Investment Services Regulatory Update

May 2, 2011

NEW RULES, PROPOSED RULES AND GUIDANCE

FINRA Proposes New Rule Regarding Outsourcing to Third-Party Service Providers

On March 29, 2011, FINRA proposed Rule 3190 to clarify the scope of the obligations and responsibilities of its member firms with respect to outsourcing arrangements. In addition to formalizing the current guidance and restrictions on outsourcing arrangements, the new rule would subject clearing and carrying firms to additional requirements and explicitly treat affiliates of member firms in the same manner as any other third-party service provider.

As proposed, Rule 3190 provides that a member firm outsourcing functions or activities related to its business as a broker-dealer is not relieved of its obligation to comply with all applicable securities laws and regulations and prohibits member firms from delegating their responsibilities for, or control over, such functions or activities being performed by third parties. The proposed rule further requires member firms to establish and maintain a supervisory system and written procedures for any outsourced functions, including ongoing due diligence measures, to ensure that arrangements with third parties are reasonably designed to achieve compliance with applicable securities laws and regulations. FINRA member firms that clear or carry customer funds and securities would be subject to additional requirements under the proposed rule. Clearing or carrying member firms would be required to limit certain activities to persons subject to the direct control and supervision of the member firm, have additional procedures to oversee third-party service providers and notify FINRA of their outsourcing arrangements.

Comments on the proposed rule are due by May 13, 2011.

SEC Proposes Rule Amendments to Remove Credit Rating References From Money Market Fund and Other Rules

On March 3, 2011, the SEC proposed various rule and form amendments under the 1940 Act in response to the requirements of the Dodd-Frank Act that any references to or requirements regarding credit ratings in the SEC's regulations be removed and replaced with other standards of creditworthiness. Specifically, the SEC proposes to remove the references to credit ratings in Rules 2a-7 and 5b-3 and replace them with alternative standards of creditworthiness, eliminate credit ratings disclosures in Form N-MFP and remove from Forms N-1A, N-2 and N-3 the requirement that credit ratings by a nationally recognized statistical rating organization ("NRSRO") be used when portraying credit quality in shareholder reports.

The proposed amendments to Rule 2a-7 would remove references to credit ratings from: (1) the determination of "eligible securities" for money market funds and whether such securities are characterized as "first tier securities" or "second tier securities," (2) the credit quality standards for securities with a conditional demand feature, (3) the monitoring requirements in connection with NRSRO ratings downgrades, and (4) the "stress testing" requirements.

As proposed, the definition of "eligible security" would be amended to remove references to credit ratings and an eligible security would be a security that the board or its delegate determines presents minimal credit risks based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations. For purposes of determining whether a security would be a "first tier security," the board or its delegate would have to conclude that the security's issuer has the "highest capacity to meet its short-term financial obligations." A "second tier security" would continue to be an eligible security that is not a first tier security. According to the SEC, an issuer of a first tier security would satisfy the SEC's proposed standard if it displays "an exceptionally strong ability to repay its short-term debt obligations and the lowest expectation of default." In turn, an issuer of second tier securities would satisfy the SEC's proposed standard if it displays "a very strong ability to repay its short-term debt obligations and a very low vulnerability to default."

With respect to securities with a conditional demand feature, the proposed rule amendments would replace references to NRSRO ratings with a requirement that a board or its delegate determine that the underlying security is of high quality and subject to low credit risk. Under the proposed rule amendments, the fund's board or its delegate would be required to reassess whether a security continues to pose minimal credit risk if the board or its delegate becomes aware of any credible information regarding a security or its issuer suggesting that the security is no longer a first tier or second tier security. The SEC indicated that, to satisfy the proposed standard, a fund's adviser would be required to exercise reasonable diligence in keeping abreast of new information about a portfolio security that the adviser believes to be credible. Finally, the proposed amendments to Rule 2a-7 would remove references to credit rating downgrades from the "stress test" requirements by replacing the hypothetical event of a downgrade with a new hypothetical event of "an adverse change in the ability of a portfolio security issuer to meet its short-term financial obligations." Under the proposed amendments, money market funds could continue to test their portfolios by treating a downgrade as a credit event that might adversely affect the value or liquidity of the portfolio security.

