Investment Management Regulatory Update

SEC Rules and Regulations

SEC Proposes New Rules Governing Mutual Fund Distribution Fees

On July 21, 2010, the U.S. Securities and Exchange Commission (the "**SEC**") voted unanimously to propose a plan that would rescind Rule 12b-1 under the Investment Company Act of 1940 (the "**Investment Company Act**") and replace it with a new framework governing asset-based distribution fees paid by mutual funds and required disclosures in fund prospectuses, in annual and semiannual reports to shareholders and in investor confirmations. The SEC had previously discussed proposing changes to the rules governing mutual fund distribution fees as reported in the ***May 20, 2008, January 16, 2008*** and ***November 2007 Investment Management Regulatory Updates***.

Rule 12b-1 allows a mutual fund to use fund assets to cover costs related to the marketing and distribution of the fund's shares. The adoption of the rule in 1980 contributed to a shift away from a traditional model of mutual fund investors paying for brokers' services at the time of share purchase (*i.e.*, paying a "front-end sales load") to the 12b-1 model of mutual funds paying sales charges and other fees out of fund assets on an ongoing basis. The proposed changes in new Rule 12b-2 (replacing Rule 12b-1) would, among other things, ensure that investors who pay ongoing charges and fees do not pay more than those who pay front-end sales loads.

In a speech given at an SEC meeting on the day the proposal was released, Mary L. Shapiro, Chairman of the SEC, explained that the new proposal was born of growing concerns that the current mutual fund

distribution system "has become confusing and potentially anti-competitive," with 12b-1 fees being used as substitutes for front-end sales loads and often representing "hidden sales charges." The SEC identified the core objectives of the proposal as (1) imposing limits on fund sales charges, (2) increasing and improving disclosure and transparency of fees, (3) promoting retail price competition and (4) revising the oversight obligations of fund directors.

Under the proposal, mutual funds would continue to be able to compensate intermediaries for distribution, marketing, personal services and maintenance of shareholder accounts, but new limitations as to the cumulative amount of fees and charges would apply. The proposal separates the asset-based fees into "marketing and service fees" and "ongoing sales charges."[1]

Under new Rule 12b-2, "marketing and service fees" could be paid out of fund assets for any type of shareholder servicing expenses or expenses related to "distribution activities" up to the amount allowed for funds to be described as "no-load" under NASD Conduct Rule 2830, which is currently 0.25% per year. Servicing expenses include personal service or the maintenance of shareholder accounts.

The proposal defines a "distribution activity" as "any activity that is primarily intended to result in the sale of shares issued by the fund, including, but not necessarily limited to, advertising, compensation of underwriters, dealers, and sales personnel, the printing and mailing of prospectuses to other than current shareholders, and the printing and mailing of sales literature." While the fund's board of directors would not be required to adopt a formal plan, it would be expected to "oversee the amount and uses of these fees in the same manner that it oversees the use of fund assets to pay any other fund operating expenses, particularly those that create a potential conflict of interest for the fund's investment adviser or other affiliated persons." The proposing release notes that administrative servicing expenses such as sub-transfer agent fees can be paid out of the fund's general assets and need not be paid under Rule 12b-2. Nonetheless, the SEC staff notes that "simply characterizing an activity as 'administrative' would not permit a fund to pay for it outside of proposed Rule 12b-2 if all or a portion of the fee is distribution-related." Additionally, shareholder approval would be required before a fund could institute, or increase the rate of, a marketing and service fee. The proposed Rule 12b-2 would require that the marketing and service fee be clearly identified and disclosed as an operating expense in the fund prospectus fee table.

The proposal also would amend Rule 6c-10 under the Investment Company Act to allow funds to make payments out of fund assets in excess of the 0.25% marketing and service fees, with such payments designated as "ongoing sales charges." These charges would be treated like a sales load and, while the proposed amendment would not impose any particular usage oversight or governance requirements upon the fund's board, the charges would be limited, cumulatively, to the highest front-end sales load charged for that fund (or in the absence of a share class with a front-end sales load, an NASD rule-based 6.25% aggregate cap). Whereas historically, the 6.25% cap was at the fund level, the proposal changes this to a shareholder account-level cap. The SEC noted that a fund that has ongoing sales charges could satisfy its obligations to observe this limit by automatically converting a shareholder to a class of shares with no ongoing sales charge once the cap in respect of such investor had been reached. This would impose a requirement on the fund and its intermediaries to track each of an investor's purchases to ensure that it converted at the appropriate time. The SEC indicated that such conversion would be required to occur no later than the end of the month in which the fund would have paid the maximum amount of sales charges cumulatively permitted with respect to an investor's shares.

[1] The proposing release states that payments of ongoing sales charges to intermediaries would constitute transaction-based compensation and therefore, without an available exception or exemption, would require intermediaries that receive such fees to register as broker-dealers under Section 15 of the Securities Exchange Act of 1934. Marketing and service charges may similarly trigger broker-dealer registration.

The amended Rule 6c-10 would permit, but not require, funds to take into account quantity discounts or scheduled variations in front-end sales loads for which an investor may qualify when determining the reference load (*i.e.*, the highest front-end load charged by the fund) that would serve as a cap for an ongoing sales charge. In the proposal, the SEC acknowledged its concern that requiring funds and their intermediaries to calculate a different reference load for each purchase of shares would likely increase cost and complexity, potentially making funds and their underwriters less willing to offer quantity discounts or scheduled variations on front-end sales loads.

