Investment Services Regulatory Update

December 1, 2010

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Proposes Rules Relating to Investment Adviser Registration

On November 19, 2010, the SEC proposed new rules and rule amendments under the Advisers Act to implement certain provisions of the Dodd-Frank Act. Specifically, the SEC's proposed rules and rule amendments would:

- facilitate the de-registration and registration of so-called "mid-sized advisers"—investment advisers with assets under management between $25 million and $100 million,
- require advisers to provide additional information about certain areas of their operations on Form ADV, including information about the private funds they manage and information about use of affiliated brokers, soft dollar arrangements and compensation for client referrals,
- require "exempt reporting advisers" (venture capital fund advisers, private fund advisers and foreign private advisers, which qualify for an exemption from registration under the Advisers Act but may be subject to certain reporting requirements) to complete certain portions of Form ADV, which would be filed through the IARD system and made available to the public,
- amend Rule 206(4)-5 under the Advisers Act (the "pay to play" rule) to expand its application to exempt reporting advisers and allow an adviser to pay a "regulated municipal advisor" to solicit business on behalf of the adviser from a state or local government entity,
- define a "venture capital fund" for purposes of the exemption from registration under the Advisers Act for advisers that exclusively advise venture capital funds,
- clarify which private fund assets an adviser must count towards the $150 million limit for purposes of the exemption from registration under the Advisers Act for advisers acting solely as investment adviser to one or more qualifying private funds with aggregate assets totaling no more than $150 million in the United States, and
- provide interpretive guidance as to many of the terms used in the Dodd-Frank Act within the definition of "foreign private adviser" for purposes of the exemption from registration under the Advisers Act for foreign private advisers.

Comments on the proposals are due within 45 days of publication in the Federal Register.

SEC Extends Compliance Date for New Short-Selling Restrictions

On November 4, 2010, the SEC extended the date for complying with the amendments to Regulation SHO adopted in February 2010 from November 10, 2010 to February 28, 2011. On February 24, 2010, the SEC adopted changes to the rules regarding short-selling under the Exchange Act, by imposing a restriction on the prices at which securities traded on a national securities exchange (other than options) may be sold short. Pursuant to the amendments to Regulation SHO, a trading center must implement written policies and procedures reasonably designed to prevent the execution or display of a short sale order for a particular security at a price that is less than or equal to the current national best bid, if the price of that security has decreased by 10% or more from the prior day's closing price. Once the "circuit breaker" is triggered, this price test will remain in effect for the remainder of the trading day and the following day. The amendments also facilitate the ability of long sellers of the affected security to sell their shares before short sellers may do so, and further short sales are permitted only when the price of the security is above the current national best bid.

SEC Proposes Whistleblower Rules Under the Dodd-Frank Act

On November 3, 2010, the SEC proposed rules to implement the whistleblower provisions of the Dodd-Frank Act. Proposed Regulation 21F under the Exchange Act would expand the SEC's ability to reward whistleblowers who alert the SEC to federal securities law violations. Among other things, proposed Regulation 21F would require the SEC to pay awards of between 10% and 30% of the monetary sanctions that the SEC and other authorities are able to collect to whistleblowers who voluntarily provide the SEC with original information about a violation of federal securities laws that leads to a successful enforcement action with monetary sanctions exceeding $1 million.

Under proposed Regulation 21F, only a natural person, either alone or jointly with others, is eligible to be a whistleblower. Proposed Regulation 21F generally allows for whistleblower anonymity and otherwise provides that the SEC will not reveal a whistleblower's identity, except under certain circumstances. However, anonymous whistleblowers must be represented by an attorney who is required to provide certification as to the whistleblower's identity and the completeness and accuracy of the whistleblower's submission. In order to receive an award as a whistleblower, the following requirements apply:

- the whistleblower must voluntarily provide the SEC with the information,

- the whistleblower must provide original information based on their independent knowledge or analysis, and

- the whistleblower's information must lead to successful enforcement by the SEC of an injunctive action in federal court or an administrative proceeding, which could be satisfied: (1) if the information results in a new examination or investigation being opened and significantly contributes to the success of a resulting enforcement action, or (2) if the conduct was already under investigation when the information was submitted, but the information is essential to the success of the action and would not have otherwise been obtained.

