection Act of 2006* in order to improve participants' access to fiduciary investment advice.

In order to minimize conflicts of interest, however, fiduciary advisers may only provide investment advice pursuant either to a level compensation arrangement or a computer model. Under a level compensation

arrangement, the fiduciary adviser may not receive compensation that varies based on the investments selected. If a computer model is used to provide the investment advice, it must be certified as unbiased by an independent expert. The investment advice must also meet several other requirements, including authorization by an independent plan fiduciary, an annual audit of the investment advice arrangements, and disclosures to both the authorizing plan fiduciary and the plan participants.

SEC Solicits Comments on Retail Investors' Financial Literacy and Ways to Improve Disclosure

The SEC recently solicited comments for the study mandated by Section 917 of the Dodd-Frank Act regarding financial literacy among investors. Section 917 requires that the SEC conduct a study of retail investors' financial literacy and submit findings to Congress by July 21, 2012. The SEC will be using qualitative and quantitative research, investor testing, and public comments to develop its findings.

Lori J. Shock, Director of the SEC's Office of Investor Education and Advocacy, noted in the public announcement of the request for comments: "Many of the issues that the Dodd-Frank Act identified for Commission study directly affect individual investors. As a result, we are especially interested in receiving comments from individual retail investors." In particular, the SEC is requesting public comment on methods to improve the timing, content, and format of disclosures to investors with respect to financial intermediaries, investment products, and investment services; the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors, including shares of registered open-end investment companies; and methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products, including shares of registered open-end investment companies.

Comments are due to the SEC by March 23, 2012. The complete SEC release, including instructions for submitting comments, can be found here.

The SEC previously solicited comments on the effectiveness of existing private and public efforts to educate investors in April 2011. Over 80 public comments were received and they can be found here.

Upcoming Deadline For Form SHC – Holdings of Foreign Securities

Treasury International Capital Form SHC ("Form SHC") generally requires U.S. resident end investors and U.S. resident custodians to report information regarding (1) foreign securities that a U.S. resident safe-keeps for itself or for its U.S. resident clients, or that are held with a foreign-resident custodian, and (2) foreign securities that are entrusted to the safekeeping of a U.S. resident custodian. A security is a "foreign security" if the underlying issuer is a foreign resident. Foreign securities may be traded or issued in the United States and in foreign countries and may be denominated in any currency.

Form SHC is a quinquennial report submitted to the Federal Reserve Bank of New York. Data must be reported as of December 31, 2011 and must be submitted no later than March 2, 2012. The content of Form SHC has not changed considerably since the last time filings were required in 2007, though interpretive questions and changes in securities markets since then may add complexity to completing the form this year. The one change of note is that managers/sponsors of private equity companies, venture capital companies and hedge funds are now specifically included in the definition of an "end investor."

Certain transactions specified in the Instructions to Form SHC (including letters of credit, derivative contracts, loans and loan participation certificates and direct investments) are exempt from reporting on Form SHC. The primary burden for fund managers will be borne by the custodian to their funds, but a thorough discussion with their custodian would be prudent in order to identify and assign responsibility for all reportable securities.

Form SHC consists of three reporting schedules.

- Schedule 1 must be filed by a reporter that (a) meets the reporting requirements for filing under Schedule 2 or 3 or (b) is notified of an obligation to file by the FRBNY. Schedule 1 requires the reporter to provide basic identifying information about itself.
- Schedule 2 must be filed by a reporter if the total fair value of its foreign securities whose safekeeping it manages for itself and for other U.S. Residents or whose safekeeping the reporter has entrusted directly to foreign-resident custodians or U.S. or foreign-resident central securities depositories equals or exceeds $100 million. Schedule 2 to Form SHC requires information regarding the reporter's foreign securities.
- Schedule 3 must be filed by a reporter if the total fair value of the reporter's foreign securities that are entrusted to an unaffiliated U.S.-resident custodian (other than a U.S.-resident central securities depository) equals or exceeds $100 million (e.g., no Schedule 3 must be filed if two U.S. custodians each hold $60 million of foreign securities for a U.S. resident reporter). Schedule 3 requires information regarding the foreign securities that the reporter has entrusted to a U.S. resident custodian.

