Ropes & Gray's Investment Management Update: August-September 2012

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

Bankruptcy Court Determines that Holders of Soft Dollar Credits Are Not Customers under SIPA

In a decision described as the first of its kind, the U.S. Bankruptcy Court of the Southern District of New York ruled that claims based on soft dollar credits issued by Lehman Brothers Inc. (LBI) to numerous investment advisers were not entitled to the special protections afforded to "customer claims" under the Securities Investor Protection Act (SIPA). As explained in Judge James Peck's opinion, the protections afforded by SIPA are available only to creditors who were "customers" of the insolvent broker-dealer and that term encompasses only persons who have securities held by the broker-dealer or who have deposited cash with the broker-dealer for the purpose of purchasing securities. Soft dollars "function something like frequent flyer miles: they are a specialized form of currency that may be redeemed solely as a means to pay for research services and other services provided by a broker-dealer to its customers." The court held that because the soft dollar credits are not securities, and (unlike cash) cannot be used to purchase securities, the holders of soft dollar credits are not "customers" for purposes of SIPA. Judge Peck characterized the claims asserted by the holders of soft dollar credits as simply claims for damages resulting from a breach of contract, *i.e.*, LBI's failure to provide research services that the claimants would be entitled to pay for using soft dollars. Accordingly, the court held that the remedy afforded to holders of soft dollars is to pursue their rights as general unsecured creditors in LBI's bankruptcy case. The full text of the decision is available here.

New Consolidated Audit Trail Rule Requires FINRA and Securities Exchanges to Monitor and Analyze Trading Activity

In the wake of the "flash crash" of May 6, 2010 and in an effort to improve oversight of high-speed electronic market centers, including exchanges, electronic communication networks, alternative trading systems and dark pools, the SEC adopted Rule 613 under the Securities Exchange Act of 1934 mandating the creation of a market-wide consolidated order tracking system. These electronic market centers and FINRA must develop a plan to create, implement and maintain the consolidated audit trail to collect data tracking each order, cancellation, modification and trade execution for all exchange-listed equities and equity options across all U.S. markets. The new system would track every order placed by an individual account holder or an investment company or other pooled investment vehicle, as well as by any investment adviser with trading discretion over an individual or fund account. National securities exchanges and securities organizations must submit their consolidated audit trail plans to the SEC for approval and public comment by April 2013, and will begin reporting data to a central repository one year following SEC approval of the plan. The SEC release adopting new Rule 613 is available here.

Second Circuit Weighs in on Aiding and Abetting Standard of Proof

In *Securities and Exchange Commission v. Apuzzo*, the U.S. Court of Appeals for the Second Circuit clarified the elements the SEC must prove in order to succeed in a civil enforcement proceeding based on "aiding and abetting" a violation of securities laws. The defendant Joseph Apuzzo was the Chief Financial Officer of the Terex Corporation (Terex), a construction and mining equipment manufacturer. Terex allegedly engaged in certain sale and leaseback transactions with United Rentals, Inc. (URI), a large equipment rental company. The SEC alleged that Apuzzo aided and abetted the violations by URI of the federal securities laws by

ATTORNEY ADVERTISING

assisting URI in carrying out "sale-leaseback" transactions designed to allow URI to recognize revenue prematurely and to inflate the profit generated from URI's sales.

The issue before the Second Circuit was whether the district court had incorrectly held, in the context of an SEC civil enforcement case, that "substantial assistance" (an element of an aiding and abetting claim) could only be established by a showing that the aider and abettor was the "proximate cause" of the harm on which the primary violation was predicated. Prior to this decision, some district courts in the Second Circuit had been applying the proximate cause standard to both private suits and government enforcement cases. Conceding that "our case law has not always made this distinction with clarity," the Second Circuit held that the appropriate standard for determining whether an alleged aider and abettor has provided "substantial assistance" in an SEC civil enforcement action is the standard articulated by Judge Learned Hand in *United States v. Peoni*, in 1938. Under this standard, the SEC must prove that the defendant "in some sort associate[d] himself with the venture, that [the defendant] participate[d] in it as in something that he wishe[d] to bring about, [and] that he [sought] by his action to make it succeed." By affirming this standard, *Apuzzo* makes it easier for the SEC to prove aiding and abetting claims in the Second Circuit, since it will not be required to prove causation. In addition, the Dodd-Frank Act recently amended the section of the Securities Exchange Act of 1934 imposing liability on aiders and abettors so that it now includes "reckless" as well as "knowing" conduct. The full opinion is available here.

