Ropes & Gray's Investment Management Update: February-March 2012

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

First Circuit Declines to Extend Sarbanes-Oxley Whistleblower Provision to Employees of Non-Public Companies

In a decision the ultimate significance of which is uncertain, a split panel of the U.S. Court of Appeals for the First Circuit held on February 3, 2012 that the "whistleblower" provision of the Sarbanes-Oxley Act of 2002 ("SOX") does not cover employees of non-public companies. *See Lawson v. FMR LLC*, No. 10-2240, 2012 U.S. App. LEXIS 2085. The court's decision addressed the scope of the term "employee" under Section 806 of SOX, 18 U.S.C. § 1514A, which generally prohibits retaliation against covered employees for protected whistleblowing activity. However, because the conduct at issue in the case occurred several years before the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), the decision does not address whether a similar and potentially far broader provision of Dodd-Frank might extend coverage to employees of non-public companies for post-enactment whistleblowing activity.

The dispute in *Lawson* arose from two separate cases involving former employees of private companies affiliated with Fidelity Management & Research Company, the investment adviser to the Fidelity family of mutual funds. The plaintiffs alleged that they were terminated for raising concerns about the Fidelity funds' registration statements and accounting methodologies. The district court denied the defendants' motion to dismiss, holding that Section 806 extends whistleblower protection to employees of contractors and subcontractors of public companies.

The First Circuit disagreed, relying primarily on the statutory text and legislative history of Section 806. That section, as enacted, provides: "No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 . . . , or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 . . . , or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of" the employee's protected whistleblowing activity.

Chief Judge Sandra Lynch's majority opinion concluded that the term "employee" under Section 806 refers to an employee of a "public" company – one "with a class of securities registered under section 12" or that "file[s] reports under section 15(d)" – and *not* to employees of contractors or subcontractors of such a company.[1] The court read the clause "officer, employee, contractor, subcontractor, or agent of such company" as identifying entities that are prohibited from taking retaliatory action against employees of public companies, not as identifying entities whose own employees are protected from retaliatory action. Accordingly, only employees of the defined public companies are covered by the whistleblower provision.

The court found support for this interpretation in the title and caption of Section 806, which both refer to "protection for employees of publicly traded companies." The court also pointed to provisions elsewhere in the statute that explicitly provide broader whistleblower protection in other circumstances, reasoning that

[1] The court noted that it considered the Fidelity mutual funds to be "public companies" within the meaning of Section 806 because they have issued securities that may be sold to the public and are required to make periodic reports to their investors.

Congress's choice to enact more limited coverage under Section 806 was not inadvertent. (Section 1107, for example, prohibits retaliation against government informants regardless of their employer's status as public or private.) The court went so far as to state that Congress's primary concern in enacting SOX was not to address the activities of the advisers to mutual funds, since Congress knew that mutual funds often do not have their own employees and are often advised and managed by private entities – and if they have no employees, they are not subject to Section 806. The court also noted that although there is a close relationship between investment advisers and their client mutual funds, had Congress intended to ignore that separation and provide whistleblower protection for the employees of private investment advisers, it could easily have done so explicitly.

In interpreting the scope of Section 806 to exclude the employees of private investment advisers to mutual funds, the First Circuit rejected the views of both the Securities and Exchange Commission (the "SEC") and the Department of Labor (the "DOL"), which filed amicus briefs arguing that the plaintiffs were covered employees under SOX. The court held that the agencies' position was not entitled to deference because Congress had given neither agency authority to interpret the term "employee" under Section 806 and because that term "is not ambiguous." Nor were regulations promulgated by the Occupational Health & Safety Administration of the DOL interpreting the coverage provision entitled to deference, because they "contained no reasoning" and lacked "persuasive power."

Judge Rogeriee Thompson issued a forceful dissent challenging both the majority's reading of the statute and its logical implications. The dissent argued that the majority's reading of the word "employee" to mean only employees of "public" companies was neither compelled by the statutory text nor suggested by the legislative history of Section 806. The dissent implies that the majority's reasoning as applied in the special context of "public" (*i.e.*, registered) investment companies – which ordinarily do not have employees and are instead managed and operated entirely by investment advisers and other service providers – would render the statute meaningless. Under the majority's reasoning, if "contractors" and "subcontractors" of mutual funds are prohibited from retaliating against only mutual fund employees rather than their own, they are not precluded from retaliating against anyone. A petition for rehearing or rehearing *en banc* by the full First Circuit Court of Appeals has been filed by one of the plaintiffs. The case will be argued *en banc* if a majority of the active circuit judges vote to rehear the case.