A copy of Form SHC and the Instructions are available here.

Recent Regulatory Activity Relating to the Use of Social Media

As has been widely reported, the SEC conducted an inspection sweep last year to understand how investment advisers are using social media. The sweep was followed by several SEC announcements and releases on January 4, 2012. On that day, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued an alert titled "Investment Adviser Use of Social Media" (the OCIE Alert) that provides a number of observations relating to the use of social media by registered investment advisers. The OCIE Alert is available here. On the same day, the SEC's Division of Enforcement (DOE) announced that it had instituted administrative proceedings against Anthony Fields, an Illinois-based investment adviser, for making fraudulent offers of securities on social media platforms. Mr. Field allegedly tried to raise the mind boggling sum of $500 billion on social media. Contemporaneously with the announcement of the action against Mr. Fields, the SEC's Office of Investor Education and Advocacy (OIEA) issued an investor alert titled "Social Media and Investing – Avoiding Fraud." The investor alert is designed to educate investors regarding fraudulent investment schemes and scams that attempt to exploit social media platforms. OIEA also issued an investor bulletin regarding the use of social media accounts for investment purposes. The DOE enforcement action is available here, the OIEA investor alert is available here, and the OIEA investor bulletin is available here. The egregious nature of the alleged conduct by Mr. Fields and the related focus on protection against fraud should not undermine the message of the OCIE Alert, which is likely to be more significant in structuring social media programs and compliance policies than the alerts related to the conduct of Mr. Fields.

Unfortunately, the OCIE Alert is not an interpretative release providing guidance on how registered investment advisers can properly use social media consistent with the requirements of the *Investment Advisers Act*. Rather, the OCIE Alert is a cautionary release that highlights the risks associated with the use of social media by identifying a number of factors that registered investment advisers should consider before using social media or permitting its use by their representatives, solicitors or third parties. In that sense, it contrasts sharply with recent FINRA guidance that seeks to assist FINRA members in using social media in compliance with FINRA rules.

Below is a summary of SEC staff observations in the OCIE Alert. It is striking that most of the SEC's guidance is framed as possible best practices, rather than mandatory requirements.

- ***Usage Guidelines.*** An adviser may consider creating usage guidelines to inform investment advisory representatives and solicitors regarding the appropriate and inappropriate use of social media. An adviser may, for example, include an exclusive list of approved social media sites or prohibit the use of specific functionalities on a site.
- ***Content Standards.*** An adviser may consider issuing clear guidelines with respect to the content of communications on social media platforms. An adviser may also consider prohibiting certain content or imposing other content restrictions.
- ***Monitoring.*** An adviser may consider how to effectively monitor its social media sites or its use of third-party sites, taking into account that many third-party sites may not provide complete access to a supervisor or compliance personnel.
- ***Frequency of Monitoring.*** An adviser may consider the frequency with which it monitors activity on a social media site depending on factors such as the volume and pace of communications posted on the site. The SEC staff notes that after-the-fact review of violative conduct, depending on the circumstances, may not be considered reasonable, particularly when social media content may be rapidly and broadly disseminated to investors.
- ***Approval of Content.*** In addition to after-the-fact review, an investment advisor may also consider requiring pre-approval of all social media content.
- ***Firm Resources.*** An investment adviser may consider whether it has allocated sufficient resources to adequately monitor IAR or solicitor activity on social media platforms. An adviser may consider employing an outside vendor to monitor social media communications, or may consider using sampling, spot-checking or lexicon-based or other search methodologies to monitor social media use and content.
- ***Criteria for Approving Participation.*** An adviser may consider the reputation of a social media site, the site's privacy policy, the ability to remove third-party posts, controls on anonymous posting and the advertising policies of the site when approving a social media site for use.
- ***Training.*** An adviser may consider implementing training programs related to the proper use of social media for its employees to ensure compliance with federal securities laws.
- ***Certification.*** An adviser may consider requiring its employees to certify that they understand and are complying with its social media policies and procedures.
- ***Functionality.*** An adviser may consider the functionality of each social media site approved for use. In light of the rapidly evolving nature of social media, the investment adviser should consider the site's continuing obligation to address any upgrades or modifications to the functionality that may affect its risk exposure.