In addition to the proposals related to money market funds, the SEC also proposed amendments to Rule 5b-3 under the 1940 Act to remove references to credit ratings with respect to securities collateralizing repurchase agreements. Under the proposed amendments, a fund's board or its delegate would be required to determine at the time the repurchase agreement is entered into that any collateral consisting of non-governmental securities is "issued by an issuer that has the highest capacity to meet its financial obligations" and is "sufficiently liquid [such] that [it] can be sold at approximately [its] carrying value in the ordinary course of business within seven calendar days."

OTHER NEWS

SEC to Consider Extending Compliance Deadlines for Mid-Sized and Private Advisers until First Quarter 2012

In a letter dated April 8, 2011 to David Massey, President of the North American Securities Administrators Association, Robert E. Plaze, Associate Director of the SEC's Division of Investment Management, stated the staff's belief that the SEC will meet its July 21, 2011 rulemaking deadline to implement two provisions of the Dodd-Frank Act related to investment adviser registration but that the SEC will consider extending until the first quarter of 2012 the compliance deadlines for advisers affected by the provisions.

Under Section 410 of the Dodd-Frank Act, mid-sized advisers (those with $25 million to $100 million of assets under management) will have to withdraw from registration with the SEC and register with one or more states. According to the letter, the IARD system must be reprogrammed to accept the transition filings of mid-sized advisers, which could take until the end of 2011. Accordingly, the SEC may extend until the first quarter of 2012 the deadline for mid-sized advisers to withdraw from the SEC and register with the appropriate states.

As of July 21, 2011, Section 403 of the Dodd-Frank Act repeals Section 203(b)(3) of the Advisers Act (the "private adviser exemption"), which currently provides an exemption from SEC registration to any adviser who has less than 15 clients and who does not advise a registered investment company. The letter states that given the time required for advisers who have been relying on this exemption to register and come into full compliance with the Advisers Act, the SEC may postpone until the first quarter of 2012 the date by which private advisers must be registered with the SEC and in compliance with the obligations of a registered adviser.

SEC Staff Issues No-Action Letter on Funds Placing Assets in the Custody of Credit Default Swap Clearinghouse

On March 1, 2011, the SEC staff issued a no-action letter to ICE Trust U.S. LLC providing that the Division of Investment Management would not recommend enforcement action under Section 17(f) of the 1940 Act against a fund if the fund or its custodian maintains certain assets in the custody of ICE Trust or its members for purposes of meeting ICE Trust's margin requirements for credit default swap ("CDS") contracts that are cleared by ICE Trust.

ICE Trust acts as a central clearing party for CDSs by accepting the rights and obligations under eligible CDS transactions entered into by its members. Upon its acceptance of a CDS transaction, ICE Trust becomes the seller of credit protection with respect to the CDS purchaser and the purchaser of credit protection with respect to the CDS seller.

Section 17(f) and the rules thereunder generally require funds to maintain their assets only with certain qualified custodians, including banks, in order to ensure they are properly safeguarded against misappropriation and other risks. The staff has previously indicated that a fund's initial margin payments on futures contracts are fund assets subject to the requirements of Section 17(f). While ICE Trust falls within the definition of a bank under Section 2(a)(5) of the 1940 Act, it would be holding a fund's margin payments at least partially for the benefit of its clearing operations and not purely for custodial purposes.

Rule 17f-6 permits a fund, subject to certain requirements, to deposit its initial margin in connection with exchange-traded futures contracts and commodity options with a futures commission merchant ("FCM"), rather than a qualified custodian. The staff notes that Rule 17f-6 does not address CDS transactions, but ICE Trust's clearing structure is similar to the arrangements of FCMs and derivatives clearing organizations that maintain custody of fund assets in compliance with the rule.

The staff noted ICE Trust's argument that the custody principles underlying Section 17(f) are supported by ICE Trust's requirements when its members deal with non-members, including funds. These requirements include members segregating assets held on behalf of non-members, maintaining adequate capital and liquidity, and maintaining adequate books and records. The staff also noted the SEC's prior statement that facilitating the establishment of central counterparties for CDS transactions can help reduce counterparty risk and mitigate potential systemic impact.