Ongoing sales charges could not be instituted or increased after any public offering of the fund's voting shares or the sale of such shares to persons who are not organizers of the fund. A new fund (*i.e.*, one that has not made a public offering) or an existing fund that offers a new class of shares would not need to obtain shareholder approval before implementing a marketing and service fee or an ongoing sales charge because shareholders that are not affiliated with the fund's sponsor would not be affected. However, after such an offering, a new or increased ongoing sales charge would not be permitted with respect to such new fund or new class of shares.

Under the amended Rule 6c-10, a fund's board would still need to fulfill its fiduciary duties by evaluating whether an ongoing sales charge is in the best interests of the fund and its shareholders, but the board would not be required to adopt a formal plan or make any special findings with respect to the ongoing sales charges. The proposal also calls for directors to exercise their reasonable business judgment to assess whether an underwriting contract is fair and reasonable and beneficial to the fund.

The proposal also would amend Rule 6c-10 to allow funds to offer share classes to be sold at net asset value (*i.e.*, without a service charge) and broker-dealers could impose their own sales charges or commissions. This would allow brokers to compete on the basis of sales charges, just as brokers currently charge competitive commissions for transactions in exchange-traded funds (ETFs) and other equity securities.

The proposal contemplates provisions in both Rule 12b-2 and Rule 6c-10 that would address what asset-based distribution fees would be allowable when one fund invests in the shares of another, or so-called fund of funds arrangements. Currently, section 12(d)(1)(A) of the Investment Company Act, the SEC's rules, and the NASD sales charge rule restrict the layering of sales loads, asset-based charges and service fees. For example, Rule 12d1-3 allows acquiring investment companies relying on section 12(d)(1)(F) to charge sales loads greater than 1.5%, if the sales charges and service fees charged with respect to the acquiring fund's securities do not exceed the limits of the NASD sales charge rule applicable to fund of funds. The SEC proposes that ongoing sales charges cannot be charged at both the acquiring and acquired fund, though marketing and service fees may be. The proposal differs from existing NASD regulations, which permit asset-based sales charges at both levels but require the rates to be aggregated in determining compliance with the relevant limits.

The proposed rule amendments would also apply to funds that serve as investment vehicles for insurance company separate accounts that offer variable annuities or life insurance contracts. Under the proposed changes, these funds would be treated like other mutual funds. The SEC seeks comment on whether it is appropriate to permit underlying funds to impose marketing and service fees or ongoing sales charges, given that most distribution activities occur at the separate account level.

Rule changes within the proposal are designed to increase and clarify disclosure to investors with regard to sales charges. The term "12b-1 fees" will be eliminated and replaced in all fund documentation with references to "ongoing sales charges" and "marketing and services fees" as applicable. The proposal also would amend Rule 10b-10 under the Securities Exchange Act to require, among other things, disclosure of front-end and deferred charges as well as ongoing sales charges and marketing and service fees by broker-dealers in confirmations relating to mutual fund security transactions. Certain other changes to Rule 10b-10 concerning callable debt securities are also proposed.

The SEC expressed concern over the increasingly prevalent practice of "revenue sharing," which consists of payments being made by fund advisers to broker-dealers and others distributing fund shares. It is particularly concerned that such payments may provide the recipients incentives to market particular funds or classes, which could result in conflicts of interest. For this reason, the SEC is considering and requesting comment on the level of disclosure that should be required with regard to such revenue sharing arrangements.

The SEC is considering whether to require point of sale disclosure for mutual fund purchases based on new authority in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC also proposed amendments to Form N-1A, including to require the separation in the fee table of asset-based distribution fees into ongoing sales charges and marketing and service fees, and amendments to Investment Company Act Rules 11a-3, 17a-8, 17d-3, 18f-3 and Forms N-3, N-4, N-6 and N-SAR, Regulation S-X and Schedule 14A.

The SEC would expect the effective date for the proposed rules to be 60 days after adoption, upon which funds would be permitted, but not required, to take advantage of the new rules. Further, the plan would include a transition period of at least 18 months after the effective date during which funds would be required to come into compliance with the proposed regulatory changes. Shares issued before the compliance date would be provided a five-year grandfathering period in which 12b-1 fees could be paid under the prior rules, after which those shares would have to convert into a share class without an ongoing sales charge.

The SEC intends that the proposed distribution fee reforms limit fund expenses and make them more transparent and easily comprehensible to investors while minimizing the financial impact on funds and service providers. The rule changes would likely engender renegotiation of revenue-sharing agreements between funds and their intermediaries. To intermediaries and service providers who fear that commissions and fees will be cut off by the new rules, the SEC points out that approximately 80% of fund assets subject to 12b-1 fees are charged 12b-1 fees of 25 basis points or less, rendering them outside the scope of the rule proposals related to ongoing sales charges. Those most affected by proposed rules would be the broker-dealers currently receiving payments from the sale of share classes that pay 12b-1 fees in excess of 25 basis points. The SEC explains that there are 207 such fund complexes that are potentially affected by the proposed rules by virtue of having at least one fund that charges more than 25 basis points. The SEC estimates that, depending on the existing share class structure and conversion systems utilized by the particular complex's funds, the likely operational cost for an affected complex to come into compliance with the proposed rules would range from approximately $48,000 to $1.27 million plus $100,000 in annual costs.

The SEC is soliciting comments with respect to the proposed changes. The 90-day comment period ends November 5, 2010.

