Investment Services Regulatory Update

March 1, 2011

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Proposes Reporting Obligations for Advisers to Private Funds

On January 26, 2011, the SEC proposed new Rule 204(b)-1 under the Advisers Act, to implement certain recordkeeping and filing requirements under the Dodd-Frank Act. Specifically, proposed Rule 204(b)-1 would require advisers to private investment funds, including advisers to hedge funds, private equity funds and “liquidity funds” (i.e., private money market funds), to file periodically new Form PF with the SEC. The content and frequency of an adviser’s reporting obligations on Form PF would vary based on the types of private funds advised and the adviser’s assets under management. For example, advisers to “hedge funds” and “liquidity funds” would generally be subject to more comprehensive reporting requirements than advisers to “private equity funds,” with certain “large private fund advisers” subject to the most comprehensive and frequent reporting requirements. Large private fund advisers with $1 billion or more in assets under management would be required to file Form PF on a quarterly basis. All other private fund advisers would be required to file Form PF annually. Information collected by the SEC on Form PF would be made available to the CFTC (as it relates to commodity pools managed by CPOs and CTAs) and the Financial Stability Oversight Council. Under the proposed rule, information reported on Form PF would remain confidential.

Information to be reported on proposed Form PF would include, among other things:

- identifying information of the adviser, as well as the adviser’s gross and net assets under management in total, and gross and net assets under management attributable to certain types of private funds, and

- fund-specific information such as the name of the fund, gross and net assets, aggregate notional value of the fund’s derivative positions, information regarding creditors and outstanding debt, performance information and investor information.

The proposed Rule would require hedge funds to disclose information relating to investment strategies, use of trading algorithms, counterparty trading exposure and general trading and clearing practices. Large private fund advisers would also generally be required to disclose a greater range of information, including the market value of assets invested (on a short and long basis) in different types of securities and commodities, the duration of fixed income portfolio holdings, the turnover rate of the adviser’s portfolios during the reporting period and the geographic breakdown of investments held. Depending on the type of fund and amount of assets under management, other information would also be required on Form PF.

Comments on the proposal are due by April 12, 2011.

SEC Proposes Net Worth Standard for Accredited Investors

On January 25, 2011, the SEC proposed an amendment to the definition of "accredited investor" to implement Section 413(a) of the Dodd-Frank Act. Specifically, the SEC proposed amendments to Rules 215 and 501(a)(5) under the Securities Act to exclude the value of a natural person's primary residence for purposes of determining whether a natural person is an "accredited investor" (i.e., has a net worth in excess of $1 million). While the provisions of Section 413(a) of the Dodd-Frank Act were effective upon enactment in July 2010, the Act required the SEC to amend these rules.

Comments on the proposal are due by March 11, 2011.

SEC Extends Compliance Date for Initial Delivery of Form ADV Brochure Supplements

On December 28, 2010, the SEC extended the compliance date for the initial delivery by registered investment advisers of brochure supplements required by Part 2B of Form ADV and Rule 204-3 of the Advisers Act. On July 28, 2010, the SEC adopted amendments to Part 2 of Form ADV, and related rules under the Advisers Act, to require advisers to deliver to clients and prospective clients a narrative brochure in plain English describing the adviser's business practices, fees, conflicts of interest and disciplinary history. The amendments also require advisers to deliver to clients and prospective clients brochure supplements which provide information on the educational background, business experience and disciplinary history of advisory personnel who provide or will provide investment advice to the client.

As originally adopted, the amendments became effective on October 12, 2010 with the following compliance dates:

- Advisers applying for registration with the SEC after January 1, 2011 must file a brochure that meets the amended requirements of Part 2A of Form ADV as part of their application for registration and deliver the brochure and brochure supplements to existing and prospective clients upon registering.

