Ropes & Gray's Investment Management Update: October-November 2012

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

D.C. District Court Vacates and Remands CFTC's Position Limits Rule

The U.S. District Court for the District of Columbia issued a ruling on September 28, 2012, vacating the Commodity Futures Trading Commission's ("CFTC") position limits rule, which established CFTC-administered speculative position limits for 28 physical delivery commodity futures and options contracts, as well as for swaps that are economically equivalent to such contracts ("Position Limits Rule").[1] The plaintiffs asserted that, in adopting the Position Limits Rule in October 2011, the CFTC misinterpreted its rulemaking authority under Section 6a of the Commodity Exchange Act ("CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Court noted that Section 6a of the CEA gives the CFTC authority to relieve the "undue and unnecessary burden on interstate commerce" caused by "excessive speculation" in a commodity by adopting such position limits as the CFTC "finds are necessary to diminish, eliminate, or prevent such burden." The specific question considered by the Court, however, was whether Section 6a clearly and unambiguously requires the CFTC to make a finding of necessity prior to imposing position limits.

The CFTC presented several arguments as to why a finding of necessity under Section 6a is not required to impose position limits, including that the amendments to Section 6a of the CEA by the Dodd-Frank Act "converted" the CFTC's *authorization* to impose position limits into a *mandate* to impose position limits. The Court noted that, in adopting the Position Limits Rule, several of the CFTC Commissioners indicated that they voted in favor of the Position Limits Rule based on their belief that Section 6a, as amended by the Dodd-Frank Act, required the CFTC to adopt position limits without any determination of their necessity. The Court determined that the Dodd-Frank amendments to Section 6a are ambiguous and lend themselves to more than one plausible interpretation. The Court noted that "[w]hen a statute is ambiguous, 'it is incumbent upon the agency not to rest simply on its parsing of the statutory language. It must bring its experience and expertise to bear in light of competing interests at stake' to resolve the ambiguities in the statute." Accordingly, although the Court expressed no opinion on whether the interpretation advanced by the CFTC is permissible, the Court determined that the Position Limits Rule must be remanded to the CFTC "so that it can fill in the gaps and resolve the ambiguities." On November 15, 2012, the CFTC announced that it would appeal the Court's decision vacating the Position Limits Rule. The full opinion is available here, the CFTC's press release announcing the appeal can be found here, and a previous Ropes & Gray Alert summarizing the Position Limits Rule can be found here.

SEC Staff Provides Guidance on Combining Administration and Advisory Agreements

The SEC staff (the "Staff") recently provided informal guidance through a posting on its Investment Management Staff Issues of Interest webpage on whether a fund could combine the terms of the fund's separate administration and advisory agreements into a single "management agreement" without obtaining shareholder approval of the single agreement under Section 15(a) of the Investment Company Act. The guidance would permit combining both agreements into a single management agreement so long as the nature and level of the advisory and administration services provided to the fund would not decrease and the

[1] Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626 (Nov. 18, 2011).

management fee rate would be equal to the sum of the fee rates assessed under the existing advisory and administration agreements. The guidance also appears to require that (i) the management agreement be approved by the board of directors of the fund, including a majority of independent directors; (ii) the fund provide written notice of the new arrangement to existing shareholders no later than the mailing of the fund's next annual or semi-annual report and include such notice in any prospectus delivered to prospective shareholders, until such time as the prospectus is amended to reflect the existence of the new agreement; (iii) the fund's prospectus fee table be updated to reflect the new fee rate as part of the fund's "management fees," and not as an "other expense" of the fund; and (iv) the fee table include a footnote breaking out the fee rates attributable to the advisory and administration services.

The Staff stated that, in its view, the scenario described above is consistent with the no-action relief granted by the Staff in *Franklin Templeton Group of Funds*,[2] which involved the reverse situation in which a fund sought to unbundle a combined advisory and administration agreement without obtaining shareholder approval. The Staff noted that any future material change to the management agreement, including any amendment that results in increasing the overall combined management fee rate, would require approval by shareholders. The Staff's complete webpage posting is available here.

Court Denies AXA's Motion to Dismiss Excessive Fee Suit

On September 21, 2012, the U.S. District Court of New Jersey denied a motion by defendants AXA Equitable Life Insurance Company and AXA Equitable Funds Management Group, LLC (collectively, "AXA") seeking to dismiss excessive fee claims under Section 36(b) of the Investment Company Act brought by a participant in a group variable annuity program. The plaintiff alleged that AXA charged excessive management fees to eight mutual funds (the "Funds") to which AXA serves as investment adviser that were "investment options" under a variable annuity program offered by the plaintiff's employer. In particular, the plaintiff contended that the portion of the advisory fees retained by AXA were excessive because AXA had delegated most of its investment management duties to the various sub-advisers of the Funds but retained most of the advisory fees. Section 36(b) gives a fund's "security holders" a right to bring a civil action on the basis that the adviser's fees are "excessive." In its motion to dismiss, AXA argued that the plaintiff did not have standing to pursue her claim under Section 36(b) because she was not a "security holder" of the Funds but rather an owner of an insurance contract with AXA, and not the funds themselves. AXA claimed that the separate account in which the plaintiff's insurance contract premiums were invested and which was the record owner of the Funds was the security holder of the Funds.

