

## Investment Services Regulatory Update

January 2, 2013

### NEW RULES, PROPOSED RULES AND GUIDANCE

#### **SEC Extends Temporary Rule Regarding Adviser Principal Trades**

On December 20, 2012, the SEC adopted an amendment to Rule 206(3)-3T to extend the Rule's expiration date by two years until December 31, 2014. The temporary Rule provides an alternative method for investment advisers who are also broker-dealers to comply with Section 206(3) of the Advisers Act, which requires an adviser to obtain client consent prior to engaging in a principal transaction with the client. Rule 206(3)-3T was initially adopted on September 24, 2007 in response to a federal appeals court decision that vacated Rule 202(a)(11)-1 of the Advisers Act, which allowed registered broker-dealers to offer fee-based accounts without being regulated as investment advisers. On December 28, 2010, the SEC extended Rule 206(3)-3T until December 31, 2012. Pursuant to Rule 206(3)-3T, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides written prospective disclosure regarding the conflicts arising from principal trades; (3) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; (4) provides the client with an annual report on all principal transactions with that client; and (5) sends confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC made no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension was necessary to provide sufficient protection to advisory clients while the SEC analyzes the findings and recommendations from its study of the standards of care applicable to broker-dealers and investment advisers as required by Section 913 of the Dodd-Frank Act and also as it obtains data and economic analysis related to standards of conduct and enhanced regulatory harmonization of broker-dealers and investment advisers.

#### **Treasury Issues Determination Exempting Foreign Exchange Swaps and Foreign Exchange Forwards from the Definition of "Swap"**

On November 16, 2012, the Department of the Treasury issued a written determination exempting foreign exchange swaps and foreign exchange forwards from the definition of "swap," in accordance with the applicable provisions of the Commodity Exchange Act (CEA). In making its determination that foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the CEA, Treasury noted the distinctive characteristics of these instruments and its belief that requiring central clearing and trading under the CEA of these instruments would potentially introduce operational risks and challenges to the current settlement process. Treasury noted that its authority to issue a determination is limited to foreign exchange swaps and foreign exchange forwards and therefore that its determination does not extend to other foreign exchange derivatives.

**OTHER NEWS****IDC Issues White Paper on Board Oversight of Exchange-Traded Funds**

In October 2012, the Independent Directors Council issued a white paper providing a general overview of exchange-traded funds (ETFs) structured as open-end funds and discussing various topics directors may wish to consider in connection with their oversight of ETFs. The white paper states that ETF directors oversee the management and operations of ETFs under the same regulatory framework as other registered open-end funds, but ETFs themselves may be subject to additional requirements imposed by the exchange on which the ETF is listed or pursuant to SEC exemptive relief received by the ETF. The paper highlighted the following six topics and related information that directors may wish to consider in connection with their oversight of existing ETFs or in contemplation of approving new ETFs:

*The Exemptive Process for ETFs.* In order to operate, ETFs require exemptive relief from certain provisions of the 1940 Act to allow them to create and redeem creation units at net asset value only with authorized participants, while also allowing their shares to trade in the secondary market at negotiated prices. Directors may want to consider the time required to obtain such relief, the type of exemptive relief sought, the conditions to the exemptive relief, the processes employed to ensure compliance with such conditions and whether the exemptive relief imposes any specific responsibilities on the directors.

*ETF Design and Investment Objective.* Directors should consider whether the ETF is an index-based ETF or an actively-managed ETF. For index-based ETFs, directors may consider how the index was selected and the due diligence performed on the index provider, whether the ETF will seek to replicate the index or use a representative sampling technique and what regulatory limitations may be imposed on the ETF, such as diversification requirements, all of which may cause the ETF not to track its index as closely as it would without such techniques or restrictions. For actively-managed ETFs, directors may consider anticipated portfolio turnover and processes employed to minimize trading ahead of the ETF.

Additionally, directors should consider whether authorized participants will be able to purchase and redeem creation units in-kind, for cash or both. Generally, because of the use of in-kind transactions and secondary market trading, many boards decide not to adopt a policy to detect and deter frequent trading and market timing of ETF shares. If creation units may be purchased or redeemed in cash, though, a board may determine to adopt such a policy.

