

# Investment Management Legal + Regulatory Update

## Regulatory Updates

### FINRA overhaul of communications rules becomes effective

FINRA's sweeping overhaul of its rules governing communications with the public became effective on February 4, 2013. The new rules and guidance, which the SEC approved last year, are likely to keep compliance officers busy for quite some time.

The revised rules simplify some rules and also create new compliance challenges. Most significantly, FINRA reduced the number of categories of communications to three from six, and requires member firms to file certain communications concerning retail structured products, such as ETNs, that reference a basket of securities, commodity or an index. These rules revise the filing and supervisory responsibilities of member firms.

While the JOBS Act eases restrictions on pre-offering communications concerning certain types of issuers, members must still be aware of how the new FINRA rules apply.

*Categories of communications.* FINRA reconfigured six categories of communications into three new categories: retail communications, institutional communications and correspondence. Each of these new categories has specific compliance requirements.

- *Retail communications* include any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar day window. The new category generally includes the old "advertisement" and "sales literature" categories, and may include some writings in the old "correspondence" category.
- *Institutional communications* include any written (including electronic) communication that is distributed or made available *only* to institutional investors. The definition excludes a member's internal communications.

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- *Correspondence* includes any written (including electronic) communication that are distributed or made available to 25 or fewer retail investors within any 30 calendar day window. Under the old category, “correspondence” included written communications to one or more current retail customers and fewer than 25 prospective retail customers within a 30 day window. The new category eliminates the distinction between existing and prospective customers.

*Retail structured products.* New FINRA rule 2210(c)(3)(E) requires member firms to file, within 10 business days of first use or publication, retail communications concerning securities registered under the Securities Act of 1933 that are derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency. FINRA published a Q&A on January 7, 2013 that provides some guidance on the types of products covered.

Among other things, FINRA said that the new filing requirement applies to exchange-traded notes that are not registered under the Investment Company Act, but are registered under the 1933 Act. Other securities include registered reverse convertibles, registered structured notes, registered principal protection notes and other registered securities that include embedded derivatives-like features.

*Public appearances* by representatives in seminars or media interviews was eliminated as a category. Participation in these events is still subject to other FINRA requirements concerning content, and sales scripts presented at a seminar for potential retail investors are considered *retail communications*.

*Filings with FINRA.* Generally, members must file all *retail communications* within 10 days prior to first use, the following types of securities:

- Registered investment companies that include performance rankings or certain comparisons, when the

ranking of companies is not generally published;

- Securities futures; and
- Bond mutual funds that include volatility ratings.

Members generally must file all *retail communications* within 10 days after first use or publication, the following types of securities:

- Registered investment companies (if the communication is not required to be filed prior to first use);
- Public direct participation programs;
- Templates for written reports produced by or concerning an investment analysis tool;
- Collateralized mortgage obligations (new)
- Registered structured products that are derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance or a foreign currency (new); and
- Television or video *retail communications* when the member previously filed a draft of the “story board.”

The requirement to file *retail communications* with FINRA, as discussed above, includes new types of communications. The new rules exclude communications based on previously filed templates when changes are limited to updates; communications that do not make financial or investment recommendations; and communications posted on online interactive forums (even though FINRA considers these posts to be *retail communications* if the forum is available to retail investors).

The old NASD rules required member firms to file within 10 business days of first use advertisements and sales literature concerning closed-end funds that are distributed during the fund’s initial public offering, and similar communications for interval funds. The new filing requirement

also applies to *retail communications* that are distributed *after* a closed-end fund’s IPO period.

“Reason to believe” standard. FINRA retained the NASD requirement that members may not treat communications as having been distributed to an institutional investor if the member has reason to believe that the communication or any excerpt will be sent or made available to retail investors. While the “reason to believe” standard does not impose an affirmative duty on firms to ask whether an institutional investor will forward these communications to retail investors, FINRA said that firms “should have policies and procedures in place reasonably designed to prevent institutional communications from being forwarded to retail investors, and make appropriate efforts to implement such policies and procedures. Procedures may include use of warning legends. Also, underwriters must follow up on “red flags” that indicate that a recipient broker-dealer intends to send institutional communications to its retail investors.

