

Investment Services Regulatory Update

September 1, 2011

LITIGATION

**Appeals Court Vacates SEC's Proxy Access Rule**

On July 22, 2011, in the case *Business Roundtable and Chamber of Commerce of the United States of America v. Securities and Exchange Commission*, a three-judge panel of the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 14a-11 (the proxy access rule) adopted by the SEC under the Exchange Act in 2010, finding that the SEC had acted "arbitrarily and capriciously" in adopting the rule without properly assessing and weighing the rule's effect upon efficiency, competition and capital formation.

Rule 14a-11 required public companies and registered investment companies to permit any shareholder or group of shareholders owning at least 3% of the company's voting stock for at least three years to include director nominees in company proxy materials. In vacating the rule, the court noted that the SEC, among other things, "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters." With respect to the final point, the court noted that the SEC failed to deal with concerns raised by the ICI and others that the rule would impose greater costs on investment companies by disrupting the unitary and cluster board structures.

The SEC issued a statement following the release of the decision stating that it was considering its options going forward. The SEC noted in its press release that the amendments to Rule 14a-8 allowing shareholders to submit proposals for proxy access at their companies, which it adopted at the same time as Rule 14a-11, were unaffected by the court's decision.

**Supreme Court Rules on Who Is the "Maker" of Statements Under Section 10(b)**

On June 13, 2011, the U.S. Supreme Court issued its ruling in *Janus Capital Group, Inc. v. First Derivative Traders*. In a 5-4 decision, the Supreme Court held that a mutual fund investment adviser cannot be held liable by the shareholders of the investment adviser's publicly-traded parent company for fraud under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, where the investment adviser did not "make" the false statements in its mutual funds' prospectuses.

The sole question before the Supreme Court was whether Janus Capital Management LLC ("JCM"), as investment adviser, could be held liable in a private action filed by the shareholders of the investment adviser's parent company under Rule 10b-5 for false statements included in its client Janus Investment Fund's ("Funds") prospectuses. In their complaint, shareholders of parent company Janus Capital Group ("JCG") sued both JCG and its subsidiary JCM for fraud under Section 10(b) of the Exchange Act and Rule

10b-5 thereunder, as well as control person liability under Section 20(a) of the Exchange Act.<sup>1</sup> According to the complaint, the Funds managed by JCM issued prospectuses creating the “misleading impression” that JCG and JCM would implement measures to “curb market timing” in the Funds. Following revelations that the Attorney General of the State of New York had filed a complaint against JCG and JCM alleging that JCG had actually permitted market timing in several of the Funds managed by JCM, investors withdrew money from the Funds and JCG’s stock price fell nearly 25%. The plaintiffs alleged that JCG and JCM made false statements in prospectuses filed by the Funds and that those statements affected the price of JCG’s stock. The complaint, however, did not allege that defendants JCG or JCM actually issued the prospectuses containing the disclosures regarding the market timing policies.

The district court dismissed the complaint for failure to state a claim against JCG and JCM. The court concluded that JCM’s dissemination of the prospectuses did not rise to the level of making a misstatement and that the plaintiffs failed to demonstrate that the alleged fraud occurred in connection with the purchase or sale of a security, since there was no nexus between plaintiffs as JCG shareholders and JCM. On appeal, the Fourth Circuit reversed—holding that the plaintiffs sufficiently alleged that “JCM, by participating in the writing and dissemination of the prospectuses, made the misleading statements contained in the documents” and that JCG could be held liable as a control person of JCM.