The no-action relief is subject to several representations made by ICE Trust and its members, including complying with certain recordkeeping and reporting requirements. Each ICE Trust member must be in compliance with the ICE Trust rules and all laws and regulations with respect to CDS transactions. Each member must provide disclosure that insolvency laws may affect a fund's ability to recover assets in any insolvency proceeding of a member. Each member must also promptly transfer assets to the omnibus margin account, provide an annual self-assessment, and provide the SEC with information upon request.

The no-action relief granted by the staff is temporary and expires on July 16, 2011, which is the date the subtitle of the Dodd-Frank Act regarding regulation of security-based swap markets becomes effective. The staff has granted similar no-action relief to LCH. Clearnet Limited and the Chicago Mercantile Exchange relating to the custody of assets for the purposes of meeting each entity's margin requirements for interest rate swaps. Like the relief granted to ICE Trust, the relief granted by these no-action letters is temporary, also expiring on July 16, 2011.

FinCEN Issues Final Rule Amending FBAR Regulations

On February 24, 2011, the Financial Crimes Enforcement Network ("FinCEN") published a final rule amending the reporting requirements for the Report of Foreign Bank and Financial Accounts ("FBAR"). The FBAR is used to report a financial interest in, or signature or authority over, financial accounts in foreign countries with a value over $10,000. The final rule exempts employees of authorized service providers (defined as an entity that is registered with and examined by the SEC, and that provides services to an SEC registered investment company) who have signature authority but no financial interest from having to file an FBAR. However, the final rule does not extend the exemption to employees of service providers to mutual funds when the service provider is not registered with the SEC. The final rule became effective March 28, 2011 and applies to FBARs required to be filed by June 30, 2011.

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.

LITIGATION

Court Rules in Favor of Eaton Vance in Lawsuit Over Payments to Distributors

On March 30, 2011, the U.S. District Court for the District of Massachusetts granted a motion to dismiss all claims in *Weiner v. Eaton Vance Distributors, Inc.* for alleged violations of the 1940 Act and the Advisers Act. The lawsuit, which was a derivative action on behalf of Eaton Vance Municipals Trust, challenged the use of 12b-1 fees to compensate Eaton Vance Distributors and other broker-dealers for the distribution of the Trust's shares. Under the federal securities laws, broker-dealers are generally prohibited from receiving asset-based compensation unless they are registered as an investment adviser. Because 12b-1 fees are based on a percentage of a fund's net assets, the plaintiff argued that payment of 12b-1 fees to Eaton Vance Distributors, which is not a registered investment adviser, and to other selling broker-dealers not registered as investment advisers constituted asset-based compensation in violation of the Advisers Act. The plaintiff claimed that, by authorizing these payments, the Trust's board had breached its fiduciary duty under Section 36(a) of the 1940 Act failed to comply with the oversight responsibilities of Rule 38a-1 thereunder. These violations, in turn, served as the plaintiff's basis for seeking to void the distribution agreement with Eaton Vance Distributors under Section 47(b) of the 1940 Act.

In its decision, the court held that the plain language of Section 47(b) creates the presumption that a private right of action to void a contract thereunder only applies when the contract involves a violation of "substantive legal obligations" found in the 1940 Act. The court ultimately found that the plaintiff did not allege any violations of Section 36(a) or Rule 38a-1 that would provide a basis for voiding the distribution agreement under Section 47(b). In addition, the court found that the Trust's payment of 12b-1 fees did not automatically constitute compensation that would require Eaton Vance Distributors and the other broker-dealers to register under the Advisers Act, as it would depend on the facts and circumstances of the services being paid for by the 12b-1 fees. Moreover, the court stated that even if the 12b-1 fees constituted asset-based compensation under the Advisers Act, the Trust's distribution agreement would not violate the Advisers Act because it is the responsibility of the broker-dealer receiving such compensation to ensure compliance with its obligation to register as an investment adviser.

The dismissal of the *Eaton Vance* case followed the result in *Smith v. Franklin Templeton Distributors, Inc.*, a case based on similar allegations in which the U.S. District Court for the Northern District of California granted the defendant's motion to dismiss. A similar action is still pending against the distributor of the Oppenheimer Funds.