*New member firm filing requirements.* New member firms, for one year, generally must file *retail communications* at least ten days before first use, consistent with the old requirement. The new rule starts the clock ticking on the one-year period from the date its membership becomes effective, rather than from the date of its initial filing of an advertisement.

*Principal approvals.* The new rules establish levels of supervisory approvals for each category. Most significant, *retail communications* must now be approved by an “appropriately qualified” registered principal. Principals need not pre-approve market letters that do not make financial or investment recommendations; communications posted in an online interactive electronic forum; and retail communications that do not make any financial or investment recommendations or otherwise promote a member’s products or services.

*Other changes.* The new FINRA rules

include substantive changes to a number of other areas including:

- Content standards
- Free writing prospectuses
- Public appearances by member registered representatives
- Investment analysis tools.

## ICI and CoC appeal Rule 4.5 ruling

On December 27, 2012, the Investment Company Institute and the Chamber of Commerce filed a [Notice of Appeal](#) of the ruling by the District Court for the D.C. district upholding the CFTC's amendments to 4.5. The rule would subject many advisers to registered funds already regulated by the SEC to dual regulation by the CFTC as commodity pool operators (CPOs).

The ICI brought the challenge because the "CFTC failed to justify the regulatory excess and added costs of its amendments to Rule 4.5, which would impose that agency's regulatory regime atop the comprehensive regulation already applied to registered funds" by the SEC, [according to ICI CEO Paul Schott Stevens](#).

## Enforcement and Litigation

### Enforcement Division priorities target hedge funds

In a [speech](#) on December 18, 2012, Bruce Karpati, the Chief of the SEC Enforcement Division's Asset Management Unit (the "AMU"), outlined hedge fund enforcement priorities. Hedge fund managers, he said, should take their fiduciary duties seriously and set a "tone at the top" to create a culture of compliance.

He reviewed the various risks to investors and what he characterized as misaligned incentives applicable to fund managers.

*The AMU's focus.* Mr. Karpati said that the Enforcement Division created the

AMU, one of three Units dedicated to investigating fraud that touch heavily on hedge funds. With a staff of 75, the AMU focuses on investigations of securities laws violations in the investment management area. This involves investment advisers, hedge funds, mutual funds and private equity funds.

In light of the growth of hedge funds over the past 20 years, the AMU has devoted more resources to alternative investments, particularly hedge fund advisers.

*Risks to investors.* Mr. Karpati summarized risks to investors identified by the Enforcement Division, including:

- Investment in complex, illiquid or opaque investments;
- Emerging retail orientation of hedge funds that increasingly exposes ordinary investors to such funds, either directly or indirectly through pensions;
- "Retailization" of hedge funds that allows unsophisticated investors to invest directly in hedge funds; and
- Risks posed by private funds advised by unregistered advisers.

*Conflicts of interest.* Mr. Karpati said that understanding "varying business motivations" of hedge fund advisers has helped identify "problematic issues" that will be the focus of the AMU's investigations. These issues include:

- Compensation structure (e.g., performance fees);
- Pressure to demonstrate positive performance;
- Need to get an "informational edge" in the market, leading to insider trading;
- Severe conflicts of interest through related-party transactions;
- Preferential treatment to certain investors; and

- Lack of independent governance, making hedge funds more susceptible to conflicts of interest and fraud.

Mr. Karpati discussed how the examination and enforcement process intersects with regulation of hedge fund advisers. He urged hedge fund managers to adopt best practices to fulfill their fiduciary duties, including:

- Set a "tone at the top" and create a culture of compliance;
- Adopt and implement a compliance program and controls geared to the risks of investment strategy; and
- Be alert and prepared for regulatory examinations.

### Independent directors respond to SEC allegations in fair valuation case

On January 3, 2013, the former independent directors of several open-end and closed-end mutual funds advised by Morgan Asset Management, Inc. [responded](#) to SEC allegations that they violated their valuation responsibilities under the 1940 Act (see our [client alert](#) regarding the SEC's claims). The directors intend to vigorously defend against the charges brought by the Division of Enforcement.