The Supreme Court ruled that plaintiffs failed to state a Rule 10b-5 claim against JCM, because only the Funds were ultimately responsible for making the alleged misstatements. Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security, for a person to directly or indirectly “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading.” The Court focused on the meaning of the word “make” and determined that JCM, as investment adviser, did not “make” the allegedly material misstatements in the Funds’ prospectuses. Specifically, the Court held “[f]or Rule 10b-5 purposes, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it.” The Court went on to note that “[o]ne who prepares or publishes a statement on behalf of another is not its maker.” The Court likened the relationship between an investment adviser and its mutual fund client to the relationship between a speechwriter and a speaker and rejected the analogy that an adviser is a “playwright whose lines are delivered by an actor.” Thus, even if an investment adviser assists with the drafting or distribution of a prospectus, the investment adviser is a mere speechwriter and the mutual fund, as the speaker, has the ultimate responsibility for statements in a prospectus. Further, the

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<sup>1</sup> Although the plaintiffs originally alleged that JCG violated Rule 10b-5, on writ of certiorari to the Supreme Court, they sought to hold JCG liable only as a control person of JCM under Section 20(a). Because Section 20(a) applies only to those who control other parties who may be held liable for securities law violations, whether the plaintiffs stated a claim against JCG depended on whether the plaintiffs had stated a claim against JCM. Thus, if JCM could not be held liable under Section 10(b), JCG could not be liable as a control person under Section 20(a).

Court noted that the Funds had ultimate responsibility for statements in their prospectuses because the Funds, unlike the investment adviser, are required to file the prospectuses with the SEC.

The Court acknowledged the plaintiffs' arguments that there is a "uniquely close relationship between a mutual fund and its investment adviser," but noted that the Funds were a legally independent entity with their own board of trustees, separate and apart from JCG and JCM. Further, the Court opined that "[a]ny reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the courts." Thus, the Court held that plaintiffs had not stated a claim against JCM under Rule 10b-5.

The dissent took issue with the majority's bright line test for primary liability and its finding that a maker of a statement is the person who had "ultimate authority" over the statement. In the dissent's view, neither common English nor the Court's earlier cases limit the scope of the word "maker" to those with "ultimate authority" over a statement's content. The dissent contended that the relationships (e.g., JCM's involvement in preparing and writing the relevant statements) alleged among JCM and the Funds and the statements in the Funds' prospectuses warranted a conclusion that JCM "made" those statements.

## **NEW RULES, PROPOSED RULES AND GUIDANCE**

### **SEC Issues Concept Release Relating to the Use of Derivatives by Investment Companies**

On August 31, 2011, the SEC issued a concept release seeking public comment on a wide range of issues relevant to the use of derivatives by investment companies, including the different types of derivatives used by different types of funds as well as the risks and costs of the use of derivatives. The concept release is a continuance of the SEC's review of the use of derivatives by investment companies in order to determine whether additional investor protections might be necessary under the 1940 Act.

The concept release requests comment on the following specific topics:

- **Restrictions on senior securities:** Section 18 of the 1940 Act and related SEC guidance place limitations on a fund's issuance of senior securities in order to limit the risks of excessive borrowing and leverage of a fund's portfolio. The SEC requests views relating to asset segregation and how funds measure leverage, among other things.
- **Compliance with diversification requirements:** In determining whether a fund is "diversified" or "non-diversified" under the 1940 Act, the value of a fund's total assets is reviewed. The SEC requests views relating to how a fund should value a derivative in order to determine the percentage of a fund's total assets invested in a particular company.

- Exposure to securities-related issuers: Section 12(d)(3) of the 1940 Act and the rules thereunder place limitations on funds' investments in broker-dealers, underwriters and investment advisers. The SEC requests comments relating to how funds treat derivatives issued by securities-related issuers, specifically whether they are treated differently from other securities issued by securities-related issuers.
- Portfolio concentration: Similar to the SEC's request relating to diversification, the SEC asks for views regarding how funds apply their concentration requirements to their investments in derivatives.
- Valuation of derivatives: The 1940 Act specifies how funds must determine the value of their assets when calculating net asset value. When market quotations are not available for a security, the fund must calculate its net asset value using the fair value of the security. The SEC requests comments on how funds value derivatives and whether the SEC should issue guidance on the fair valuation of derivatives.