Under the proposal, whistleblowers are not required to report potential securities law violations through a company's internal reporting system before submission to the SEC. However, proposed Regulation 21F would not disqualify an individual who reports a potential securities law violation internally prior to submitting such information to the SEC, provided that the individual provides such information to the SEC within 90 days of the internal reporting.

Proposed Regulation 21F provides that culpable whistleblowers may not recover awards and are not given amnesty. Additionally, individuals whose job descriptions require them to investigate and uncover corporate wrongdoing generally may not receive an award.

Comments on the proposal are due by December 17, 2010.

SEC Proposes Rule on Institutional Investment Manager Reporting of Proxy Votes on Executive Compensation

On October 18, 2010, the SEC proposed Rule 14Ad-1 under the Exchange Act, which would require institutional investment managers subject to Section 13(f) of the Exchange Act (i.e., advisers with discretionary authority over accounts holding equity securities with an aggregate fair market value of at least $100 million) to report how they vote proxies on, among other things, executive compensation matters. Specifically, proposed Rule 14Ad-1, if adopted, would require institutional investment managers to disclose annually on Form N-PX how they voted on so-called "say-on-pay" and related matters proposed by companies over which the institutional investment managers have voting authority.

To assist in the implementation of proposed Rule 14Ad-1 and to provide clarity to the reporting requirements, the SEC also proposed certain amendments to Form N-PX, which is currently only used by registered funds. The proposed amendments to the Form are meant to accommodate reporting by institutional investment managers. Among other things, Form N-PX would be amended to include a new summary page intended to enable users to identify any institutional investment manager (in addition to the person filing the report) whose say-on-pay votes are included in the report, and those institutional investment managers whose say-on-pay votes are not included in the Form. These new requirements would also apply to the proxy voting reporting by registered funds.

While information filed on Form N-PX is publicly available under the proposal, an institutional investment manager could request confidential treatment of information reported on the Form.

FinCEN Extends Compliance Date for AML Travel Rule for Mutual Funds

On October 15, 2010, FinCEN issued a final rule extending the date by which mutual funds must comply the "Travel Rule" from January 10, 2011 to April 10, 2011. FinCEN extended the compliance date to provide mutual funds with an opportunity to implement changes to their transaction reporting and record keeping systems. The Travel Rule requires financial institutions, including mutual funds, to create and retain records for transmittal of funds and transmit information on these transactions to other financial institutions in the payment chain. Since mutual funds would be excepted from most of the Travel Rule's requirements, the effect of the Rule is that mutual funds would need to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities and credit for transactions exceeding $10,000.

SEC Proposes Rule Defining "Family Office" Adviser

On October 12, 2010, in its first step towards implementing the provisions of Section 409 of the Dodd-Frank Act, the SEC proposed new Rule 202(a)(11)(G)-1 under the Advisers Act defining the term "family office" for the purpose of excluding them from the definition of "investment adviser" in the Advisers Act, and thereby exempting them from registration as investment advisers under the Advisers Act.

Historically, family offices that would otherwise fall within the definition of investment adviser have relied on the "private adviser exemption" under Section 203(b) of the Advisers Act, which provides an exclusion for advisers with fewer than 15 clients that do not hold themselves out as investment advisers. Throughout the years, the SEC has also provided significant exemptive relief to family offices for which the private adviser exemption was unavailable. Effective July 21, 2011, the Dodd-Frank Act renders obsolete the private adviser exemption. The proposed Rule, if adopted, would effectively codify a substantial portion of the exemptive relief provided to family offices over the years.

SEC Stays Effectiveness of Amendments to Proxy Rules that Facilitate Rights of Shareholders to Nominate Directors

On October 4, 2010, the SEC ordered a stay of the effect of proxy rules adopted on August 25, 2010 that enhance the rights of shareholders to nominate directors for corporate boards, including boards of investment companies. The stay was granted in response to a petition by the Business Roundtable and the U.S. Chamber of Commerce pending resolution of court challenges to the rules that they filed on September 29, 2010 with the Court of Appeals for the District of Columbia Circuit.

The amendments create Rule 14a-11 under the Exchange Act, which allows eligible shareholders to have their nominees included in a company's proxy materials. Shareholders must meet all the requirements of Rule 14a-11 to have their nominee included in a company's proxy materials and Rule 14a-11 is not available if applicable state law or the company's governing documents prohibit shareholders from nominating candidates to the board. In addition, the amendments modify Rule 14a-8 under the Exchange Act to allow shareholders, subject to the other requirements of the Rule, to include proposals in a company's proxy materials that would amend provisions of a company's governing documents concerning the company's director nomination procedures or other director nomination disclosure provisions.