According to the directors, the SEC failed to state a claim under Rule 22c-1 of the 1940 Act. They point to several factors supporting their view, including:

- the SEC has never issued rules that require specific fair valuation methodologies and the staff has admitted that valuation is a "notoriously gray area;"
- contrary to the SEC's allegations, the directors established appropriate valuation procedures and lawfully delegated responsibilities thereunder to the funds' adviser;
- the SEC "implicitly endorsed" such procedures in a prior proceeding for

fraud against the adviser and certain of its officers;

- the valuation procedures were annually reviewed with the funds' CCO and were prepared under the direction of the funds' outside counsel;
- the valuation procedures and security valuations determined thereunder were reviewed three times a year by the funds' outside independent auditors;
- the directors received back-testing reports comparing recent sale prices for securities that were valued under the procedures to the most recent price of such securities used for calculating the funds' NAV; and
- the SEC staff examined the valuation procedures during the course of on-site examinations in 2003 and 2005, and an examination focused specifically on valuation in May 2007, but no concerns were raised with the directors until August 2007.

The directors raise several other defenses, including a lack of negligence on the part of the independent directors, estoppel, and the intervening fraud on the part of the adviser and certain of its employees (as determined by the SEC in the related case). The directors also allege that the SEC is barred by the statute of limitations from bringing this case; there is little doubt they will carefully be watching the pending decision of the U.S. Supreme Court in *Gabelli v. Securities and Exchange Commission* (see our discussion on this case below) on the issue of when a claim accrues for purposes of applying the five-year limitations period applicable to the government's ability to bring a civil action.

Regardless of whether the eventual decision in *Gabelli* precludes the SEC from proceeding against these directors, the SEC is sending a clear message to fund boards: One size does not fit all when it comes to valuation of portfolio securities, and directors must provide "meaningful substantive guidance" when delegating the responsibility of fair valuing such securities.

This case signals that despite the continued lack of specific valuation guidance from the SEC staff, fund directors should review the appropriateness of their funds' valuation procedures, and should consult with the funds' investment adviser, chief compliance officer, auditors and counsel for guidance on how to appropriately satisfy their responsibilities regarding valuation of portfolio securities. Perhaps most importantly, fund directors should ensure that the record appropriately documents their valuation efforts.

### **It's not dead yet: the SEC fights another market timing battle**

In a case arising out of the 2003 marketing timing scandals, the U.S. Supreme Court recently heard oral arguments in *Gabelli v. Securities and Exchange Commission*. The question presented is whether the district court properly dismissed as time-barred the SEC's fraud claims against two individual officers of Gabelli Global Growth Fund ("GGGF") or whether the Second Circuit correctly inferred a "discovery rule" on the statute of limitations applicable to SEC enforcement actions.

The case arose out of a fund's decision to let a particular hedge fund engage in time zone arbitrage to time its investments in GGGF during the period from 1999 until 2002. The SEC began its investigation into the matter in 2003 and filed its lawsuit in April 2008.

Under the relevant statute of limitations, an SEC enforcement action for civil penalties must be "commenced within five years from the date when the claims first accrued." Defendants assert that the claims accrued as early as September 1999 and, in any event, not later than August 2002 when GGGF stopped allowing market timing. The SEC asserts that its claim accrued when the fraud was discovered; in this case when it started its investigation in September 2003.

The district court dismissed the case because the statute of limitations does not contain a discovery rule. The court also

said that since there were no allegations that the defendants tried to conceal what they were doing, the SEC could not rely on the doctrine of fraudulent concealment. The Second Circuit reversed, holding that in a fraud case, "the discovery rule defines when the claim accrues and, correlatively, that the SEC need not plead that the defendants took affirmative steps to conceal their fraud."

If the Second Circuit ruling stands in this case, the resulting discovery rule potentially could give the SEC unlimited time to discover securities fraud, followed by an additional five years in which to bring a claim. In contrast, when Congress has enacted a discovery rule in the securities law context, it usually couples the rule with a longer statute of repose, which provides an outer boundary for the limitations period. Without a firm end-point provided by a clear statute of limitations or a discovery rule coupled with a statute of repose, market participants could not be certain that potential exposure to securities liability has passed.

That lack of certainty arising from the SEC's position appeared to concern the Justices on oral argument. Among other things, they noted that the SEC could provide no cases to support its position and that the position of the government would have the effect of abolishing the statute of limitations. This is of particular concern since the statute at issue is not limited to securities actions but applies to governmental actions in general.

A decision in this case is expected by June.