- Existing registered advisers must file a revised brochure that meets the amended requirements of Part 2A as part of their annual updating amendment to Form ADV for fiscal years ending on or after December 31, 2010. The revised brochure and brochure supplements must be delivered to new and prospective clients following the filing of the adviser's annual updating amendment and to existing clients within 60 days after the filing of the annual updating amendment.

The SEC is maintaining the original compliance dates for the filing and delivery of the brochure required by Part 2A of Form ADV, but is extending the compliance dates for initially delivering brochure supplements required by Part 2B of Form ADV. The new compliance dates for delivering brochure supplements are:

- Advisers applying for registration with the SEC from January 1, 2011 through April 30, 2011 have until May 1, 2011 to begin delivering brochure supplements to new and prospective clients and until July 1, 2011 to deliver brochure supplements to existing clients.

- Existing registered advisers having a fiscal year ending on December 31, 2010 through April 30, 2011 have until July 31, 2011 to begin delivering brochure supplements to new and prospective clients and until September 30, 2011 to deliver brochure supplements to existing clients.

SEC Extends Temporary Rule Regarding Adviser Principal Trades

On December 28, 2010, the SEC extended by two years 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, 2012, 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 provide sufficient protection to advisory clients while the SEC conducts its study of the standards of care applicable to broker-dealers and investment advisers as required by Section 913 of the Dodd-Frank Act and also as it considers more broadly the regulatory requirements applicable to broker-dealers and investment advisers, including principal trading by advisers.

OTHER NEWS

SEC Outlines 2011 Exam Priorities

In February 2011, SEC staff in the Office of Compliance Inspections and Examination (OCIE) outlined priorities for the upcoming year in remarks given at the CCOutreach National Seminar, the PLI Investment Management Institute Conference and in an interview with *Ignites*. Despite uncertainty about OCIE's budget, SEC staff stated that OCIE is moving forward with new and expanded initiatives, including a certification program and expanded training for examiners and a national exam program to make the examination process more efficient. OCIE also will seek to conduct more targeted exams in order to gather detailed information on registrants and, accordingly, OCIE may issue exam notices up to three months in advance. Furthermore, OCIE plans to take what examiners learn about effective practices and risk concerns and provide more guidance to registrants through ComplianceAlerts or similar releases. OCIE's primary risk focus areas for 2011 are said to include valuation, conflicts of interest where certain accounts are favored over others, portfolio management where there is a drift in advertised strategy, performance and marketing, asset verification and governance and risk management.

ICI Issues Legal Memorandum Regarding Effect of State Laws on "Pay-to-Play" Policies and Procedures

On February 18, 2011, the ICI published a memorandum from private counsel summarizing the results of a six state (California, Colorado, Connecticut, Massachusetts, New York and Texas) survey on the potential effects that the laws of these states could have on an adviser's ability to restrict or ban its employees' political contributions. Based on the information in the memorandum, the ICI noted that when developing "pay-to-play" policies and procedures pursuant to the recently adopted SEC rule, advisers should be mindful of state employee protection laws and appropriately tailor any limits imposed on employee political contributions to avoid violating such laws, including adequately protecting the privacy interests of their employees and ensuring that any action taken against an employee in connection with political contributions relates to a violation of the adviser's policies and procedures adopted to implement the SEC rule. In addition, the ICI noted that advisers should be aware that some state laws may actually limit an adviser's ability to ban employee political contributions.

Clarification of Inapplicability of "Say on Pay" Rule to Closed-End Funds

In February 2011, the ICI reported that the SEC staff had orally confirmed that closed-end funds are not required to include shareholder advisory votes in their proxy statements related to "say on pay" and "say on frequency" pursuant to the new rules adopted in January 2011.

SEC Staff Submits Study on Investment Adviser and Broker-Dealer Regulatory Standards

On January 21, 2011, the SEC staff submitted to Congress its study, as required by the Dodd-Frank Act, which evaluates the effectiveness of the existing standards of care for broker-dealers and investment advisers when providing personalized investment advice to retail customers. The study also examines the existence of any gaps or overlaps in the standards of care. The study recommends implementing a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice to retail customers.