Southern District of New York Dismisses Leveraged ETF Class Action

On September 10, 2012, the Southern District of New York dismissed all of plaintiffs' claims in a consolidated securities lawsuit arising out the performance of ProShares' exchange-traded funds ("ETFs") during the 2008-2009 financial crisis. The ProShares ETFs in question pursued investment objectives designed to deliver either a multiple or an inverse multiple of the daily performance of a securities index. Starting in August 2009, numerous plaintiff groups brought class-action claims against 44 different ProShares ETFs, alleging that the registration statements in question failed to properly disclose the risk that the ETFs, when held for a period of time greater than one day, could lose substantial value quickly, especially in periods of high volatility of the underlying benchmark or index. The court dismissed the suits on the basis of its findings that ProShares had adequately disclosed the risk that plaintiffs claimed later materialized, namely that if investors held their ETFs for periods of time longer than one day, there was a risk that their value could diverge significantly from the expected daily result. Significantly, the court also agreed that certain recent decisions in SDNY and elsewhere which allowed similar claims to proceed against other ETF companies were not applicable because they involved key factual differences. Ropes & Gray partner Rob Skinner represented ProShares in this litigation. The full opinion is available here.

No-Action Letter Grants Advisers of College Savings 529 Plans Relief from Surprise Inspection Requirement

In a recent no-action letter requested by the Investment Company Institute (ICI), the SEC Staff stated that it would not recommend enforcement action against an investment adviser that treats a 529 plan trust as a "pooled investment vehicle" for purposes of Rule 206(4)-2 under the Investment Advisers Act (sometimes referred to as the "Custody Rule"). Under the Custody Rule, a "pooled investment vehicle" is not required to obtain a surprise examination by an independent public accountant provided various other requirements are met. As a result of this no-action letter, an adviser to registered investment companies (which are excepted from the Custody Rule) that is also acting as the program manager for a 529 plan will not be subject to the prospect of having a surprise examination conducted on the 529 plan portion of its business. A copy of the SEC's No-Action Letter is available here.

ATTORNEY ADVERTISING

SEC Registration Fees to Increase on October 1st

The SEC announced that effective October 1, 2012, the fees payable in connection with Form 24F-2 (Annual Notice of Securities Sold Pursuant to Rule 24f-2) will increase from $114.60 per million dollars of net aggregate sales during a fiscal year to $136.40 per million dollars of net aggregate sales. Funds with fiscal years that ended after June 30, 2012, which are otherwise not required to file their Form 24F-2 by September 28, 2012, respectively, may wish to accelerate their filing and submit their Form 24F-2 and the related payment before 5:30 p.m. ET on Friday, September 28, 2012, in order to pay a lower fee at the current rate. A copy of the Commission's order and calculation methodology is available here.

Regulatory Priorities Corner

The following brief updates exemplify trends and areas of current focus of relevant regulatory authorities:

> ***SEC Issues Financial Literacy Study.*** As required by the Dodd-Frank Act, the staff of the SEC's Office of Investor Education and Advocacy ("OIEA") released a study identifying the existing level of financial literacy among retail investors as well as methods and efforts to increase the financial literacy of investors. Some areas discussed that may develop into regulatory initiatives include (i) improving the timing, content, and format of disclosures; and (ii) improving the transparency of expenses and conflicts of interest. The study is available by clicking here.

> ***SEC Sanctions Adviser for Failing to Disclose Revenue Sharing Arrangement.*** On September 6, 2012, the SEC fined two Portland, Oregon-based investment advisory firms, a total of $1.1 million for failing to disclose a revenue-sharing agreement and other potential conflicts of interest to clients. Although the alleged conduct of the adviser was egregious, the fines serve as a reminder that accurate disclosures of the conflicts of interest inherent in revenue sharing arrangements continue to be a focus for SEC enforcement. The SEC's Order can be found here.

Other Developments

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

The SEC Proposes Rules to Remove Prohibitions on General Solicitation and General Advertising in Certain Regulation D Offerings
September 7, 2012
On August 29 the SEC, responding to a directive in the JOBS Act enacted on April 5, 2012, proposed new Rule 506(c) of Regulation D under the Securities Act. Proposed Rule 506(c) would allow private funds and other issuers to engage in "general solicitation" and "general advertising" in offerings made under Rule 506. This Alert describes proposed Rule 506(c), highlights items of interest in the SEC's proposing release, and identifies outstanding issues under the proposed rule and other federal statutes and rules applicable to offerings of private fund interests.

NFA Proposes Waiving Proficiency Exam Requirements in Connection with Certain Swaps Activities
August 28, 2012
Among its many provisions, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended the definitions of Commodity Pool Operator (CPO) and Commodity Trading Advisor (CTA) to include firms managing funds or accounts that engage in "swaps." The Commodity Futures Trading Commission (CFTC) recently defined "swaps" very broadly. As a result of these

ATTORNEY ADVERTISING

developments, firms engaged in a broad range of swaps transactions that were not previously required to register as CPOs or CTAs must now register or find a registration exemption on which to rely. For a firm that is required to register, the firm's "Associated Persons" ordinarily must satisfy a proficiency examination requirement. This Alert discusses recent developments relating to this requirement.

