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

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

SEC Credits Former Executive's Cooperation by Declining to Take Enforcement Action

For the first time since the publication of its plan to incentivize individual cooperation in investigations, the Securities and Exchange Commission (the "SEC") publicly recognized the assistance of a former executive that led to settled enforcement actions against the executive's employer – an investment adviser – and the company's co-founder.[1] On March 19, 2012, the SEC announced that it had credited the cooperation of the former executive, who was not named, by declining to take enforcement action against him for his role in the cover-up of a material computer coding error at AXA Rosenberg Group LLC. While the SEC's announcement provides insight into the potential benefits of cooperating in an SEC investigation, the fact-specific nature of the case complicates any effort to draw conclusions on how the SEC will evaluate (and potentially credit) cooperation in future investigations.

In its March 2012 announcement, the SEC revealed that the former AXA Rosenberg executive's cooperation was instrumental in enabling the agency to conduct its investigation. The SEC evaluated the executive's assistance under the four factors laid out in the agency's Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions (the "Cooperation Policy"). Applying these factors, discussed below, the SEC concluded that it was appropriate not to take enforcement action against the former executive:

- *Assistance provided by the individual.* The SEC determined that the senior executive's cooperation made a difference in the investigation because of its timeliness and quality. The executive voluntarily agreed to cooperate early in the investigation. His position within the company, together with his relationship with its co-founder and his intimate knowledge of the investment models, enabled him to provide detailed and complete information. His credibility was enhanced by his willingness to provide unconditional assistance, without the promise of any specific outcome in exchange for his testimony.
- *Importance of the underlying matter.* The SEC noted that the enforcement actions brought in this matter were the first ever arising from errors in a quantitative investment model, a priority area for the SEC's Division of Enforcement. The results of the settlement were also significant, including restitution of $217 million and over $25 million in penalties.
- *Interest in holding the individual accountable.* The SEC determined that the former executive had a relatively low level of culpability in the matter under investigation but played an important role in the SEC's investigation. While the executive played a "limited" role in events surrounding the cover-up, he advocated that the company's CEO be informed of the error and was given instructions to conceal the error and not fix it. The SEC did not elaborate on the executive's conduct with respect to the cover-up but stated that the executive's cooperation maximized the SEC's law enforcement interests by facilitating the quick and successful resolution of its enforcement actions.
- *The individual's profile.* Lastly, the SEC noted that the former executive did not have any disciplinary history and had retired from the investment management industry. In addition, the executive was not at the time of his assistance an associated person of any regulated entity, a fiduciary for other individuals regarding financial matters, or an officer or director of a public company. Under the

[1] Our prior Alert discussing these enforcement actions is available here.

circumstances, the SEC concluded that the executive was not in a position to commit future violations of the securities laws.

In some ways, this case presents a model of cooperation with a government investigation, in which all four factors weigh in favor of leniency toward the cooperating individual. The SEC's choice to publicize the case as the first example of substantial assistance under its Cooperation Policy sets a high bar for individuals seeking to benefit from cooperation. It is particularly significant that the executive in this case played only a "limited" role in the cover-up and has since retired from the asset management industry.

The SEC's announcement therefore does not address a situation in which the cooperating individual is more culpable or remains in a position to commit future violations of the securities laws – even if the individual's assistance proves extremely valuable to the investigation. These factors underscore a basic tension between the publicized goal of creating incentives for individuals to cooperate with law enforcement authorities and the governmental interest in holding individuals fully accountable for their misconduct. While the SEC may be inclined to resolve that tension in favor of the individual on the "ideal" facts presented here, the announcement does little to clarify how the agency would respond to a closer case.

SEC Re-opens Comment Period for Target Date Fund Proposal to Allow Comments on the SEC Study

On April 3, 2012, the SEC stated that it is seeking public comment on the results of investor testing regarding target date retirement funds. The SEC will consider the comments before acting on a proposal it issued in 2010 intended to enhance the information provided to individuals investing in such funds.

