Investment Services Regulatory Update

February 1, 2010

LITIGATION

Court Rules State Market Timing Claims Precluded by SLUSA

On January 6, 2010, in *Kircher v. Putnam Funds Trust,* the Illinois Appellate Court reversed the circuit court and remanded the case for dismissal, holding that the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") precluded the plaintiffs' class action lawsuit against defendants alleging state law claims that their investments were diluted by the defendants' market timing activities that were brought to light in September 2003. The defendants had removed the lawsuits to federal court and argued that SLUSA precluded such lawsuits from being filed and therefore the district court should dismiss the action. After a long battle over appropriate jurisdiction at the federal level that eventually led to a U.S. Supreme Court decision in June 2006, the case was sent back to the state level. In arriving at its decision, the Illinois Appellate Court explained that SLUSA does not actually preempt any state law cause of action but simply denies plaintiffs the right to use the class action device to vindicate certain claims. Under the terms of SLUSA, an action will be dismissed if it is (1) a covered class action, (2) that is based on a state law, (3) alleging a misrepresentation or omission of material fact or use of any manipulative or deceptive device or contrivance, (4) in connection with the purchase or sale of a covered security. After over six years of back and forth in multiple courts, the Illinois Appellate Court held that the action was indeed precluded by SLUSA .

Second Circuit Reverses Decision in Derivative Action Against Fund Board, Certifies Question to Massachusetts Supreme Court

On December 29, 2009, the Second Circuit Court of Appeals issued its ruling in *Helabian v. Berv*, a case that could have meaningful implications for the protection of the business judgment rule and the procedures to be followed in shareholder derivative suits in Massachusetts. In *Helabian*, the District Court for the Southern District of New York dismissed a shareholder's derivative action for an alleged breach of fiduciary duty by the Board of CitiFund Trust in connection with the approval of new investment advisory agreements following Legg Mason Inc.'s acquisition of Citigroup's asset management business. In dismissing the suit, the district court relied upon the Trustees' good-faith determination (i.e., their business judgment) that prosecuting the action would not be in the Trust's best interests.

The Massachusetts Business Corporations Act contains a universal demand requirement that prevents shareholders from filing a derivative action until a board has had at least 90 days to evaluate the claim and make a formal recommendation. The district court found that, although the plaintiff had satisfied the demand requirement before filing suit, the Board's decision not to pursue the action required dismissal of the lawsuit, despite the fact that it came six weeks after the 90 day-period for review had expired. The district court's analysis was based largely on its interpretation of a provision the Act, which states that a derivative proceeding commenced after the rejection of a demand shall be dismissed by the court on motion by the corporation.

On appeal, the Second Circuit reversed the district court's decision, but withheld judgment in the case, opting to certify a question to the Supreme Judicial Court of Massachusetts. The Second Circuit has asked whether the business judgment rule can be applied to dismiss a derivative complaint filed timely under the Act but prior to a corporation's rejection of the demand serving as the basis for the suit. The outcome of the case will turn on whether a board is required to respond within the 90-day period described in the statute, even if that response only requests a stay of judicial proceedings to allow the board to conclude its examination of the claims.

The case highlights the importance of understanding the procedures outlined by state law in shareholder derivative suits, particularly with regard to the timing of responses and the deliberation period a board has to make its good-faith review of a demand. Following the receipt of a response from the Supreme Judicial Court of Massachusetts, the Second Circuit will make a final judgment on the appeal.

Court Rules in Favor of American Funds in Fee Case

On December 28, 2009, a Los Angeles federal district court ruled in favor of the defendants in the *American Mutual Funds Fee Litigation* case. Applying the *Gartenberg* standard to the plaintiff's excessive fee claims under Section 36(b) of the 1940 Act, the court held that the plaintiffs failed to sustain their burden of proving that the fees charged were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been a product of arm's-length bargaining. In citing *Gartenberg*, the court stated that the *Jones v. Harris Associates* standard is flawed because it ignores the plain language of Section 36(b) and essentially emasculates the statute. The court also stated that the *Gallus v. Ameriprise Financial* standard is flawed because it expands Section 36(b), providing for a cause of action even where a challenged fee passed muster under the *Gartenberg* standard.