In addition to the specific issues noted above, the SEC invites public comment relating to any other matters that are relevant to the use of derivatives by funds. Comments are due within 60 days of publication of the release in the Federal Register.

#### **FINRA Issues Additional Guidance on Social Media Websites**

On August 18, 2011, FINRA issued Regulatory Notice 11-39 to provide additional guidance on the application of FINRA rules governing communications with the public to social media sites. The notice was provided to address a number of questions that FINRA received regarding recordkeeping, supervision, third-party posts/links on firm websites and accessing social media sites from personal devices following Regulatory Notice 10-06, which provided initial guidance on member firms' use of blogs and social networking websites. Specifically, the Notice provides for the following:

- A firm's responsibilities under NASD Rule 3010 require the registered principal to review, prior to use, any social media site that an associated person intends to employ for a business purpose. The registered principal may approve use of the site for a business purpose only if the principal has determined that the associated person can and will comply with all applicable FINRA rules, the federal securities laws and all recordkeeping requirements.
- Firms may not establish a link to any third-party site that the firm knows or has reason to know contains false or misleading content. FINRA notes that a firm is responsible under NASD Rule 2210 for content on a linked third-party site if the firm has "adopted" or has become "entangled" with the content on the third-party site. In addition, firms may delete inappropriate third-party content without being considered to have adopted such content.

- Firms must adopt procedures to manage data feeds that are incorporated into their own websites. At a minimum, these procedures should include being familiar with the proficiency of the vendor supplying the data and its ability to provide data that is accurate as of the time it is presented on the firm's website. Firms must also understand the criteria employed by such vendors in producing the data they provide in order to determine whether the vendor is producing information in a reasonable manner.
- For purposes of recordkeeping, the fact that a communication is transmitted using a personal device or technology has no bearing on whether the firm must maintain a record of the communication. In determining whether a particular communication is subject to recordkeeping requirements, firms should only look to whether a communication relates to its "business as such," not the manner in which the communication is disseminated.
- Firms may not sponsor a social media site or use a communication device that includes technology that automatically erases or deletes content.
- Firms must conduct appropriate training and education concerning their policies, including those relating to social media.

### **SEC Adopts Rule Relating to "Large Traders"**

On July 27, 2011, the SEC adopted Rule 13h-1 and Form 13H under the Exchange Act to assist the SEC in identifying, and obtaining information on, "large traders."

Rule 13h-1 defines a "large trader" as a person who directly or indirectly transacts at least 2 million shares or \$20 million in exchange-listed securities during any calendar day, or at least 20 million shares or \$200 million in exchange-listed securities during any calendar month. A "large trader" is also anyone who voluntarily registers as a large trader. Voluntary registration as a large trader is permitted in order to mitigate the monitoring burden of those who expect to reach the trading activity thresholds in the future.

A large trader must register as such with the SEC by submitting Form 13H, which requires certain disclosures including, among other items, its type of business and a list of affiliates. The SEC will assign each large trader a large trader identification number (LTID). Large traders will be required to disclose their LTID to their broker-dealers, as well as the accounts to which their LTID applies. Large traders must submit annual filings on Form 13H with 45 days after each calendar year and must file an amended filing on Form 13H no later than the end of the calendar quarter in which any information in their filing becomes inaccurate.

Rule 13h-1 requires additional recordkeeping by broker-dealers regarding large traders. The Rule expands upon the Electronic Blue Sheets (EBS) system used to collect transaction data from broker-dealers currently in place under Rule 17a-25. Rule 13h-1 requires broker-dealers to maintain records identifying the LTID associated with a

transaction and the time a transaction occurs. This information must be available the morning after the transaction occurs and must be kept for three years, the first two in an easily accessible place.

The Rule becomes effective on October 3, 2011. Large traders will have two months to comply with the identification requirements, and broker-dealers will have seven months to comply with the recordkeeping and reporting requirements.