Pursuant to new Rule 14a-11, a shareholder is eligible to have a nominee included in a fund's proxy materials if the shareholder provides proper notice to the fund and, as of the date of such notice: (1) owns at least 3% of the outstanding fund voting securities entitled to vote on the election of directors at the meeting, (2) continuously held securities equaling the 3% threshold for at least three years prior to the notice date and (3) continues to hold the securities through the date of the shareholders meeting. Rule 14a-11 allows multiple shareholders to aggregate their individual holdings to meet the minimum ownership threshold, but each shareholder in the group must have held their qualifying shares for the required three-year period and must continues to hold their shares through the meeting date. For purposes of Rule 14a-11, unless a fund is a series company, a shareholder may determine the total amount of voting power of a fund's securities entitled to vote on the election of directors by reference to information included in the fund's most recent annual or semi-annual report on Form N-CSR. For a fund that is a series company, the fund must file a Form 8-K within four business days of setting a meeting date disclosing the total number of shares outstanding and entitled to vote on the election of directors as of the end of the most recent calendar quarter.

In addition to the ownership requirements, under Rule 14a-11, shareholders must certify that they are not holding their shares for the purpose of gaining control of the company or to gain more than a minority representation on the board of directors. An eligible shareholder is allowed to have one nominee or a number of nominees that would represent 25% of a company's board of directors, whichever is greater, included in the company's proxy materials. A nominating shareholder is required to file Schedule 14N with the SEC, which includes the information and certifications required by Rule 14a-11. A company that includes shareholder nominees in its proxy materials is not liable for any false or misleading statements in information provided by the nominating shareholder unless the company knows or has reason to know the information is false or misleading.

The amendments become effective on November 15, 2010, but their effectiveness is stayed pending resolution of the request for expedited review of the rules by the D.C. Court of Appeals.

SEC Amends Regulation FD as Required by the Dodd-Frank Act

On September 29, 2010, the SEC adopted an amendment to Regulation FD that became effective on October 4, 2010 and removed the exemption from public disclosure of material nonpublic information provided to nationally recognized statistical rating organizations (NRSROs) and credit rating agencies solely for the purpose of determining or monitoring a credit rating. The SEC amended Regulation FD to comply with a specific directive included in the Dodd-Frank Act that the exemption for information provided to NRSROs and credit rating agencies be removed.

CFTC Requests Comments on Amendments to Limit the Use of Futures by Investment Companies

On September 17, 2010, the CFTC issued a notice seeking comments on proposed amendments to CFTC Rule 4.5, which provides an exclusion from the term commodity pool operator for eligible persons operating certain qualifying entities, including registered funds. The proposed amendments would restore restrictions substantially similar to those in effect prior to 2003. Prior to 2003, persons seeking to fit within the exclusion were required to file a notice of eligibility and represent that the qualifying entity (1) has not marketed, and will not market, participations to the public as in a commodity pool or otherwise as a vehicle for trading commodity futures or commodity options and (2) will use commodity futures or commodity options contracts solely for bona fide hedging purposes and that the aggregate initial margin and premiums for speculative futures positions will not exceed 5% of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and losses on all such contracts. The amendments would also modify the limitation on speculative futures positions from former Rule 4.5 by referring directly to the qualifying entity claiming the exclusion. This could prohibit funds from trading futures and options on futures in wholly-owned subsidiaries, unless the subsidiary has also claimed an exemption under the Rule.

LEGISLATION

House Passes Regulated Investment Company Modernization Act of 2010

On September 28, 2010, the House of Representatives passed the Regulated Investment Company Modernization Act of 2010, which would amend the Internal Revenue Code to modify certain rules governing the taxation of regulated investment companies ("RICs"). Among other provisions, the Act would:

- permit RICs an unlimited carryforward of their net capital losses;
- allow income from commodities to be treated as qualifying income for purposes of the RIC gross income test;
- add savings provisions for failures of RICs to satisfy the RIC gross income and asset tests;
- modify the rules for designating and allocating RIC capital gain dividends;
- permit certain nondeductible items of income to be included in a RIC's earnings and profits calculations;
- allow qualified funds-of-funds to pass through to their shareholders tax-exempt interest and foreign tax credits, without regard to certain investment limitations;

- modify the rules relating to spillover dividends, return of capital distributions and stock redemptions;
- repeal the preferential dividend rule for publicly offered RICs;
- permit RICs to defer certain late-year losses; and
- modify certain excise tax and penalty rules applicable to RICs.