The First Circuit is the first federal appellate court to address the scope of covered employees under Section 806, and the case is significant because many private companies – including virtually all investment advisers to mutual funds – are contractors or subcontractors of one or more public companies. However, neither opinion noted the enactment – subsequent to the facts giving rise to the dispute in *Lawson* – of a separate, parallel whistleblower protection regime under Section 922 of Dodd-Frank, which by its terms extends coverage to "any individual who provides . . . information relating to a violation of the securities laws."[2] The coverage of Section 922 appears to be quite broad and may be construable as applying to all employees, not just employees of public companies. Thus, even if the *Lawson* case is not reheard or the decision is upheld, its significance (as well as the concerns voiced by the dissent) may be largely muted for whistleblowing activity falling within the scope of the Dodd-Frank provision.

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[2] Though the court considered the post-enactment history of SOX Section 806 (which was expanded by Dodd-Frank to include employees of statistical rating agencies and certain subsidiaries of public companies), the scope of Dodd-Frank Section 922 was not before the court.

Money Market Fund Reforms Expected from the SEC

The SEC is widely reported to be considering new regulations governing money market funds, although recently three of the five SEC commissioners have expressed reluctance to support new reforms, making the outcome of any proposal highly uncertain at this time. The SEC is expected to release a two-part proposal offering alternatives for money market fund reform. The first proposal will likely require money market funds to use a floating net asset value ("NAV"); the second is anticipated to require a capital buffer as well as redemption restrictions in the case of full redemptions. Following a comment period that is likely to generate widespread and critical attention, the SEC will likely select only one of the proposed reforms in the final rule, according to industry reports. Before the rule proposals can be submitted to the public for comment, at least three of the five SEC commissioners must approve the proposals.

Under the anticipated floating NAV proposal, a money market fund's NAV would no longer be fixed at $1 per share and would instead rise and fall daily, as is the case with non-money market funds. The SEC has raised the possibility of a floating NAV for money market funds before. In 2009, the SEC sought comments on the idea in its rule proposal that preceded the 2010 amendments to Rule 2a-7 under the Investment Company Act of 1940, which governs money market funds. Various commenters opposed the idea of a floating NAV as raised by that proposal, and while the 2010 amendments raised standards for credit quality, liquidity and transparency, they did not include a floating NAV.

Under the anticipated capital buffer and redemption restrictions proposal, firms would be required to set aside capital reserves using one of three methods. Under the proposal, firms could increase their capital reserves by bringing in cash from corporate coffers, issuing stock or debt securities or collecting money from shareholders. Additionally, investors wishing to liquidate all of their holdings at once would be subject to a 30-day redemption limitation, also called a "liquidity fee," which would require funds to hold back 3% to 5% of an investor's money for 30 days.

Both proposals have received heavy criticism, with widespread criticism from the money market fund industry indicating that firms are prepared to do battle with the SEC over the potential reforms. Paul Schott Stevens of the Investment Company Institute (the "ICI") has stated, with respect to the first proposal, that a floating NAV would not reduce the chance of "runs" on money market funds nor reduce systemic risk and warned that it would drive millions of investors away from the funds; regarding the second proposal, he warned that the redemption restrictions would hinder the convenience and liquidity that investors seek in money market funds and that implementing the redemption freeze would cost investors, funds and financial intermediaries hundreds of millions of dollars. Demonstrating that the SEC does not necessarily have full support in Washington, U.S. Senator Pat Toomey, a Republican member of the Senate Banking Committee, commented that if the SEC proceeds with the planned reforms, he would not rule out introducing legislation to protect money market funds.

