Investment Services Regulatory Update

March 1, 2012

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC and CFTC Propose Rules to Help Prevent and Detect Identity Theft

On February 28, 2012, the SEC and the Commodity Futures Trading Commission proposed joint rules and guidelines in order to address identity theft, as required under the Dodd-Frank Act. The SEC and CFTC note in the proposing release that the proposed rules and guidelines are similar to those adopted in 2007 by the Federal Trade Commission ("FTC") and other agencies. Similar to the FTC rules, the proposed rules would require financial institutions and creditors to develop and implement a written identity theft prevention program that is designed to identify relevant red flags, detect the occurrence of red flags, respond appropriately to any red flags when detected and periodically update the program. The proposed guidelines provide examples of red flags and means to detect certain types of red flags, and also provide other information intended to assist in the formulation and administration of an identity theft program.

The proposed rules would apply to "financial institutions" and "creditors." The proposing release notes that the scope of the terms "financial institutions" and "creditors" would include broker-dealers, investment companies and investment advisers. However, the SEC specifically requests comments regarding whether any type of entity should be excluded from the scope of the rules.

Comments on the proposed rules are due by May 7, 2012.

SEC Adopts Adjustment to Dollar Amount Thresholds and Rule Amendments Relating to Investment Adviser Performance Fees

On February 15, 2012, the SEC adopted amendments to Rule 205-3 under the Advisers Act in order to adjust for inflation the dollar amount tests for determining if a person is a "qualified client." Rule 205-3 permits investment advisers to charge a performance fee to "qualified clients" only. The amendments codify the revisions to the dollar amount tests that the SEC made by order on July 12, 2011. Prior to the July 2011 order, a person was considered a "qualified client" for purposes of Rule 205-3 if the person had at least $750,000 under the management of the adviser immediately after entering into the advisory contract or the adviser reasonably believed that the person had a net worth of more than $1.5 million at the time the advisory contract was entered into. The July 2011 order increased these thresholds to $1 million and $2 million, respectively, and the amendments to Rule 205-3 now codify the increased thresholds.

The SEC also adopted further 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 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.

The amendments to the Rule become effective on May 22, 2012.

CFTC Adopts Final Amendments to Rule 4.5

On February 9, 2012, the Commodity Futures Trading Commission announced the adoption of final amendments to CFTC Rule 4.5 and other CFTC rules regarding registration and compliance obligations for commodity pool operators and commodity trading advisors. Prior to the amendments, registered investment companies were able to claim an exclusion from the definition of commodity pool operator and did not have to register with the CFTC as a commodity pool operator. As amended, the Rule 4.5 exclusion can be claimed by a fund only if it meets certain trading thresholds and complies with certain marketing restrictions. With respect to the trading thresholds, a fund must meet one of the following limits:

- The fund must limit its trading such that aggregate initial margin and premiums required to establish commodity futures, options on futures, or commodity swap positions do not exceed 5% of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses ("percentage-of-margin test"). The percentage-of-margin test does not apply to transactions entered into for "bona fide hedging purposes" and allows funds to exclude from the calculation any portion of an option that is in-the-money at the time the option is purchased.

- The fund's aggregate net notional value of its commodities-related trading positions not used for bona fide hedging purposes, determined at the time its most recent position was established, must not exceed 100% of the liquidation value of the fund's portfolio, after taking into account unrealized profits and losses ("net notional test"). The term notional value is defined by asset class (e.g., with different definitions applying to futures and swaps) and the ability to net positions is also defined by asset class. For example, a fund may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade, but swaps may be netted only if cleared by the same designated clearing organization.

With respect to marketing restrictions, amended Rule 4.5 prohibits a fund from marketing itself "as a vehicle for trading in the commodity futures, commodity options, or swaps markets." In the adopting release, the CFTC provided the following list of non-exclusive factors relevant to making a determination of whether or not a fund is marketed as a vehicle for investing in commodity futures, commodity options, or swaps:

- The name of the fund,

- Whether the fund's primary investment objective is tied to a commodity index,

- Whether the fund makes use of a controlled foreign corporation for its derivatives trading,

- Whether the fund's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index,

- Whether, during the course of its normal trading activities, the fund or entity acting on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives,

- Whether the futures/options/swaps transactions engaged in by the fund or on behalf of the fund will directly or indirectly be its primary source of potential gains and losses, and

- Whether the fund is explicitly offering a managed futures strategy.

The CFTC noted that it would give more weight to the final factor in the list, but that a fund that does not expressly hold itself out as a managed futures fund could nevertheless be viewed as violating the marketing restrictions if other indicia of a managed futures strategy are present. The CFTC also noted that merely disclosing that a fund may engage in derivative transactions incidental to its main strategy would not violate the marketing restrictions.