Currently, broker-dealers and investment advisers are each regulated extensively, but under different regimes with differing standards. Despite the differing standards, broker-dealers and investment advisers provide many of the same services, including providing personalized investment advice to retail investors. The SEC staff's study found evidence that retail investors generally do not understand the difference between investment advisers and broker-dealers or the standards of care applicable to each. The study noted that many retail investors expect any investment advice they receive to be in their best interest.

In order to decrease investor confusion and increase investor protection, the SEC staff recommends that the SEC adopt a rule, with appropriate interpretive guidance, to establish a uniform fiduciary standard to regulate all investment advisers and broker-dealers when providing personalized investment advice to retail investors, which should be no less stringent than the standard currently applied to investment advisers, i.e., "act in the best interest of the client." The SEC staff noted that the SEC should provide guidance regarding how broker-dealers should fulfill the uniform fiduciary standard when engaging in principal trading.

The study also recommends that the SEC consider harmonizing other regulatory requirements in order to provide investors with similar protections when broker-dealers and investment advisers are performing the same or substantially similar functions, including regulatory requirements regarding:

- content of advertising and other customer communications,
- the use of and disclosure requirements of finders and solicitors,
- supervisory requirements including examination and oversight,
- licensing and registration of firms, including disclosure requirements of Form ADV and Form BD, and
- books and records requirements.

The SEC staff recommends that the SEC take into account the best elements of each regime when considering the harmonization of regulations.

Two SEC commissioners issued a separate statement to express their view that the study does not adequately document retail investors' confusion regarding the differing standards and does not address the possibility that the recommended uniform fiduciary standard may not solve the confusion. The two SEC commissioners also expressed concern that the overall cost of the recommended regulatory actions is not appropriately considered by the study, but noted that with further research and analysis, they could ultimately support the recommendations of the study. Because the Dodd-Frank Act does not impose a deadline for rulemaking, the two SEC commissioners suggested further research and analysis.

SEC Staff Submits Study on Investment Adviser Examinations

On January 19, 2011, the SEC staff submitted to Congress its study, as required by the Dodd-Frank Act, evaluating the SEC's need for enhanced examination and enforcement resources for its oversight of investment advisers. Based on the data presented in the study, the staff concluded that the SEC is unlikely to have sufficient capacity to conduct effective examinations of registered investment advisers under the current framework. The study presents three options to address these capacity challenges and recommends that Congress consider implementing one or more of them.

The study recommends imposing user fees on registered investment advisers to fund their examinations and notes that the SEC could be permitted to set user fees at a level designed to achieve acceptable examination frequency. User fees could provide enough resources to allow the staff to perform earlier examinations of newly-registered investment advisers and more frequent examinations on existing advisers, which the staff believes could provide a greater deterrence from wrongdoing. This option would also allow the responsibility for registered investment adviser examinations to remain solely within the purview of the SEC, which would avoid certain costs and inefficiencies expected if coordination with one or more self-regulatory organizations ("SROs") were necessary in order to perform examinations.

Another option is for Congress to authorize one or more SROs to examine all registered investment advisers, subject to SEC oversight. SROs would be funded by membership fees, and earlier and more frequent examinations could be a benefit of this option as well. However, because the SEC would be required to oversee the operations of any SRO, it would still be required to use considerable resources. The study indicates that because of the diversity in size and complexity of registered investment advisers, authorizing multiple SROs which would each focus on a specific industry group could be advantageous.

The study also recommends that Congress consider amending the Exchange Act in order to permit FINRA to examine all of its members who are also registered investment advisers for compliance with the Advisers Act. This approach could provide for more cost-efficient oversight of dual registrants.

One SEC commissioner issued a separate statement regarding the staff study to express the view that the study's presentation of the three options was not balanced and the recommendation to Congress was not sufficiently precise. The statement also emphasized that, in implementing the SRO recommendation, it does not have to be a single SRO and it does not need to be FINRA.