Congress Passes Legislation Limiting Confidentiality Protection for Materials Provided to the SEC

In September 2010, the Senate and House of Representatives each passed legislation amidst criticism that Section 929I of the Dodd-Frank Act undermines the goal of enhancing transparency and accountability in the financial system. As adopted, Section 929I modified the 1940 Act and the Advisers Act to generally provide that, with certain exceptions, the SEC shall not be compelled by a request under the Freedom of Information Act ("FOIA") to disclose any records or information it obtained in connection with its examination and surveillance efforts. The SEC had contended that such confidentiality provisions were necessary as regulated entities have refused to provide certain requested information that may not be protected by a FOIA exemption. The SEC's position failed to sway Congress and, as drafted, the current version of the legislation removes the confidentiality provisions in their entirety from the Acts.

LITIGATION

Funds Face Lawsuits Over Payments to Distributors; California Court Dismisses First Case

During 2010, several lawsuits have challenged payments made to broker-dealers which are not also registered as investment advisers in connection with the distribution of fund shares. The lawsuits, which are derivative actions on behalf of the funds, allege payment of asset-based compensation to broker-dealers holding fund shares in brokerage accounts. The claims are based on the March 30, 2007 decision in *Financial Planning Association v. SEC*, in which the D.C. Circuit Court of Appeals overturned a rule under the Advisers Act permitting fee-based brokerage accounts for certain broker-dealers. Under federal securities laws, broker-dealers may not receive compensation based on a percentage of assets in a client's account unless they are registered under the Advisers Act.

According to the lawsuits, pursuant to the 1940 Act and Rule 38a-1 (the compliance program rule thereunder), the board of a mutual fund has ultimate responsibility for ensuring compliance with all federal securities laws. Each complaint alleges that by authorizing payments not permitted under the Advisers Act, the funds and their boards have abdicated their duties under Rule 38a-1. The lawsuits generally assert a claim under Section 47(b) of the 1940 Act against each fund's distributor that seeks to void the existing distribution agreement, a breach of contract action against each distributor and claims for breach of fiduciary duty and waste against the funds' directors.

In *Smith v. Franklin Templeton*, the U.S. District Court for the Northern District of California dismissed claims made against Franklin Templeton, but permitted the plaintiff to amend his complaint with respect to the sole federal claim. The judge in the case disagreed with the theory that Section 47(b) of the 1940 Act provides a separate cause of action or basis of liability for a claim, as well as the plaintiff's reading of the D.C. Circuit Court of Appeals case regarding fee-based brokerage accounts. The opinion noted that, in the absence of some other violation of the 1940 Act, Section 47(b) alone is insufficient to support a private right of action. In characterizing the *Financial Planning Association* decision as "irrelevant" to the claims before the court, the judge distinguished the service-based fees that violate the prohibition on asset-based compensation from distribution fees paid by Franklin Templeton under Rule 12b-1.

On October 22, 2010, the U.S. District Court for the Northern District of California dismissed the plaintiff's amended complaint in *Franklin Templeton*. In addition to again finding that the plaintiff had failed to allege sufficient facts to state a claim, Judge Hamilton ruled that Sections 36(a) and 47(b) under the 1940 Act do not offer a basis of liability under which plaintiffs may sue. The holding also confirmed the court's previous ruling that Rule 38a-1 under the 1940 Act does not provide either an express or implied private right of action, and that the Rule does not impose on funds a duty to assure that broker-dealers comply with registration requirements. Rather, Rule 38a-1 only requires funds to adopt and implement compliance programs that are reasonably designed to prevent violation of the federal securities.

The ruling by the Northern District of California court could have a significant impact on two other cases with similar allegations involving Eaton Vance and Oppenheimer Funds. A Massachusetts court in *Eaton Vance* recently held a hearing regarding the defendants' motion to dismiss, while the case against Oppenheimer Funds was transferred from Colorado to New York in October 2010.

