Investment Services Regulatory Update

October 3, 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.

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 by November 7, 2011.

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 became 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.

OTHER NEWS

SEC Staff Issues "Pay-to-Play" No-Action Relief for Advisers to Registered Funds

On September 12, 2011, the SEC staff issued a no-action letter stating that the Division of Investment Management would not recommend enforcement action under the "pay-to-play" recordkeeping requirements of the Advisers Act against investment advisers to registered funds that comply with alternative recordkeeping requirements. Under the "pay-to-play" recordkeeping requirements, an investment adviser is required to maintain records of all government entities that are, or were, investors in any covered investment pool (including registered funds) to which the adviser provides, or has provided, investment advisory services in the past five years, but not prior to September 13, 2010.

In recognition that a government entity may hold shares of a registered fund through one or more omnibus accounts, the SEC staff granted no-action relief from the "pay-to-play" recordkeeping requirements applicable to an investment adviser to a registered fund that is an investment option of a plan or program of a government entity (a "Covered Investment Pool"). In order to rely on the no-action relief, an investment adviser to a Covered Investment Pool is required to make and maintain a list or other record that includes:

- each government entity that invests in a Covered Investment Pool, where the account of the government entity can reasonably be identified as being held in the name, or for the benefit, of the government entity on the records of the Covered Investment Pool or its transfer agent;
- each government entity, the account of which was identified as that of a government entity—at or around the time of the initial investment—to the adviser or one of its client servicing employees, regulated persons or covered associates (all as defined in the no-action letter or the "pay-to-play" rule);
- each government entity that sponsors or establishes a 529 plan and has selected a specific Covered Investment Pool as an option to be offered by the 529 plan; and
- the government entity that has been solicited to invest in a Covered Investment Pool either by (1) a covered associate or regulated person of the adviser; or (2) an intermediary or affiliate of the Covered Investment Pool if a covered associate, regulated person or client servicing employee of the adviser participated, or was involved, in the solicitation, regardless of whether the government entity invested in the Covered Investment Pool.

The no-action letter specifically notes that, for purposes of the granted relief, a Covered Investment Pool does not include any company that would be an investment company but for the exclusions provided by Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the 1940 Act. The no-action letter also notes that the granted relief only applies to the portion of the "pay-to-play" recordkeeping requirements relating to Covered Investment Pools, and investment advisers are otherwise required to make and maintain a list of all government entities to which the adviser provides, or has provided, investment advisory services.

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.

ENFORCEMENT ACTIONS

SEC Charges Former Goldman Sachs Employee and His Father with Insider Trading in Securities Underlying an ETF

On September 21, 2011, the SEC charged Spencer Mindlin, a former Goldman, Sachs & Co. employee, and his father with insider trading with respect to confidential trading strategies and information that he learned while working on Goldman's ETF desk. The SEC alleged that Mr. Mindlin learned of and shared with his father information regarding Goldman's plans to purchase and sell large amounts of securities underlying the SPDR S&P Retail ETF ("XRT").

During the relevant period, Goldman allowed its customers to short the XRT and as a result, according to the SEC's order, was the largest institutional holder of the XRT. In addition, in order to hedge its own exposure, Goldman shorted the individual securities underlying the XRT. The SEC alleged that by virtue of his position on Goldman's ETF desk, Mr. Mindlin was aware of Goldman's non-public position in the XRT and was aware of Goldman's intentions to trade large amounts of securities underlying the XRT in order to hedge its position in the XRT. According to the SEC, Mr. Mindlin and his father placed multiple trades on inside information and obtained at least $57,000 in illicit profits.

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.

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