### **FINRA Proposes New Rules Relating to Member Firms' Communications with the Public**

On July 28, 2011, the SEC published for comment a proposal by FINRA to adopt new rules governing member firms' communications with the public. As proposed, the following FINRA rules would encompass, with certain changes, the current provisions of NASD Rules 2210 and 2211 and NASD Interpretive Materials 2210-1 and 2210-3 through 2210-8.

- FINRA Rule 2210 would replace NASD Rules 2210 and 2211 and NASD Interpretive Materials 2210-1 and 2210-4. FINRA Rule 2210 would reduce the six categories of communications included in NASD Rule 2210 to the following three categories: (1) Institutional Communications, which would include any written communication distributed or made available only to institutional investors; (2) Retail Communications, which would include any written communication distributed or made available to more than 25 retail investors within any 30-day calendar period; and (3) Correspondence, which would include any written communication that is distributed or made available to 25 or fewer retail investors within any 30-day calendar period. FINRA Rule 2210 would continue to require, subject to certain exceptions, that an appropriately qualified registered principal of the member firm also approve each "retail communication" before the earlier of its use or filing with FINRA. The content requirements of the current NASD rules are also largely incorporated into FINRA Rule 2210.
- FINRA Rule 2212 would replace NASD Interpretive Materials 2210-3 regarding the standards applicable to the use of investment company rankings in communications. Although the standards would generally remain the same, FINRA Rule 2212 would revise the standards applicable to investment company rankings for more than one class of shares within the same portfolio. These rankings would need to be accompanied by prominent disclosure of the fact that the classes have different expense structures.
- FINRA Rule 2213 would replace NASD Interpretive Materials 2210-5 regarding the standards applicable to the use of bond mutual fund volatility ratings in communications, but the standards would remain unchanged.

- FINRA Rule 2214 would replace NASD Interpretive Materials 2210-6 regarding the standards applicable to the use of investment analysis tools. The current NASD interpretation requires a member firm that offers or intends to offer an investment analysis tool to provide FINRA with access to the tool and file any template for written reports produced by, or advertisements or sales literature concerning, the tool within 10 days of its first use. FINRA Rule 2214 would require that FINRA be provided with such access and the accompanying filings made within 10 *business* days of the first use.
- FINRA Rule 2215 would replace NASD Interpretive Materials 2210-7 regarding the standards applicable to communications concerning security futures and would include several changes. First, the proposed rule would apply to all retail communications (as defined under proposed FINRA Rule 2210), as opposed to the current rule which applies only to advertisements. Second, the proposed rule would require members to submit all retail communications concerning security futures to FINRA at least 10 business day prior to first use, and prohibit firms from using such communications until any changes specified by FINRA have been made. Third, the proposed rule would revise the requirement regarding delivery of a security futures risk disclosure document to apply only to communications that contain the names of specific securities. Fourth, communications containing historical performance of security futures would be required to disclose all relevant costs associated with the investment, and reflect such costs in the performance information.
- FINRA Rule 2216 would replace NASD Interpretive Materials 2210-8 regarding the standards applicable to retail communications concerning collateralized mortgage obligations, but the standards would remain unchanged.

If approved by the SEC, the new rules would become effective within 45 days after their publication in the Federal Register or such later date designated by the SEC or consented to by FINRA. Following SEC approval, FINRA, within 90 days, will publish a *Regulatory Notice* setting the implementation date for the new rules, which will be no later than one year from the date of SEC approval.

### **SEC Adjusts the Dollar Amount Thresholds and Proposes Rule Amendments Relating to Investment Adviser Performance Fees**

On July 12, 2011, the SEC issued an order adjusting for inflation the dollar amount tests for determining if a person is a “qualified client” for purposes of Rule 205-3 under the Advisers Act, which permits investment advisers to charge a performance fee to “qualified clients.” On September 19, 2011, the effective date of the order, a person will be considered a “qualified client” for purposes of Rule 205-3 if the person has at least \$1 million under the management of the adviser immediately after entering into the

advisory contract or the adviser reasonably believes that the person has a net worth of more than \$2 million at the time the advisory contract is entered into.