As an aside, the court noted that the *Gartenberg* standard is a very high threshold for a plaintiff to overcome and that its holding should not be mistaken for a determination that the directors obtained the best possible deal for investors as suggested in the defendants' proposed findings and conclusions of law. The court quoted Judge Posner's dissent in *Jones* and observed that the directors had little incentive to police the compensation paid to the defendants. For instance, the court noted that the directors were never provided data showing the compensation paid to employees of the defendants as part of their review of profitability.

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Adopts Money Market Fund Reforms

On January 27, 2010, the SEC adopted amendments to certain rules under the 1940 Act that govern money market funds. The amendments seek to: (1) increase the resilience of money market funds to short-term market risks, (2) reduce the likelihood of money market funds "breaking the buck," and (3) improve the ability of the SEC to oversee money market funds. The rule amendments:

- prohibit money market funds from buying "second tier securities" with a maturity in excess of 45 days (rather than 397 days),
- restrict investments in "second tier securities" to 3% of assets (rather than 5%),
- limit investments in "second tier securities" issued by a single issuer to ½ of 1% of a fund's assets,
- impose a 60-day weighted average maturity limit,
- impose a new maturity test that would limit "weighted average life maturity" (the measurement of a money market fund's portfolio maturity without regard to any interest reset dates) to 120 days,
- redefine "illiquid security" and limit holdings in illiquid securities to 5% of assets (rather than 10%),
- require money market funds to hold at all times highly liquid securities sufficient to meet reasonably foreseeable redemptions,
- require *taxable* money market funds to hold at least 10% of assets in cash, U.S. Treasury securities and securities that convert to cash within one business day,
- require all money market funds (including tax-exempt funds) to maintain weekly liquidity requirements of 30% of assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less or securities that convert to cash within one week,
- require money market fund managers to stress test periodically a fund's portfolio, including testing of a fund's ability to maintain a stable net asset value per share based on certain "shocks,"

- limit money market funds to investing in repurchase agreements collateralized by cash or U.S. government securities in order to obtain special treatment under the diversification provisions of Rule 2a-7,

- require money market funds to evaluate the creditworthiness of a counterparty to a repurchase agreement, whether or not the repurchase agreement is collateralized fully,

- require money market funds to post their portfolio holdings as of each month end to their website and to maintain such information on the website for at least six months,

- require money market funds to file a monthly portfolio holdings report, including “shadow” NAVs, with the SEC on new Form N-MFP (this information would be available to the public 60 days later),

- require money market funds and their administrators to be able to process purchases and redemptions electronically at a price other than $1.00,

- require money market funds to annually designate at least four nationally recognized statistical rating organizations (“NRSROs”) whose ratings the fund board considers reliable,

- eliminate the requirement that money market funds invest only in those asset-backed securities that have been rated by an NRSRO,

- expand Rule 17a-9 to allow an affiliate to purchase a portfolio security from a money market fund (1) if the security has defaulted (other than an immaterial default unrelated to the financial condition of the issuer) even though the security remained an eligible security or (2) for any reason if the security is purchased with cash at the greater of amortized cost value or market value and the affiliate promptly remits to the fund any profit it realizes from a later sale of the security,

- require a money market fund whose securities have been purchased by an affiliate in reliance on Rule 17a-9 to provide the SEC via e-mail with prompt notice of the purchase and the reasons for the purchase, and

- create new Rule 22c-3, which would permit money market funds to suspend redemptions if a fund is about to break the buck if the fund’s board, including a majority of independent directors, approves the liquidation of the fund in order to facilitate an orderly liquidation of the fund.

The amendments will be effective 60 days after their publication in the Federal Register, with mandatory compliance for some rules phased in throughout 2010.

FINRA Provides Guidance on Blogs and Social Networking Websites

On January 25, 2010, FINRA issued Regulatory Notice 10-06, which provides guidance to securities firms and brokers on communications with the public through blogs and social networking websites. The Notice follows previous rules issued by FINRA on Internet communications, including NASD Rule 2210, which defines the term "public appearance" to include participation in an interactive electronic forum. The Notice is presented in question and answer format and includes the following recommendations and conclusions:

- Every firm that intends to communicate through social media sites, or permit its associated persons to communicate through such sites, must comply with specified record retention requirements.
- Any communication via a social media site that constitutes a "recommendation" is also subject to suitability requirements for every investor to whom it is made.
- In addition to triggering FINRA's suitability rule, communications containing recommendations of specific investment products through social media sites may trigger disclosure requirements under the federal securities laws, such as Rule 482 under the 1933 Act and the filing requirements of Section 24(b) of the 1940 Act.
- Interactive electronic communications by the firm or its registered representatives must be supervised in a manner reasonably designed to ensure that FINRA's communications rules are not violated.
- Third-party content posted to social media sites established by the firm or its personnel will generally not be treated as communications with the public, unless such content becomes "attributable" to the firm under the "entanglement" or "adoption" theories outlined in the Notice.