- See a copy of the SEC's proposal
- See a copy of the SEC's press release
- See a copy of Mary Schapiro's speech regarding the proposal

SEC Adopts Amendments to Part 2 of Form ADV

On July 21, 2010, the Securities and Exchange Commission (the "**SEC**") adopted amendments (the "**Amendments**") to Part 2 of Form ADV ("**Part 2**") and related amendments to certain rules under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). Part 2 is the primary disclosure document for investment advisers registered with the SEC. The Amendments are largely intended to provide clients and prospective clients (generally referred to herein as "**clients**") with clear and concise disclosure regarding information that is important to a client's evaluation of the investment adviser and its advisory personnel and services. The SEC had issued a proposing release regarding the amendments to

Part 2 of Form ADV back in March 2008, as previously reported in the ***March 14, 2008 Investment Management Regulatory Update***.

Narrative, Uniform Disclosure

The amended Part 2 is a narrative-style brochure written in plain English, which differs from the current "check-the-box" format. The instructions to the amended Part 2 provide specific guidance on how an investment adviser can effectively communicate information to clients. In addition, investment advisers are required to address the items specified in Part 2 in a unified format by adhering to the order and form presented. This uniformity is largely designed to allow clients to easily compare the Part 2 of various investment advisers.

Form and Content

The amended Part 2 comprises two subparts. Part 2A, the "**Firm Brochure**," describes the investment adviser's services, fees, business practices and conflicts of interest. Investment advisers with multiple service offerings are permitted to create separate Firm Brochures for each different type of offering. Investment advisers that sponsor wrap fee programs are required to prepare a separate, specialized wrap fee brochure instead of the Firm Brochure, which is substantially similar to the brochure currently required in Schedule H of Part 2. Part 2B, the "**Brochure Supplement**," provides information about advisory personnel on whom clients rely for investment advice.

Part 2A – Firm Brochure. The Firm Brochure comprises 18 separate items and expands the disclosure currently required in Part 2. In the adopting release for the Amendments (the "**Release**"), the SEC stated that investment advisers already have a fiduciary obligation to provide much of the information required in the amended Part 2. Thus, many investment advisers will likely have existing disclosure that can be used as a basis for drafting the disclosure required in the Firm Brochure. Below is a discussion of certain notable categories of required information.

- *Advisory Business*. The Firm Brochure must include information regarding the business of the investment advisory firm, such as the principal owners of the firm, the type of services the firm offers, the fees, costs and expenses charged to clients and the amount of client assets under management. An investment adviser is permitted to omit its fee schedule(s) from a Firm Brochure that is provided only to clients that are "qualified purchasers," as defined under section 2(a)(51)(A) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**").
- *Business Practices and Conflicts of Interest.* An investment adviser is also required to include extensive disclosure regarding the business practices in which the adviser engages or is likely to engage (such as brokerage and trading practices, affiliated dealings and personal trading by firm employees). An investment adviser is also required to discuss the conflicts of interests arising out of such practices, as well as the manner in which the adviser addresses such conflicts. The disclosure must be specific enough to enable a client to understand, and provide informed consent to, the particular conflict or business practice.
- *Financial and Disciplinary Information.* An investment adviser must disclose in its Firm Brochure certain information regarding financial, legal and disciplinary events, which is substantially similar to the information currently required under Rule 206(4)-4 under the Advisers Act (which was rescinded by the SEC as part of the Amendments to avoid redundancy) and must include an audited balance sheet if it requires or solicits clients to pay more than $1,200 of fees six months or more in advance.

An investment adviser, according to the Release, may be required to provide disclosure that goes beyond the technical requirements of the Firm Brochure to meet its fiduciary obligation to clients, such as disclosure regarding additional business practices or conflicts of interest. Investment advisers may

choose to include such disclosure in a separate document or in the Firm Brochure so long as it does not obscure the required disclosure.

Part 2B – Brochure Supplement. The Brochure Supplement includes certain information about the advisory personnel on whom the particular client receiving the Firm Brochure relies for investment advice. The following categories of information must be included in a Brochure Supplement for each such individual: (i) formal education, (ii) business background, (iii) legal and disciplinary events (which mirror the types of legal and disciplinary events required in the Firm Brochure, as described above), (iv) certain other business activities or occupations of the individual, (v) economic benefits received by the individual from non-clients, such as the receipt of transaction-based compensation or awards for the sale of investment products to clients and (vi) supervisory information for the individual. The Brochure Supplement(s) can be incorporated into the Firm Brochure or provided separately, and may be prepared separately for each such individual or combined to cover a group of individuals.

Delivery to Clients

Firm Brochure. Under amended Rule 204-3, an investment adviser must make an initial delivery of the Firm Brochure to clients before or at the time it enters into an advisory contract with them. In addition to the initial delivery, each year an adviser must deliver to existing clients, no later than 120 days after the end of the adviser's fiscal year, either (i) a current Firm Brochure that includes a summary of material updates to the prior version or (ii) a summary of material updates made to the prior version of the Firm Brochure, together with an offer to provide a copy of the current Firm Brochure. Other-than-annual updates to the Firm Brochure (or a separate document describing the updates) are required to be delivered to clients only when the investment adviser adds a disciplinary event, or makes material changes to information already disclosed regarding such an event.