On May 10, 2011, the SEC also proposed amendments to Rule 205-3 to: (1) provide that the SEC will adjust the dollar amount thresholds for inflation approximately every five years; (2) exclude the value of a person's primary residence for purposes of determining a person's net worth under the Rule; and (3) clarify that the amended Rule requirements would apply to new contractual arrangements and not to existing contractual arrangements, except that new parties to existing contracts would be subject to the amended Rule requirements.

### **SEC Adopts Rules Relating to Investment Adviser Registration**

On June 22, 2011, the SEC adopted several new rules and rule amendments under the Advisers Act in order to implement certain provisions of the Dodd-Frank Act.

*Mid-Sized Adviser Transition.* Rule 203A-5 was adopted in order to provide an orderly transition to state registration for mid-sized advisers. Under the Dodd-Frank Act, advisers with assets under management between \$25 million and \$100 million are not eligible for registration with the SEC unless the mid-sized adviser's state does not require registration or does not examine advisers, in which case such advisers are required to register with the SEC. Rule 203A-5 provides until March 30, 2012 for any adviser registered with the SEC to determine whether it remains eligible for registration and provides an additional 90 days (until June 28, 2012) to register with the state and withdraw its registration with the SEC. In addition, all advisers registered with the SEC on January 1, 2012 must file an amendment to their Form ADV by March 30, 2012, confirming their eligibility.

*Exempt Reporting Advisers.* The Dodd-Frank Act eliminates the private adviser exemption, except for foreign private advisers, in Section 203(b)(3) effective July 21, 2011, and creates two new exemptions from registration for certain advisers. Section 203(l) exempts advisers that advise only venture capital funds and Section 203(m) exempts advisers that advise only private funds and have assets under management of less than \$150 million. Although they are not required to register with the SEC, Rule 204-4 requires these "exempt reporting advisers" to file reports with the SEC by completing certain sections of Form ADV. Form ADV was amended to accommodate use by exempt reporting advisers, and the information submitted by such advisers will be made public. The SEC also amended Rule 204-1 to require an exempt reporting adviser to amend its reports on Form ADV at least annually. The initial filing on Form ADV by exempt reporting advisers must be made by March 30, 2012.

*Venture Capital Funds Defined.* Rule 203(l)-1 was adopted to define "venture capital fund" for purposes of the exemption from registration under the Advisers Act for advisers that exclusively advise venture capital funds. A "venture capital fund" is a fund that (1) holds no more than 20% of its capital commitments in non-qualifying investments; (2) does not borrow or incur leverage (other than short-term borrowing); (3) does not offer redemption rights except in extraordinary circumstances; (4) represents itself as

pursuing a venture capital strategy to investors; and (5) is not registered under the 1940 Act and is not a business development company. The Rule provides a grandfather provision for funds that began raising capital before the end of 2010 and represented themselves as pursuing a venture capital strategy.

*Private Fund Adviser Exemption.* Rule 203(m)-1 provides an exemption from registration for any investment adviser that advises only private funds and has less than \$150 million in assets under management. The number of funds advised is not a factor. Under the Rule, the adviser must aggregate the value of all of the assets of the private funds it advises in determining its eligibility for this exemption. The adviser must calculate its assets under management annually using market value (or fair value if necessary). A non-U.S. adviser may rely on this exemption as long as all of the adviser's clients are qualifying private funds. The type of its non-U.S. clients and the amount of its non-U.S. assets under management are not considered.

*Foreign Private Advisers.* Rule 202(a)(30)-1 was adopted to define certain terms used in Section 202(a)(30), which defines "foreign private adviser" for purposes of the Section 203(b)(3) exemption from registration.