SEC Whistleblower Office Issues First Award
August 22, 2012
This Alert discusses the SEC announcement that an anonymous tipster was eligible to receive the first award paid under its Dodd-Frank Act-mandated whistleblower program.

FAQs Regarding Private Equity Firms Launching Registered Funds
August 20, 2012
Private equity firms have begun to launch registered funds (*i.e.*, mutual funds), and many of our private equity clients have been asking us about the feasibility of offering their investment strategies through registered fund products. We have set forth in this client alert the questions that we frequently receive from private equity firms that are considering launching registered funds.

CFTC Staff Responds to Frequently Asked Questions on CTA and CPO Registration and Compliance
August 16, 2012
On August 14, 2012, the CFTC Staff released guidance, in a question and answer format, which addresses frequently asked questions relating to (i) compliance obligations of CPOs and CTAs following rescission of the registration exemption under CFTC Rule 4.13(a)(4) previously relied on by many private funds, (ii) the inclusion of swaps in the trading threshold calculation under the registration exemption established by CFTC Rule 4.13(a)(3), and (iii) the amendments to the CFTC Rule 4.5 exclusion from registration for registered investment companies. This Alert discusses the highlights of the CFTC's new guidance.

Update: SEC and CFTC Adopt Final Swap Definitional Rules, Triggering Compliance Dates for Multiple Dodd-Frank Act Rules
August 13, 2012
The SEC and the CFTC adopted regulations defining the terms "swap" and "security-based swap." This marks a critical milestone in the Dodd-Frank Act regulatory timeline, as the compliance dates for many other rules under the Dodd-Frank Act are dependent on the effective date of these swap definitional rules, which is 60 days following the date of publication in the Federal Register, *i.e.*, October 12, 2012. A summary of certain of these rules which will have the greatest impact on buy-side users of derivatives, and their respective compliance dates, is included in this Alert.

CFTC Proposes to Require Mandatory Clearing of Certain Interest Rate Swaps and Credit Default Index Swaps
July 25, 2012
On July 24, 2012, the CFTC issued proposed rules that would require certain interest rate swaps and credit default index swaps to be cleared. This is the first proposed mandatory clearing determination by the CFTC pursuant to the Dodd-Frank Act. The CFTC also adopted final rules that create a phased-in implementation schedule for compliance with mandatory clearing determinations under the Dodd-Frank Act. This Alert discusses the types of derivatives that would be subject to the clearing requirement and the implementation schedule.

ATTORNEY ADVERTISING

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 member of the Ropes & Gray Investment Management group listed below.

United States

Mark I. Bane
New York, NY
+1 212 841 8808
mark.bane@ropesgray.com

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

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

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

Sarah Davidoff
New York, NY
+1 212 596 9017
sarah.davidoff@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 D. Donovan
Boston, MA
+1 617 951 7566
john.donovan@ropesgray.com

John C. Ertman
New York, NY
+1 212 841 0669
john.ertman@ropesgray.com

Laurel FitzPatrick
New York, NY
+1 212 497 3610
laurel.fitzpatrick@ropesgray.com

Leigh R. Fraser
Boston, MA
+1 617 951 7485
leigh.fraser@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

William D. Jewett
Boston, MA
+1 617 951 7070
william.jewett@ropesgray.com

Susan A. Johnston
Boston, MA
+1 617 951 7301
susan.johnston@ropesgray.com

Jeffrey R. Katz
Boston, MA
+1 617 951 7072
jeffrey.katz@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

R. Hardin Matthews
Boston, MA
+1 617 951 7259
hardin.matthews@ropesgray.com

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

Stephen C. Moeller-Sally
Boston, MA
+1 617 951 7012
ssally@ropesgray.com

Deborah A. Monson
Chicago, IL
+1 312 845 1225
deborah.monson@ropesgray.com

ATTORNEY ADVERTISING

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

Robert A. Skinner
Boston, MA
+1 617 951 7560
robert.skinner@ropesgray.com

Jeremy C. Smith
New York, NY
+1 212 596 9858
jeremy.smith@ropesgray.com

Amy B. Snyder
Boston, MA
+1 617 951 7073
amy.snyder@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

Joel A. Wattenbarger
Boston, MA
+1 617 951 7537
joel.wattenbarger@ropesgray.com

London

Anand Damodaran
London
+44 20 3122 1146
anand.damodaran@ropesgray.com

Andrew Henderson
London
+44 20 3122 1277
andrew.henderson@ropesgray.com

Matthew Judd
London
+44 20 3122 1252
matthew.judd@ropesgray.com

Asia

Daniel M. Anderson
Hong Kong
+852 3664 6463
daniel.anderson@ropesgray.com

ropesgray.com

This alert should not be construed as legal advice or a legal opinion on any specific facts or circumstances. This alert is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. The contents are intended for general informational purposes only, and you are urged to consult your attorney concerning any particular situation and any specific legal question you may have. © 2012 Ropes & Gray LLP

ATTORNEY ADVERTISING