*ETF Contractual Relationships.* In addition to typical fund service providers, ETFs also work with exchanges and index providers. With respect to the ETF's primary listing exchange, directors may consider the costs of listing on such exchange, applicable listing standards and any responsibilities imposed on the directors, information about the designated market maker and, if listing on a foreign exchange, any additional responsibilities and potential liabilities of directors under the laws of that jurisdiction. As to index providers, directors may consider the terms of the licensing agreement, including costs, exclusivity and duration, as well as contingency plans if the adviser is unable to renew the license.

*Trading of ETF Shares.* Directors may wish to receive regular reports as to premiums and discounts, bid-ask spreads, tracking error, correlation and trading volume. For any persistent trading issues, directors should consider whether there are any steps that should be taken to address the issues.

*Portfolio Management and Trading of Underlying Securities.* For index-based ETFs, directors should review and monitor tracking error and the causes of such tracking error and the effectiveness of any sampling strategy. Additionally, if ETFs have investment objectives similar to

other funds in the fund complex, directors should consider the policies in place to address potential conflicts of interest between the funds.

*Disclosure.* ETF disclosure is similar to that for other funds, with a few exceptions, including that ETFs must disclose (1) that their shares are traded on an exchange and may not be purchased or redeemed from the ETF except in creation units by authorized participants, (2) that ETF shares may trade at a premium or discount to net asset value and the number of days ETF shares traded at a premium or discount, and (3) their portfolio holdings or creation basket composition daily. Directors also should review the adequacy of the ETF's disclosure in regards to causes of tracking error, use of derivatives and securities lending. Directors may also consider the process for ensuring that marketing and web materials are consistent with the ETF's registration statement.

The white paper is available at: [http://www.ici.org/idc/pubs/white\\_papers](http://www.ici.org/idc/pubs/white_papers).

### **Professional Organizations Issue Guidance to Audit Committees Regarding Evaluation of External Auditors**

In October 2012, a group of seven professional organizations, including the Independent Directors Council and the Mutual Fund Directors Forum, issued a report setting forth an evaluation tool for audit committees to use in assessing a company's external auditor. The report notes that audit committees have direct responsibility for overseeing a company's financial reporting process and controls and for hiring and overseeing a company's external auditor, and states that, as a part of this responsibility, audit committees should annually evaluate their external auditors in order to make an informed recommendation to the board as to whether it should retain the auditor. The report provides guidelines and recommendations for audit committees to follow when conducting evaluations of external audit firms. The report states that such evaluations should include an assessment of the following areas:

- the quality of services and sufficiency of resources provided by the audit firm, the auditor's engagement team and the engagement partner;
- the communication and interaction between the audit committee and the auditor, including the frequency, completeness and openness of such communication; and
- the independence, objectivity and professional skepticism of the auditor as it relates to the auditor's ability to evaluate and challenge, when necessary, the methods, assumptions and disclosures used by management in its financial reporting.

The report provides sample questions for audit committees to use in assessing each of the above elements. In addition, the report encourages audit committees to obtain observations from management, internal audit staff and other employees of the company that have substantial contact with the external auditors. A sample survey for obtaining input on the external auditor from company personnel is included in the report. The report also includes relevant requirements and standards related to prohibited non-audit services and an overview of auditor communications with audit committees.

The report is available at:  
[http://www.mfdf.org/director\\_resources/resource/AuditorEvaluation/](http://www.mfdf.org/director_resources/resource/AuditorEvaluation/).