SEC Adopts Amendments to Investment Adviser Custody Rule

On December 30, 2009, the SEC adopted amendments to Rule 206(4)-2 under the Advisers Act, which regulates the custody practices of registered investment advisers. The SEC also adopted related amendments to Form ADV and Form ADV-E. The amendments, become effective on March 12, 2010 and are intended to improve the safekeeping of client assets when an adviser has custody of client funds and/or securities. The SEC has amended Rule 206(4)-2 by:

- Requiring that all advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets. (This requirement will not apply to advisers with custody of client assets solely because of their authority to deduct fees from client accounts or to advisers to pooled investment vehicles that are already subject to an annual audit.)

- Requiring advisers with custody of client assets to enter into a written agreement with an independent public accountant that, among other things, obligates the accountant to: (1) conduct a surprise examination, with the first of such examinations to occur by December 31, 2010; (2) notify the SEC within one business day of finding a material discrepancy; (3) submit Form ADV-E to the SEC within 120 days of the time chosen for the surprise examination; and (4) submit Form ADV-E to the SEC within four business days of the accountant's resignation from or termination of the engagement.

- Making privately-offered securities (as defined in the Rule) that advisers hold on behalf of their clients subject to the surprise examination.

- Providing that an adviser is deemed to have custody of any client securities or funds that are directly or indirectly held by a related person of the adviser (i.e., a person directly or indirectly controlling or controlled by the adviser or any person under common control with the adviser) in connection with advisory services provided by the adviser to its clients.

- Requiring that when an adviser or a related person serves as a qualified custodian for client assets, the adviser obtain, or receive from the related person, an annual written internal control report from an independent public accountant registered with the Public Company Accounting Oversight Board regarding the adviser's or the related person's controls regarding custody of client assets, which includes an opinion of the accountant regarding the custody controls in place and tests of their effectiveness (e.g., a Type II SAS 70 Report).

- Requiring that when an adviser or a related person serves as a qualified custodian for client assets, the annual surprise examination be performed by an independent public accountant registered with the PCAOB.

- Requiring advisers with custody of client assets to have a reasonable belief based on due inquiry that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains assets.

- Requiring advisers that send account statements separate from the ones the custodian delivers to include a statement in the notice sent to clients upon opening a custodial account on their behalf that the client should compare the account statements they receive from the custodian with those they receive from the adviser.

Registered advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.

SEC Extends Temporary Rule Regarding Adviser Principal Trades

On December 23, 2009, the SEC extended by one year the temporary rule that provides an alternative method for investment advisers who are also broker-dealers to comply with Section 206(3) of the Advisers Act, which requires an adviser to obtain client consent prior to engaging in a principal transaction with the client. Temporary Rule 206(3)-3T was initially adopted on September 24, 2007 in response to a federal appeals court decision that vacated Rule 202(a)(11)-1 of the Advisers Act, which allowed registered broker-dealers to offer fee-based accounts without being regulated as investment advisers. Pursuant to Rule 206(3)-3T, which will now expire on December 31, 2010, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; and (3) provides the client with an annual report on all principal transactions. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC made no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension was necessary to give the SEC additional time to evaluate the operation of the Rule.

SEC Adopts New Disclosure Requirements for Board Governance Matters

On December 16, 2009, the SEC adopted amendments to the rules governing proxy statement disclosure and to the forms for fund registration statements that significantly expand the information that funds must disclose regarding certain board governance matters. The amendments become effective on February 28, 2010 and require enhancements to proxy statement disclosure in the following areas: (1) the board's leadership structure; (2) the board's role in risk oversight; (3) the qualifications and experience of directors and director nominees; (4) prior directorships; (5) directors' prior legal and disciplinary actions; and (6) the role of diversity in considering board candidates.

With respect to registration statement disclosure, the amendments apply to disclosure regarding the management of funds included in the SAI. The SAI amendments mirror the proxy statement amendments, but do not require the enhanced disclosure regarding directors' prior legal and disciplinary actions or the role of diversity in considering board candidates.