Update on IRS's Suspension of Private Ruling Practice for RICs Investing Indirectly in Commodities; Senate Subcommittee Holds Hearing on this Ruling Practice

As we previously reported in a prior Alert, in July 2011, the Internal Revenue Service (the "IRS") announced that it was suspending 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 ("CLNs"), in order to reconsider the basis on which it has issued these rulings. The IRS had previously issued over 70 letter rulings to RICs in this area, concluding that such investments generate "qualifying income" for RIC qualification purposes. The IRS's reevaluation of its rulings in this area is part of a larger examination by lawmakers and regulators of registered funds' investing in commodity-linked instruments: last month, the Commodity Futures Trading Commission (the "CFTC") issued final amendments to Rule 4.5 and other exemptive rules, which will limit the availability of the rules' exemptions from CFTC regulation for registered funds and their commodity subsidiaries (see our prior Alert from February 2012 discussing these rule changes).

Apparently driven by concerns about excessive speculation in the commodity markets, on January 26, 2012, the Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations held a hearing to examine specifically the IRS's rulings practice in respect of commodity subsidiaries and CLNs.[3] A few weeks before the hearing Senators Carl Levin (D-MI), chairman of the Subcommittee, and Thomas Coburn (R-OK), the Subcommittee's ranking minority member, had sent a letter to the IRS requesting that it permanently halt the further issuance of these letter rulings.

At the hearing and in the letter, Senator Levin expressed the view that RICs should not be permitted to invest indirectly in commodities if they cannot do so directly and questioned whether the commodity subsidiaries or CLNs lack economic substance or should be regarded as "sham corporations" or "sham transactions." The IRS Commissioner and a Treasury Department official testified at the hearing, each expressing the view that the IRS's rulings provided a reasonable interpretation of existing law. They also stated that, in view of the Senators' concerns, they are taking a fresh look at their policies toward RICs' use of commodity subsidiaries and CLNs, including considering whether to issue industry-wide guidance in this area. Representatives of the industry were not given the opportunity to testify at the hearing; the ICI submitted a written response to the hearing in support of the IRS's ruling positions.

It is unclear whether this attention by lawmakers will lead to any future legislation concerning registered funds and their use of commodity subsidiaries or other commodity-linked instruments, or affect IRS decision making in this area, including the nature and substance of any future IRS guidance. At a minimum, it is likely to delay further any IRS action concerning its suspended ruling practice.

Unless and until the IRS (or Congress) acts, a RIC that does not already have a letter ruling and wishes to invest indirectly in commodities through the use of structured notes or a commodity subsidiary has one or two alternatives to obtaining a letter ruling. See our prior Alert for a discussion of these alternatives.

SEC and CFTC Jointly Propose Rules to Help Prevent and Detect Identity Theft

On February 28, 2012, the SEC and CFTC (the "Commissions") jointly issued proposed rules and guidelines intended to help protect investors from identity theft by ensuring that broker-dealers, mutual funds and other entities regulated by the Commissions create programs to detect and respond appropriately to red flags. The proposed rules implement new provisions enacted by Title X of Dodd-Frank, which amends the Fair Credit Reporting Act ("FCRA") and transfers authority over certain parts of the FCRA from the Federal Trade Commission ("FTC") to the Commissions for entities they regulate. The proposed rules and guidelines are substantially similar to rules and guidelines adopted in 2007 by the FTC and other federal financial regulatory agencies that were previously required to adopt such rules. Our previous Alert on the 2007 rules can be found here.

Because many entities that are regulated by the Commissions already comply with the FTC's 2007 rules and guidelines, the Commissions have proposed that their new rules and guidelines not contain new requirements not already in the 2007 rules, nor would they expand the scope of those rules to include new

[3] Video of the hearing, written testimony and exhibits may be found here.

entities that were not already covered by the 2007 rules. The proposed rules and guidelines do contain examples and minor language changes that the Commissions anticipate may help some entities discern whether and how the identity theft rules and guidelines apply to them.

The proposed rules would (i) require each entity regulated by the Commissions who falls within the scope of the rules to develop and implement a written identity theft program that includes reasonable policies and procedures to identify, prevent and mitigate identity theft in connection with certain existing accounts or the opening of new accounts and (ii) require that the identity theft program be subject to periodic review and updates. The Commissions also proposed guidelines to assist entities in formulating and maintaining a program that would satisfy the requirements of the proposed rules.[4]

Comments are due to the Commissions by May 7, 2012. The Commissions propose to make the rules and guidelines effective 30 days after publication of the final rules in the Federal Register. The complete SEC/CFTC release, including instructions for submitting comments, can be found here.

