Investment Management Legal + Regulatory Update

Regulatory Updates

FSOC's Nonbank Designation Rule Allows Broad Regulatory Discretion

The Financial Stability Oversight Council ("FSOC") approved a final rule that describes how and when it will consider nonbank financial institutions, including investment managers, hedge funds, private equity funds and mutual fund complexes, as systemically important and thus subject to regulation by the Federal Reserve Board.

In the aftermath of the global financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") established FSOC. The law requires FSOC to designate nonbank financial firms as "Systemically Important Nonbank Financial Institutions," or "nonbank SIFIs," and directs the Fed to supervise nonbank SIFIs in much the same way that it supervises bank holding companies with assets of more than $50 billion.

These bank holding companies and nonbank SIFIs will be subject to "enhanced prudential regulation." This means that the Fed may require a nonbank SIFI to conduct stress tests, increase capital or liquidity, and overall to be subject to greater regulatory oversight. These requirements could have significant implications for mutual fund complexes and private funds that earn nonbank SIFI status.

FSOC may bestow nonbank SIFI status on a firm because of the potential impact of its failure or merely because the scope of its activities are large and complex. The initial universe of firms subject to review for nonbank SIFI status in Stage 1 are those with $50 billion in consolidated assets worldwide and that meet one or more of five other quantitative thresholds that relate primarily to the firm's liabilities and liquidity.

A firm that meets the necessary thresholds in Stage 1 automatically enters Stage 2. FSOC may place other firms in Stage 2 as well, based on publicly available information. We understand that, although the rule is silent on this point, FSOC will notify a firm that it has entered Stage 2. At this point, FSOC will undertake a company-specific review based on public and supervisory information of the risks posed by the firm. FSOC will apply six categories of factors: interconnectedness, substitutability, size, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. Each factor has several qualitative and quantitative elements. For example, companies with large exposures to derivatives positions or large short-term debt ratios are more likely to be of concern to FSOC.

Based on the analysis conducted during Stage 2, FSOC intends to identify firms that it believes merit further review. When a firm moves to Stage 3 of the designation process, FSOC will look to review specific information to be requested from and provided by the company that is not necessarily publicly available. Again, FSOC will notify each firm that will be reviewed in Stage 3.

While the new rules prescribe some metrics to identify potential threats to U.S. financial stability, they also leave much to the discretion of the regulators.

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Given the broad reach of the new rule, and the dramatic implications of nonbank SIFI designation, non-bank financial firms should understand the FSOC's designation process and its implications. Moreover, because a surprising number of mutual fund complexes and private funds may be drawn into this regulation, they should develop a strategy for addressing the designation process.

Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (Apr. 3, 2012), available at http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designations%20-%20Final%20Rule%20and%20Guidance.pdf.

SEC Reopens Comment Period on Target Date Retirement Funds Proposal

In a proposal dated April 3, 2012, the SEC has reopened the comment period for its Target Date Retirement Fund proposal, which now ends May 21, 2012. This will allow for comments on a study of investor testing of comprehension of target date retirement fund characteristics that was sponsored by the SEC and submitted in February 2012. The SEC is concerned that investors do not understand the risks associated with, and the differences among, target date funds. Substantial differences in comparably named target date fund performance during the market downturn in 2008 caused concern that investors had an inadequate understanding of these funds and the related risks.

Target date funds are particularly popular investments for 401(k) plans, and are often designated by plan sponsors as default investments. The date appearing in a fund's name is used to represent the anticipated year of retirement, or the expected end of investor contributions to the fund. Withdrawals may be expected to begin thereafter, perhaps over an extended period of years, to fund living expenses or as a result of IRS required minimum distributions.

The schedule by which a target date fund's asset allocation is adjusted is commonly referred to as the fund's "glide path." The glide path typically becomes more conservative by decreasing equity exposure and increasing exposure to fixed income investments and/or cash over the life of the fund, reaching a particular allocation in the stated year, and then continuing to become more conservative until reaching a "landing point" after which the allocation remains relatively static. Allocations differ dramatically between different fund families, and the time differential between the target date and the landing point ranges from zero to 30 years. As a result, funds with similar names may have dramatically different asset allocations, a fact that apparently is not well understood by prospective investors.

