Investment Services Regulatory Update

May 1, 2012

LEGISLATION

Representatives Bachus and McCarthy Introduce the Investment Adviser Oversight Act of 2012

On April 25, 2012, Representative Spencer Bachus (R-Ala.), Chairman of the House Financial Services Committee, and Representative Carolyn McCarthy (D-N.Y.), a member of the Committee, introduced the Investment Adviser Oversight Act of 2012. The proposed legislation would amend the Advisers Act to provide for the creation of one or more National Investment Adviser Associations (SROs), to be registered with and overseen by the SEC, and require that each SEC- and state-registered investment adviser, unless exempt, become a member of an SRO. The bill would exempt from the SRO membership requirement advisers that (1) advise one or more registered investment companies or (2) have total assets under management at least 90% of which are attributable to one or more of the following clients: (a) non-U.S. investors; (b) qualified purchasers (as defined in the 1940 Act); (c) private funds; (d) collective trust funds; (e) charitable investment funds; or (f) other institutional clients, such as mortgage REITs, issuers of asset-backed securities, employee securities companies or business development companies. Investment advisers that are affiliated with an exempt adviser could also claim an exemption from the SRO membership requirement if 90% or more of the combined assets under management of the exempt adviser and the affiliated adviser are attributable to the clients listed above. The bill provides, however, that the SEC may determine that an affiliate is an “independent affiliate” that has “compliance programs, operations and businesses that are sufficiently independent” from those of the exempt adviser such that membership of the independent affiliate in an SRO is necessary for the protection of investors. The proposed legislation would also grant an SRO the authority to conduct examinations of its members, provided that state-registered advisers that maintain their principal office and place of business in a state that adopts a plan to conduct on-site examinations every four years generally would be exempt from SRO examinations. Under the bill, an SRO would have the authority to enforce the provisions of the Advisers Act and the rules thereunder. Finally, the bill would allow an SRO to adopt its own rules, subject to the approval of the SEC after notice, a comment period and a cost-benefit analysis performed by the SRO.

LITIGATION

ICI and U.S. Chamber of Commerce File Lawsuit Challenging CFTC Amendments to Rule 4.5

On April 17, 2012, the ICI and the U.S. Chamber of Commerce filed a lawsuit against the Commodity Futures Trading Commission challenging the legality of recently enacted amendments to CFTC Rule 4.5. As amended, the rule reinstates certain restrictions on registered investment companies’ use of futures contracts and derivatives in effect prior to 2003, and requires CFTC registration for investment advisers to registered investment companies that engage in non-hedging commodity trading above certain thresholds or registered investment companies marketing themselves as vehicles for trading in the commodities markets.

The lawsuit, filed in the U.S. District Court for the District of Columbia, challenges the Rule 4.5 amendments by alleging that the CFTC failed to discharge its statutory obligations under both the Commodity Exchange Act and the Administrative Procedure Act when enacting new rules. Specifically, the complaint alleges that the amendments to Rule 4.5 are arbitrary and capricious in that they are unnecessary, redundant and costly for registered investment companies and requests injunctive relief to prevent the CFTC from implementing amended Rule 4.5. In support of their position, the ICI and the U.S. Chamber of Commerce allege numerous defects in the rulemaking process, including the CFTC's failure to discharge its obligations to:

- Perform the required cost-benefit analysis of the impact of the amended rule as required by the Commodity Exchange Act.
- Provide the public with sufficient opportunity to participate in the rule-making process as required under the Administrative Procedure Act.
- Explain the benefits to be derived from the amended rule above those already provided to investors through existing regulation, as well as explain the reversal of the CFTC's 2003 determination that regulation of investment companies was unnecessary, burdensome and impaired liquidity.
- Provide adequate justification for the increased regulatory requirements, obligations and restrictions that the amended rule would impose on registered investment companies.

Eighth Circuit Affirms Dismissal with Prejudice of *Gallus* Excessive Fee Case

On March 30, 2012, in *Gallus v. Ameriprise Financial, Inc.,* the U.S. Court of Appeals for the Eighth Circuit affirmed the district court's dismissal with prejudice of plaintiffs' excessive fee claims. The decision follows almost two years after the U.S. Supreme Court vacated and remanded *Gallus* to the Eighth Circuit for further consideration in light of the Supreme Court's decision in *Jones v. Harris Associates L.P*. The Eighth Circuit, in turn, remanded the case to the district court, which, on December 8, 2010, reinstated its earlier order granting summary judgment and re-entered judgment in favor of Ameriprise.

On remand, the district court stated that in its earlier decision it had weighed the evidence in the case under the factors set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.* and that the Eighth Circuit had found that the district court had properly applied the *Gartenberg* factors. The district court then reviewed the Supreme Court's conclusion in *Jones* that "*Gartenberg* was correct in its basic formulation of what §36(b) requires: to face liability under §36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The district court found that reinstating its previous order granting summary judgment was appropriate after considering the parties' submissions, the procedural posture of the case, the Supreme Court's adoption of the *Gartenberg* framework in *Jones* and the district court's previous orders.

On appeal, the Eighth Circuit concluded that the plaintiffs failed to raise a genuine issue of material fact that Ameriprise charged a disproportionately large fee. In rendering its decision, the Eighth Circuit rejected plaintiffs' argument that "a defective process implies an excessive fee," stating, rather, "[a] defective process affects the amount of deference we give to the fee arrangement reached between the board of directors and the adviser of the fund." The Eighth Circuit continued, stating "[w]e do not read *Jones* to allow a deficient process to be the additional evidence required to survive summary judgment . . . because the opinion's language again focuses on evidence that the fee is outside the arm's length range." The Eighth Circuit also rejected the plaintiffs' arguments that the standard for review of Rule 12b-1 fees is whether such fees benefit the mutual fund and its shareholders and that the Ameriprise fund shareholders received no net benefit from the Rule 12b-1 fee. The Eighth Circuit found that by failing to show that the Rule 12b-1 fees are outside the "range of what would have been negotiated at arm's-length in the light of all surrounding circumstances," when viewed in light of the proper analytical framework, the plaintiffs failed to meet the *Gartenberg* standard, as applied in *Jones*.

NEW RULES, PROPOSED RULES AND GUIDANCE

Federal Reserve Board Clarifies Volcker Rule Compliance Deadline

On April 19, 2012, the Federal Reserve Board approved a statement clarifying that banking entities have until July 21, 2014 to fully comply with Section 619 of the Dodd-Frank Act (commonly known as the "Volcker Rule") and any rules adopted to implement the Volcker Rule. The Volcker Rule imposes certain prohibitions and restrictions on a banking entity's ability to engage in proprietary trading and maintain interests in hedge funds and private equity funds. The Federal Reserve Board's statement provides registered investment companies with additional time to determine how they may be affected by the implementation of the Volcker Rule. The SEC and other federal agencies have proposed a joint rule to implement the Volcker Rule.

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.

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