*Form ADV Amendments.* A number of amendments to Form ADV were adopted in order to require advisers to provide additional information about three areas of their business: (1) the private funds advised by an adviser; (2) the types of clients, advisory practices and business practices that may present conflicts of interest (e.g., using affiliated brokers, soft dollar arrangements, compensation for client referrals); and (3) non-advisory activities and financial industry affiliations. Form ADV filings made after January 1, 2012 will need to include the additional required information.

*"Pay to Play" Rule.* Rule 206(4)-5 was amended to expand its scope to apply to exempt reporting advisers and foreign private advisers. In addition, an adviser is permitted to pay a registered "municipal advisor" to solicit government entities, if the registered municipal advisor is subject to a pay-to-play rule adopted by the MSRB that is at least as stringent as the pay-to-play rule applicable to the adviser. Also, registered broker-dealers and investment advisers that are subject to FINRA's pay-to-play rule may solicit business on behalf of an adviser from a state or local government entity. The Rule amendments become effective on September 19, 2011.

### **SEC Adopts Rule Defining "Family Office" Adviser**

On June 22, 2011, the SEC adopted Rule 202(a)(11)(G)-1 under the Advisers Act defining the term "family office" for the purpose of excluding family office advisers from the definition of "investment adviser" in the Advisers Act, and thereby exempting them from registration as investment advisers under the Advisers Act. The Rule generally defines "family office" as a company that (1) has no clients other than family members; (2) is wholly owned by family clients and is controlled by family members; and (3) does not hold itself out to the public as an investment adviser.

### **CFTC and SEC Issue Guidance to Address Dodd-Frank Act Swap Provisions**

In light of the July 16, 2011 effective date for certain derivatives provisions of the Dodd-Frank Act and the number of swap rulemakings that had not been finalized, both the CFTC and the SEC issued guidance regarding the effective date of various statutory and regulatory requirements for swaps. The CFTC issued a proposed exemptive order in June, and issued the final exemptive order, essentially as proposed, on June 14, 2011. The SEC issued a final exemptive order effective June 15, 2011. Under the Dodd-Frank Act, the derivatives provisions without a designated effective date would become effective on the later of (1) where rulemaking was required, not less than 60 days after publication of a final rule, or (2) where rulemaking was not required, July 16, 2011 (the “self-effectuating provisions”).

*CFTC Guidance.* Similar to the proposed order, the final CFTC order categorizes the derivatives provisions of the Dodd-Frank Act as (1) provisions requiring a rulemaking; (2) self-effectuating provisions that reference terms requiring further definition; (3) self-effectuating provisions that do not reference terms requiring further definition and that repeal provisions of current law; and (4) self-effectuating provisions for which relief is not being proposed. The final order states that the provisions in categories 1 and 4, which are listed in an appendix to the final order, are outside of the scope of the temporary relief and would take effect on the effective date of the required CFTC rule (for category 1) or on July 16, 2011 (for category 4).

With respect to category 2, the final order temporarily exempts persons or entities from complying with requirements of the Commodity Exchange Act (“CEA”) that became effective on July 16 and that refer to one or more terms requiring further definition, including “swap,” “swap dealer,” “major swap participant” or “eligible contract participant.” The relief applies only to those requirements or portions of such provisions that specifically relate to the referenced terms. On July 14, 2011, the CFTC also issued a no-action letter regarding the category 2 provisions which may not be subject to the exemptive relief granted in the final order. The final order and the no-action letter extend relief to the earlier of the effective date of the rules defining the relevant terms or December 31, 2011.

With respect to category 3, the final order expands the current derivatives exemption under Part 35 of the CEA to replace the CEA exemptions for swaps and other transactions that were repealed effective July 16. The temporary relief exempts certain transactions in exempt or excluded commodities from the CEA if the transaction would otherwise comply with Part 35, notwithstanding that: (1) the transaction may be executed on a multilateral transaction execution facility; (2) the transaction may be cleared; (3) persons offering or entering into the transaction may be eligible contract participants as defined in the CEA prior to July 16; (4) the transaction may be part of a fungible class of agreements that are standardized as to their material economic terms; and/or (5) no more than one of the parties to the transaction is entering into the transaction in conjunction with its line of business, but is neither an eligible contract participant nor an eligible swap participant as defined in the CEA, and the transaction was not and is not

marketed to the public. The final order extends relief to the earlier of the repeal or replacement of Part 35 or Part 32 of the CEA or December 31, 2011.