Specifically, under the amendments, funds must describe the funds' leadership structure, including a description of the responsibilities of the board and a statement as to whether the board has an independent chair. If the board chair is not independent, funds are required to disclose whether they have a lead independent director and the function of the lead independent director. In describing their leadership structure, funds must also include a statement about why the leadership structure is appropriate in light of the specific characteristics of the funds. With respect to the required disclosure regarding the board's role in risk oversight, funds must describe how the board administers its risk oversight function, whether through the whole board or through a committee.

The amendments also require funds to disclose for each director or nominee (i.e., including those directors *not* up for election), the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director. In addition, if an individual is chosen to be a director or a nominee because of specific expertise related to service on a specific committee (such as the audit committee), then this information should be disclosed as part of the discussion of the person's qualifications to serve on the board. In addition, funds must disclose any directorships held by a director or nominee during the past five years with any public company or other fund, whether or not the director still serves as a director of that entity. For proxy statements, the disclosure amendments also require a fund to disclose information regarding specified legal proceedings involving a director or nominee that occurred during the prior ten years, rather than the prior five years as is currently required.

Finally, the amendments require funds to disclose in proxy statements whether, and if so how, a nominating committee considers diversity in identifying nominees for director. If the board or the nominating committee has a policy regarding the consideration of diversity, funds must also disclose how this policy is implemented and how the board or committee assesses the policy's effectiveness. The amendments do not define diversity, but instead allow funds to define diversity as they consider appropriate (such as on the basis of varied professional experience, education, skill, race or gender).

The SEC's Division of Investment Management has published guidance to assist funds in determining when they are required to implement the disclosure amendments based, among other things, on a fund's fiscal year-end.

Federal Regulatory Agencies Issue Model Privacy Notice Form

On November 17, 2009, eight federal regulatory agencies, including the SEC, released a final model privacy notice form that is designed to make it easier for consumers to understand how financial institutions collect and share nonpublic personal information.

Since 2001, under rules adopted pursuant to the Gramm-Leach-Bliley Act, financial institutions, including funds and registered investment advisers, have been required to provide a privacy notice to their shareholders and clients initially when a relationship is formed and annually thereafter. Recognizing that privacy notices are often long and complex, Congress directed the regulatory agencies to develop a model form that would be succinct and easy for consumers to use and understand. Use of the model form issued by the agencies is optional, but those institutions that choose to use the model form will obtain a "safe harbor" and will be deemed to satisfy the disclosure requirements for privacy notices.

NEW LEGISLATION

Congressman Introduces Banking Integrity Act

On January 15, 2010, Representative John D. Dingell introduced the Banking Integrity Act of 2010, which would prohibit, with limited exceptions, any officer, director or employee of any corporation or unincorporated association, any partner or employee of a partnership, and any individual primarily engaged in the issue, flotation, underwriting, public sale or distribution of stocks, bonds or other similar securities from serving simultaneously as an officer, director or employee of any member bank. The Act also would prohibit a depository institution from engaging in the business of insurance, including writing insurance or providing reinsurance, or any insurance-related activity. The Act has been referred to the House Committee on Financial Services.

Congressmen Introduce Regulated Investment Company Modernization Act of 2009

On December 16, 2009, Chairman of the Ways and Means Committee, Charles Rangel, along with Representatives Joseph Crowley, Richard Neal and Allyson Schwartz, introduced the Regulated Investment Company Modernization Act of 2009, which would amend the Internal Revenue Code to modify certain rules governing the taxation of regulated investment companies. The Act would conform certain tax rules applicable to funds to similar rules applicable to individuals or real estate investment trusts. Among other provisions, the Act would: (1) permit unlimited net capital loss carryforwards, (2) include income from commodities as a source of good income, (3) permit funds to cure inadvertent failures to comply with gross income and gross asset tests and (4) modify rules related to distributions, dividends and the annual excise tax. The Act has been referred to the House Committee on Ways and Means.