As reported in a prior Update, on February 15, 2012, the SEC released findings from a study it sponsored that was designed to study individual investors' understanding of target date retirement funds and advertisements related to those funds. The study found that many survey respondents have misconceptions regarding the asset allocation mix of target date funds and how such funds operate. The study also found that comprehension increased among respondents who viewed a target date fund's "glide path" illustration along with various other disclosure documents. The complete SEC study can be found here.

As discussed in a prior Update, in June 2010, the SEC proposed amendments to its advertising rules which are intended to provide enhanced information to investors about target date retirement funds and reduce the potential for investors to be confused or misled regarding such funds and their risk profiles. The proposed amendments would, if adopted, (i) require a target date retirement fund that includes the target date in its name to disclose the fund's intended asset allocation at that target date immediately adjacent to the first use of the fund's name in marketing materials; (ii) require marketing materials for target date retirement funds to include a table, chart, or graph (*e.g.*, a "glide path") depicting the fund's asset allocation over time, together with a statement highlighting the fund's final asset allocation when it ceases to shift; and (iii) require a statement in marketing materials to the effect that a target date retirement fund should not be selected based solely on age or retirement date and is not a guaranteed investment, and that its stated asset allocations may be subject to change. The SEC's proposed amendments would provide additional guidance regarding potentially misleading statements in marketing materials for target date retirement funds and other investment companies. The proposed rule can be found here.

Comments are due to the SEC by May 21, 2012. Interested parties may submit comments via the SEC's online comment form.

SEC No-Action Letter Regarding Exemption from Registration as an Investment Adviser under Section 203(b) of the Advisers Act

In a March 12, 2012 letter to the SEC, Industrial Alliance, Investment Management Inc., a corporation incorporated under the laws of Canada ("IAIM"), sought assurance from the staff of the SEC's Division of Investment Management (the "Staff") that it would not recommend enforcement action under Section 203(a) of the Investment Advisers Act of 1940 (the "Advisers Act") if IAIM did not register with the SEC as an investment adviser. On March 14, 2012, the Staff issued a no-action letter in response to this request.

Pursuant to Section 203(a) of the Advisers Act, an investment adviser may not make use of U.S. jurisdictional means in connection with its business as an investment adviser unless the adviser is registered with the SEC; however, Section 203(b)(2) provides an exemption from registration for investment advisers whose only clients are insurance companies.

IAIM is a wholly-owned subsidiary of Industrial Alliance Insurance and Financial Services Inc. (the "Parent"). In addition to offering various types of advisory services in Canada, IAIM manages the assets of five U.S. insurance companies that are direct or indirect wholly-owned subsidiaries of the Parent. These five insurance companies are IAIM's only U.S. clients. IAIM has no place of business in the U.S. and does not hold itself out as providing investment advice to the public in the U.S.

In its request, IAIM acknowledged that it does not fit within the literal language of the Section 203(b)(2) exemption because the five insurance companies are not its *only* clients; however, these insurance companies are IAIM's *only U.S.* clients. IAIM explained that other than its limited use of U.S. jurisdictional means for the purposes of acquiring information about the securities of U.S. issuers and effecting transactions in securities of U.S. issuers through U.S. brokers and dealers (a practice which IAIM noted the Staff has acknowledged is permissible for foreign advisers to non-U.S. clients), it only uses U.S. jurisdictional means in connection with its business as an investment adviser in providing advice to the insurance companies. IAIM also cited numerous SEC releases and no-action letters supporting its contention that the Advisers Act does not generally extend its reach to a foreign adviser's activities outside the U.S. with its foreign clients. Finally, IAIM stated that the costs of registration and ongoing compliance would outweigh the need for registration. If required to register, IAIM would only be required to provide Advisers Act disclosures to the insurance companies, because it would still be able to provide advisory services to its Canadian clients in compliance only with Canadian law, not the Advisers Act. However, if the insurance companies were IAIM's *only* clients, IAIM would not be required to provide such disclosures to the insurance companies, because IAIM would not be required to register as an investment adviser.