In the adopting release, the CFTC clarified that, if a fund cannot claim exclusion from the definition of commodity pool operator, the investment adviser to the fund is the entity required to register as a commodity pool operator. Investment advisers required to register as commodity pool operators as a result of the amendments to Rule 4.5 must register by the later of December 31, 2012 or 60 days after the effective date of the final rulemaking by the CFTC defining the term "swap," which will be covered under amended Rule 4.5.

Concurrently with the adoption of amended Rule 4.5, the CFTC also proposed rule amendments to harmonize the CFTC's disclosure, reporting and recordkeeping requirements with those of the SEC with respect to funds that will be subject to oversight by both the SEC and CFTC. Comments on the CFTC's proposed harmonization rules are due by April 24, 2012.

NYSE Further Limits Broker Discretion to Vote Uninstructed Shares

On January 25, 2012, the NYSE announced new restrictions on broker discretionary voting. NYSE Rule 452 governs when NYSE member organizations may vote customer shares on behalf of a client when specific voting instructions for the securities have not been received. The NYSE has ruled that certain corporate governance proposals are "Broker May Vote" matters when the proposal in question is supported by company management. In 2010, the NYSE amended Rule 452 to provide that brokers could no longer vote uninstructed shares in the election of directors (other than directors of an investment company registered under the 1940 Act), which was codified with the enactment of the Dodd-Frank Act along with the prohibition on brokers voting unrestricted shares on executive compensation matters.

Noting recent Congressional and public policy trends towards disfavoring broker voting of unrestricted shares, the NYSE determined that it will no longer permit member organizations to vote on corporate governance matters under Rule 452, including:

- Proposals to de-stagger the board of directors,
- Majority voting in the election of directors,
- Eliminating supermajority voting requirements,
- Providing for the use of consents,
- Providing rights to call a special meeting, and
- Certain types of anti-takeover provision overrides.

For companies whose organizing documents require a majority of the shares “entitled to vote” to be present in person or by proxy to establish a quorum, the decrease in “Broker May Vote” items could complicate shareholder meetings going forward. The changes to Rule 452 do not disturb the ability of brokers to vote on proposals to ratify auditors or for an increase in authorized common stock.

OCIE Publishes Risk Alert Regarding the Use of Social Media by Investment Advisers

On January 4, 2012, the SEC’s Office of Compliance Inspections and Examinations issued a National Examination Risk Alert to address the use of social media by investment advisory firms. In the Alert, the SEC staff noted that the use of social media by investment advisory firms is rapidly accelerating, and that such use must comply with various provisions of the federal securities laws, including antifraud, compliance and recordkeeping provisions. The SEC recommended that investment advisory firms evaluate their policies by first identifying conflicts and compliance risks in light of the firm’s particular circumstances and then testing whether their existing policies and procedures effectively address those risks. To assist with this evaluation, the SEC staff provided the following non-exhaustive list of factors that investment advisory firms may want to consider:

- **Usage Guidelines**. Firms may want to consider whether to create firm usage guidelines that provide guidance on appropriate/inappropriate use of social media, including restrictions or prohibitions on specific sites or functionalities of sites.

- **Content Standards**. Firms may want to assess whether the content created by the firm, its representatives or solicitors creates risks related to fiduciary or other regulatory issues (e.g., content that contains investment recommendations, information on specific investment services or investment performance).

- **Monitoring/Frequency of Monitoring**. Firms may want to consider how to effectively monitor the firm's social media sites or the firm's use of third-party sites, including the frequency of such monitoring.

- **Approval of Content**. Firms may want to consider pre-approval requirements as opposed to after-the-fact review.

- **Firm Resources**. Firms may want to consider whether they have dedicated sufficient compliance resources to adequately monitor social media activity, including the ability to monitor the activity of numerous representatives or solicitors.

- **Criteria for Approving Participation**. Firms may want to consider the reputation of a site, a site's privacy policy, the ability to remove third-party posts from a site, a site's controls on anonymous posting and a site's advertising practices before the firm, its representatives or solicitors use the site to conduct business.

- **Training**. Firms may want to consider training related to social media to promote compliance and to prevent potential violations.

- **Certification**. Firms may want to consider obtaining certifications confirming that social media policies have been communicated clearly and are being followed.

- **Functionality**. Firms may want to consider the functionality of each social media site approved for use, including any continuing obligation to address upgrades or modifications to the site that affect the risk exposure of the firm or its clients.