*SEC Guidance.* The SEC order provides guidance and temporary relief with respect to the July 16 effective date for certain Dodd-Frank Act provisions relating to security-based swaps. The SEC order identifies those provisions requiring rulemaking for effectiveness, including those that are dependent on such rulemaking, and states that such provisions will go into effect not less than 60 days after publication of a final rule. The SEC order also notes that a number of the Dodd-Frank Act provisions relating to security-based swaps apply only to “registered” persons and that until the registration processes have been established by final SEC rules and such persons have become registered pursuant to the rules, they will not be required to comply with the provisions. The SEC order also identifies those provisions that are self-effectuating and states whether temporary relief has been granted with respect to the provisions, or, if temporary relief was not granted in the order, whether the SEC will consider requests for relief from compliance with the provision. The SEC order states that the temporary relief will expire upon the adoption of related final rules and the compliance dates specified in the related final rules.

Additionally, the SEC order provides temporary relief from Section 29(b) of the Exchange Act, which may act to void a contract made in violation of any provision of the Exchange Act, or the rules thereunder. The SEC order temporarily exempts any security-based swap contract entered into on or after July 16 from being void or considered voidable by reason of Section 29 of the Exchange Act because any person that is a party to the security-based swap contract violated a provision of the Exchange Act that was amended or added by the Dodd-Frank Act and that has been determined to not be effective as of July 16.

## **OTHER NEWS**

### **GAO Submits Report on Mutual Fund Advertising**

On July 26, 2011, the Government Accountability Office (the “GAO”) submitted a report to Congress on mutual fund advertising, as required by the Dodd-Frank Act. Specifically, the report focused on (1) the known impact of mutual fund advertisements on investors; (2) the extent to which performance information is included in advertisements; and (3) regulatory requirements and enforcement for fund advertisements. The report found evidence is mixed regarding whether investors are harmed by advertisements emphasizing superior past returns. The report also concluded that FINRA has not, in all cases, effectively communicated its new interpretations of existing advertising rules to the industry. The GAO also found that the FINRA process of communicating rule interpretation changes through formal comment letters to individual funds that submitted affected materials is limited. The report also noted that developing effective communication mechanisms will decrease the potential for investors to be misled and the potential for some funds to have an unfair competitive advantage over others that use inappropriate advertisements.

The GAO report recommends that the SEC takes steps to ensure FINRA develops appropriate mechanisms for notifying the mutual fund industry about changes in rule interpretations regarding mutual fund advertising. SEC Chairman Schapiro and FINRA Executive Vice President of Regulatory Policy Thomas Selman both supported these suggestions in comment letters included in the report. Specifically, Chairman Schapiro stated that uniform dissemination of regulatory positions enhances compliance, which furthers investor protection. She assured the GAO that the SEC will work with FINRA to ensure enhanced transparency in its new interpretations. Mr. Selman's letter stated that FINRA intends to publish through notices any significant new interpretations of the advertising rules that affect a broad section of the industry, as well as develop a mechanism to provide a regular summary and interpretation of advertising issues and rules.

#### **Office of Inspector General Releases Report on Compliance with SEC Exemptive Orders and No-Action Letters**

On June 29, 2011, the SEC's Office of Inspector General released a report assessing the SEC's processes for ensuring adherence to the conditions under which exemptive orders and no-action letters are granted. The report concluded that the SEC's divisions that issue exemptive relief do not have a coordinated process for reviewing compliance with the conditions and representations contained in the orders and letters, and instead rely on the Office of Compliance Inspections and Examinations (OCIE) to review compliance as part of its examinations. The report emphasizes the importance of monitoring compliance because the exemptions allow companies to conduct activities that, without the relief, could violate securities laws and regulations. Accordingly, the report makes five recommendations intended to enhance the SEC's oversight of compliance with exemptive relief and increase coordination with OCIE in the examination of companies for compliance with conditions and representations contained in exemptive relief. In response to the report, the SEC was asked to submit a corrective action plan within 45 days.