Brochure Supplements. An investment adviser must deliver to each client a Brochure Supplement covering for each individual who (i) formulates advice for, or interacts directly with, such client or (ii) makes discretionary investment decisions for such client's assets. If a team of more than five individuals renders the investment advice or manages client assets, the adviser need only provide supplements for those individuals who have the most significant responsibility for the day-to-day advice provided to the client. A Brochure Supplement covering an individual must be delivered to a client at or before the time the specific individual begins to provide advisory services to that client. An investment adviser is required to amend a Brochure Supplement promptly if information in it becomes materially inaccurate but is not required to deliver an updated Brochure Supplement, unless there is disclosure of a new disciplinary event, or a material change to disciplinary information previously disclosed.

An investment adviser is not required to deliver its Firm Brochure or Brochure Supplement(s) to clients that are investment companies registered under the Investment Company Act or business development companies subject to Section 15(c) of the Investment Company Act. An investment adviser is also not required to deliver to clients that receive only impersonal investment advice Brochure Supplements, or, if the adviser charges less than $500 per year for such advice, its Firm Brochure. In addition, Brochure Supplements need not be delivered to certain "qualified clients" under Rule 205-3(d)(1)(iii) who are also officers, directors, employees and other persons related to the adviser.

Electronic Delivery. The Amendments permit an investment adviser to deliver electronically the Firm Brochure and Brochure Supplement(s) to clients in accordance with the requirements of the SEC's interpretive guidance on delivering documents electronically. *See* Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Investment Advisers Act Release No. 1562 (May 9, 1996) [61 FR 24643 (May 15, 1996)], *available at* www.sec.gov/rules/concept/33-7288.txt. The Amendments do permit, however, an investment adviser that sends the Brochure Supplement to clients electronically to state if an individual covered by the supplement is subject to a disciplinary event and provide a hyperlink to either the BrokerCheck or the Investment Adviser Public Disclosure system (which are online databases that provide information

regarding brokerage and advisory firms and certain investment professionals associated with them) in order to provide the required disclosure regarding the event.

Electronic Filing and Public Availability

Investment advisers are required to file the Firm Brochure electronically via the IARD system. The Firm Brochure and any updates will be publicly accessible through the IARD system. The SEC received comment letters to the proposed amendments to Part 2 expressing concern that public disclosure of the Firm Brochure could jeopardize reliance on the private placement exemptions under U.S. securities laws by onshore and offshore private investment funds managed by a registered investment adviser. In response to this concern, the Release indicated that information required in Part 2 would not necessarily jeopardize such exemptions. Nevertheless, the Release cautioned that information included in the Firm Brochure beyond what is required, such as subscription instructions, performance information and fund financial statements, could in fact jeopardize reliance on the private placement exemptions, because such information could constitute a public offering or conditioning the market for securities issued by the funds, which is prohibited under such exemptions.

Brochure Supplements and updates are not required to be filed with the SEC, and thus will not be publicly available.

Effective Date and Transition Period

The Amendments will become effective on October 12, 2010. The Amendments provide a transition period for investment advisers registered with the SEC whose fiscal year ends on or after December 31, 2010. Such advisers must electronically file their next annual updating amendment through the IARD system using the new Firm Brochure. Thus, for example, advisers with a fiscal year end of December 31 must file the new Firm Brochure no later than March 31, 2011. Following the initial filing, an investment adviser must begin delivering the Firm Brochure and Brochure Supplement(s) to new and prospective clients and must deliver such documents to existing clients within 60 days.

Investment advisers that file for registration with the SEC after January 1, 2011 are required to file a Firm Brochure as part of their application for registration. Upon registering, the adviser must begin to deliver to clients a Brochure and Brochure Supplement.

- See a copy of the Release
- See a copy of the SEC's Investor Bulletin regarding the Amendments
- See a copy of the SEC's press release
- See a copy of Mary Shapiro's speech regarding the Amendments

Industry Update

SEC Provides Guidance on Derivatives-Related Disclosure by Investment Companies

In a July 30, 2010 letter to the Investment Company Institute ("**ICI**"), the SEC's Division of Investment Management communicated its guidance regarding derivatives-related disclosure in light of its review of the use of derivatives by mutual funds, exchange-traded funds and other investment companies (as announced in a May 25, 2010 press release). The letter notes that while the review is ongoing, the SEC thought it important to provide immediate guidance to investors on what the SEC considers proper disclosure related to derivatives and the risks associated with them. For previous discussions of the SEC's views on derivatives-related disclosure, see the ***May 8, 2009***, ***April 6, 2010*** and ***May 10, 2010 Investment Management Regulatory Updates***. The following is a description of the disclosure issues addressed in the SEC's letter to the ICI.

Registration Statement Disclosures

The SEC has observed that many funds provide generic disclosure about derivatives that, in the SEC's view, is of limited usefulness for investors. Some are "highly abbreviated disclosures that briefly identify a variety of derivative products or strategies" while others are "lengthy, highly technical, disclosures that detail a wide variety of potential derivative transactions without explaining the relevance to the fund's investment operations." According to the SEC, the generic disclosures do not allow an investor to determine which derivatives will actually be part of the principal investment strategies of a fund, to what extent they will be included in such strategies and what specific risks the derivatives will be subject to.

The SEC believes the manner of disclosure is contrary to the intent of Form N-1A, which is used by mutual funds to register under the Investment Company Act and to offer their securities under the Securities Act of 1933. The Form requires a fund to disclose its principal strategies, the types of securities in which it will principally invest and the principal risks of investing in the fund. The SEC noted that it intended the prospectus disclosure to focus on the fund's *principal* investment strategies to provide investors with useful information as to how the fund will actually invest and how the fund's portfolio will actually be managed. The SEC believes an investment company should list only those types of securities in which it *will* principally invest and those that will have a significant effect on the fund's performance, as opposed to listing all types of securities in which the fund may invest.