- **Personal/Professional Sites**. Firms may want to consider whether to adopt policies to address an advisory representative or solicitor that conducts firm business on personal (non-business) or third-party social media sites.

- **Information Security**. Firms may want to consider whether any information security risks arise in connection with the use of social media and consider measures to create appropriate firewalls between permitted sites and sensitive information.

- **Enterprise-Wide Sites**. Investment advisory firms that are part of a larger financial services or other corporate enterprise may want to consider whether to create usage guidelines reasonably designed to prevent the advertising practices of firm-wide social media sites from violating the Advisers Act.

- **Third-Party Content**. The SEC staff noted that the policies and procedures governing third-party content vary considerably, and that firms should consider developing policies to review, monitor or even restrict such content.

- **Testimonials**. Determining whether a third-party statement is a testimonial under the Advisers Act depends on the particular facts and circumstances surrounding the statement. The SEC staff noted that it has interpreted the term "testimonial" to include a statement of a client's experience with, or endorsement of, an investment adviser. As a result, the SEC staff noted that the use of "social plug-ins" such as a "like" button by a third party could be a testimonial under the Advisers Act if it is an explicit or implicit statement of a client's experience with an investment adviser.

- **Recordkeeping.** The SEC staff noted that recordkeeping responsibilities under the Advisers Act do not differentiate between different types of media. In the SEC staff's view, investment advisory firms that communicate through social media must retain records of those communications if they contain information covered by the Advisers Act. Firms should assess whether it is possible to retain and make available for inspection all required records for specific types of social media communications.

SEC Adopts New Net Worth Standard for Accredited Investors

On December 21, 2011, the SEC adopted an amendment to the definition of "accredited investor" in order to implement Section 413(a) of the Dodd-Frank Act. The SEC adopted the amendment substantially as proposed on January 25, 2011, with some changes made in response to comments. Specifically, the SEC adopted 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). The amended definition also includes a grandfathering provision to permit the application of the former definition in certain limited circumstances and a provision addressing the treatment of incremental debt secured by the primary residence that is incurred within 60 days of the sale of securities to the individual. The amended definition of "accredited investor" became effective on February 27, 2012.

LITIGATION

Seventh Circuit Affirms Dismissal with Prejudice of State Law Breach of Fiduciary Duty Action Preempted by SLUSA

On November 10, 2011, in *Brown v. Calamos*, the U.S. Court of Appeals for the Seventh Circuit affirmed the dismissal with prejudice of a suit brought on behalf of a putative class of common shareholders of Calamos Convertible Opportunities and Income Fund against the fund's investment adviser, Calamos Advisors LLC, and the members of the fund's Board of Trustees, alleging breach of fiduciary duty in connection with the fund's redemption of its auction-market preferred stock ("AMPS") from preferred shareholders amidst the 2008 financial crises and collapse of the auction markets. The complaint generally alleged that the defendants breached their fiduciary obligations under state law to the fund's common shareholders by improperly redeeming the then-illiquid AMPS on terms unfavorable to the common shareholders, as the fund borrowed money with higher interest rates and shorter terms to repay AMPS owners despite the absence of a maturity date or any redemption rights on these instruments. The complaint contended that the defendants caused the fund to incur greater expenses and risk in redeeming AMPS solely to placate brokerage firms that could offer distribution conduits for other Calamos-sponsored products. Presumably seeking to avoid preemption under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), the complaint included a disclaimer stating that the plaintiff asserted no securities fraud claims, but only state law claims for breach of fiduciary duty. SLUSA prohibits securities class actions if, among other things, the suit is brought by "any private party alleging a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" (a security traded nationally and listed on a regulated national exchange). The defendants removed the action to federal court under SLUSA and moved to dismiss. The district court held that the complaint alleged "the misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" and thus was barred by SLUSA.

In upholding the district court's handling of the suit, the Seventh Circuit highlighted the disparate approaches among the circuit courts of when an action is removable to federal court under SLUSA and whether a district court may dismiss an action prohibited by SLUSA with prejudice, or whether it must remand the action to provide the plaintiff with an opportunity to amend the complaint. Rather than endorsing a particular approach, the Seventh Circuit held that the plaintiff's suit was barred "under any reasonable standard" because the allegation of fraud would be "difficult and maybe impossible to disentangle from the charge of breach of duty of loyalty" that the defendants owed to the common shareholders. The complaint's disclaimer of fraud claims "cannot save it" since the allegations regarding fiduciary obligations were dependent on an allegation of fraud. The Seventh Circuit interpreted a passage in the complaint—"the Fund's public statements indicated that the holders of its common stock could realize, as one of the significant benefits of this investment, leverage that would continue indefinitely, because… the term of the AMPS was perpetual"—as alleging a misrepresentation. In addition, the Seventh Circuit found an implicit allegation of a misleading omission of a conflict of interest: the omission to state that the fund might at any time redeem AMPS on terms unfavorable to the common shareholders because motivated by broader concerns of the entire Calamos fund family.