- ***Personal/Professional Sites.*** An adviser may consider policies related to the conduct of its business on employees' personal social media accounts. Examples of such policies include specifying the types of official communications that are permitted on personal accounts or outright prohibitions on the conduct of business on personal accounts.
- ***Information Security.*** An adviser may consider whether social media communications subject it to any information security risks. In order to alleviate this risk, an adviser may consider adopting compliance policies and procedures to create appropriate firewalls between its sensitive information and any social media site.
- ***Enterprise-Wide Sites.*** An adviser that is part of a larger corporate enterprise may consider whether to create usage guidelines designed to prevent the advertising practices of an enterprise-wide social media site from violating federal securities laws.

The OCIE Alert also notes that social media platforms allow for a variety of possible third-party interactions. Investment advisers could determine (i) to permit third party posts and interaction between the adviser and the third parties, (ii) to permit only "one way postings," such that the adviser posts and third parties may post, but the adviser does not interact with the third parties or respond to their posts, (iii) to permit only authorized third parties to post or (iv) to not permit any third party posts. The OCIE Alert also notes that many advisers disclaim third-party posts. The SEC staff suggests that advisers permitting third-party posts consider instituting reasonable safeguards relating to the third-party posts.

The OCIE Alert further notes that social media content is subject to recordkeeping requirements to the same extent as content in other media. The SEC staff suggests that advisers determine that they can create and retain all required records related to social media communications before determining to use a social media platform.

Other Developments

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

CFTC Adopts Final Swap Recordkeeping and Reporting Rules
January 5, 2012
The Commodity Futures Trading Commission recently adopted its final swap recordkeeping and reporting rules under the Dodd-Frank Act. These rules are designed to increase transparency in the over-the-counter derivatives markets, both to regulators and to the public. The final rules impose fewer requirements on funds and other buy-side derivatives users than were contemplated by the proposed rules, although such entities will need to comply with certain new requirements, including recordkeeping requirements and, in certain limited circumstances, reporting requirements.

CFTC Adopts Final Rules Regarding Protection of Cleared Swaps Collateral
January 18, 2012
On January 11, 2012, the Commodity Futures Trading Commission adopted its final rules regarding protection of cleared swaps collateral under the Dodd-Frank Act. These rules impose requirements on futures commission merchants and derivatives clearing organizations regarding the treatment of cleared swaps collateral, and make certain conforming amendments to bankruptcy provisions applicable to commodity brokers under the *Commodity Exchange Act*. The final rules have many similarities to the existing rules regarding treatment of futures collateral, but include several additional customer protections.

SEC Releases Guidance on Whether Entities Related to a Registered Adviser Need to Register
January 20, 2012
On January 18, 2012, the staff of the Securities and Exchange Commission (the "SEC") released guidance on various issues regarding the status under the *Investment Advisers Act of 1940* of certain private fund general partners and investment advisers that are related to investment advisers that are registered with the SEC. The SEC staff reconfirmed its earlier position that a special purpose vehicle established by an investment adviser to act as the general partner of a private fund does not need to register separately as an investment adviser if certain conditions are met. The staff also issued no-action guidance to the effect that an investment adviser (a "filing adviser") may file a single Form ADV on behalf of itself and each other adviser that is controlled by, or under common control with, the filing adviser (each, a "relying adviser"), provided that the filing adviser and each relying adviser collectively conduct a "single advisory business." The staff set forth certain criteria for determining whether entities should be regarded as conducting a "single advisory business."

Final ERISA Fee Disclosure Rules
February 3, 2012
On February 2, 2012, the Department of Labor ("DOL") released its long-awaited final rule under Section 408(b)(2) of the *Employee Retirement Income Security Act of 1974* ("ERISA") regarding fee disclosures by service providers to ERISA plans. The final rule includes several changes from the interim final rule. The final rule also moves the effective date from April 1, 2012 to July 1, 2012. As a consequence, the DOL's related participant-level fee disclosure rule will not take effect until August 30, 2012. In addition, the DOL has provided, in an appendix to the rules, a sample disclosure "guide" to be used by service providers to help plan fiduciaries find where compensation and other information is located in relevant documents.