House Approves Wall Street Reform and Consumer Protection Act of 2009

On December 11, 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009, which is a broad compilation of legislation introduced throughout 2009. The Act was referred to the Senate Committee on Banking, Housing and Urban Affairs on January 20, 2010. Among other provisions, the Act would:

- establish a Financial Services Oversight Council comprised primarily of the heads of various financial regulatory entities that would monitor and identify potential threats to the stability of the U.S. financial markets, resolve disputes among federal financial regulatory entities and, together with the Federal Reserve or other applicable federal regulator, impose stricter prudential standards on any financial company, activity or practice that poses a threat to the stability of the markets;

- provide that, unless exempted by the SEC, an issuer of a security registered under Section 12 of the Exchange Act is required to submit its executive compensation to shareholders for non-binding approval during any proxy solicitation related to such securities;

- require investment advisers of certain unregistered investment companies (i.e., 3(c)(1) and 3(c)(7) funds) to register with and provide information to the SEC;

- hold broker-dealers who provide investment advice to retail customers to the same standard of care as investment advisers;

- authorize the SEC to assess a fee on federally-registered investment advisers to fund inspections and examinations;

- authorize the SEC to prescribe rules and regulations requiring the inclusion of shareholder-proposed board nominees in issuer proxy solicitations;

- permit the SEC to limit the use of pre-dispute arbitration provisions in broker-dealer agreements; and

- subject auditors of broker-dealers to regulation by the Public Company Accounting Oversight Board.

OTHER NEWS

IDC Issues Task Force Report on Board Oversight of Subadvisers

On January 28, 2010, the Independent Directors Council issued a task force report, “Board Oversight of Subadvisers.” The report discusses: (1) the business reasons for retaining a subadviser and industry trends in the use of subadvisers; (2) board evaluation of the principal adviser’s recommendation and due diligence in retaining a new subadviser, along with resolving any board member independence issues and the process for communicating and reporting to the board; (3) board approval of a subadvisory agreement, including an assessment of the services under the subadvisory agreement and the subadvisory fees (including profitability); (4) the integration of a subadviser into a fund’s business practices and processes, including operations, valuation, proxy voting and soft dollars; (5) a board's ongoing oversight of a subadviser, including assessing the subadviser's investment performance and compliance program; and (6) the termination of a subadviser. The report also provides documents, including an outline of various tasks that may be delegated to a subadviser and some of the common provisions found in subadvisory agreements, a sample compliance certification and a sample compliance questionnaire.

The IDC task force report is available on the IDC's website at http://www.idc.org/pdf/idc_10_subadvisers.pdf.

SEC Makes Enforcement Changes

On January 13, 2010, the SEC announced new enforcement initiatives, including an "enforcement cooperation initiative" and five national specialized units that focus on complex areas of securities laws. The cooperation initiative permits enforcement staff to make deferred prosecution and non-prosecution agreements between the SEC and a cooperator pursuant to which the SEC agrees to forego or not pursue an enforcement action against the cooperator if that person agrees to cooperate fully and truthfully and comply with express undertakings. In addition, the SEC enforcement staff may agree in writing to recommend to the SEC that a cooperator receive credit for cooperating in investigations or related enforcement actions if the cooperator provides substantial assistance to the staff. In the past, all of these agreements were informal.

The new specialized units include an asset management unit, which will focus on investigations involving investment advisers, mutual funds, hedge funds and private equity funds. The other four new units include: (1) market abuse, (2) structured and new products, (3) foreign corrupt practices and (4) municipal securities and public pensions. The new units were created to provide additional resources and expertise for enforcement staff. As part of the enforcement changes, a new Office of Market Intelligence also was created that is responsible for the collection, analysis and monitoring of tips that the SEC receives.

Director of SEC's Division of Investment Management Comments on Independent Director Issues at IDC Conference

In the keynote address at the IDC Investment Company Directors Conference on November 12, 2009, the Director of the Division of Investment Management, Andrew J. ("Buddy") Donohue, discussed various challenges faced by independent directors in exercising their oversight duties, focusing primarily on issues faced by closed-end fund independent directors when determining actions to take in response to fund takeover attempts. Mr. Donohue highlighted five specific actions that have been taken by fund boards in response to takeover attempts and stressed that, when considering such actions, directors must ultimately determine whether the action is in the best interests of the fund and its shareholders.

The actions discussed by Mr. Donohue were (1) the adoption of a shareholder rights plan, commonly known as a “poison pill,” (2) the use of state law “control share” statutes to restrict the ability of large shareholders to vote their shares at shareholder meetings, (3) delaying a fund’s annual meeting, (4) requiring the affirmative vote of a majority of outstanding shares for the election of directors and (5) adopting a by-law that imposes certain requirements for director candidates, while exempting a fund’s current directors (including those affiliated with fund management) from such requirements. In discussing these actions, Mr. Donohue stated that, although fund management may for various reasons advocate taking one or more of such actions in response to a takeover attempt, the fund’s board must always consider whether the action is in the best interests of the fund and its shareholders.