FinCEN Issues Advance Notice of Proposed Rulemaking Regarding Customer Diligence Requirements

On February 29, 2012, the Financial Crimes Enforcement Network ("FinCEN") issued an advance notice of proposed rulemaking to solicit public comment on questions pertaining to the development of an explicit rule requiring U.S. financial institutions to perform customer due diligence ("CDD") that would, according to FinCEN, codify, clarify, consolidate and strengthen existing CDD regulatory requirements and supervisory expectations and establish a requirement for financial institutions to identify beneficial owners of their account holders, subject to risk-based verification and pursuant to an alternative definition of beneficial ownership described in the advance notice.

The advance notice indicated that the proposed rules would cover all of the industries that have anti-money laundering ("AML") program requirements under FinCEN's regulations. The potential CDD rule would cover banks, brokers or dealers in securities, mutual funds, futures commission merchants and introducing brokers in commodities, although FinCEN noted that it could extend the rule to any and all other financial institutions subject to its regulations. FinCEN is concerned that there is a lack of uniformity and consistency in the way financial institutions address their implicit CDD obligations and believes that an express CDD rule may be necessary to protect the United States financial system from criminal abuse and to guard against financial crimes such as terrorist financing and money laundering.

The advance notice addresses four elements that FinCEN believes are essential for an effective CDD program:

1. Conducting initial due diligence on customers, which includes identifying the customer and verifying the customer's identity as appropriate on a risk basis, at the time of account opening;
2. Understanding the purpose and intended nature of the account and expected activity associated with the account for the purpose of assessing risk and identifying and reporting suspicious activity;
3. Except as otherwise provided, identifying the beneficial owners(s) of all customers, and verifying the beneficial owner(s)' identity pursuant to a risk-based approach; and

[4] The proposed rules would also establish special requirements for credit and debit card issuers, although the SEC expects that few, if any, entities under its jurisdiction would be subject to the proposed card issuer rules.

4. Conducting ongoing monitoring of the customer relationship and conducting additional CDD as appropriate, based on such monitoring and scrutiny, for the purposes of identifying and reporting suspicious activity.

FinCEN indicated that it does not believe the first, second or fourth elements would create new or additional obligations for financial institutions. The third element, however, if adopted as a component of an express CDD program rule, would create a new express regulatory obligation to obtain and verify beneficial ownership information.

FinCEN currently defines the beneficial owner of an account as "an individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the account." In connection with the potential CDD program requirement, the advance notice offers for consideration the following additional definition of "beneficial owner" that would, in the case of legal entities, include:

1. Either:
   (a) Each of the individual(s) who, directly or indirectly, through any contract, arrangement, understanding, relationship, intermediary, tiered entity, or otherwise, owns more than 25 percent of the equity interests in the entity; or
   (b) If there is no individual who satisfies (a), then the individual who, directly or indirectly, through any contract, arrangement, understanding, relationship, intermediary, tiered entity, or otherwise, has at least as great an equity interest in the entity as any other individual, and
2. The individual with greater responsibility than any other individual for managing or directing the regular affairs of the entity.

Recognizing that financial institutions may not have beneficial ownership information on existing customers, FinCEN is considering applying the beneficial ownership identification requirement to all new customers and considering how such a requirement could be phased into ongoing CDD.

FinCEN identified two possible meanings of verification of the beneficial owner under the third element described above. One meaning would require verifying the identity of the individual identified by the customer as the beneficial owner of the account, *i.e.*, verifying the existence of the identified beneficial owner. The other meaning would require verifying that the individual identified by the customer as the beneficial owner is indeed the beneficial owner of the account, *i.e.*, verifying the status of the identified individual. FinCEN is considering the appropriateness of and challenges associated with each possible meaning.

FinCEN is seeking comments from interested parties on a wide range of questions. Because it is considering expressly requiring that financial institutions conduct CDD as part of their existing AML program requirements, and as part of this requirement, that financial institutions collect beneficial ownership for all customers, with limited exceptions, FinCEN is seeking comment concerning the implementation of CDD programs in general pursuant to existing rules and the guidance described in the advance notice. FinCEN is also interested in better understanding what types of CDD information are currently collected, specifically in relation to beneficial ownership information, and under what circumstances the information is collected. Comments must be received by May 4, 2012. The advance notice of proposed rulemaking, which describes in detail the specific questions on which FinCEN is seeking input, can be found here.