IRS and Treasury Publish New Rules Regarding Payments of Synthetic Dividends
February 3, 2012
On January 23, 2012, the IRS and Treasury published temporary and proposed regulations setting forth the tax and withholding regime applicable to U.S.-source "dividend equivalent" payments made to non-U.S. persons (including offshore hedge funds, swap dealers, banks and others) pursuant to stock loans, repos, swaps, and certain other instruments. The temporary regulations continue the previous regime through the end of this year.

The proposed regulations are intended to apply to any payments made on or after January 1, 2013. They create a vastly-expanded tax and withholding regime that will, if adopted in present form, result in the imposition of an up to 30% tax on many common dividend equivalent payments. The proposed regime presents a number of uncertainties and compliance concerns for recipients of such payments and for withholding agents.

Senior SEC Officials Discuss Asset Management Examination and Enforcement Initiatives and Priorities for 2012
February 7, 2012
In several recent public appearances, senior members of the SEC staff have commented on their current examination and enforcement priorities for the asset management industry in 2012. This alert highlights areas that will be an area of focus of SEC scrutiny in the coming year,

SEC Adopts "Accredited Investor" Definition
February 7, 2012
Our previous alert dated December 19, 2011, described proposed changes to the "accredited investor" standards. On December 29, 2011, the Securities and Exchange Commission adopted final rules implementing these proposed changes. The primary differences between the proposed and final rules are described in the attached alert.

SEC Extends Temporary Registration of Municipal Advisors
February 8, 2012
On December 21, 2011, the Securities and Exchange Commission (the "SEC") amended the interim final temporary rule that provides for the temporary registration of municipal advisors (the "Interim Rule") to extend the term of the Interim Rule to September 30, 2012. The municipal advisor registration regime may have significant implications for investment advisers and broker-dealers, though the current state of the rulemaking leaves open several interpretive questions.

Massachusetts' Data Security Regulation: Important Deadline Approaching
February 9, 2012
The deadline for compliance with a key requirement of the Massachusetts Data Security Regulation, 201 CMR 17.00 *et seq.* (the "Regulation") is less than a month away. The Regulation requires that by March 1, 2012, all entities subject to the Regulation must require their respective "service providers" (as defined below) to implement and maintain appropriate security measures to protect personal information that are consistent with the Regulation and applicable federal regulations.

CFTC Rescinds and Revises Hedge Fund Registration Exemptions and Adds Reporting Requirements
February 13, 2012
The Commodity Futures Trading Commission recently announced final rules rescinding or revising registration exemptions for private funds. Hedge funds typically rely on exemptions for funds with sophisticated investors, or for funds that trade only a *de minimis* level of commodity interests. With the first exemption rescinded and the second exemption revised to include swaps, funds and trading advisors must determine whether an alternative exemption is available or whether registration is required. Moreover, the CFTC announced new reporting requirements for registered commodity pool operators and commodity trading advisors.

Commodity Futures Trading Commission Adopts Final Rules Limiting Exclusion from Registration for Registered Investment Companies
February 14, 2012
The Commodity Futures Trading Commission recently adopted amendments to Rule 4.5 under the Commodity Exchange Act, limiting the availability of the exclusion from the definition of commodity pool operator relied upon by many registered investment companies. A registered investment company using commodity futures, options on commodities or commodity futures, or swaps is considered a commodity pool operator, triggering an obligation to register with the CFTC, unless the investment company satisfies the exclusion set forth in Rule 4.5. With the availability of the exclusion limited by the amendments, advisers to registered investment companies must determine whether registration is required. The CFTC also proposed new rules to harmonize compliance obligations for entities required to register with both the Securities and Exchange Commission and the CFTC.

Legal and Compliance Officers Left in Doubt about their Personal Liability

February 14, 2012

Compliance and legal officers of SEC regulated investment managers and broker-dealers have been closely monitoring developments in an administrative proceeding instituted by the SEC against a former general counsel of a broker-dealer. This case has given rise to controversy within the industry due to the scope of the liability that the SEC has sought to impose based on a "failure to supervise" theory of liability. On January 26, 2012, the SEC dismissed the case, leaving legal and compliance officers with no clear guidance as to the standard of liability that applies to their conduct in carrying out their duties and responsibilities. For a discussion of this proceeding and its implications please see our alert.

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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