In response, the Staff stated that it would not recommend enforcement action based particularly on the following representations by IAIM: (1) IAIM's principal office and place of business is in Canada, and it has no office or place of business in the United States, (2) IAIM's only U.S. clients are the U.S. insurance companies and (3) IAIM only uses U.S. jurisdictional means in the limited ways described in its letter.

The response looks like an early example of the SEC's approach to the *Unibanco* line of no-action letters announced in connection with the Advisers Act registration rules adopted in June 2011. The adopting release for the rules specifically noted that the Staff has said that it will not recommend enforcement action if a non-U.S. advisory affiliate of a registered adviser shares personnel with, and provides certain services through, the registered affiliate without such non-U.S. advisory affiliate registering under the Advisers Act. Our prior Alert discussing the registration rules is available here.

SEC Approves FINRA Best Execution Rule

On December 5, 2011, the SEC approved FINRA's proposed rule change to adopt FINRA Rule 5310 (Best Execution and Interpositioning) in the Consolidated FINRA Rulebook, and on March 2, 2012, FINRA announced that the approved changes and renumbering of the rule will take effect on May 31, 2012. Although the general best execution requirements remain the same as those under the existing NASD Rule 2320, the Supplementary Material to Rule 5310 includes four notable changes to the NASD formulation:

(1) *Securities with limited quotation or pricing information available (replacing NASD Rule 2320(f), commonly referred to as the "Three Quote Rule")*: In replacing the Three Quote Rule, the Supplementary Material stresses that members must be "especially diligent" with respect to best execution obligations for securities with limited quotation or pricing information available. It requires members to have written policies outlining steps they will take to determine the best market for these types of securities and to document how they have complied with their internal policies and procedures.

(2) *Orders for foreign securities with no U.S. market*: The Supplementary Material notes that even though a foreign security may not trade in the U.S., member firms still have an obligation to seek best execution. Consequently, a firm that handles orders for such securities must have specific written policies and procedures in place regarding its handling of customer orders for such securities that are reasonably designed to obtain the most favorable terms available, taking into account any differences between U.S. and foreign markets. Firms must also regularly review their policies and procedures to account for their evolving best execution obligations.

(3) *Customer instructions regarding the routing of orders*: The Supplementary Material addresses situations where a customer has, on an unsolicited basis, specifically instructed a firm to route its order to a particular market. Under those circumstances, the firm is not required to make an additional best execution determination, but the firm must process the order promptly and in accordance with the order's terms. The Supplementary Material also clarifies that, where a customer has directed a firm to route an order to another broker-dealer that is also a FINRA member firm, the exception would not apply to the receiving broker-dealer to which the order was directed.

(4) *Regular and rigorous review of execution quality*: The Supplementary Material codifies, and does not alter, existing guidance regarding regular and rigorous review of execution quality, which includes, at a minimum, quarterly review, though more frequent review may be required depending on a broker-dealer's particular business mix and level of sales and trading activity.

The text of FINRA Rule 5310 is available in the online FINRA manual, and FINRA's notice is available here.

Increasingly Global Reach of SEC

The SEC announced on March 23, 2012 that it had entered into supervisory cooperation arrangements with the Cayman Islands Monetary Authority ("CIMA") and the European Securities and Markets Authority ("ESMA"). The two memoranda of understanding ("MOUs") are part of a long-term strategy to improve the SEC's oversight of regulatory entities that operate across national borders.

The new MOUs are intended to improve the SEC's ability to share information about regulated entities such as investment advisers, investment fund managers, broker-dealers and credit rating agencies. The Cayman Islands is a major offshore financial center for hedge funds, investment advisers and investment managers that frequently access the U.S. market. ESMA fosters regulatory convergence among European Union securities regulators, including on such initiatives as the Alternative Investments Fund Managers Directive (AIFMD), and also regulates credit rating agencies.