In addition to the challenges faced by closed-end fund independent directors in connection with takeover attempts, Mr. Donohue addressed (1) expense recapture, (2) fund mergers, (3) fulcrum fees, and (4) ”yield” and managed distribution plans. In discussing the staff’s position on expense recapture (i.e., clawbacks), Mr. Donohue stated that a “fund’s expense ratio should be below the expense cap upon which the waiver was initially based in order for the adviser to recapture the difference between the lower ratio and the expense cap.”

In discussing fund mergers, Mr. Donohue expressed concern that certain fund mergers were being carried out for the sole purpose of merging away a fund with poor performance and that, in some cases, the performance used for the combined fund was that of the acquiring fund, which was the relatively newer fund, the fund with less assets or the fund with shareholders affiliated with the adviser. Mr. Donohue suggested that directors consider the impact a fund merger would have on an acquired fund’s shareholders in order to make sure that the fund merger is in the best interests of such shareholders.

Mr. Donohue also stated that directors must carefully consider the implementation of fulcrum (or performance-based) fees and clearly understand what the fulcrum fee represents, including the possibility that an adviser may owe a fund money under certain conditions. Mr. Donohue noted that some funds have tried implementing a floor total fee without proportionally limiting an adviser’s upside, which is not permissible because the incentive adjustments must be symmetrical.

Finally, Mr. Donohue discussed disclosures regarding a fund’s yield or managed distribution plan. Mr. Donohue stated that directors must make sure that a fund’s disclosures explain what the distribution yield represents and that it is not to be confused with actual investment performance. He also stated that directors should consider whether managed distribution plans continue to be in the best interests of shareholders. Mr. Donohue pointed out that the SEC staff has noted inconsistencies between Rule 19a-1 notices and other information posted on a fund’s website and that no additional disclosure was provided to explain such inconsistencies. Mr. Donohue suggested that directors review their fund’s disclosures to make sure that the information is disclosed consistently or to provide disclosure for any inconsistencies.

The full text of Mr. Donohue's speech is available on the SEC's website at http://www.sec.gov/news/speech/2009/spch111209ajd.htm.

ENFORCEMENT ACTIONS

SEC Charges Advisers for Unlawful Short Selling Practices

On January 26, 2010, the SEC settled charges against two investment advisory firms for engaging in improper short selling of securities in advance of their participation in a company's secondary offering. The cases mark the first filed under the SEC's amended Rule 105 of Regulation M, which is designed to prohibit manipulative short selling ahead of follow-on securities offerings.

In one case, the SEC charged AGB Partners LLC and its principals, Gregory A. Bied and Andrew J. Goldberger, finding that they netted thousands of dollars in improper profits by shorting in advance of their purchase of stock in a secondary offering. In the other case, the SEC charged Palmyra Capital Advisors LLC, finding that the firm violated short selling rules and improperly profited in three of its hedge funds.

The SEC alleged that AGB Partners violated both the pre- and post-amendment Rule 105 to gain illicit profits. According to the SEC's order, AGB Partners used secondary offering shares in April 2007 to cover a portion of a short position in Boots & Coots International Well Control, Inc. In June 2008, under the amended rule, AGB Partners sold short shares of BGC Partners, Inc. and then purchased BGC shares in the company's secondary offering. AGB Partners, Mr. Bied and Mr. Goldberger agreed to pay more than $50,000 in disgorgement and penalties.

The SEC alleged that Palmyra violated Rule 105 in connection with short sales made in advance of a public offering by Capital One Financial Corp., resulting in improper profits of $225,500. Palmyra sold short a total of 50,000 shares of Capital One stock six days before receiving 50,000 shares from Capital One's secondary offering. Palmyra agreed to pay more than $330,000 in disgorgement and penalties.