The Court noted that, while the term "security holder" is not clearly defined in the Investment Company Act, the plaintiff and similarly situated investors have "all of the economic stake in these transactions" because, among other reasons, the investors (i) are responsible for and paid all of the challenged fees, (ii) bear the full risk of poor investment performance, (iii) have the right to instruct AXA how to vote the Funds' shares, and (iv) pay the taxes on the investment upon withdrawal. The Court also noted that Section 36(b) should be interpreted broadly to protect the investing public and that it would make little sense to limit the scope of the term "security holders" to entities that do not have any economic interest or stake in the transaction. Accordingly, the Court denied AXA's motion to dismiss the excessive fee claims under Section 36(b). The Court's full opinion can be found here.

[2] Franklin Templeton Group of Funds, Staff No-Action Letter (July 23, 1997).

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Supreme Court to Review Statute of Limitations in Civil Penalty Case

The U.S. Supreme Court has granted certiorari to review a decision by the U.S. Court of Appeals for the Second Circuit regarding when an action "accrues" for purposes of the federal statute of limitations that applies to civil enforcement actions brought by federal agencies such as the SEC. In *SEC v. Gabelli*, the SEC alleged that, between 1999 and 2002, the portfolio manager of a mutual fund and the chief operating officer of the mutual fund's investment adviser secretly allowed an investor to engage in market timing transactions while misleading the mutual fund's board of directors and shareholders. In April 2008, the SEC brought an enforcement action seeking, among other things, civil penalties as a result of the defendants' alleged violations of the antifraud provisions of the federal securities laws, and the defendants moved to dismiss the case on the grounds that the five-year statute of limitations had expired. On appeal, the Second Circuit reversed the lower court's decision and read into the relevant statute of limitations a so-called fraud-based "discovery rule." Under the discovery rule, a claim of fraud does not accrue for purposes of the statute of limitations until the federal agency discovered or, in the exercise of due diligence, should have discovered the facts constituting the fraud. Certain other federal appeals courts that have ruled on this question have reached a different result, thereby prompting the grant of certiorari by the Supreme Court. A decision in this case is expected by June 2013. A copy of the Second Circuit's opinion can be found here.

CFTC Releases Enforcement Division's Annual Results

On October 5, 2012, the CFTC released its Enforcement Division's annual results. The results show a steady increase in CFTC enforcement actions in recent years, with the CFTC having initiated 102 enforcement cases in fiscal year 2012 (the highest number of enforcement actions by the CFTC in a single year), following 99 enforcement actions during the prior year. In addition, the CFTC also opened more than 350 new investigations in fiscal year 2012 and obtained orders imposing more than $585 million in sanctions, which included $416 million in civil monetary payments and $169 million in restitution and disgorgement. One of the most significant enforcement actions during this period resulted in a $200 million settlement, the largest fine every imposed by the CFTC, with Barclays PLC and two of its affiliates for attempted manipulation and false reporting concerning LIBOR and other global benchmark interest rates.

The CFTC's press release highlighted three main categories of enforcement actions in fiscal year 2012: (i) cases involving manipulation, false reporting, wash trades and position limits; (ii) cases involving customer funds safeguards and supervision obligations; and (iii) cases involving ponzi and other fraud schemes, and false statements to the CFTC. In addition, the release also highlighted the CFTC's cooperation with other regulators, including other federal and state law enforcement authorities and international regulators. The CFTC press release can be found here.

SEC Announces Presence Exam Initiative

In a letter to newly registered investment advisers dated October 9, 2012, the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced a new initiative by the National Exam Program to conduct focused, risk-based examinations of certain newly registered investment advisers to private funds, to be called "Presence Exams." This initiative is to take place over the next two years and will focus on the following areas that the SEC has identified as higher-risk areas of business and operations of advisers: (i) the use of marketing materials to solicit new investors or retain existing investors; (ii) advisers' portfolio decision-making practices, including the allocation of investment opportunities and whether advisers' practices are consistent with disclosure provided to investors; (iii) conflicts of interest, safety of client assets and custody issues; and (iv) advisers' policies and procedures relating to valuation. The presence exam initiative may apply to newly registered advisers to private funds even if they are affiliated with larger institutions that control

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advisers that have been registered for a longer period of time. Numerous Ropes & Gray clients have already been subject to exams under this initiative, which have tended to move much more quickly than traditional exams, and a modest level of advanced planning can greatly ease the process. A copy of the SEC letter can be found here.