### **ENFORCEMENT ACTIONS**

#### **Janney Montgomery Scott Charged for Failure to Maintain and Enforce Policies to Prevent Misuse of Material, Nonpublic Information**

On July 11, 2011, the SEC announced that it had settled charges against Janney Montgomery Scott LLC, a broker-dealer, for failure to establish and enforce policies and procedures required by law to prevent the misuse of material, non-public information. According to the SEC, from January 2005 to July 2009, Janney's policies and procedures for its equity sales, trading, syndicate and research departments were deficient. The SEC found that in certain circumstances the policies were either incomplete, not enforced or not followed as written. Specifically, the SEC found that Janney failed to (1) adequately monitor trading in the securities of companies that were clients of its investment banking division, (2) maintain an adequate email 'firewall' between its investment banking and research staff, (3) enforce procedures regarding meetings between investment banking and research staff, (4) require investment

bankers to pre-clear personal trades, and (5) enforce policies regarding brokerage accounts at other firms. Janney agreed to be censured and to pay an \$850,000 penalty.

### **Morgan Keegan Settles Fraud Charges Related to Valuations of Subprime Mortgage-Backed Securities**

On June 22, 2011, the SEC, state regulators and FINRA announced that Morgan Keegan agreed to pay \$200 million to settle fraud charges related to valuations of subprime mortgage-backed securities held by five Morgan Keegan funds. The settlement also prohibits Morgan Keegan from valuing fair valued securities on behalf of funds for three years. Finally, two employees of Morgan Keegan, including the funds' portfolio manager, agreed to pay \$500,000 and \$50,000 in penalties, respectively.

The SEC found that Morgan Keegan and the two employees caused the false valuation in 2007 of subprime mortgage-backed securities in five funds managed by Morgan Keegan. According to the SEC, Morgan Keegan failed to employ reasonable pricing procedures with respect to the valuation of the funds' portfolio securities, which resulted in the calculation and dissemination of inaccurate net asset values. Specifically, the SEC found that the funds' portfolio manager instructed the fund accounting department to make arbitrary "price adjustments" to the fair values of certain portfolio securities that ignored lower values for those same securities provided by outside broker-dealers as part of the pricing process, and often lacked a reasonable basis. The SEC also found that the portfolio manager instructed fund accounting to lower values over a period of days, instead of when pricing information was received. Moreover, the SEC found that the portfolio manager screened and influenced the price confirmations received from at least one broker-dealer.

### **SEC Charges Investment Adviser with Undisclosed Cash Payments**

On June 15, 2011, the SEC charged Pegasus Investment Management, LLC, a registered investment adviser and the general partner of two private funds, and two of its officers in connection with undisclosed cash payments. According to the SEC, between 2008 and 2009, Pegasus aggregated its futures trades with a proprietary trading firm's trades placed through a common broker in order for the proprietary trading firm to obtain reduced commission rates from the broker and, in exchange, the proprietary trading firm made monthly cash payments to Pegasus. The proprietary trading firm paid an estimated \$90,000 in cash to Pegasus under this arrangement. Pegasus treated the \$90,000 as its own asset and did not disclose the arrangement to the funds' investors in offering documents, partnership agreements or Pegasus' Form ADV. The SEC found that Pegasus' arrangement with the proprietary trading firm constituted fraud, and Pegasus was ordered to pay disgorgement of \$90,000 and prejudgment interest of \$5,469. Two of Pegasus' officers were censured and ordered to pay civil money penalties in the amounts of \$50,000 and \$25,000, respectively.

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