SEC Settles Charges Against Adviser's CFO/CCO for Aiding and Abetting Adviser's Fraud

On January 5, 2010, the SEC settled charges against Mary Beth Stevens for her role in the misappropriation of funds belonging to the clients of AA Capital Partners, Inc., a registered investment adviser. According to the SEC, between 2004 and 2006, Ms. Stevens aided and abetted AA Capital and its president, John Orecchio, in misappropriating more than $23 million of investor funds. The SEC found that, in May 2004, Mr. Orecchio approached Ms. Stevens and told her that he owed a significant amount of money to the IRS based on his ownership interest in one of AA Capital's affiliated private equity funds and a failure by AA Capital's auditors to timely file certain tax returns. At Mr. Orecchio's direction, she withdrew over $600,000 from AA Capital's client trust accounts, deposited the funds into AA Capital's main operating bank account and then wired the money to Mr. Orecchio's personal bank account. Other alleged violations include at least 20 separate disbursements to Mr. Orecchio between May 2004 and October 2005, totaling over $5.7 million, for the purported tax liability, including wiring funds directly to the bank accounts of two entities in which Mr. Orecchio had a personal interest, a Michigan horse farm and a company which managed a Detroit strip club. The SEC also found that Ms. Stevens falsified the account statements she sent to AA Capital's clients in order to conceal the improper withdrawals. As a result of these actions, Ms. Stevens agreed to pay disgorgement of $79,583.50, prejudgment interest of $22,472.24 and civil penalties of $50,000.

SEC Settles Charges Against Investment Adviser Representative for Aiding and Abetting and Causing Morgan Stanley's Advisers Act Violation

On January 4, 2010, the SEC settled charges against William Keith Phillips for aiding and abetting and causing Morgan Stanley & Co. Incorporated's Advisers Action violation. According to the SEC, from at least 2000 through April 2006, Mr. Phillips worked as a financial adviser at Morgan Stanley, which serviced individual retail advisory clients as well as several institutional brokerage customers.

During the relevant time period, Morgan Stanley offered advisory clients a program called Vision I. Morgan Stanley's disclosure materials regarding Vision I described the advisory services it provided which included assisting clients in identifying money managers to manage clients' assets. Morgan Stanley disclosed the detailed due diligence process it followed to select and approve money managers for participation in Vision I. According to its disclosure materials, Morgan Stanley financial advisers selected money managers from this approved list of managers to recommend to clients based on the client's investment profile and objectives.

According to the SEC, Mr. Phillips recommended to certain advisory clients of Morgan Stanley certain money managers who were not approved for participation in Vision I and had not been subject to the firm's due diligence review, which fact was not disclosed to those advisory clients. The SEC also found that Mr. Phillips had undisclosed relationships with the money managers who had not been approved by Morgan Stanley from which Mr. Phillips and Morgan Stanley received substantial brokerage commissions and/or fees. As a result of these actions, Mr. Phillips agreed to pay an $80,000 penalty.

SEC Charges U.S. Subsidiary of World's Largest Inter-Dealer Broker for Displaying Fictitious Trades and Misleading Customers

On December 18, 2009, the SEC charged a U.S. subsidiary of the world's largest inter-dealer broker, U.K.-based ICAP plc, with fraud for engaging in deceptive activity and making material misrepresentations to customers concerning its trading activities. According to the SEC, ICAP's U.S. Treasuries ("UST") brokers displayed thousands of fictitious flash trades to ICAP's customers between December 2004 and December 2005. The SEC also found that ICAP represented to its off-the-run UST customers that its electronic trading system would follow certain workup protocols in handling customer orders. However, ICAP's brokers on the UST desks used manual tickets to bypass such protocols and close out of thousands of positions in their ICAP house accounts, thereby rendering ICAP's representations concerning the workup protocols false and misleading. In some instances, ICAP's customers' orders received different treatment than the customers expected pursuant to the workup protocols.

The SEC also found that ICAP held itself out as a firm that did not engage in proprietary trading. The SEC alleged that during the relevant period, however, two former ICAP brokers on the voice-brokered collateralized pass-through mortgage-backed securities ("MBS") desk routinely engaged in profit-seeking proprietary trading that rendered ICAP's representations regarding proprietary trading false and misleading. The SEC's order found that ICAP failed to make and keep certain required books and records on the UST desks and the MBS desk. ICAP agreed to settle the SEC's charges by, among other things, paying $25 million in disgorgement and penalties. The SEC also charged five ICAP brokers for aiding and abetting the firm's fraudulent conduct and two senior executives for failing reasonably to supervise the brokers. The individuals have agreed to pay penalties to settle the SEC's charges.