### **SEC settles with closed-end fund over improper stock repurchase**

On December 20, 2012, without admitting or denying the allegations, a registered closed-end fund and its officers settled SEC charges that the fund improperly repurchased its auction term preferred (ATP) stock to avoid a failed auction.

The SEC alleged that the \$15 million repurchase unfairly discriminated against

other ATP holders, and was contrary to the fund's prior statements in shareholder reports that the fund would repurchase ATP to maintain asset coverage requirements.

The fund and its executives were forced to disgorge approximately \$400,000, as well as to pay civil penalties of \$10,000.

### **Court orders hedge fund to disgorge funds in connection with deceptive returns**

On January 9, 2013, the SEC [announced](#) that the U.S. District Court for the Southern District ordered a hedge fund manager and one of its principals to disgorge \$4 million and pay civil penalties of \$1 million, in connection with material overstatements of the firm's track record and other credentials. The judgment follows a partially-settled civil injunctive action filed by the SEC on November 10, 2011. The SEC's original complaint alleged that the firm and its principal falsely gave investors the impression that returns were consistently positive and minimally volatile, and repeatedly inflated the amount of the firm's assets and exaggerated the firm's longevity, performance history and the credentials of its managers.

### **Excessive fee case survives motion to dismiss**

On December 17, 2012, the U.S. District Court for the District of New Jersey allowed a Section 36(b) excessive fee claim to proceed against Hartford Investment Financial Services, LLC ("HIFSCO"). A similar claim pertaining to distribution fees was dismissed.

The case alleges that HIFSCO charged excessive management and distribution fees in violation of Section 36(b) of the 1940 Act. The U.S. [Supreme Court](#) [has confirmed](#) that to succeed in a Section 36(b) challenge, a fee must be "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." Despite this high standard, the plaintiffs' bar continues to bring claims under

Section 36(b), which provides a private right of action to challenge investment management fees.

In deciding to allow the claim related to investment management fees to proceed, the court considered:

- the difference between the fees HIFSCO charges the funds and what it pays sub-advisers;
- the difference between fees charged by HIFSCO and Vanguard, a direct competitor; and
- the fees charged to institutional clients by a HIFSCO affiliate.

Both HIFSCO and Vanguard use the same sub-adviser, but the complaint alleges that HIFSCO's fees are on average three times larger than Vanguard's fees for comparable products. The court acknowledged the limited applicability of a comparison to an acknowledged low cost provider, but concluded that "since Vanguard and HIFSCO employ the same sub-adviser, this comparison is more apt than the typical case."

Although the funds' fee schedules include breakpoints, the court determined that the complaint sufficiently alleges that they do not provide shareholders with meaningful economies of scale. The court also said that allegations that the board oversees 85 funds, approved contracts and fees notwithstanding the comparative fee data, and allegedly disregarded an enforcement action regarding HIFSCO's improper use of fund assets, "create an inference that the board of directors may not have adequately considered important facts."

In contrast, the pleadings regarding the Rule 12b-1 fees were not sufficient. The court granted HIFSCO's motion to dismiss this claim because (i) it appears that the funds appropriately disclosed that Class A shareholders could pay both front-end sales charges and Rule 12b-1 fees and (ii) the plaintiffs do not own Class B shares and they presented no argument regarding their standing to bring that claim under Article III of the Constitution.

This case is at a preliminary stage, and many more facts and arguments will be presented before it reaches conclusion or settlement.

### **Brokers fined for inadequate supervision of prospectus delivery**

In December 2012, FINRA fined five broker-dealers amounts ranging from \$40,000 to \$400,000 for failure to establish an adequate supervisory system and written procedures to supervise compliance with prospectus delivery requirements. A representative form of the settlements can be found [here](#).

Section 5(b)(2) of the Securities Act of 1933, together with Rule 10b-10 under the Securities Exchange Act of 1934, effectively require that broker-dealers send mutual fund prospectuses and confirmations to purchasers "at or before completion of such transaction," generally within three business days, unless otherwise specified. NASD Conduct Rule 3010 requires FINRA members to establish, maintain and enforce appropriate supervisory procedures which are reasonably designed to achieve compliance with securities laws and regulations.