ICI Issues Comment Letter on President's Working Group 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.

In accordance with the report, the SEC issued a request for comments on the options, which include: (1) requiring floating NAVs; (2) 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); (3) requiring mandatory redemptions-in-kind for large redemptions by institutional investors; (4) implementing an insurance program for money market funds; (5) creating a two-tier system of money market funds with enhanced protection, and more stringent requirements, for stable NAV funds; (6) creating a two-tier system of money market funds with stable NAV funds reserved for retail investors; and (7) regulating stable NAV money market funds as special purpose banks.

On January 11, 2011, the ICI issued a comment letter on the proposed options. The ICI letter discusses each option in detail, noting the potential issues and detrimental effects each could have on money market funds, investors and the market, including that certain of the proposed options could increase, rather than decrease, systemic risk. The ICI letter states that while each option has drawbacks, a private emergency liquidity facility for prime money market funds has the most promise for achieving the policymakers' objective with the least negative impact. The ICI letter then addresses the concerns enumerated in the report regarding a private emergency liquidity facility.

In particular, the proposed model liquidity facility described in the ICI letter would require all prime money market funds, or, alternatively, all prime money market funds that continue to use amortized cost pricing, to participate in the liquidity facility. The liquidity facility would be a state-chartered bank or trust company funded by initial contributions from prime money market fund sponsors and ongoing commitment fees from member funds, as well as additional capacity eventually being gained from the issuance of time deposits to third parties. The liquidity facility would be structured to enable participating money market funds to meet redemptions while maintaining a stable NAV during times of unusual market stress by purchasing such funds' high-quality, short-term assets. To protect against money market funds attempting to sell low-yielding securities to the liquidity facility, the funds would be required to present their entire portfolio to the facility for review and to pay an access fee. The liquidity facility would further limit the prime money market funds that may participate to those demonstrating a liquidity need and excluding those that have already broken the dollar. The ICI letter states that the liquidity facility would help protect the broad money market by allowing prime money market funds to sell portfolio holdings in a challenging market environment and could also provide reassurance to investors.

In addition to reviewing the seven options proposed in the report, the ICI letter proposes an additional reform for consideration. The letter recommends that the SEC consider a rule that would require intermediaries, upon the request of a money market fund, to provide information about underlying fund investors to facilitate the fund's compliance with the "know your investor" requirements.

LEGISLATION

President Obama Signs Regulated Investment Company Modernization Act of 2010

On December 22, 2010, President Obama signed into law the Regulated Investment Company Modernization Act of 2010, which amends the Internal Revenue Code to modify certain rules governing the taxation of regulated investment companies ("RICs"). Among other provisions, the Act:

- permits RICs an unlimited carryforward of their net capital losses;
- adds savings provisions for failures of RICs to satisfy the RIC gross income and asset tests;
- modifies the rules for designating and allocating RIC capital gain dividends;
- permits certain nondeductible items of income to be included in a RIC's earnings and profits calculations;
- allows qualified funds-of-funds to pass through to their shareholders tax-exempt interest and foreign tax credits, without regard to certain investment limitations;
- modifies the rules relating to spillover dividends, return of capital distributions and stock redemptions;
- repeals the preferential dividend rule for publicly offered RICs;
- permits RICs to defer certain late-year losses; and
- modifies certain excise tax and penalty rules applicable to RICs, including increasing a RIC's required capital gain distribution to avoid excise tax from 98% to 98.2%.

The Act does not include a provision that was included in the original bill that would have allowed income from commodities to be treated as qualifying income for purposes of the RIC gross income test.

The provisions of the Act are generally effective for taxable years of a RIC beginning after December 22, 2010.