SEC Charges Investment Adviser and COO for Trade Allocation Violations

On December 14, 2009, the SEC charged investment adviser Ark Asset Management Co., Inc., and Stephen Jay Mermelstein, Ark's COO, for trade allocation violations. According to the SEC's order, a portfolio manager at Ark favored the NorthStar Funds (hedge funds) over the client accounts in the allocation of securities between August 2000 and December 2003.

According to the SEC, the portfolio manager placed orders for securities, but changed or delayed making allocations of the purchases and sales until after the order had been filled, which allowed the portfolio manager to allocate more favorable trades to the hedge funds. As a result of this fraudulent conduct, according to the SEC, Ark realized at least $19 million of ill-gotten gains in the form of performance fees from the hedge funds.

According to the SEC, when placing trades, neither the portfolio manager nor the traders who worked for him documented how the trade would ultimately be allocated between the two sets of accounts. While each set of accounts had different order tickets, orders were routinely written on an order ticket for one of the two sets of accounts. The order tickets, however, allegedly did not reflect how the portfolio manager would ultimately decide to allocate the securities, and in some instances, traders were directed to move an order from one set of accounts to the other by creating a new order ticket, transferring the security to that ticket and discarding the old order ticket.

Ark is required to file an answer to the SEC's order within 20 days after service of the SEC's complaint. Mr. Mermelstein has agreed to pay a civil money penalty in the amount of $50,000.

FINRA Fines Terra Nova Financial $400,000 for Improper Soft Dollar Payments

On November 23, 2009, FINRA announced that it fined Terra Nova Financial, LLC $400,000 for allegedly making more than $1 million in improper soft dollar payments to or on behalf of five hedge fund managers, failing to supervise its soft dollar program and failing to implement adequate supervisory procedures. FINRA also sanctioned the three Terra Nova employees who were primarily responsible for the implementation and oversight of Terra Nova's soft dollar program.

According to FINRA, Terra Nova made numerous soft dollar payments on behalf of five hedge funds between 2004 and 2005 which were not authorized by fund documents. The payments were used to pay for, among other things, various entertainment expenses and unauthorized employee salaries and consulting fees.

In addition to the fine, Terra Nova is required to retain an independent consultant to review and enhance its policies, systems and procedures relating to its soft dollar operations.

SEC Charges Investment Adviser and Two Senior Officers for $24 Million Fraudulent Scheme

On November 4, 2009, the SEC charged Value Line Inc. (an investment adviser), Jean Buttner, Value Line's CEO, David Henigson, Value Line's former chief compliance officer, and Value Line Securities, Inc., Value Line's affiliated broker-dealer, with defrauding the Value Line family of mutual funds by charging over $24 million in bogus brokerage commissions on mutual fund trades funneled through Value Line Securities.

The SEC alleged that, from 1986 to 2004, Value Line directed a portion of the funds' securities trades to Value Line Securities through a "commission recapture program." In the commission recapture program, Value Line arranged for one of three unaffiliated brokers to execute, clear and settle the funds' trades at a discounted commission rate. Instead of passing the discounted rate to the funds, the unaffiliated brokers allegedly billed the funds the standard rate and then "rebated" the difference between the standard rate and the discount rate to Value Line Securities. In total, Value Line Securities received over $24 million in brokerage commissions from the funds pursuant to this scheme; Value Line Securities did not perform any bona fide brokerage services for the funds on these trades.

The SEC also alleged that, through Ms. Buttner and Mr. Henigson, Value Line falsely represented to the Value Line funds' independent directors and shareholders that Value Line Securities provided bona fide brokerage services for the commissions it received and that Value Line Securities otherwise served the best interests of the funds and their shareholders. According to the SEC, Ms. Buttner directed the "commission recapture program" and monitored its profitability to Value Line Securities, and thus to Value Line, by receiving periodic updates from Mr. Henigson, who was responsible for implementing the scheme. Ms. Buttner and Mr. Henigson were also involved in structuring and negotiating the recapture arrangement with the unaffiliated rebate brokers.

As a result of these allegations, Value Line agreed to pay $24,168,979 in disgorgement, $9,536,786 in prejudgment interest and a $10 million penalty. Ms. Buttner and Mr. Henigson agreed to pay $1 million and $250,000 in penalties, respectively. In addition, Ms. Buttner and Mr. Henigson were each barred from association with any broker, dealer, investment adviser or investment company and were prohibited from acting as an officer or director of any public company.

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This Regulatory Update is only a summary of recent information and should not be construed as legal advice.