OTHER NEWS

ICI Challenges Montana Notice Filing Fee Change

On November 22, 2010, the ICI filed suit in the Montana First Judicial Court challenging the Montana Securities Department's authority to increase mutual fund notice filing fees by executive order. The Montana Securities Department had notified notice filers that effective January 1, 2011, the Department would begin charging notice filing fees at the class level, rather than at the portfolio (series) level. The ICI complaint alleges that the Montana blue sky law requires the payment of notice filing fees at the portfolio level, that the filing fees historically have been charged at the portfolio level and that any change to the fee structure must be enacted by the Montana legislature.

SEC Staff Opposes Closed-End Fund Use of Maryland Takeover Statute

On November 15, 2010, the SEC staff took the position in a no-action letter with respect to the Boulder Total Return Fund, Inc., that a registered closed-end fund may not opt in to the Maryland Control Share Acquisition Act. The SEC's position effectively removes an important anti-takeover device for closed-end funds. The no-action letter was issued under Section 18(i) of the 1940 Act, which generally provides that every share of stock issued by a registered fund shall be voting stock and have equal voting rights with every other outstanding voting stock. The Maryland Act provides that, when an investor crosses certain threshold percentages of stock ownership, the investor's shares lose their voting rights, unless the voting rights are restored by a shareholder vote in which the investor may not participate. The SEC staff stated that nullifying the voting rights of an acquiring person as contemplated by the Maryland Act would be inconsistent with Section 18(i) because the acquiring person would no longer presently be entitled to vote such shares for the election of directors—which is, the staff noted, precisely the aim of the Maryland Act. Because many closed-end funds are organized in Maryland, the no-action letter will likely have broad applicability. The no-action letter also lists 25 other states with control share acquisition statutes and notes that the same analysis may be applicable to them.

SEC Staff Issues Letter on Director Responsibilities under Affiliated Transaction Rules

On November 2, 2010, the SEC staff issued a letter to the Chairs of the Independent Directors Council and Mutual Fund Directors Forum regarding the responsibilities of fund directors with respect to affiliated transactions under Rules 10f-3, 17a-7 and 17e-1 under the 1940 Act. These rules permit funds to engage in otherwise prohibited affiliated transactions provided that fund directors fulfill certain responsibilities, including making a determination at least quarterly that all such affiliated transactions made during the preceding period were effected in compliance with the procedures adopted by the board under the applicable rule. The letter was issued in response to the SEC staff's observations that some boards believe that they can delegate their responsibilities to make such determinations under the rules. The letter notes that, while the rules do not specify how boards should make such determinations, boards retain the ultimate responsibility for making the determinations required by the rules and cannot delegate such responsibilities.

President's Working Group Releases Report on Money Market Funds

In October 2010, the President's Working Group on Financial Markets released its report, Money Market Fund Reform Options, which sets forth options for additional money market reform to be considered by the Financial Stability Oversight Council. The Council is charged with identifying and pursuing those options that are most likely to reduce money market funds' susceptibility to runs, with the primary goal of mitigating systemic risk and containing the effect an individual money market fund can have on other money market funds or the broad financial system. The SEC is charged with soliciting public comments, including supporting documentation, on the options.

The report describes five features of money market funds, their sponsors and their investors that make the funds susceptible to runs, including: (1) maturity transformation with limited liquidity resources; (2) net asset values (NAVs) rounding to $1.00; (3) portfolios exposed to credit and interest rate risks; (4) discretionary sponsor capital support; and (5) investors' low risk tolerance and risk-free expectations. The report acknowledges that the SEC's recent money market reforms addressed some of these features, but discusses the need for additional reform to address systemic risk and the funds' structural vulnerabilities.

The report sets forth the benefits and drawbacks of seven options aimed at reducing money market funds' susceptibility to runs. The options include measures both within and beyond the SEC's current regulatory authority. These options include: (a) requiring floating NAVs; (b) establishing private emergency liquidity facilities for money market funds (the facility described in the report would not assist funds that take on excessive capital risks or have isolated credit losses); (c) requiring mandatory redemptions-in-kind for large redemptions by institutional investors; (d) implementing an insurance program for money market funds; (e) creating a two-tier system of money market funds, with enhanced protection and more stringent requirements for stable NAV funds; (f) creating a two-tier system of money market funds with stable NAV funds reserved for retail investors; and (g) regulating stable NAV money market funds as special purpose banks.