ENFORCEMENT ACTIONS

SEC Charges Adviser and Chief Executive Officer for IPO Allocations

On February 7, 2011, the SEC charged Alpine Woods Capital Investors, LLC, a registered investment adviser, and its chief executive officer, Samuel A. Lieber, for failing to (i) disclose the material impact that initial public offerings had on performance of two Alpine funds, (ii) implement policies for IPO allocations and (iii) adequately disclose risks related to IPOs.

The SEC found that two of the newest and smallest mutual funds advised by Alpine, the Alpine Dynamic Financial Services Fund and the Alpine Dynamic Innovators Fund, participated in a disproportionate number of IPOs in 2006 and 2007 as compared to Alpine's other existing funds. According to the SEC's order, the two funds' returns from participating in IPOs materially contributed to the positive performance of those funds during Alpine's 2007 fiscal year. However, according to the SEC, Alpine failed to disclose to shareholders through the funds' annual reports and prospectuses and to the funds' board the extent to which the funds invested in IPOs and the material impact IPO allocations had on fund performance. The SEC also found that Alpine, through Mr. Lieber, failed to implement written policies and procedures reasonably designed to prevent such violations. Alpine agreed to pay a $650,000 civil penalty and Mr. Lieber agreed to pay a $65,000 civil penalty.

SEC Charges AXA Rosenberg Entities for Concealing Error in Quantitative Investment Model

On February 3, 2011, the SEC charged AXA Rosenberg Group LLC ("ARG"), AXA Rosenberg Investment Management LLC ("ARIM") and Barr Rosenberg Research Center LLC ("BRRC") with securities fraud for concealing a significant error in the computer code of the quantitative investment model that they used to manage client assets.

ARIM, a registered investment adviser, used the quantitative investment model that was created by BRRC to manage client portfolios. The SEC found that a material error that disabled one of the model's key components for managing risk was introduced into the model in April 2007. The error was not discovered until June 2009. Following the discovery of the error in June 2009, instead of disclosing and fixing the error immediately, according to the SEC, a senior ARG and BRRC official directed others to keep quiet about the error and declined to fix the error at that time. According to the SEC, the error was eventually fixed for all portfolios by November 2009, but clients were not notified of the error until April 15, 2010.

The SEC found that ARG, BRRC and ARIM made material misrepresentations and omissions about the error to ARIM's clients by failing to disclose the error and its impact on client performance, attributing the model's underperformance to market volatility rather than the error and misrepresenting the model's ability to control risks. In addition, the SEC found that BRRC did not have reasonable compliance procedures in place to ensure that the model would assess certain risk factors as intended, since BRRC did not have procedures in place to ensure coding functioned properly and in the manner represented to clients. ARG, BRRC and ARIM agreed to pay $217 million to harmed clients plus a $25 million penalty, and to hire an independent consultant with expertise in quantitative investment techniques to review disclosures and enhance the role of compliance personnel.

SEC Charges Merrill Lynch for Misusing Customer Order Information and Charging Undisclosed Trading Fees

On January 25, 2011, the SEC charged Merrill Lynch, Pierce, Fenner & Smith Incorporated with securities fraud for misusing customer order information to place proprietary trades for the firm and for charging customers undisclosed trading fees. According to the SEC, between 2003 and 2005, Merrill Lynch had an Equity Strategy Desk ("ESD") whose traders used information about institutional customer orders from trades on the market making desk to place trades on Merrill Lynch's behalf after executing customer trades, which was contrary to Merrill Lynch's representations to customers. The ESD traded securities solely for the firm's own benefit and had no role in executing customer orders.

The SEC also found that, between 2002 and 2007, Merrill Lynch had agreements with certain institutional and high net worth customers providing that Merrill Lynch would only charge a commission equivalent for executing riskless principal trades, but that in some instances, Merrill Lynch also charged customers undisclosed mark-ups and mark-downs. The undisclosed trading fees were accomplished by filling customer orders at prices less favorable to the customer than the prices at which Merrill Lynch purchased or sold the securities in the market. Merrill Lynch agreed to pay a $10 million penalty and consent to a cease-and-desist order.