**LITIGATION AND ENFORCEMENT ACTIONS****SEC Charges Adviser with Federal Securities Law Violations Relating to Use of Options Contrary to Fund's Strategies and Policies**

On December 21, 2012, the SEC charged Top Fund Management, Inc. (TFM), a registered investment adviser, and its president and sole control person, Barry C. Ziskin (together, the Respondents) with violating federal securities laws in connection with the management of the Z Seven Fund leading to significant losses and, ultimately, the fund's liquidation. The SEC alleged that, contrary to the fund's investment objective of long-term capital appreciation, its principal investment strategy of investing at least 80% of its total assets in common stocks and its fundamental investment policy restricting the use of options to hedging purposes, the Respondents primarily pursued a strategy for the fund of buying put options on stock index ETFs and stock index futures for speculative purposes. The SEC also alleged that the fund's prospectuses had no disclosure regarding options trading and no discussion of the principal risks related thereto. Moreover, the SEC alleged that the fund's certified shareholder report for the period ended June 30, 2010, for which Ziskin was responsible, inaccurately described the use of options as a means of hedging.

The SEC's order alleges that the Respondents willfully violated Sections 206(1) and 206(2) of the Advisers Act, Section 206(4) of the Advisers Act and Rule 206(4)-8(a) thereunder, Section 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 34(b) of the 1940 Act. The SEC's order also alleges that the Respondents caused violations of Section 13(a)(3) of the 1940 Act by the fund, which provides that no registered fund may deviate from any fundamental investment policy. The Respondents agreed to cease and desist from committing or causing any violations and any future violations of the foregoing provisions and TFM agreed to a censure. In addition, Mr. Ziskin consented to an industry bar. Each Respondent also submitted a sworn Statement of Financial Condition asserting an inability to pay a civil penalty.

**District Court Allows Claim of Excessive Investment Management Fees to Proceed**

On December 17, 2012, the U.S. District Court for the District of New Jersey granted in part and denied in part the motion to dismiss of Hartford Investment Financial Services, LLC with respect to claims brought under Section 36(b) of the 1940 Act on behalf of six Hartford mutual funds that were sub-advised. The shareholder plaintiffs alleged that Hartford, the funds' investment adviser, charged excessive investment management and distribution (12b-1) fees in violation of Section 36(b). The court granted Hartford's motion to dismiss with respect to the distribution fees but allowed the plaintiffs' claim regarding the investment management fees to proceed. In considering Hartford's motion to dismiss, the court applied the standard for Section 36(b) cases articulated in the Supreme Court's decision in *Jones v. Harris Associates L.P.* that "to face liability under Section 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." In applying this standard, the court noted that it must consider "all relevant circumstances," guided by the factors set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.* in which the *Jones* standard was first articulated. The court applied each of the *Gartenberg* factors in its consideration of Hartford's motion to dismiss.

With respect to the plaintiffs' claim that the investment management fees charged by Hartford were excessive, Hartford argued in its motion to dismiss that the court should not consider—or should give limited weight to—the plaintiffs' allegations that Hartford's fees vastly exceeded (1) the fees paid by Hartford to the funds' sub-adviser and (2) the fees charged by Vanguard for similar services. The court rejected the first argument outright, giving full consideration to the allegation that Hartford charged the funds, on average, three times the amount it paid to the funds' sub-adviser, even though Hartford provided minimal additional supervisory or

administrative services. The court proceeded to accept Hartford's argument that the comparison to fees charged by Vanguard should be given limited weight due to Vanguard's reputation as a low-cost mutual fund provider and its not-for-profit status. However, persuaded by the fact that Hartford and Vanguard employed the same sub-adviser, the court refused to discount entirely the allegation that the effective fee charged by Hartford exceeded the corresponding Vanguard fee by a factor of fifty to one. The court proceeded to apply the remaining *Gartenberg* factors, concluding that the plaintiffs' allegations gave rise to a plausible inference that Hartford's investment management fees were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arms' length bargaining.

With respect to the 12b-1 fees charged by Hartford, the plaintiffs, each of whom held only Class A shares, alleged that the mere fact that they were charged both a front-end sales load and 12b-1 fees meant that the 12b-1 fees were excessive under *Gartenberg*. In dismissing the claim, the court noted that the plaintiffs failed to cite any case law to support their contention and that, according to the SEC, charging both a front-end sales load and a 25 basis point 12b-1 fee on Class A shares was customary in the industry. The court also dismissed the plaintiffs' parallel claim on behalf of Class B shareholders due to lack of standing, noting that while mutual fund investors may have statutory standing to pursue claims on behalf of shareholders of other classes, such plaintiffs "still must allege a distinct and palpable injury to [themselves]."