With respect to derivatives, the SEC recommends that all funds that use or intend to use derivative instruments should review their disclosure for completeness and accuracy, including whether such disclosure "is presented in an understandable manner using plain English." According to the SEC, any principal investment strategy disclosure regarding derivatives should be tailored to the specific fund's strategies and should address only those strategies that are most important in meeting the fund's objectives and that will have a significant effect on the fund's performance. The degree of economic exposure as well as the amount invested in the derivatives strategy should be taken into account when determining the appropriateness of the disclosure.

In addition, the SEC stated, the fund's risk disclosure should show a complete risk profile for the fund's investments taken as a whole, rather than listing the risks associated with various derivatives strategies. Finally, when a fund prepares its annual registration statement update, it should review its actual use of derivatives and determine whether any revisions to the disclosures are needed to reflect their actual use.

Shareholder Reports and Financial Statement Disclosures

In the letter to the ICI, the SEC also presents its observations regarding derivatives-related disclosure by mutual funds in shareholder reports and financial statements. Mutual funds (except for money market funds) are required to provide a Management's Discussion of Fund Performance section ("**MDFP**") in their annual report to shareholders. The MDFP is intended to discuss material factors which affected the fund's performance for the most recently completed year.

The SEC observed that some mutual funds include limited or no discussion about derivatives in their MDFP even though they appear to have significant derivatives exposure in their financial statements or they disclose principal strategies that include the use of derivatives in their registration statements. Also, the SEC observed that some funds that did include derivatives disclosure in their MDFP only included forward-looking statements rather than a discussion of the impact the derivatives had on the fund's performance for the most recently completed year.

In addition, the SEC had observations regarding the derivatives-related disclosure required to be in U.S. GAAP financial statements by FASB Accounting Standards Codification Topic 815: *Derivatives and Hedging* ("**Topic 815**"). In trying to meet Topic 815's disclosure requirements, the SEC stated that funds must "provide qualitative disclosures about their objectives and strategies for using derivative instruments by addressing the effect of using derivatives during the reporting period."

Finally, the SEC noted that Topic 815 also requires funds that sell protection through credit default swaps to include credit spreads as part of their disclosure and to explain the relevance of those spreads (*e.g.*, the significance of the size of the spreads in relation to the likelihood of a credit event or the possible requirement for funds to make payments to counterparties). Due to the risk of non-performance by a counterparty to a swap contract, the SEC noted that the identity of a swap counterparty should be disclosed along with the other disclosed risks related to a particular derivative instrument.

- See a copy of the SEC's letter to ICI
- See a copy of the SEC's press release announcing the review of the use of derivatives by funds

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SEC No-Action Letter Permits an FCM to Custody Assets for '40 Act Funds for Cleared CDS Transactions

On July 16, 2010, the SEC's Division of Investment Management issued a letter granting no-action relief to the CME Group Inc. ("**CME Group**") from Section 17(f) of the Investment Company Act of 1940 (the "**Investment Company Act**") in instances where a registered investment company (a "**Fund**") or its custodian places and maintains cash or securities in the custody of the Chicago Mercantile Exchange ("**CME**") or a CME clearing member that is a futures commission merchant ("**FCM**") registered with the Commodity Futures Trading Commission ("**CFTC**") (a "**CME Clearing Member**") in order to meet the CME's (or the CME Clearing Member's) margin requirements for certain credit default swaps contracts ("**CDS**") cleared by the CME.

Background of CDS Clearing by the CME

The CME is a designated contract market regulated by the CFTC for the trading of futures contracts and options on futures contracts. The CME also operates its own clearing house that clears, settles and guarantees the performance of other types of financial transactions, including CDS trades.

Pursuant to an SEC Order dated March 2010 (the "**Commission Order**"), the CME and CME Clearing Members are authorized to clear CDS centrally on a temporary basis until November 30, 2010. The Commission Order exempts CME Clearing Members from certain requirements under the Securities Exchange Act of 1934 ("**Exchange Act**") with respect to certain CDS transactions and exempts the CME from clearing agency registration under Section 17A of the Exchange Act so that it can perform the functions of a clearing agency for such CDS transactions. In order to ensure that customer assets are properly safeguarded, the Commission Order also contains requirements as to the handling of customer property by CME Clearing Members, including a requirement that such property be held in one of three types of enumerated accounts.

The CME clears CDS by acting as a central counterparty for CDS transactions. Customers wishing to clear CDS through the CME are required to maintain a clearing relationship with a CME Clearing Member, which serves as the customer's agent and guarantor in respect of the cleared CDS. In accordance with its established procedures, the CME requires each customer to deposit a specified amount of assets with the CME Clearing Member as initial margin and security before the CME Clearing Member clears the transaction and itself posts margin either directly with the CME or, in some cases, with another CME Clearing Member which, in turn, clears and posts margin directly with the CME.

17f-6 Relief

Section 17(f) of the Investment Company Act and the rules thereunder govern the safekeeping of Fund assets, and generally provide that a Fund may custody securities and other assets only with certain persons. While Rule 17f-6 under the Investment Company Act provides that Funds may place and maintain assets with an FCM to effect a Fund's transactions in exchange-traded futures contracts or

commodity options, Rule 17f-6 does not permit Funds to place and maintain assets with an FCM to effect CDS transactions.