In support of the "severe" sanction of dismissal with prejudice, the Seventh Circuit warned that "a lawyer who files a securities suit should know about SLUSA and ought to be able to control the impulse to embellish his securities suit with a charge of fraud." Moreover, if the motion was dismissed without prejudice, to permit an amended complaint without allegations of fraud, the state court might permit the reinsertion of fraud allegations later in the course of litigation, warranting yet another removal and motion to dismiss in federal court. This approach would, in the Seventh Circuit's view, unreasonably increase the cost and length of litigation and thwart SLUSA's "goal of preventing state-court end runs around the limitations that [SLUSA] had placed on federal suits for securities fraud." The Seventh Circuit observed that, in any event, deleting the fraud allegation in this instance would "not be credible, if we are correct that the allegation may well be central to the plaintiff's case despite his disclaimer."

ENFORCEMENT ACTIONS

SEC Charges UBS Global Asset Management with Pricing Violations

On January 17, 2012, the SEC charged UBS Global Asset Management (Americas) Inc. with failing to properly price securities in three mutual funds it advised, resulting in violations of the 1940 Act. The pricing violations were discovered during the course of a routine SEC staff examination of UBS. The SEC found that, in June 2008, UBS improperly valued mortgage-backed securities that it purchased for the funds' portfolios by failing to follow the funds' valuation procedures. According to the SEC, in valuing the mortgage-backed securities, UBS used prices provided by third-party pricing sources that significantly exceeded the purchase price of the securities, in many cases by more than 100%. The SEC order stated that, pursuant to the funds' valuation procedures, because of the significant variation in prices, UBS should have issued price challenges to the third-party pricing sources and valued the mortgage-backed securities at their purchase prices for up to five business days, after which time UBS should have determined that the prices provided by the third-party pricing services were justified or else set fair value prices for the securities. The SEC found that, instead of following the valuation procedures, UBS valued the mortgage-backed securities at the higher prices provided by the third-party pricing sources for two weeks before issuing price challenges and setting fair value prices for the securities. According to the SEC, UBS' failure to follow the funds' valuation procedures with respect to the mortgage-backed securities caused the NAVs of the funds to be overstated, by between one and ten cents per share, for several days. The SEC found that, by selling and redeeming shares based on inaccurate NAVs, the funds violated Rule 22c-1 under the 1940 Act and that UBS willfully aided and abetted and caused the funds' violation of Rule 22c-1. In addition, the SEC found that, by not adequately implementing the valuation procedures, the funds violated Rule 38a-1 under the 1940 Act and that UBS willfully aided and abetted and caused the funds' violation of Rule 38a-1. UBS agreed to pay $300,000 to settle the SEC's charges.

SEC Files Complaint Against Former Evergreen Portfolio Manager

On January 17, 2012, the SEC issued an order instituting proceedings against Lisa Premo, a former portfolio manager of the Evergreen Ultra Short Opportunities Fund, alleging that her conduct resulted in the Fund's NAV being materially overstated from at least March 2008 to early June 2008. In 2009, Evergreen Investment Management Company LLC, the fund's investment adviser, agreed to pay $41 million to settle SEC charges stemming from the mispricing of the fund's shares in 2008. The SEC now alleges that Ms. Premo's actions in connection with the mispricing of the fund's shares violated and caused Evergreen to violate Sections 206(1) and 206(2) under the Advisers Act and also caused the fund to violate Rule 22c-1 under the 1940 Act.

According to the SEC, in early 2008, Ms. Premo learned that a collateralized debt obligation ("CDO") owned by the fund had defaulted and would no longer make payments to the fund. The SEC alleges that, under the fund's valuation procedures, Ms. Premo, as the fund's portfolio manager, was required to review on a daily basis the price being assigned to the CDO and to notify Evergreen's valuation committee of any price that she did not think reflected the holding's fair value. The SEC alleges that Ms. Premo failed to tell the valuation committee (of which she was a member) about the CDO's default and stoppage of payments to the fund. The SEC order states that, in June 2008, when the valuation committee became aware of the default and payment stoppage, it reduced the aggregate value assigned to the CDO from approximately $6.98 million to $0, resulting in a $0.10 per share drop in the fund's NAV. The SEC alleges that the drop in the fund's NAV set in motion a chain of events that ultimately led to the fund's liquidation in 2008.

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