FinCEN Proposal Seeks to Strengthen Customer Due Diligence Requirements

The U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") recently hosted roundtable discussions to continue gathering feedback on a recent advance notice of proposed rulemaking ("ANPRM"). FinCEN issued the ANPRM in March 2012 to solicit public comment on a wide range of questions pertaining to the development of a customer due diligence ("CDD") regulation that would codify, clarify, consolidate, and strengthen existing CDD regulatory requirements and supervisory expectations, and establish a categorical requirement for financial institutions to identify beneficial ownership of their accountholders. The ANPRM states that FinCEN is considering developing a CDD rule to specifically cover banks, brokers or dealers in securities, mutual funds, futures commission merchants, and introducing brokers in commodities, but that any proposed CDD rule may be appropriate for all financial institutions subject to FinCEN's regulation. Under current regulation, certain financial institutions are generally required to establish anti-money laundering programs and verify customer information on certain large foreign-controlled accounts or those that they deem to be high-risk. A CDD rule proposal could expand this obligation to require financial institutions, including mutual funds, to collect information on all beneficial owners of such institutions' shares. Such a proposal could pose a particular challenge to open-end mutual funds, whose shares are often held by omnibus accounts, which makes identifying beneficial owners more difficult. It is also not clear whether or how any proposed rule would affect investment advisers, if at all. FinCEN has not yet issued a proposed rule. The ANPRM can be found here.

Jury Clears Reserve Primary Managers of Fraud Charges in SEC Case

On November 12, 2012, a federal jury cleared Bruce Bent Sr. and his son, Bruce Bent II, two former money market fund managers at Reserve Management Company, Inc. ("RMCI"), of civil fraud charges stemming from the September 2008 collapse of The Reserve Primary Fund (the "Reserve Fund"). In May 2009, the SEC filed a civil fraud lawsuit against the Bents alleging that the managers "engaged in a systematic campaign to deceive the investing public into believing that the [Reserve] Fund…was safe and secure despite its substantial Lehman holdings." The SEC's complaint alleged that the Bents disseminated false information to the Reserve Fund's board of trustees, investors, and rating agencies. After a four-week civil trial in the U.S. District Court for the Southern District of New York, the jury found the Bents not liable for fraud, though Mr. Bent II was found liable for one claim of negligence relating to certain communications he made to investors. The jury also found the Reserve Fund's investment adviser, RMCI, and the Reserve Fund's distributor, Resrv Partners, Inc., liable for fraud. The SEC's 2009 complaint can be found here, and the verdict can be found here.

Regulatory Priorities Corner

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

> ***SEC Issues Investor Bulletin on Hedge Funds.*** Following several recent enforcement actions involving fraud and misfeasance by hedge fund managers, the SEC put out an investor bulletin in October to educate individual investors about hedge funds. The bulletin details some of the recent hedge fund malfeasance cases as examples of why investors must rigorously evaluate a hedge fund before investing. The bulletin can be found here.

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Reports Highlight Changes to Registered Advisers Landscape as a Result of Dodd-Frank. According to an SEC report released on October 19, 2012, 1,504 investment advisers to hedge funds and other private funds (of approximately 4,061 investment advisers that manage one or more private funds) have registered with the SEC since the effective date of the Dodd-Frank Act. A total of 11,002 investment advisers are now SEC-registered, with 37% reporting that they advise at least one private fund. Additionally, according to a report released by the Investment Adviser Association ("IAA") and National Regulatory Services ("NRS"), the Dodd-Frank Act requirement that mid-sized investment advisers—those managing less than $100 million in assets—move from federal to state regulation and registration has resulted in approximately 2,400 mid-sized advisers transitioning to state regulation and registration. The SEC report can be found here. The IAA/NRS report can be found here.

FINRA to Arbitrate Disputes Between Investment Advisers and Investors. In recently released guidance, FINRA announced that it will open up its arbitration forum to resolve disputes between investors and investment advisers who are not FINRA-regulated firms on a voluntary, case-by-case basis if (i) both parties submit a post-dispute agreement to arbitrate; (ii) the investment adviser or other parties agree to pay all arbitration surcharge fees; and (iii) the investor files a special written submission agreement to submit the dispute to FINRA. The FINRA guidance statement can be found here.

SEC to Extend Aberrational Performance Initiative to Registered Investment Companies. The director of the SEC's Chicago Regional Office recently noted that the SEC will be applying its aberrational performance initiative ("API") to target entities other than hedge funds, including entities registered under the Investment Company Act. The API program uses quantitative analytics to identify outlier performance and advertising. The SEC considers outlier performance to be one indicator that a fund or adviser may be violating securities laws and may target such funds and advisers for further investigation. Until now, API has only been applied to hedge funds, but these comments suggest that the SEC may extend the program to target registered investment companies.

