Investment Management Legal + Regulatory Update

Regulatory Updates

SEC Allows Limited Use of Social Media for Public Disclosure

Public companies may disseminate material information on social media websites, such as Twitter and Facebook, without running afoul of federal securities laws, so long as investors have been properly alerted about which social media the issuer may use to disseminate the information.

In a report published on April 2, 2013, the Securities and Exchange Commission confirmed that Regulation FD applies to social media and other emerging means of communication the same way it applies to issuers' websites.

Companies should consider the Commission's 2008 guidance on the use of company websites when considering if a particular social media channel is a "recognized channel of distribution." Companies should also provide investors with notice that the company will use that channel to disseminate material nonpublic information.

Click here to read our client alert, which describes the Commission's social media report in greater detail.

Federal Reserve Board Publishes a Final Rule Specifying when Nonbank Firms are "Predominantly Engaged in Financial Activities"

The Federal Reserve Board has adopted a rule defining when a nonbank financial company is "predominantly engaged in financial activities." This action was required by the Dodd-Frank Act, which provides that the Financial Stability Oversight Council (FSOC) may only designate nonbank companies as systemically important if they are predominantly engaged in financial activities.

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While the rule mainly deals with treatment of nonbank financial companies, the Board concluded that investment companies, including exchange-traded funds (ETFs), mutual funds, money market funds and closed-end investment companies, are engaged in financial activities. Accordingly, FSOC may take the position that certain firms are significant financial firms and therefore systemically important.

Click here to read our client alert, which describes the Federal Reserve Board's rule in greater detail.

The SEC Speaks

At the annual SEC Speaks conference held in Washington, DC on February 22, 2013, the Commission explained, justified, prodded, ruminated and complained. And, despite the threat of imminent staff cuts if sequestration sets in, the Commissioners and senior staff offered an ambitious program for the coming year.

Among other notable commentary, Commissioner Daniel Gallagher lamented the loss of the SEC's independence, suggesting that the implementation of the Dodd-Frank Act was a significant turning point. He cautioned that the SEC must not allow itself to assume a secondary role in the regulation of matters within its jurisdiction. He cited the Volcker Rule and the establishment of the FSOC as examples.

Commissioner Troy Paredes also voiced his concerns about the Dodd-Frank Act, stating that it could "overregulate our financial system and in turn suppress our country's economic growth."

For additional commentary about the annual event, see our Jumpstarter blog.

SEC Adviser Exams Uncover Widespread Violation of Custody Rule

The Commission's Office of Compliance Inspections and Examinations (OCIE) reports finding widespread compliance deficiencies related to custody of securities. In its March 4, 2013 National Exam Program Risk Alert, OCIE stated that approximately one third of its examinations of registered investment advisers revealed significant deficiencies. As a result of these findings, OCIE referred violations to the Commission's Division of Enforcement, where appropriate.

For a more detailed description of OCIE's findings, click here.

Remarks to the Investment Management Institute 2013

On March 7, 2013, David Grim, Deputy Director of the Commission's Division of Investment Management advised the attendees at the 2013 Investment Management Institute that although the Division is focused on statutorily mandated rulemaking under the Dodd-Frank Act and the JOBS Act, it has not lost sight of other issues. The Division has also identified several short-term and long-term discretionary rulemaking initiatives.

According to Mr. Grim, the Division is actively working on the following short-term regulatory priorities:

- Establishing potential money market fund reforms;
- finalizing rules designed to detect and prevent identity theft of mutual fund investors and clients of asset managers; and
- completing guidance regarding funds' and fund directors' valuation responsibilities.

The staff also identified five longer term regulatory initiatives to which it may allocate resources:

- proposing summary prospectuses for variable annuity products to facilitate communication of concise, user-friendly information to investors and to enhance the transparency of the benefits, risks and costs of variable annuities;
- finalizing a 2008 rule proposal that would codify exemptive relief routinely granted for exchange-traded funds;
- proposing a rule requiring investment companies to report data similar to the monthly reporting currently required of money market funds;
- considering if there are aspects of rules under the Advisers Act that should be updated to address investor protection concerns and the business models of private fund advisers; and
- considering issues identified in its 2011 concept release on funds' use of derivatives and analyzing the comments received on that release to determine if the staff should propose new rules addressing the role of derivatives in fund investment portfolios.