In granting no-action relief, the SEC noted several key points. First, under the Commission Order, the CME and CME Clearing Members are already subject to various requirements that argue in favor of flexibly applying the custody requirements of the Investment Company Act. In particular:

- CME Clearing Members will hold Fund assets either (i) in an account established pursuant to an order under Section 4d of the Commodities Exchange Act (a "**Section 4d Order**"), (ii) in the absence of a Section 4d Order, in an account meeting the requirements of the "cleared over-the-counter derivatives" account class recently created through CFTC rulemaking which the CME expects to implement through its own rulemaking by September 13, 2010, or (iii) if both of (i) and (ii) above are not available, as an account established in accordance with CFTC Rule 30.7, if additional disclosure is also made to the Funds that uncertainty exists as to whether the Funds would receive priority in bankruptcy vis-à-vis certain other customers with respect to the assets held by CME Clearing Members;
- each CME Clearing Member annually will provide the CME with a self-assessment that it is in compliance with the representations in the Commission Order along with a report by the clearing member's independent auditor that confirms such assessment;
- each CME Clearing Member will segregate customer funds and securities from the CME Clearing Member's own assets;
- each CME Clearing Member will be in material compliance with the CME's rules; and
- each CME Clearing Member will be in material compliance with applicable laws and regulations relating to capital, liquidity and segregation of customer assets, including related books and records provisions, with respect to CDS that are cleared by the CME.

Second, the CME and CME Clearing Members represented that they would address each of the requirements of Rule 17f-6 under the Investment Company Act, essentially mirroring the protections already approved by the SEC for exchange-traded futures contracts or commodity options.

Third, the CME and CME Clearing Members who purchase, sell, or hold CDS positions for other customers must comply with certain other requirements that provide additional protections, including (i) registration with the CFTC as an FCM; (ii) separation of customer assets held in custody or control for the purpose of purchasing, selling, or holding CDS positions; (iii) maintenance of adequate capital and liquidity; and (iv) maintenance of certain books and records relating to capital and liquidity and to segregation of assets.

The SEC stated that the no-action relief expires when the Commission Order is rescinded or otherwise no longer effective.

- ▸ See a copy of the no-action letter from the SEC
- ▸ See a copy of the letter requesting no-action relief
- ▸ See a copy of the Commission Order permitting CDS clearing

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SEC Releases Guidance on Recent Changes to Accredited Investor Standard

On July 23, 2010, the SEC released guidance in its Compliance and Disclosure Interpretations (the "**C&DIs**") on the calculation of an individual's net worth for the purposes of the accredited investor definition for individuals, as modified by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"). A summary of the Act can be found in the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010***.

More information on the Act's treatment of accredited investors can be found in the ***July 14, 2010 Investment Management Regulatory Update***.

Section 413(a) of the Act provides that, upon enactment and for four years thereafter, the accredited investor net worth threshold for natural persons is $1 million, excluding the value of the investor's primary residence. This provision led to the question of how to calculate the value of the investor's primary residence for purposes of determining an investor's net worth.

The SEC indicated that a person's indebtedness secured by their primary residence must be excluded from the net worth calculation, up to the home's fair market value. Nonetheless, the SEC noted, if the indebtedness exceeds the value of the home (*i.e.*, if the mortgage is underwater), then the excess should be considered a liability that reduces the person's net worth.

- See the SEC Compliance and Disclosure Interpretations

SEC Requests Public Comments to Inform Study on Broker-Dealer Investment Adviser Standard of Care

On July 27, 2010, the SEC published a request for comment to assist and inform its study of the obligations and standards of care for broker-dealers and investment advisors who provide personalized investment advice to retail investors. The study is intended to determine whether there are "gaps, shortcomings, or overlaps" in the legal and regulatory standards that relate to broker-dealers and investment advisers. The study will explore a variety of issues relating to the effectiveness of the legal standards of care for broker-dealers and investment advisers with respect to the provision of personalized investment advice to retail investors including, but not limited to:

- the substantive differences in the standards of care applicable to investment advisers and broker-dealers, with specific examples of when one standard or the other provides more protection to retail investors;
- the extent to which retail customers understand the different standards of care that apply to broker-dealers and investment advisers;
- the efficacy of the various regulatory and examination resources aimed at the enforcement of these standards of care;
- the potential impact of the elimination of the broker-dealer exclusion from the definition of "investment adviser" under the Investment Advisers Act of 1940; and
- the potential impact of other regulatory changes to the standards of care affecting broker-dealers, including additional costs associated with such changes.

The SEC is required to conduct the study under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"). A summary of the Act can be found in the Davis Polk Client Memorandum ***Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010***. The public comment period will remain open until August 30, 2010.

- See a copy of the SEC release requesting comment on its study

Litigation

Supreme Court to Review Liability of Investment Adviser to Mutual Funds in Private Securities Fraud Cases

The Supreme Court has granted certiorari in *Janus Capital Group, Inc., et al. v. First Derivative Traders*, No. 09-525, a case involving the liability of an investment adviser to certain mutual funds in a private securities fraud action.

The plaintiffs, shareholders of Janus Capital Group Inc. ("**Janus Capital**"), filed the lawsuit in November 2003 alleging that Janus Capital and its wholly-owned subsidiary, Janus Capital Management (the "**Adviser**", and together with Janus Capital, "**Janus**"), the adviser to a family of mutual funds (the "**Funds**") sponsored by Janus Capital, were responsible for misleading statements in the Funds' prospectuses relating to market timing.