The report acknowledges that further regulation of money market funds may motivate investors to invest their money with unregulated counterparties that may pose even greater systemic risk than money market funds. The report also notes the significance of money market funds in the U.S. financial system and suggests that any changes be considered carefully.

On November 3, 2010 the SEC solicited public comments on the options discussed in the report. Specifically, the SEC seeks comments on the options described in the report both individually and in combination, as well as comments on the issues believed to be relevant to further money market reform, including other approaches for lessening systemic risk not identified in the report. Comments are due by January 10, 2011.

CFTC and SEC Staff Issue Joint Report on May 6, 2010 Market Events

In a September 30, 2010 report to the Joint Advisory Committee on Emerging Regulatory Issues, the staffs of the CFTC and the SEC detailed their findings regarding the market events of May 6, 2010. The report reflects the culmination of market data analysis and interviews with various market participants and exchanges regarding the events of May 6, and describes the events in terms of two liquidity crises.

The report states that on May 6, the markets opened turbulently on news of the European debt crisis. When the Euro began a sharp decline against the U.S. Dollar and Japanese Yen, volatility pauses on the New York Stock Exchange and the S&P 500 volatility index both increased, yields of ten-year Treasuries decreased, the Dow Jones Industrial Average fell, and there was a drop in both buy-side liquidity in E-Mini S&P 500 futures contracts and the SPDR S&P 500 ETF Trust (SPY).

The report describes the first liquidity crisis at the broad index level in the E-Mini. According to the report, against the backdrop of turbulent market conditions, a large fundamental trader entered an order to sell 75,000 E-Mini contracts via an automated execution algorithm at an execution rate calculated based on trading volume without regard to price or time. During this time, high frequency traders traded E-Mini contracts comprising nearly 33% of the total trading volume, which triggered the algorithm, feeding additional contracts into the market even though fundamental buyers in the futures market and cross-market arbitrageurs had not absorbed the previous orders.

According to the report, a series of factors, including sell pressure from the algorithm, lack of demand from fundamental buyers and cross-market arbitrageurs and a “hot potato” volume effect as high frequency traders rapidly traded the same positions back and forth, contributed to rapid declines in the prices of the E-Mini and SPY. The sudden decline in price and liquidity triggered a five-second regulatory trading pause. From the start of the algorithm until the trading pause, the algorithm sold 35,000 contracts. During the same time, all fundamental sellers combined sold more than 80,000 contracts, resulting in a net imbalance of 30,000 contracts. As the prices stabilized, the algorithm continued to sell the remaining 40,000 contracts.

The report describes the second liquidity crisis with respect to individual stocks. According to the report, in reaction to the E-Mini crisis, the automated trading systems used by many liquidity providers also paused as designed to allow traders and risk managers to perform a risk assessment of continued trading. As a result, some market makers and liquidity providers widened quote spreads, reduced liquidity and a significant number withdrew from the markets. The reduced liquidity caused further price declines until eventually, liquidity evaporated in a number of individual securities and ETFs. Those participants instructed to trade at market found no interest, resulting in trades during this time being executed at prices ranging from 1¢ to $100,000. After market close, the exchanges and FINRA later agreed to cancel trades that were executed at a price more than 60% away from their value prior to the market events under their “clearly erroneous” trade rules.

In response to the May 6 events and to provide clarity around when erroneous trades will be broken, regulators established the circuit breaker program and related procedures. The report states that the CFTC and SEC staffs will work with market centers to review their members’ trading practices to identify any abusive or manipulative conduct that may cause system delays that inhibit a fair and orderly process of price discovery.

SEC’s Enforcement Head Testifies on Mutual Fund Fee Initiative

On September 22, 2010, Robert Khuzami, the head of the SEC’s Division of Enforcement, discussed a “Mutual Fund Fee Initiative” during his testimony before the Senate Committee on the Judiciary. When discussing the SEC's newly-created asset management unit (which focuses on mutual funds, private funds and investment advisers), Mr. Khuzami noted that the unit, along with the other SEC divisions, has established a Mutual Fund Fee Initiative to develop analytics for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees. He stated that the analytics are expected to result in examinations and investigations of investment advisers and fund boards concerning duties under the 1940 Act.