The SEC has already made progress on its short-term priorities. On April 10, 2013, the SEC and the CFTC announced joint final rules requiring regulated entities to adopt programs to address the risks of identity theft.

SEC Examinations to Focus on Revenue Sharing and Potential Conflicts of Interest

In an attempt to "increase transparency, strengthen compliance, and inform the public and the financial services industry about key risks," OCIE recently published its 2013 examination priorities. Among other things, OCIE stated it will specifically focus on broker-dealer sales practices, newly registered advisers to private funds, and conflicts of interest.

Perhaps most notably, OCIE advised registrants that it will look at whether "revenue sharing" payments by investment advisers and payments by funds are really "payments for distribution in guise." Indeed, the staff did not waste any time in making good on this announcement. On March 11, OCIE began a sweeping examination to review payments made to mutual fund distributors, including revenue-sharing arrangements, fees paid to industry conference sponsors and Rule 12b-1 fees.

OCIE will continue to prioritize fraud detection and prevention, corporate governance and enterprise risk management, technology issues, and conflicts of interest. In each area, OCIE continues to use both quantitative and qualitative tools to identify unusual behavior. In addition, the National Examination Program (NEP) is actively soliciting whistleblower tips.

In addition to its market-wide areas of focus, OCIE identified program-specific focus areas. With respect to investment advisers and investment companies, these include:

- custody of client assets;
- conflicts of interest related to solicitation agreements and third party services;
- performance advertising;
- allocation of investment opportunities;
- the quality and completeness of disclosure to fund boards;
- establishing a "meaningful presence" with newly registered advisers; and
- alternative products such as ETFs, the use of hedge fund strategies in mutual funds and variable annuity structures.

OCIE also said it will expand coordinated examinations of dually registered broker-dealer/investment advisers. These examinations are likely to focus on suitability, supervision and sales practices.

The staff indicated that "this priority list is not exhaustive and priorities may be adjusted throughout the year in light of ongoing risk assessment activities."

Click here to read our client alert for a more detailed description of OCIE's 2013 priorities.

SEC Asks for Data on Benefits of a Potential Uniform Fiduciary Standard for Broker-Dealers

The Commission has requested quantitative data and economic analysis relating to the benefits and costs that could result from adoption of a uniform fiduciary standard governing personalized investment advice provided to retail customers. The Commission indicated that its request would not only provide information related to the effects of potential rulemaking, but would also give it a "baseline" understanding of current practices.

The Commission requested information principally in the following three areas of benefits and costs:

- the current standards of conduct applicable to broker-dealers and investment advisers when providing personalized advice to retail customers;
- the implementation of a uniform fiduciary standard of conduct; and
- the harmonizing of existing regulatory regimes applicable to investment advisers and broker-dealers.

Although the Commission has not yet determined whether to exercise its Dodd-Frank Act authority to implement a uniform fiduciary standard of care applicable to broker-dealers and investment advisers providing personalized advice to retail investors, the release provides some insight into how the Commission might design such a standard. For more detailed information, click here to read our client alert.

SEC Staff: Internet-Based Platforms for Start-Ups Need Not Register as Broker-Dealers

The SEC's Division of Trading & Markets said that it would not recommend enforcement action if two Internet-based platforms that provide investors with a means to invest in start-up companies do not register as broker-dealers. The letters are notable because they represent the first indication of the Division's views on such platforms following the enactment of the JOBS Act.

The letters do not, however, address the JOBS Act's crowdfunding exemption, or the ability to conduct a Rule 506 offering using general solicitation. Neither of these avenues are currently available to issuers pending additional rulemaking.

In a no-action letter dated March 26, 2013, the staff said that it would not recommend enforcement action for failure to register as a broker-dealer under Section 15(a)(1) of the Exchange Act if a company operated a platform through which their members could participate in offerings allowed by Rule 506 (part of Regulation D).