Originally issued on June 16, 2010, the proposal would require changes to the way information regarding target date retirement funds is included in prospectuses, advertisements and marketing literature. Among the proposed revisions is a requirement that such funds disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in marketing materials. Marketing materials with "more than insubstantial focus" on a target date fund would also be required to include a table, chart or graph depicting the fund's asset allocation over time (both historical and projected, in increments no greater than five years), together with a statement that would highlight the fund's final (landing point) asset allocation. Disclosure of a range of asset allocations may also be permissible, subject to a possible limitation on the breadth of that range, which is yet to be determined and subject to comment. Additional required disclosure would include a statement (i) that a target date retirement fund should not be selected based solely upon age or retirement date, (ii) that such fund is not a guaranteed investment, and (iii) disclosing the extent to which stated target asset allocations may be subject to change without a shareholder vote. Target date funds that have reached their target date would be required to disclose actual asset allocations rather than target allocations. Sales literature for any type of fund could be considered misleading if it suggests that a fund is a simple investment plan or requires little or no monitoring, or if it places emphasis on a single factor (such as the investor's age or tax bracket) as the basis for determining that the investment is appropriate.

Improved disclosure and increased understanding of the glide path of target date funds and their landing points is a worthy goal which would allow investors to make more informed choices. However, this detailed projection of the glide path over various periods creates potential risk of liability for advisers that may, for good reason, deviate in future years from a glide path previously provided to prospective investors, perhaps decades earlier.

Investment Company Advertising: Target Date Retirement Fund Names and Marketing, SEC Release No. IC-30026 (Apr. 3, 2012), available at http://www.sec.gov/rules/proposed/2012/33-9309.pdf; SEC Release No. IC-29301 (June 16, 2010), available at http://www.sec.gov/rules/proposed/2012/33-9309.pdf.

Congress Enacts the JOBS Act, Repeals Ban on General Solicitation and General Advertising

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the "JOBS Act"), which includes a number of measures that ease significant regulatory restraints on capital formation, primarily with respect to growth stage companies. Summarized below are the major changes included within the JOBS Act, some of which impact private funds.

First, the JOBS Act creates a transitional "on-ramp" for emerging growth companies to encourage them to pursue IPOs by phasing in compliance measures over time following their IPOs. Second, it amends the Securities Act of 1933, as amended (the "Securities Act"), to permit companies to conduct offerings to raise up to $50 million through a "mini-registration" process similar to that allowed under Regulation A. The legislation also modifies the triggers for SEC reporting obligations under Section 12(g) of the Securities Exchange Act of 1934, as amended. Finally, the JOBS Act directs the SEC to update its regulations to repeal the prohibition against "general solicitation and general advertising" in connection with certain private placements to accredited investors or qualified institutional buyers, and provides an exemption under the Securities Act for "crowdfunding" offerings.

Together, the measures contained in the JOBS Act may make a significant difference for emerging companies in the United States. Certain portions of the JOBS Act, such as Title I which creates the regulatory "on-ramp" described above, are effective immediately. Title II, however, directing the SEC to amend its rules to remove the ban on general solicitation and general advertising, will only become effective upon adoption of final rules by the SEC.

See H.R. 3606, available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf*; see also The JOBS Act* (Mar. 26, 2012), David Lynn, Anna Pinedo, *available at* http://www.mofo.com/files/Uploads/Images/120326-The-JOBS-Act.pdf*; Raising Capital in the Internet Age—the Ban on General Solicitation and Advertising in Private Offerings* (Aug. 25, 2011), John Hempill, Luke Bagley, *available at* http://nvcatoday.nvca.org/index.php/from-our-sponsors/raising-capital-in-the-internet-agethe-ban-on-general-solicitation-and-advertising-in-private-offerings.html.

SEC Approves New FINRA Advertising Rules

On March 29, 2012, the SEC approved various new FINRA advertising rules. The rules had been proposed as part of FINRA's ongoing process of updating and consolidating various NASD rules and interpretations, as well as rules incorporated from the New York Stock Exchange, into a more logical and coordinated format.

The most significant change is the amendment of Rule 2210, which would reduce the number of defined categories of communication from six in the current rule to three. The three new categories are: (1) institutional communications; (2) retail communications; and (3) correspondence. (The prior categories were advertisement, sales literature, correspondence, institutional sales material, public appearance, and independently prepared reprint.) The proposal would also set forth requirements governing pre-use principal approval of communications, recordkeeping, filing with FINRA's Advertising Regulation Department, and content standards.

Additional rule changes would establish guidelines and restrictions governing the use of investment companies rankings in retail communications; the use of bond mutual fund volatility ratings; the use of investment analysis tools; communications with the public regarding security futures; and communications with the public about collateralized mortgage obligations.

Retail communications would include any written communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. Institutional investors include various entities, including those with at least $50 million in total assets.