ENFORCEMENT ACTIONS

SEC Charges Brokerage Executives with Failing to Protect Confidential Customer Information

On April 7, 2011, the SEC charged Frederick O. Kraus, David C. Levine and Mark A. Ellis for failing to protect confidential customer information in violation of Regulation S-P. Messrs. Kraus, Levine and Ellis were the former president, national sales manager and chief compliance officer, respectively, of GunnAllen Financial Inc., a former Tampa, Florida-based registered broker-dealer.

According to the SEC, Mr. Levine, with the approval of Mr. Kraus, took information from more than 16,000 GunnAllen accounts to his new employer as GunnAllen wound down operations in April 2010. The SEC found that Mr. Levine downloaded customer names, addresses, account numbers and account values to a portable thumb drive, and provided the records to his new employer after resigning from GunnAllen. Since account holders found out about the information transfer after the fact and were not provided opt-out procedures, the SEC found that the record transfer violated Regulation S-P. Messrs. Kraus and Levine agreed to pay civil penalties of $20,000 each.

The SEC also found that Mr. Ellis, as CCO, aided and abetted and caused GunnAllen's violations of Regulation S-P as a result of his failure to revise or supplement GunnAllen's policies and procedures for safeguarding customer information even after several serious securities breaches between July 2005 and February 2009. According to the SEC, GunnAllen's policies and procedures to protect customer information were vague and did little more than recite a provision of Regulation S-P known as the "safeguard rule." Mr. Ellis agreed to pay a $15,000 civil penalty.

SEC Charges Investment Adviser with Misrepresentations

On April 7, 2011, the SEC instituted cease-and-desist proceedings against Delta Global Advisors, Inc., a registered investment adviser, and its principal and control person, Charles P. Hanlon, with making materially misleading statements and omissions. According to the SEC, Delta made misrepresentations to existing and prospective investors regarding its eligibility for SEC registration, including that it served as an investment adviser to a registered investment company and managed as much as $1.5 billion in assets, when in fact, Delta was not an adviser to a registered investment company and at times managed no more than $9 million in assets. In addition, the SEC alleged that Delta failed to disclose its poor financial condition, a default judgment entered against it in a breach of fiduciary duty lawsuit brought by a client, and that Mr. Hanlon had been the subject of disciplinary action by FINRA. The SEC also alleged that Delta did not disclose its poor financial condition to clients, revise its Form ADV to accurately reflect assets under management or deregister with the SEC, after being requested to do so by the staff of the SEC.

SEC Charges Adviser and Officers for Undisclosed Financial Benefits

On March 14, 2011, the SEC charged JSK Associates, Inc., Jerome Keenan, JSK's president, and Paul Dos Santos, JSK's vice president, with failing to disclose to their advisory clients the financial benefits received as a result of cash held in client advisory accounts and from fixed-income trades on a riskless principal basis with advisory clients.

The SEC alleged JSK failed to disclose to advisory clients that, during 2006 through 2010, JSK's affiliated broker-dealer, International Equity Services, Inc. ("IES"), received a financial benefit in the form of payments based on cash holdings in advisory client accounts. According to the SEC, IES had clearing and custodial arrangements with Southwest Securities, Inc. ("SWS") and was entitled to receive payments from SWS equal to 0.25% of the average credit balances for JSK's advisory client accounts that were invested in the AMR Money Market Fund and the average balance of uninvested cash in JSK's advisory clients' brokerage accounts. According to the SEC, JSK disclosed that IES might receive forms of compensation such as clearing and processing fees, trail commissions and other revenues which broker-dealers normally receive in the course of doing business, but failed to disclose that compensation based on JSK's advisory clients' uninvested cash and certain money market fund balances would be received by IES.

The SEC also alleged that, during the same period, JSK, through IES, engaged in hundreds of fixed-income transactions on a riskless principal basis involving mark-ups and mark-downs with advisory clients without providing prior written disclosure to, or obtaining consent from, the clients. JSK, Keenan and Santos were ordered to pay civil money penalties of $60,000, $10,000 and $10,000, respectively, and to pay disgorgement, on a joint and several basis, of $60,350 and prejudgment interest of $3,805.

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.

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