SEC Charges BNY Mellon and Order Desk Manager for Best Execution Failure

On January 14, 2011, the SEC charged BNY Mellon Securities LLC, a formerly registered broker-dealer, for its failure to reasonably supervise the order desk manager on its institutional order desk and traders under his supervision from November 1999 through March 2008. During the relevant period, the institutional order desk executed orders to purchase and sell securities on behalf of a BNY Mellon affiliate, Mellon Investor Services LLC, an administrator for various employee stock purchase plans, employee stock option plans, direct stock purchase and sale plans and similar plans (the "plan customers"). According to the SEC, BNY Mellon's order desk manager failed to meet his duty of best execution to certain plan customers by executing many of their orders at stale or inferior prices, which in many instances were outside of the national best bid and offer at the time of execution, in cross trades with a favored handful of accounts held by hedge funds and individuals and instructing traders under his supervision to do the same. BNY Mellon agreed to pay $19 million of disgorgement, plus prejudgment interest of approximately $4 million, and $1 million in civil penalties.

SEC Charges Schwab Advisers and Two Executives with Making Misleading Statements

On January 11, 2011, the SEC charged Charles Schwab Investment Management ("CSIM") and Charles Schwab & Co., Inc. ("CSC") with making misleading statements regarding the Schwab YieldPlus Fund and failing to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information. The SEC also charged CSIM and Schwab Investments with deviating from the fund's concentration policy without obtaining the required shareholder approval. On the same day, FINRA settled with CSC regarding improper marketing of the fund. In addition, the SEC filed a complaint in federal court against CSIM's former fixed income chief investment officer, Kimon Daifotis, as well as Randall Merk, an executive vice president at CSC and formerly president of CSIM and a trustee of the fund, alleging that Mr. Daifotis and Mr. Merk committed fraud and other securities law violations in connection with the offer, sale and management of the fund.

According to the SEC, investors were not adequately informed about the risks of investing in the fund. For example, the fund was described in marketing materials as having only slightly higher risk than a money market fund. The SEC found that the statements were misleading because the fund was more than slightly riskier than money market funds, and CSIM, CSC and the executives did not adequately inform investors about the differences between the fund and money market funds. The SEC also found that the fund deviated from its concentration policy when it invested more than 25% of its assets in private-issuer mortgage-backed securities, contrary to its policy of not concentrating more than 25% of its assets in any one industry.

Furthermore, the SEC found that material misstatements and omissions concerning the fund were made. The fund suffered a significant decline during the credit crisis of 2007 and 2008 and its assets fell from $13.5 billion to $1.8 billion during an eight-month period due to redemptions and declining asset values. The fund's portfolio consisted of investments that were scheduled to mature within the next several months. However, when investors began pulling money out of the fund, the fund had to sell assets in a depressed market to raise cash. In response to market events and fund redemptions, CSIM, CSC, and the executives held conference calls, issued written materials, and had other communications with investors that contained a number of material misstatements and omissions concerning the fund, including misstatements by Mr. Daifotis regarding minimal investor redemptions and by Mr. Merk regarding the liquidity of the fund and its ability to avoid selling assets at depressed prices.

In addition, the SEC found that CSIM and CSC did not have policies and procedures reasonably designed to prevent the misuse of material, nonpublic information about the fund, including specific policies and procedures governing redemptions by fund portfolio managers, and did not have appropriate information barriers concerning nonpublic and potentially material information about the fund.

CSIM and CSC agreed to pay the SEC a total of nearly $119 million, including $52 million in disgorgement of fees by CSIM, a $52 million penalty against CSIM, a $5 million penalty against CSC, and pre-judgment interest of $9 million. CSC agreed to pay FINRA $18 million, including a fine of $500,000 and $12.5 million to a fair fund to be established by the SEC to repay fund shareholders for fees paid to CSC. The SEC's case continues against the executives.

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