#### **District Court Rules on Industry Challenges to CFTC Rule 4.5**

On December 12, 2012, the U.S. District Court for the District of Columbia ruled in *Investment Company Institute et al. v. United States Commodity Futures Trading Commission* (CFTC). The plaintiffs in the case, the ICI and the U.S. Chamber of Commerce, challenged amendments to Rule 4.5 under the Commodity Exchange Act (CEA), which sets forth an exclusion from the definition of "commodity pool operator" for registered investment companies, and amendments to Rule 4.27. The plaintiffs alleged that the rule-making process did not meet the standards set forth in the CEA relating to cost-benefit analysis and was arbitrary and capricious under the Administrative Procedures Act.

In denying the plaintiffs' motion for summary judgment, granting the CFTC's motion to dismiss in part and granting the CFTC's cross-motion for summary judgment, the court found the following:

- There was no basis on which to disturb the CFTC's findings.
- The rule-making process met all the requirements under the CEA and the final rule was a "logical outgrowth" of the proposed rule.
- The CFTC "provided a reasoned explanation for its actions" and considered the costs and benefits as required.
- The CFTC provided an adequate basis for the shift in its views from the 2003 amendments to Rule 4.5.
- The challenged amendments were aligned with the intent of the Dodd-Frank Act to give the CFTC greater power to oversee swaps and the derivatives markets and to bring more transparency to those markets. Thus, the CFTC's actions were not arbitrary and capricious.

The plaintiffs have appealed the court's decision to the U.S. Court of Appeals for the District of Columbia Circuit.

**SEC Charges Eight Fund Directors for Failure to Properly Oversee Fair Valuations**

On December 10, 2012, the SEC filed an order instituting enforcement proceedings against eight former directors, including six independent directors, of five registered investment companies advised by Morgan Asset Management, Inc. (Morgan Keegan) alleging that the directors failed to satisfy their statutory obligations with respect to the fair valuation of mortgage-backed securities held by the funds. The SEC's order alleges that the directors delegated their asset-pricing responsibilities to Morgan Keegan without giving adequate guidance on how fair valuations should be made or ascertaining how fair values were determined. The SEC action against the directors follows a related \$200 million settlement by Morgan Keegan with the SEC, state regulators and FINRA in 2011.

The SEC's order states that between January 2007 and August 2007, a significant portion (in some cases up to 60%) of the funds' portfolios contained below-investment grade debt securities, including a large number of securitized products backed by subprime mortgages, for which market quotations were not readily available. The SEC's order notes that, pursuant to Section 2(a)(41)(B) of the 1940 Act, such securities were required to be valued at a fair value as determined in good faith by the directors. The SEC alleges that the process employed in making fair valuation determinations for the funds' securities was deficient in many respects. The SEC's order alleges that the directors did not know and did not inquire as to the manner in which Morgan Keegan was making fair value determinations for particular types of securities and did not receive information that would allow the directors to understand the methodology that was being used to fair value securities. The SEC notes that, although the directors met more frequently and inquired about liquidity and valuation matters after being contacted by the SEC staff regarding valuation issues in July 2007, the directors never asked specific questions about valuation methodology and testing. The SEC's order alleges that these failures were "particularly egregious" given that fair valued securities made up the majority of the funds' net asset values.

The SEC's order alleges that the directors caused the funds to violate the following rules under the 1940 Act: (1) for the open-end funds, Rule 22c-1 by redeeming and repurchasing securities at a price other than the current net asset value; (2) Rule 30a-3(a) by failing to maintain internal control over financial reporting; and (3) Rule 38a-1 by failing to adopt and implement meaningful fair-valuation methodologies and related procedures. The SEC's order also alleges that, as a result of their conduct, the directors caused certain of the funds' registration statements to contain statements that were false or misleading with respect to material facts or to omit material facts which were required to be stated in the registration statements.

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