Market timing refers to the practice of rapidly trading in and out of mutual fund shares to take advantage of inefficiencies in the ways the fund values its shares. In this case, the Funds disclosed in their prospectuses that they had specific policies and procedures in place to deter investors from utilizing market timing practices that might harm long-term investors in the Funds. In September 2003, however, the New York Attorney General filed a complaint making public that, notwithstanding the Funds' language in their prospectuses, the Funds had secret arrangements with hedge funds that allowed market timing transactions to occur. Assets under management in the Funds dropped precipitously, along with the stock price of Janus Capital.

The plaintiff shareholders of Janus Capital alleged that misleading statements fraudulently induced purchases of the Funds' shares and that the New York Attorney General's public allegations led to redemptions of such shares, thereby reducing the Adviser's assets under management and Janus Capital's stock price and causing them injury. The plaintiffs brought their claims under Section 10(b) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and Rule 10b-5 thereunder.

The district court dismissed the case. With respect to the claim against Janus Capital, it held that Janus Capital's involvement in the preparation and dissemination of the Funds' prospectuses did not rise to a sufficient level such that the allegedly misleading statements could be attributed to Janus Capital. With respect to the claim against the Adviser, the district court held that because a mutual fund investment adviser does not owe a duty to the shareholders of its parent and because the plaintiffs were Janus Capital shareholders, there was no nexus between the plaintiffs and the Adviser.

On appeal, the U.S. Court of Appeals for the Fourth Circuit reversed. *In re Mutual Funds Inv. Litig.*, 566 F.3d 111 (4th Cir. 2009). With respect to the Adviser, it held that the plaintiffs sufficiently alleged that the Adviser made the misleading statements by way of its participation in the preparation and dissemination of the Funds' prospectuses, even though the statement may not have been directly attributable to the Adviser. The court noted that investors would attribute a substantial role to the Adviser in preparing and approving the statements because of the Funds' organizational structure and the manner in which the Adviser was described in the Funds' prospectuses. In addition, the Fourth Circuit held that Janus Capital, as the Adviser's parent, could be held liable as a control person under Section 20(a) of the Exchange Act.

The court indicated that the Supreme Court had previously concluded, in *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), that for the purposes of a Section 10(b) claim a defendant cannot be liable without a showing that the plaintiff relied on the defendant's statements. The Fourth Circuit noted that the Courts of Appeal have diverged over the degree of attribution required in light of *Central Bank*. The court noted that the Second and Eleventh Circuits have required direct attribution of the allegedly misleading statement to the defendant while other courts, such as the Ninth Circuit, have concluded that substantial participation, rather than direct attribution, is sufficient for reliance purposes. The Fourth Circuit concluded that, at least for fraud-on-the-market cases, the attribution

determination may be satisfied if interested investors would have known that the defendant had played a "substantial role in preparing or approving the allegedly misleading statement," even if the statement on its face cannot be directly attributed to the defendant.

The Supreme Court granted certiorari to resolve the question of whether a service provider such as an investment adviser can be found liable in a private securities action under Section 10(b) for its participation in an issuer's misstatements, even if such misstatements are not directly attributable to such service provider. Before accepting the case, the Supreme Court solicited the views of the U.S. Solicitor General, whose brief argues against characterization of a fund's adviser as a "mere service provider" (a term it feels more accurately describes an accountant, lawyer, or bank) and proposes instead that the adviser, given its close relationship with the fund, be thought of as a corporate insider to which a different standard of attribution should apply.

The Supreme Court's next term begins in October 2010. Davis Polk will continue to monitor developments in the case.

- See a copy of the Fourth Circuit's decision
- See the petition for writ of certiorari

SEC Awards $1 Million for Insider Trading Information

On July 23, 2010, the SEC announced an award of $1 million to Glen and Karen Kaiser for information leading to the settlement of the insider trading case against hedge fund adviser Pequot Capital Management, Inc. ("**Pequot**") and its chief executive, Arthur J. Samberg. This marks the largest award to date paid by the SEC for information in connection with an insider trading case. Further information about the complaint and settlement can be found in the ***July 14, 2010 Investment Management Regulatory Update***.

The case considers allegations of insider trading in Microsoft Corporation securities by Pequot, Samberg, and a Microsoft employee who was hired by Pequot, David E. Zilkha. The SEC had previously conducted an investigation of these allegations, but closed the investigation without action. The SEC reopened the investigation with the discovery of key evidence by Karen Kaiser, the ex-wife of Zilkha, and her husband Glen Kaiser in late 2008. In particular, the Kaisers provided a key email communication between Zilkha and another Microsoft employee who had not been disclosed to the SEC in the previous investigation.

Without admitting or denying the allegations in the complaint, Pequot and Samberg consented to the entry of injunctions and orders that required Pequot and Samberg to pay civil penalties of $10 million and disgorgement totaling over $17 million. Samberg also agreed to a ban on investment advisory activities and Pequot to a censure. The SEC has also issued an order instituting administrative and cease-and-desist proceedings against Zilkha in connection with his actions.