The lapses are alleged to have occurred between January 2009 and June 2011, and relate to late delivery or failure to deliver mutual fund prospectuses. These matters indicate that reliance on registered representatives or on third party service providers alone is not sufficient to meet regulatory requirements. FINRA requires that firms implement appropriate supervisory procedures, and continuously monitor them for compliance. As part of compliance programs, firms should periodically audit any third party service provider.

### **FINRA proposes disclosure of compensation paid to move customers**

FINRA proposed a [new rule](#) in November 2012 requiring brokers to disclose to non-institutional clients "enhanced compensation" in excess of \$50,000 in

connection with their recruitment and transfer from one broker-dealer to another. The rule would require brokers to disclose enhanced compensation to clients transferring from one firm to another for a period of one year from the broker's start date. Enhanced compensation includes signing bonuses, upfront bonuses, back-end bonuses, loans, accelerated payouts, transition assistance, and similar arrangements, paid in connection with a job transfer to a new employer.

Former SEC Chair Mary Schapiro in August 2009 expressed concerns to chief executives at brokerage firms that generous recruiting bonuses carry with them enhanced risks to customers. She stated that these bonuses could cause brokers to engage in activity that generates commission revenue but is not in the best interests of customers.

FINRA's proposed rule would not regulate the amount of those payments, but would require brokers to disclose, in writing, the nature and amount of incentives paid to encourage their brokers to move their accounts to their new employers.

### ALJ bars fund PM over pricing matter

The SEC's Chief Administrative Law Judge sanctioned a former bond fund portfolio manager for withholding material information from a fund fair valuation committee.

In a December 2012 opinion, the judge found that the former fixed income portfolio manager intentionally withheld material information with respect to a single fixed income instrument, including an event of default, acceleration and missed interest payment, "because they would have weakened her professional opinion that the market for fixed income instruments was temporarily distressed and a cash

flow analysis, rather than market value, remained the correct way to value the . . . bond." "In a time of stress," the judge said, the portfolio manager's ego "overcame her duty to communicate information."

The judge barred the portfolio manager from associating with an investment company, its adviser or principal underwriter for five years, and ordered her to cease and desist from future violations.

### Broker fined for late pricing of mutual fund orders

Without admitting or denying the findings, a broker-dealer agreed to pay at least \$10.7 million in restitution plus interest and a \$550,000 fine for late pricing of written mutual fund orders.

FINRA alleged that the broker-dealer's administrative arm mistakenly believed that written mutual fund orders received by mail or fax from customers could be processed within one or two business days of receipt. In actuality, broker-dealers must process all orders received in good order prior to the close of trading for a fund (generally 4:00 P.M. on weekdays) at the price next computed on the date of receipt pursuant to Investment Company Act of 1940 Rule 22c-1.

The error affected approximately 40,000 accounts over a seven- year period from late 2003 through June 2011 resulting in many customers receiving a less favorable price than that to which they were entitled. The fine was minimized as a result of the broker self-reporting the error and agreeing to make restitution.

Supervisors are responsible for accurate implementation of procedures to comply with securities laws and regulations, including oversight of the minutiae of day-to-day operational mechanics. This

matter is an example of a circumstance where the relevant high level personnel at the firm knew the rules and how to apply them, but failed to supervise their implementation to the extent required.

### SEC Bans Investment Adviser from Securities Industry for Deviating from Mutual Fund's Investment Policy

The SEC barred an Arizona-based mutual fund manager from the securities industry for failing to follow the fund's investment objectives.

According to the SEC order instituting settled administrative proceedings against the manager and the fund's adviser, the fund's prospectuses, statements of additional information and shareholder report provided that the fund could trade options only for hedging purposes. However, starting in September 2009, the fund allegedly invested in put options for speculative purposes. The SEC stated that the fund's speculative options trading resulted in significant losses to the fund, which led to investor redemptions and ultimately the fund's liquidation in December 2010.

The SEC order finds that the adviser and the manager willfully violated the antifraud provisions of the Securities Act, the Exchange Act, the Advisers Act and the Investment Company Act. The order also finds that the adviser and the manager caused the fund to violate Section 13(a)(3) of the Investment Company Act, which prohibits registered investment companies from deviating from a stated fundamental investment policy.

SEC sanctions included the censure of the adviser and bar of the manager from the securities industry.

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