The SEC has used MOUs to facilitate cross-border cooperation since the late 1980s, when it began entering into enforcement cooperation arrangements with foreign counterparts. Such enforcement cooperation arrangements were designed to facilitate the sharing of information between the SEC and foreign securities regulators in securities enforcement matters. In 2002, the International Organization of Securities Commissions ("IOSCO") created a Multilateral MOU ("MMOU"), the first global multilateral information-sharing arrangement among securities regulators. Currently over 80 securities and derivatives regulators are signatories to the MMOU. The signatories agree, among other things, to provide certain critical information, to permit the use of that information in civil or administrative hearings, to share information with self-regulatory organizations and criminal authorities, and to keep such information confidential. The MMOU has significantly enhanced the SEC's enforcement program by allowing increased and expedited access to information from many foreign jurisdictions. The SEC has also entered into bilateral information sharing MOUs with 20 different countries. In light of the MMOU, however, the SEC only recommends the negotiation of a bilateral MOU if foreign authorities are able to provide assistance beyond that required in the MMOU.

In contrast to enforcement cooperation agreements, supervisory cooperation arrangements like those signed with CIMA and ESMA generally establish mechanisms for continuous and ongoing consultation, cooperation and the exchange of supervisory information related to the oversight of globally active firms and markets. The SEC entered into its first supervisory cooperation arrangement in 2006 with the United Kingdom's Financial Services Authority. Following the recent financial crisis, the SEC has expanded its focus on supervisory cooperation arrangements in an effort to better identify emerging risks to U.S. capital markets and the international financial system.

In 2010, the SEC co-chaired an international task force to develop principles for cross-border supervisory cooperation, which have proven to be a useful guideline for structuring the MOUs. MOUs for regulatory cooperation can vary in scope and purpose, and to date, the MOUs the SEC has entered into cover information sharing and cooperation related to:

1. affiliates within a financial group subject to consolidated supervision by the SEC and/or a foreign authority;
2. firms registered with both the SEC and a foreign authority;
3. the oversight of markets in the U.S. and a foreign jurisdiction affiliated through a common ownership structure; and/or
4. the sharing of non-public issuer-specific information relating to the application of International Financial Reporting Standards by dually-listed companies.

The older MOUs and MMOU and the recently signed MOUs, which signal the potential for increased cooperation between the SEC and foreign securities regulators, may increase the number of international securities fraud cases. These arrangements facilitate the ability of regulators to cooperate with the SEC and with each other, helping to increase the level of information flow that enables such regulators to effectively monitor the entities within their jurisdiction and identify potential and actual risks to both local markets and the global financial system.

IOSCO Report Identifies Fifteen Principles of ETF Regulation

On March 14, 2012, IOSCO released a consultation report, *Principles for the Regulation of Exchange Traded Funds*. The report was prepared by an IOSCO Standing Committee co-chaired by the SEC. The Standing Committee was charged with highlighting the experience and key regulatory aspects regarding exchange-traded funds ("ETFs") and related issues across IOSCO member jurisdictions, identifying the common issues of concern and developing a set of principles or best practices on ETF regulation. The report identified fifteen common investor-protection principles for regulators to consider. The report noted that the principles should not be construed as a "one-size-fits-all" approach. Instead, they are intended to be adaptable to different regulatory frameworks, and some may be better viewed as industry best practices than as regulatory requirements. The report divides the proposed principles into four groups: (1) Classification and Disclosure; (2) Marketing and Sale of ETF Shares by Intermediaries; (3) ETF Structuring; and (4) Issues Broader than ETFs, which focuses on the risk of shock transmission across markets. The principles relating to ETF classification, which recommend that regulators require disclosure of distinguishing characteristics and regulatory requirements that are applicable to ETFs but not to other exchange-traded products, can be viewed as related to BlackRock's recent proposal to adopt nomenclature standards for ETFs and other exchange-traded products.

The Standing Committee requested that comments on the report be submitted on or before June 27, 2012.