Revised SEC Rule Restricts Investor Qualification for Advisory Performance Fee Charges

On February 15, 2012, the SEC adopted amendments to Rule 205-3 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which permits investment advisers to charge performance-based compensation to "qualified clients" (as defined in the rule). In an effort, according to the SEC, to reduce the risks associated with advisory performance fee arrangements, the amended rule raises the net worth requirement for investors who may be charged such fees and excludes the value of an investor's home from the net worth calculation.

The amended rule will require "qualified clients" to have at least $1 million of assets under management with the adviser or a net worth of at least $2 million, increasing the thresholds from $750,000 and $1.5 million, respectively. The increases were required by Dodd-Frank and codify the thresholds that currently apply to investment advisers, which were set by a July 12, 2011 SEC order (the "Order"). The amended rule states that the SEC will issue an order that makes inflation adjustments to these dollar thresholds every five years.

The amended rule will also exclude the value of a person's primary residence and certain debt secured by the residence, up to the fair market value of the residence, from the net worth calculation. Although this change is not required by Dodd-Frank, the SEC stated that it believes that the value of a person's residence has little relevance to the individual's financial experience or ability to bear the risks associated with performance fee arrangements. This change parallels recent amendments to the calculation of dollar thresholds in the definition of "accredited investor" for purposes of the private placement rules under Regulation D (see our prior Alert discussing those changes).

The amended rule includes three transition provisions that were not set out in the Order. Registered investment advisers will be permitted to continue to charge performance fees to clients who met the definition of "qualified client" when they entered into the advisory contract, even if they do not meet the dollar amount thresholds in the amended rule. In addition, the amended rule allows newly registering investment advisers to continue charging performance fees to clients pursuant to existing contractual arrangements if they were already charging those fees prior to registering, by providing that Section 205(a)(1) of the Advisers Act will not apply to contractual arrangements into which the registered adviser entered when it was not registered with the SEC. Finally, the amended rule allows for limited transfers of interests from a "qualified client" to a person that was not a party to an existing contract and is not a "qualified client" at the time of the transfer (*e.g.*, transfers of interests in private funds by gift or bequest or pursuant to an agreement related to a legal separation or divorce).

The amendments will become effective on May 22, 2012, and advisers may rely upon the amended transition provisions before that date. The revised rule can be found here.

SEC Releases Study Testing Investor Target Date Retirement Fund Comprehension and Communications

On February 15, 2012, the SEC released findings from a study it sponsored to test individual investors' understanding of target date retirement funds and advertisements related to those funds. The study found that many survey respondents have misconceptions regarding target date funds' asset allocation and how such funds operate. For example, 30% of the respondents with assets invested in target date funds believed that the "target date" is the point at which a fund is at its most conservative allocation and that the allocation stops changing thereafter (*i.e.*, the so-called "to" date, rather than the so-called "through" date employed by many target date funds). Additionally, only 36% of respondents correctly indicated that a target date fund does not provide guaranteed income in retirement. The study also found that comprehension of target date funds' changing allocation over time was greater among respondents who viewed a target date fund's glide path illustration along with various other disclosure items. The complete SEC study can be found here.

The study follows the SEC's June 2010 issuance of proposed amendments to its advertising rules intended to clarify the meaning of a date in a target date fund's name and enhance the information provided to investors in target date funds to address potential misunderstanding of the nature of such funds' asset allocation. The SEC's proposal would, among other things, require marketing materials for a target date fund that includes the target date in its name to disclose the asset allocation of the fund among types of investments and require graphic depictions of asset allocations in such materials. The proposed rule changes were never adopted, and the text of the 2010 proposing release can be found here.

Although nothing in the study appears to contradict the 2010 proposed rule changes, based on informal statements by the SEC staff, the ICI has speculated that the SEC may re-open the comment period for the target date fund proposal to allow interested parties to comment in light of the SEC's study.