- See a copy of the SEC's press release
- See a copy of the SEC's order against Pequot and Samberg

New York Court of Appeals Affirms Summary Judgment Decision in Favor of Hedge Fund Accountant in Fraud Claim Brought by Hedge Fund Investors

On June 29, 2010, the New York Court of Appeals, in *Continental Cas. Co. v. PricewaterhouseCoopers, LLP*, 2010 N.Y. Slip Op. 05677, 2010 WL 2569187 (N.Y. June 29, 2010), affirmed a lower court's decision to grant summary judgment for the defendant, the auditor of a dissolved private fund, where the plaintiffs, a group of investors that were formerly limited partners of the dissolved fund, alleged direct injuries from the auditor's fraudulent actions. In arriving at its conclusion and interpreting New York partnership law, the majority emphasized the fact that the plaintiffs were not able to show damages that were different in

nature from damages experienced by the partnership as a whole, and therefore, had only derivative damages to claim. The Court agreed with the lower court's finding that the plaintiffs failed to show injuries from their claim that were distinct from the partnership's losses.

The plaintiffs in the case were former limited partners of Lipper Convertibles, LP, a private investment fund (the "**Fund**"), who alleged that they were fraudulently induced to make approximately $120 million in initial investments into the Fund between 1997 and 2001 because of their reliance on representations about the Fund's performance and value in financial statements that were verified and audited by the defendant, PricewaterhouseCoopers, LLP ("**PWC**"). During the time in question, PWC had audited the Fund's financial reports and had attested to their accuracy and conformity with generally accepted accounting principles ("**GAAP**").

In 2002, the Fund publicly disclosed the occurrence of fraud after the Fund's portfolio manager suddenly resigned. A reevaluation of the Fund's portfolio led to a 40% reduction in the net equity value of the Fund, which prompted a wave of withdrawals from the Fund and ultimately a decision to liquidate. After formal liquidation proceedings ended, the plaintiffs collectively recovered approximately $111.5 million.

A Trustee was appointed in 2003 to investigate and pursue claims against the former Fund managers and any other culpable parties, including the defendant. In July 2004, the Trustee brought an action against PWC for damages caused by PWC's improper audits of the Fund's financial statements.

The instant case before the Court of Appeals arose out of a separate action brought by the plaintiffs at the end of 2003 in New York Supreme Court. There, they alleged, among other things, that PWC fraudulently induced them to invest in the Fund through materially misleading financial statements and monthly reports. PWC quickly moved to dismiss the fraud claim, arguing that plaintiffs pleaded no injury distinct from the injury suffered by the Fund as a whole and, further, that the plaintiffs' claims overlapped those brought in the other proceeding by the Trustee on behalf of all injured limited partners, including the plaintiffs.

At the end of the trial, PWC moved for summary judgment and the Supreme Court granted PWC's motion, finding that the plaintiffs did not prove any direct injury beyond the damages already claimed in the Trustee's proceeding. The Appellate Division affirmed and the case arrived before the Court of Appeals.

Although partners of a limited partnership generally may not bring claims based on injuries shared by a partnership, the Court indicated that limited partners may assert direct claims of fraud in the inducement, provided that such limited partners come forward with proof that the damages were "direct, date-of-investment injuries" as opposed to simply their share of the partnership losses and thus derivative in nature.

In ruling for the defendants, the majority made two key points. First, the standard for measuring damages in a fraud action is the "difference between the value of the bargain which a plaintiff was induced by fraud to make and the amount or value of the consideration exacted as the price of the bargain." In this instance for the plaintiffs, it meant that the true measure of damages was the difference in actual value between the overstated partnership interest and the cost of that interest *at the time of the investment*. Instead, the plaintiffs claimed the difference between the inflated cost of the limited partner interests *at the time of the investment* and the value of such interests *upon liquidation*. These damages, the Court noted, were not legally sufficient to support their direct fraud claim. Second, because no separate injury was claimed, the Court found that the Trustee had prosecuted claims seeking the same category of damages. Thus, while the overlapping claims required plaintiffs to come forward with injuries that were distinct "date-of-investment injuries," the only injury the plaintiffs claimed was a diminution in value of their limited partner interests – an injury that they had already experienced in their capacities as limited partners in the partnership.

- See a copy of the court's opinion

Goldman Sachs and SEC Reach a $550 Million Settlement

On July 15, 2010, the SEC announced that it had reached a settlement with Goldman, Sachs & Co. ("**Goldman**") under which Goldman would pay $550 million, the largest SEC penalty ever paid by a Wall Street firm, and reform its business practices relating to the marketing of a subprime mortgage product. Goldman agreed to settle the SEC's charges without admitting or denying the allegations made against the firm.

On April 16, 2010, the SEC filed a complaint which alleged that Goldman misled investors by misstating and omitting key facts relating to a synthetic collateralized debt obligation ("**CDO**") that was linked to the performance of certain subprime residential mortgage-backed securities. Under the settlement agreement, Goldman acknowledged that it should have disclosed that the hedge fund, Paulson & Co. Inc. ("**Paulson**"), was involved in the portfolio selection process of the CDO and that Paulson had economic interests that were adverse to the investors in the CDO.

The settlement also requires Goldman to reevaluate and remedy its review and approval procedures in connection with offerings of certain mortgage securities. According to the release, this includes the roles of internal counsel, compliance personnel and outside counsel with regard to reviewing written marketing materials used in the offering of such products.

Regarding this settlement, Robert Khuzami, Director of the SEC's Division of Enforcement, said "[t]his settlement is a stark lesson to Wall Street firms that no product is too complex, and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing."

- See a copy of the SEC's press release

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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