Investment Services Regulatory Update

June 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.

OTHER NEWS

Mutual Fund Directors Forum and eSecLending Issue Practical Guidance on Securities Lending Programs

In May 2012, the Mutual Fund Directors Forum and eSecLending issued separate reports providing an overview of securities lending practices and offering guidance on the oversight and implementation of securities lending programs. The MFDF report focused on providing fund boards with guidance on evaluating proposals to implement securities lending programs and overseeing such programs. The eSecLending report focused on providing guidance to fund management for creating, monitoring and managing securities lending programs. The reports included the following guidance:

- Whether a fund can lend securities and the extent to which it may do so should be established in a board-approved securities lending policy. Such a policy may include the objectives of the securities lending program, criteria to determine appropriate borrowers, preferred routes to market (e.g., using a custodian, third party, principal exclusive or other type of model), securities lending restrictions, proxy voting guidelines on loaned securities, collateral guidelines and reinvestment guidelines.

- As part of determining whether to approve a securities lending program, boards should understand the costs and benefits of the program, any tax implications of the program, how collateral received in connection with loaned securities will be invested and what service providers fund management will use to implement the program.

- Boards should also understand the risks of securities lending, such as operational risks, counterparty risks, reinvestment risk, market risk and liquidity risk, among others, as well as the policies and procedures fund management has implemented to identify, monitor and mitigate such risks.

- Boards should initially approve the contracts with the service providers that will implement and manage the securities lending program. Boards should also review the performance and fees of the service providers on an ongoing basis and consider whether the fees remain appropriate in light of the services provided.

- Once a securities lending program is in place, the board, with the assistance of the fund's chief compliance officer, should review the program on a regular basis. Fund management should regularly provide the board with reports about the securities lending program that include the performance of the program, as well as a review of compliance, risk management, operational information, collateral reinvestment, income earned and performance benchmarking. Fund management should provide the board with market color that discusses the strategies and interest for individual securities and asset classes to enhance the board's understanding of what is driving the demand for the fund's securities.

- Fund management should consider forming a working group comprised of management personnel responsible for monitoring the securities lending program and performing due diligence on the service providers.

- When deciding on a specific route to market and which lending agent to use, fund management should conduct proper due diligence, and ensure that the lending agent provides a comprehensive trading strategy for fund securities and that the lending agent understands the fund's preferences for proxy voting and security restrictions.

- Fund management should conduct thorough due diligence of a lending agent's collateral management process. Fund management should understand the lending agent's operational processes around collateralization and what rights the fund will have to the collateral in the event of a borrower default.

The reports are available at the following websites:

MFDF Report:
http://www.mfdf.org/images/uploads/newsroom/Board_Oversight_of_Securities_Lending_May_2012.pdf

eSecLending Report:
http://www.eseclending.com/pdfs/Securities%20Lending%20Best%20Practices%20Mutual%20Funds%202012.pdf.

ENFORCEMENT ACTIONS

Four Firms Sanctioned by FINRA for Sales of Leveraged and Inverse ETFs

On May 1, 2012, FINRA announced that it imposed more than $9 million in fines against Citigroup Global Markets, Inc., Morgan Stanley & Co., LLC, UBS Financial Services and Wells Fargo Advisors, LLC for practices related to sales of leveraged and inverse ETFs. According to FINRA, the firms failed to maintain a reasonable supervisory system over the sale of these "non-traditional" ETFs. FINRA also found that these firms failed to provide adequate training to educate registered representatives about these funds and failed to perform reasonable diligence to understand the nature of these funds, including the potential risks and rewards.

According to FINRA, leveraged and inverse ETFs expose customers to risk of performance when held for longer periods of time in volatile markets. Notwithstanding these risks, FINRA found these firms supervised their customers' investments in non-traditional ETFs in the same manner as traditional ETFs. As a result, FINRA found that these firms made unsuitable recommendations to customers to purchase leveraged and inverse ETFs, some of which continued to hold these securities for extended periods of time despite their conservative risk tolerance profiles and extreme market volatility. The sanctions announced by FINRA consisted of $7.3 million of fines and $1.8 million in restitution to certain customers.

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