The staff based its position on several factors, including:

- information about start-up companies is posted on a website only available to the platform's members, all of whom are accredited investors;
- each affiliated investment fund relies on Rule 506 of Regulation D to conduct an offering; and
- the activities of the platform and related fund managers comply with Section 201 of the JOBS Act in part because they and their associated persons receive no compensation (or any promise of future compensation) in connection with the purchase or sale of securities. They will be compensated only for their roles in organizing and managing the investment funds.

In a no-action letter dated March 28, 2013, the staff said that it would not recommend enforcement action for failure to register as a broker-dealer if an investment adviser subsidiary of a parent company, and their affiliates, established an Internet-based platform to facilitate angel investing by accredited investors.

The registered investment adviser will provide advisory services to investment vehicles established for the purpose of investing in companies identified by the platform.

The staff's no-action guidance is premised on the SEC's longstanding views of the factors that indicate broker-dealer activity (namely, the advisers will not receive transaction-based compensation), and is consistent with the matchmaking guidance contained in Title II of the JOBS Act.

Funds and Advisers: Ensure You Comply with Conditions in Orders

Investment companies and registered investment advisers that rely on exemptive orders should adopt and implement policies and procedures that are reasonably designed to ensure ongoing compliance with the representations and conditions of the orders.

In a Guidance Update dated May 2013, the Division of Investment Management urged funds and advisers to review their procedures to ensure compliance with the exemptive orders. The concern arose out of a June 2011 report by the Commission's Office of the Inspector General, which found examples of firms that failed to comply with representations and conditions in those orders. Firms that fail to comply with those orders are at risk of violating federal securities laws. The consequences of non-compliance can be severe, the Division cautioned.

After-Tax Returns Must Reflect New 3.8 Percent Tax

In response to questions from registrants, the staff of the Division of Investment Management stated that in determining the highest individual marginal federal income tax rate used to calculate after-tax returns in fund prospectuses, funds should include the 3.8 percent tax imposed on certain taxpayers' net investment income by the Health Care and Education Reconciliation Act of 2010. The staff also stated that since investors that are subject to the highest marginal rate on taxable income are also subject to the 3.8 percent tax, it believes that registrants should include the 3.8 percent tax in after-tax return calculations. The staff also said that registrants should include the 3.8 percent tax when calculating the tax on qualified dividend income and long-term capital gains or any tax benefit resulting from capital losses.

SEC Approves BlackRock Copper ETF; Upholds Approval of JPMorgan Copper ETF

The SEC approved an NYSE Arca proposed rule change to list and trade shares of the iShares Copper Trust, an ETF sponsored by BlackRock Asset Management International Inc. The ETF will hold copper.

In comment letters to the SEC, end-users of copper raised concerns that such ETFs would decrease the availability of copper and increase prices.

Addressing commenters' objections, the SEC said that it did not believe that the listing and trading of the ETF's shares "is likely to increase the likelihood of manipulation of the copper market." The SEC also said it did not believe that the ETF would "disrupt the supply of copper available for immediate delivery."

The Commission also addressed comments challenging its December 2012 approval of a proposed rule change to list and trade shares of a similar ETF sponsored by J.P. Morgan Commodity ETF Services LLC, the JPM XF Physical Copper Trust. In a Response to Comments upholding its approval of the rule change, the Commission said commenters failed to present new evidence to suggest the ETF was likely to lead to scarcity of certain brands of copper in particular locations.

The SEC's decision to uphold its approval has been appealed to the U.S. Court of Appeals.

SEC Staff Comings and Goings

Mary Jo White, a former defense lawyer and U.S. Attorney, was sworn in as Chair of the Commission on April 10, 2013. The following staff changes soon followed:

- George Canellos and Andrew Ceresney were named Co-Directors of the Division of Enforcement on April 22. Mr. Canellos previously served as Acting Director, and Mr. Ceresney served as Deputy Chief Appellate Attorney in the United States Attorney's Office for the Southern District of New York.
- Anne K. Small, formerly Special Assistant to the President and Associate Counsel to the President, was named General Counsel on April 23.
- David P. Bergers, Acting Deputy Director of the Enforcement Division and Director of the Boston Regional Office, announced his departure on May 7.
- Carlo di Florio, the head of OCIE's National Exam Program, announced that he will leave the Commission to lead a new division of risk and strategy at FINRA.
- Bruce Karpati, the chief of the Enforcement Division's Asset Management Unit, announced his return to the private sector on May 9.