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:

Treasury Department Issues Final Determination Exempting Foreign Exchange Swaps and Certain Foreign Exchange Forwards from the Definition of "Swap"
November 21, 2012
On November 16, 2012, the Treasury Department issued a final determination that exempts foreign exchange swaps and certain foreign exchange forwards from the definition of swaps under the CEA.

Financial Stability Oversight Council Issues Proposed Recommendations Regarding Money Market Reform
November 20, 2012
On November 13, 2012, the members of the Financial Stability Oversight Council voted unanimously to advance for public comment Proposed Recommendations Regarding Money Market Reform. In the Proposed Recommendations, the FSOC sets forth its views regarding the need to address the "inherent structural vulnerabilities" of money market funds and puts forward three far-reaching proposals to address these concerns: (i) elimination of the stable $1.00 share price, (ii) a stable NAV fund with a NAV

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buffer and "Minimum Balance at Risk" limitations, and (iii) a stable NAV fund with a NAV buffer combined with other measures to increase diversification, liquidity and transparency.

New San Francisco Gross Receipts Tax May Hit Investment Managers/Fund Sponsors
November 20, 2012
On November 6, 2012, San Francisco voters approved "Proposition E," a measure that introduces a new gross receipts tax on all taxable business activities attributable to the city of San Francisco. The measure is intended to replace, over time, the city's 1.5% payroll expense tax. The gross receipts tax will be phased in, and the payroll expense tax will be phased out, over a five year period, beginning in tax year 2014. The phase-in factor will be 10% in 2014 and will reach 100% in 2018. The new tax will be imposed at graduated rates, which will vary based on the taxpayer's industry. For businesses in the financial services industry, the tax, once fully phased in, is expected to be imposed at rates between 0.40% (for gross receipts up to $1 million) and 0.56% (for gross receipts in excess of $25 million). Taxpayers deriving gross receipts from business activities both from within the city of San Francisco and outside the city are required to allocate or apportion their taxable gross receipts in accordance with the new rules. The new tax will likely be welcomed by many start-ups and other businesses that have a material payroll expense but that generate little in revenues. However, investment managers and certain private equity and venture sponsors that have a relatively higher ratio of "revenues" to payroll expense are generally more likely to be hurt by the new tax.

SEC Releases Whistleblower Program's 2012 Annual Report
November 19, 2012
On November 15, 2012, the SEC released its *Annual Report on the Dodd-Frank Whistleblower Program* (the "Report"). The Report – which was prepared by the SEC's Office of the Whistleblower ("OWB") to satisfy its annual reporting obligations under the Dodd-Frank Act and the Securities Exchange Act of 1934 – summarizes OWB's activities during fiscal year 2012 and demonstrates an increase in enforcement activity.

A Collective Sigh of Relief: IRS Announces Revisions to Timelines for Due Diligence and Other Requirements under FATCA
October 25, 2012
In Announcement 2012-42, the IRS announced its intention to modify proposed regulations issued in February 2012 by the IRS and Treasury Department that implement a set of statutory rules commonly referred to as FATCA (the Foreign Account Tax Compliance Act).

New European Short Selling Regulation to Take Effect November 1
October 23, 2012
On November 1, 2012, EU Regulation 236/2012 on short selling and certain aspects of credit default swaps (the "SSR") will come into force. The SSR will harmonize rules on short selling across the European Economic Area and will affect all investment managers, including U.S. managers, engaged in short sales of shares primarily traded in Europe, or short sales of sovereign debt of European countries (including entering into credit default swaps in respect of such debt).

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CFTC Provides Temporary Relief Regarding Registration Deadlines for Certain CPOs and CTAs and the Treatment of Foreign Exchange Swaps and Deliverable Forwards
October 17, 2012
This Alert discusses temporary no-action relief granted by the Division of Swap Dealer and Intermediary Oversight of the CFTC regarding the December 31, 2012 registration deadline for commodity pool operators and commodity trading advisors who are required to register with the CFTC solely as a result of their swaps activities.

Update on Swaps Clearing Timetable
October 10, 2012
This Alert discusses recent statements from the CFTC staff regarding the phasing-in of the mandatory clearing requirements under the Dodd-Frank Act.

NFA Announces Waiver of Proficiency Exam Requirement in Connection with Certain Swaps Activities
October 5, 2012
This Alert discusses the Notice to members issued by the National Futures Association which (i) provide for a swaps exemption from the proficiency examination requirement, and (ii) establish a process for designation as a "swaps firm" or "swaps associated person."

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