SEC Expands Investigation of ETF Trading

The SEC is expanding its ongoing investigation of exchange-traded funds ("ETFs"), as reported by Reuters. The investigation began last year after the SEC became concerned that frequent trading in leveraged ETFs was contributing to excess market volatility, following the 2010 "flash crash." The SEC's investigation is taking a closer look at a possible connection between high-frequency traders and hedge funds jumping in and out of ETFs and so-called settlement "fails" – instances where ETF trades are not completed within four days. The SEC is concerned that settlement "fails" might be contributing to excess volatility and systemic risk in the financial markets. The SEC's decision to expand its investigation came after the occurrence of a settlement "fail" with respect to a sizable trade in a large, liquid (but unidentified) ETF, according to a person familiar with the investigation. So far, the SEC has said little about the nature of its concerns and has declined to comment on the expanded investigation, but an SEC spokesman confirmed that the agency is looking into failed trades and ETFs.

European Regulators Adopt the European Market Infrastructure Regulation to Regulate the Over-the-Counter Derivatives Market

On February 9, 2012, European Union finance ministers and the European Parliament adopted new reforms covering all segments of the roughly $700 trillion over-the-counter ("OTC") derivatives market. The European Commissioner, Michel Barnier, stated that the regulations are designed to create more stability, transparency and efficiency in European derivatives markets.

The European Market Infrastructure Regulation (the "EMIR") includes a requirement that most trades pass through central clearinghouses. The process is designed to mitigate counterparty credit risk in OTC derivatives transactions by placing a clearinghouse between the buyer and seller to ensure that each party receives what it is owed, even if one of the parties defaults. The EMIR also requires that information on all European derivative transactions be reported to central data centers and be accessible to supervisory authorities, thus improving the overall transparency of the OTC derivatives market. European legislators said they hoped that by increasing transparency and forcing derivative trades through a central clearinghouse, they will reduce market risk and avoid a repeat of the 2008 financial meltdown.

The passage of the EMIR is intended to bring the European regulators in line with the commitment made by G20 countries in 2009 to implement reforms in the derivatives markets. Although Title VII of Dodd-Frank imposes new regulations on the U.S. derivatives market, European regulators had so far lagged behind the U.S. in adopting new derivatives regulation. European regulators anticipate that the EMIR will be fully in place by the end of 2012.

An FAQ published by the European Commission regarding the rules can be found here.

Regulatory Priorities Corner

A summary of SEC regulatory priorities that have been brought to our attention recently:

- *Compliance Culture*: The Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE") told attendees of the SEC's January 2012 Compliance Outreach Program National Seminar (the "Compliance Outreach Program") that the SEC will be focusing on whether senior management of investment advisers and the boards of investment companies set the appropriate tone for strong compliance cultures. The SEC also will be looking to determine the profile and prominence of the chief compliance officer (the "CCO") within a firm, and an SEC associate director noted that firms should think about empowering their CCOs to report up to senior management.
- *Priority Enforcement Areas*: At the Compliance Outreach Program, staff of the Asset Management Unit of the SEC's Division of Enforcement identified the focus of current enforcement efforts as including:
    - valuation issues, stemming from the important role that valuation of assets plays in determining a manager's fees;
    - conflicts of interest, as the Enforcement Division routinely finds unauthorized and undisclosed self-dealing across a broad spectrum of investment managers;
    - compliance issues, due to the importance of a compliance program customized to the actual business operations and strategies of an investment manager and the funds it manages; and
    - deceptive fee practices as a way to generate revenue.
- *National Examination Risk Alert*: OCIE issued a risk alert on February 27, 2012 titled "Strengthening Practices for Preventing and Detecting Unauthorized Trading and Similar Activities." The risk alert encouraged firms to review their controls designed to prevent unauthorized trading and other unauthorized activities and stated that firms may want to consider actively engaging such control functions as operational risk, audit, legal and compliance to work closely with management in performing an independent identification of risks and practices that could permit unauthorized trading. OCIE also stated that firms might consider reviewing and/or testing internal controls on a regular basis, assessing their adequacy to prevent unauthorized trading in light of internal business changes and current market conditions, among other factors, and working closely with control functions to develop enhanced controls and procedures to address any identified potential weaknesses. The risk alert, which also highlights insights from the SEC's National Examination Program that may help firms identify risks and strengthen their practices for preventing and detecting unauthorized trading, can be found here.