Enforcement and Litigation

SEC Charges Advisers for Misleading Valuation and Performance Information

On March 11, 2013, the Commission charged two investment advisers affiliated with a private equity firm for misleading investors about valuation policies and the performance of a fund they managed. The Commission's investigation found that the fund's quarterly reports and marketing materials were misleading because they stated that the fund's holdings were valued "based on the underlying managers' estimated values." In fact, however, the fund's portfolio manager had marked up valuations provided by the underlying managers, and in one case this resulted in a 25.5 percent difference in IRR.

The Commission's order found that employees of the advisers made the following misrepresentations:

- That the increase in the fund's value was due to performance when, in fact, the increase was attributable to a change in valuation methodology;
- that a third-party firm wrote up the valuation of the fund; and
- that the fund and its underlying funds were audited.

The order also found that the investment adviser's policies and procedures were not reasonably designed to ensure that valuations provided to investors were consistent with written representations made to such investors.

SEC Charges Private Equity Firm with Improperly Soliciting Investments

On March 11, 2013, the Commission charged a private equity firm, its senior managing director and an unregistered consultant in connection with the solicitation of investments for a number of its funds. The charges arose out of an arrangement in which the private equity firm paid a consultant a one percent "finder's fee" in violation of Exchange Act requirements that an individual who solicits investments in return for transaction-based compensation must be registered as a broker-dealer.

While use of a finder's fee is generally allowed subject to numerous restrictions, the consultant's activities in this case went far beyond those of a finder. For example, he regularly communicated directly with investors and provided them with investment documentation that he received from the private equity firm, and he urged at least one investor to consider adjusting the portfolio allocations to accommodate an investment with the firm. These actions amounted to "engaging in the business of effecting transactions in securities" and represent a disregard of established practices for use of finders.

FINRA Panel Orders Schwab to Correct Language in Account-Opening Documents

A FINRA hearing panel fined a broker-dealer for violating consumer protection rules by requiring customer account agreements to waive the right to assert claims through class actions.

In a decision dated February 21, 2013, the panel determined that, although the language purporting to waive client rights to bring class actions violates FINRA rules, FINRA may not enforce those rules because they conflict with the Federal Arbitration Act (FAA). The FAA does not, however, dictate how an arbitration forum should be operated or prohibit consolidation of individual claims.

SEC Seeks New Trial in Reserve Primary Case

In February 2013, the Commission filed a motion seeking a new jury trial to consider whether Bruce Bent and Bruce Bent II committed fraud in connection with the Reserve Primary Fund "breaking the buck" in 2008. The SEC asked the court to consider if the Bents committed fraud under the general antifraud provisions of the Exchange Act.

According to the Wall Street Journal, the Commission is also seeking a $130 million penalty from Reserve Management Company, the investment adviser to the Reserve Primary Fund, and $1.3 million from Bruce Bent II. The Bents, for their part, are seeking $72 million in legal and management fees.

A victory for the Commission would result in a second jury trial for the Bents. A federal court acquitted the Bents of fraud charges in November 2012, although it found Bruce Bent II guilty on one count of negligence.

Pension Funds Sue ETFs for Excessive Securities Lending Fees

Two pension funds filed suit against a leading ETF group, alleging that the ETFs (the "Funds") paid affiliates excessive fees for the affiliates' services as securities lending agents.

The complaint alleges that the defendants, including the Funds, their investment adviser, affiliated securities lending agent, and Fund directors, engaged in a scheme whereby affiliates of the Funds would retain 40% of securities lending revenues, "at the expense of investors – a fee so disproportionate to the performance of those affiliates that it amounted to 'money for nothing.'"

The plaintiffs claim that the securities lending fees charged to the Fund investors were "disproportionately large – about three times more than what is typical in the industry."

The plaintiffs allege violations under Section 36(a) and 36(b) of the Investment Company Act. According to plaintiffs, the Fund directors breached their fiduciary duty to Fund investors when they approved the excessive fees, and the investment adviser and affiliated securities lending agent breached their fiduciary duties when accepting these fees.

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