SEC Staff Issues No-Action Letter on Soft Dollar Arrangements

On September 21, 2010, the SEC staff issued a no-action letter to BNY ConvergEx Group, LLC stating that a broker-dealer's provision of research services to an institutional investment adviser would not establish an adviser-client relationship under the Advisers Act between the broker-dealer and the institutional investment adviser's clients. According to BNY ConvergEx's letter, many research broker-dealers have refused cash payments for their proprietary research from executing brokers because the investment adviser's clients may be viewed as the research broker-dealer's clients and, as a result, the principal transaction restrictions under the Advisers Act may apply.

ENFORCEMENT ACTIONS

SEC Charges Managing Director of Securities Lending Program

On November 22, 2010, the SEC charged Emil Busse, Jr., the former managing director of the securities lending program at FAF Advisors, Inc., for willfully aiding and abetting and causing FAF's violations with respect to its securities lending program. The charges involve Mr. Busse's role in violations of the antifraud provisions of the federal securities laws as the result of his attempt to prevent a mutual fund from dropping below a net asset value of $1.00 per share.

The securities lending program managed by FAF provided customers of its parent, U.S. Bank, the option of loaning securities they held at U.S. Bank to certain approved broker-dealers in exchange for cash collateral. Customers who participated in the program could then invest the cash proceeds into either the Prime Portfolio or the Bond Portfolio. The Bond Portfolio was not required to maintain an NAV of $1.00 per share and the bank was prepared to notify customers that the NAV may drop below $1.00. However, according to the SEC, Mr. Busse caused the reallocation of numerous loans of securities from customers invested in the Prime Portfolio to customers invested in the Bond Portfolio in an effort to increase the assets in the Bond Portfolio and enable the fund to keep its NAV at $1.00 per share. Eventually, Mr. Busse's efforts failed and the NAV of the Bond Portfolio decreased to $0.99 per share. As a result of his actions, according to the SEC, certain customers in the inflated Bond Portfolio suffered losses of approximately $6 million. Mr. Busse agreed to pay a civil money penalty in the amount of $65,000.

SEC Charges Investment Adviser for Books and Records and ADV Violations

On November 16, 2010, the SEC charged Thrasher Capital Management, LLC and James Perkins, its chief executive officer, for failing to make Thrasher's books and records available to the staff of the SEC and for untrue statements of material facts in Thrasher's Form ADV.

According to the SEC's order, Mr. Perkins failed to make Thrasher's books and records available after the staff requested the items following an office visit. The books and records were not produced until a subpoena was issued. In addition, according to the

SEC, Thrasher's Form ADV inaccurately disclosed that 40% of its clients were high net worth at a time when Thrasher did not have any high net worth clients and the Form ADV failed to disclose an individual with a significant ownership interest. As a result, the SEC revoked Thrasher's registration as an investment adviser and suspended Mr. Perkins from any association with an investment adviser for a period of nine months.

SEC Charges Investment Adviser, Broker Dealer and CCO for Compliance Violations

On November 17, 2010, the SEC charged investment adviser Buckingham Capital Management Inc. ("BCM"), its broker-dealer parent company, The Buckingham Research Group Inc. ("BRG"), and Lloyd Karp, the firms' chief compliance officer, with failing to have adequate policies and procedures to prevent misuse of nonpublic information. BCM was also charged with supplementing and altering its records prior to turning them over to SEC examination staff.

The SEC found that BCM and BRG failed to establish, maintain, and enforce written policies and procedures reasonably designed to prevent misuse of material, nonpublic information, including forthcoming BRG research reports. According to the SEC's order, BRG's written policy required analysts to certify confidentiality of information whenever a material research event occurred. However, BRG only required a certification in instances where a BCM portfolio traded in the same direction and in many instances, analyst certifications were lacking, incomplete or dated long after the research event had occurred. With respect to BCM, the SEC found that when BCM began preparing for an SEC examination in 2006, the firm discovered that it was missing over 100 pre-approval trade forms. According to the SEC, BCM created the missing pre-approval forms and provided the forms to the examination staff of the SEC without disclosing what had been done. In addition, BCM replaced incomplete compliance logs and failed to follow its written policy regarding nonpublic information. As a result, BRG agreed to pay a $50,000 penalty, BCM agreed to pay a $75,000 penalty and Mr. Karp agreed to pay a $35,000 penalty.