Regulatory Priorities Corner

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

CFTC Enforcement Actions Regarding Customer Fund Segregation: On March 13, 2012, the U.S. Commodity Futures Trading Commission (the "CFTC") announced several enforcement actions against firms for allegedly failing to properly segregate client funds. The actions included allegations of failure to diligently supervise various parties, failure to segregate customer funds and fraud via the issuance of false account statements. The CFTC discussed the importance of segregation of client funds at the Futures Industry Association International Futures Industry Conference the same week.

- *CFTC Focusing on High-Frequency Trading*: The CFTC appears poised to implement new regulatory reforms over high-frequency trading and other technologies blamed for the May 2010 "flash crash." CFTC Chairman Gary Gensler stated that the agency would request comments in the coming month on potential rule changes aimed at so-called "high-frequency" or "algorithmic" trading, which typically involves sophisticated computer systems using complex algorithms to trade on minute changes in prices within a fraction of a second.
- *SEC Watching Fund Fees*: At the March 8-9, 2012 Investment Adviser Association Investment Adviser Compliance Conference (the "IAA Conference"), Robert Kaplan, the co-chief of the asset management unit of the SEC's Division of Enforcement, discussed the unit's focus on proper disclosure of mutual fund fees. The unit intends to verify that fees are being properly disclosed to investors and to look at fees provided for in the annual renewal of funds' advisory contracts.
- *OCIE Priorities*: At the IAA Conference, Norman Champ, the deputy director of the SEC's Office of Compliance Inspections and Examinations ("OCIE"), indicated that current areas of focus for the OCIE include: complex entities such as newly registered private fund advisers and high frequency traders; quantitative investment vehicles; problematic sales practices, such as in the marketing of senior and retirement products as safe; fund governance; registrants' "tone at the top" and how their compliance, audit, and management functions are working together; safety of assets; and performance and advertising.

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:

2012 Mutual Funds and Investment Management Conference
April 11, 2012

Ropes & Gray's memorandum summarizing the general and workshop sessions at the 2012 Mutual Funds and Investment Management Conference sponsored by the ICI and the FBA is available above.

If you would like to discuss a specific session, or any other aspect of the conference, please contact any of the lawyers listed on the cover of the memorandum or the Ropes & Gray lawyer with whom you regularly work.

Congress Passes JOBS Act
March 29, 2012

On March 27, 2012, Congress passed the Jumpstart Our Business Startups Act, H.R. 3606, as amended (the "JOBS Act"). President Obama is expected to sign the bill shortly. The JOBS Act, which combines six different bills, is intended to make it easier for small businesses to access capital. Of particular interest to the funds industry, the JOBS Act eases the regulatory framework for private offerings by (a) removing the prohibitions against general solicitation and general advertising for securities offerings exempt from registration under Rule 506 of Regulation D, so long as all purchasers of such securities are accredited investors, and (b) raising the equityholder threshold that triggers public reporting in Section 12(g) of the Securities and Exchange Act of 1934 from 500 persons to either (i) 2,000 persons in total or (ii) 500 persons who are not accredited investors. Once signed into law and implemented by the Securities and Exchange Commission, the JOBS Act is expected to substantially ease restrictions on advertising and other offering practices that have historically been imposed on private fund sponsors, including sponsors of private equity funds, hedge funds and funds of funds, conducting offerings in the United States.

National Mortgage Settlement Consent Judgments Filed with U.S. District Court of D.C.
March 28, 2012

The federal government and state attorney generals of 49 states and the District of Columbia recently filed consent judgments in the United States District Court for the District of Columbia, setting forth details of the National Mortgage Settlement, involving the five largest servicers of residential mortgages.

The Settlement currently provides for the payout of approximately $25 billion dollars to be allocated among individual homeowners, states and the federal government, to provide relief to homeowners and to fund counseling, refinancing and other foreclosure prevention programs. This amount could potentially increase if additional mortgage servicers join the Settlement. The Settlement also sets forth guidelines for comprehensive reforms of mortgage loan servicing, including more stringent documentation, processing and oversight requirements. While the primary impact of the Settlement will fall on mortgage servicers and borrowers, third-party purchasers of residential mortgage loans will also be affected.

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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