Other Developments

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

Recent Wave of Actively Managed ETFs Overcomes Lengthy Approval Process
March 13, 2012

Ten new actively managed ETFs were approved in February for listing on NYSE Arca, including PIMCO Total Return Exchange-Traded Fund, an ETF managed by Bill Gross, manager of the prominent PIMCO Total Return Fund. Advisers looking to join this budding market must be ready to navigate the complex regulatory regime. Launching an actively managed ETF not only requires exemptive relief from the SEC's Division of Investment Management, but also requires approval of the SEC's Division of Trading and Markets, including the 19b-4 filing process, introducing additional uncertainty to, and sometimes significantly extending, the product launch cycle.

Second Circuit's *Absolute Activist* Decision Further Clarifies Extraterritorial Reach of U.S. Securities Laws
March 6, 2012

On March 1, 2012, the Second Circuit provided important clarification on the extraterritorial reach of the U.S. securities laws. In *Absolute Activist Value Master Fund Ltd. v. Ficeto*, the court held that the antifraud provisions of the federal securities laws reach transactions involving unlisted U.S. securities only when (i) one party incurs irrevocable liability within the United States to *purchase or deliver* a security, or (ii) *title is transferred* domestically. The decision puts important limitations on application of the U.S. securities laws to transactions involving foreign issuers and foreign exchanges and sets margins on the Supreme Court's recent decision confining the antifraud laws to "domestic transactions."

Significant Developments for the Implementation of FATCA: The IRS and Treasury Department Release Proposed Regulations
March 1, 2012

On February 8, 2012, the IRS and Treasury Department released long-awaited proposed regulations on a set of statutory rules commonly referred to as the Foreign Account Tax Compliance Act rules (or, "FATCA"). FATCA establishes a new information reporting regime to identify U.S. persons holding assets through offshore entities and overseas accounts. Non-compliance with FATCA generally leads to a 30% withholding tax on most U.S. source income and, potentially, on all or a portion of non-U.S. source income. The FATCA regime institutes significant changes not only for offshore entities (such as non-U.S. funds and banks) but also for U.S. entities (such as U.S. private investments funds, RICs and U.S. banks) that will be required to implement the new FATCA reporting and withholding procedures. These proposed regulations provide guidance on a wide range of issues that allows entities to evaluate how they will be affected and to begin adopting appropriate policies and procedures in time to ensure compliance with FATCA.

The proposed regulations do not delay the phase-in of FATCA withholding and reporting requirements, which are scheduled to begin January 1, 2014. Similarly, the application deadline by which a foreign financial institution is required to enter into an agreement with the IRS to avoid the withholding tax remains June 30, 2013. For fund-specific considerations, private equity funds and hedge funds should refer to pages five and six of the Alert. RICs should refer to page seven for RIC-specific observations.

FBAR Filing Deadline Further Extended to June 30, 2013 for Certain Employees and Officers with Signature Authority over Foreign Financial Accounts
February 21, 2012

On February 14, 2012, FinCEN issued Notice 2012-1 extending the filing deadline for U.S. Treasury Form TD F 90-22.1, "Reports of Foreign Bank and Financial Accounts" ("FBARs"), until June 30, 2013 for two groups of individuals whose filing obligations had previously been extended until June 30, 2012 under Notice 2011-1 and Notice 2011-2 (the "2011 Notices"), including employees and officers of investment advisers registered with the SEC who have signature authority over, but no financial interest in, foreign financial accounts of one or more persons that are not registered investment companies. Generally, each U.S. person who has a financial interest in, or signature authority over, one or more foreign financial accounts during a calendar year is required to report those accounts by filing an FBAR with the IRS by June 30 of the succeeding calendar year. The extension to June 30, 2013 for the individuals covered by Notice 2012-1 is applicable to FBARs for calendar year 2011, as well as to FBARs for all earlier years previously extended under the 2011 Notices. The filing deadline for all other U.S. persons with an FBAR filing obligation remains unchanged – *i.e.*, for the calendar year 2011, the deadline is June 30, 2012.

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.

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
New York, NY
+1 212 596 9858
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