SEC Charges Hedge Fund Manager with Defrauding Investors by Overvaluing Fund Position

On October 25, 2010, the SEC charged Southridge Capital Management LLC and Southridge Advisors LLC, each unregistered hedge fund advisers, and their principal, Stephen Hicks, for defrauding investors. First, the SEC alleged that Mr. Hicks overvalued the largest position held by certain funds by fraudulently misstating the acquisition price of the assets, thereby causing the funds to pay or accrue more than $1.8 million of management fees since 2004. According to the SEC's complaint, in early 2004, Mr. Hicks arranged the sale of a company acquired by the funds as a result of a defaulted note to Fonix Corporation in exchange for securities with a stated value of $33 million. The complaint alleged that neither the company sold nor the Fonix securities obtained in the transaction were accurately valued and that Fonix securities were thereafter wrongfully valued at acquisition cost.

Second, the SEC alleged that beginning in late 2003, Mr. Hicks fraudulently solicited investors to put money in new funds that were supposed to have a majority of their investments in unrestricted, free-trading liquid shares, cash or near cash. According to the SEC's complaint, Mr. Hicks raised $80 million for the new funds and at year-end 2006 more than half of the assets in one new fund (and more than one-third of the assets in another new fund) were invested in relatively illiquid assets. The SEC alleged that by 2007 investors had submitted nearly $7 million in redemption requests that were unable to be satisfied.

Finally, the SEC alleged that between 2005 and 2008, the Southridge advisers and Mr. Hicks caused certain of the funds that had available cash to pay approximately $5 million of legal and administrative expenses of older funds that were illiquid and had no available cash. The SEC's complaint alleged that investors in the funds from which money was taken were not told about this misappropriation of fund assets while it was taking place. Instead, in February 2009, Mr. Hicks sent a letter to investors admitting that certain legal and administrative expenses had been improperly allocated between the funds, but rather than repaying the money to the funds, the Southridge advisers and Mr. Hicks transferred certain illiquid securities.

Former State Street Employees Charged by SEC for Misleading Investors About Subprime Mortgage Investments

On September 30, 2010, the SEC charged two former employees at State Street Bank and Trust Company with misleading investors about their exposure to subprime investments in State Street's Limited Duration Bond Fund. The SEC charged State Street in a related case earlier this year, in which the firm agreed to settle the charges by repaying fund investors more than $300 million. When the SEC announced its settlement with State Street in February, it also announced that State Street had agreed—pursuant to a limited privilege waiver—to provide information to enable the SEC to assess the potential liability of individuals involved with State Street's investor communications about the fund.

According to the order, John P. Flannery, formerly the chief investment officer, and James D. Hopkins, formerly a product engineer, played an instrumental role in drafting a series of misleading communications beginning in July 2007. The communications to investors related to the effect of the turmoil in the subprime market on the Limited Duration Bond Fund and other State Street funds that invested in it. According to the SEC, State Street provided certain investors, including State Street's internal advisory groups, with more complete information about the fund's subprime concentration and other problems with the fund.

SEC Charges Broker-Dealer for Deficient CIP Procedures

On September 1, 2010, the SEC charged Pinnacle Capital Markets LLC, a broker-dealer, with failing to comply with customer identification program ("CIP") requirements. Pinnacle's managing director, Michael A. Paciorek, was also charged with causing Pinnacle's violations. According to the order, Pinnacle established, documented and maintained a CIP that specified it would identify and verify the identities of all of its customers; however, during a six-year period, Pinnacle failed to follow the identification and verification procedures set forth in its CIP.

According to the order, many of Pinnacle's foreign institutional customers hold omnibus accounts at Pinnacle through which the entities carry sub-accounts for their own corporate or retail customers and the sub-account holders are treated in the same manner as regular account holders. Also, according to the order, Pinnacle did not verify the identities of 34 out of a sample of 55 corporate account holders from October 2003 to August 2006, and from October 2003 through November 2009, Pinnacle did not collect or verify identifying information for the vast majority of the beneficial owners of sub-accounts maintained by Pinnacle's omnibus brokerage accounts. As a result, the SEC found that Pinnacle's documented procedures differed materially from its actual procedures. Pinnacle and Mr. Paciorek agreed to settle the SEC's enforcement action without admitting or denying the allegations, and Pinnacle will pay $25,000 in penalties.

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