The proposal also provides that no member may treat a communication as having been distributed to an institutional investor if the member "has reason to believe that the communication or any excerpt thereof will be forwarded or made available to any retail investor," and this is known as the "reason to believe" standard. FINRA has indicated that a member firm should not be able to treat a communication as an institutional communication in circumstances where, despite any policies or procedures to the contrary, the firm becomes aware that previous institutional communications have been routinely redistributed to retail investors.

As a practical matter, this will require tracking of known non-compliance by each institutional recipient, which may be burdensome. The implications of repeated non-compliance by an institutional recipient are that the member would no longer be able to treat communications sent to that recipient as institutional communications, but would be required to treat them as retail communications, which would likely change both content and filing requirements. A member would be required to reasonably conclude that the improper practice has ceased before being permitted to consider future communications sent to that recipient to qualify as institutional communications. Similarly, where the member firm is a fund underwriter and the recipient is a broker-dealer, if there are red flags indicating that the broker-dealer has used or intends to use an institutional communication provided by the member firm with retail investors, the member firm would be expected to discontinue distribution of such materials to that broker-dealer until the underwriter reasonably concludes that the broker-dealer has adopted appropriate measures to prevent future redistribution of such communications to retail investors.

These requirements heighten compliance responsibilities to monitor for and follow up on red flags, document the investigative process and findings, and implement necessary corrective actions. In addition, members will be required to evaluate any reform measures adopted by non-compliant recipients in order to determine whether or not to reinstitute distribution of institutional communications to them. We anticipate additional guidance from FINRA on these issues when the rule changes are ultimately adopted. However, it is clear that the compliance bar with respect to limitations on the distribution of institutional communications is being raised for institutions, broker-dealers and member firms.

SEC Release No. 34-66681, File No. SR-FINRA-2011-035 (Mar. 29, 2012), *available at* http://www.sec.gov/rules/sro/finra/2012/34-66681.pdf.

SEC and CFTC Propose Rules to Help Detect and Prevent Identity Theft

On February 28, 2012, the SEC and the CFTC jointly proposed rules that would require funds and advisers to affirmatively combat identity theft. The proposed rules would require registered investment companies, investment advisers, commodity pool operators ("CPOs"), commodity trading advisors ("CTAs"), and other SEC- or CFTC-regulated entities to create programs to detect and respond to red flags. The proposed rules would also establish special requirements for certain credit and debit card issuers to assess the validity of notifications of changes of address in certain circumstances.

The SEC's proposed rules and guidelines would apply to a financial institution or creditor, as defined by the Fair Credit Reporting Act of 1970 (the "FCRA"), including SEC-registered investment companies, investment advisers, brokers, dealers, and other entities registered under the Securities Exchange Act of 1934. The CFTC's proposed rule would apply to CPOs, CTAs, futures commission merchants, introducing brokers, swap dealers, major swap participants, and retail foreign exchange dealers.

A "covered account" would include any account "that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution or creditor from identity theft." The SEC's proposed definition includes, for example, a brokerage account with a broker-dealer and an account maintained by a mutual fund that permits wire transfers or other payments to third parties. The CFTC's proposed definition of a "covered account" includes a margin account as an example.

The proposed rules would require covered entities to adopt a written identity theft program ("Program") that would include reasonable policies and procedures designed to: (1) identify relevant red flags; (2) detect the occurrence of red flags; (3) respond appropriately to the detected red flags; and (4) provide for periodic updates.

The proposed guidelines would require a covered entity to report at least annually to its board of directors, board committee, or to a designated senior management employee on compliance with the proposed rules. The report would address, among other things: the effectiveness of the policies and procedures; service provider arrangements; incidents involving identity theft and management's response; and recommendations for changes to the Program.

Section 1088 of the Dodd-Frank Act transferred authority over certain parts of the FCRA from the Federal Trade Commission ("FTC") to the SEC and CFTC. In particular, the Dodd-Frank Act amended the FCRA by adding the SEC and the CFTC to the list of federal agencies required to jointly prescribe and enforce identity theft red-flag rules and guidelines and credit/debit card issuer rules for entities they regulate.[1]

The joint proposal by the SEC and the CFTC is similar to final rules and guidelines adopted in 2007 by the FTC and the other federal financial regulatory agencies previously required to adopt such rules. The SEC and the CFTC noted that most of the entities over which they have jurisdiction are likely already in compliance with the 2007 rules. According to the Commissions, the proposal does not contain any new requirements not in the 2007 rules, and does not expand the scope of the 2007 rules to include new entities. The Commissions stated that the joint proposal contains examples and minor language changes intended to help entities "discern whether and how the identity theft rules and guidelines apply to their circumstances."

Comments on the proposal must be received by the SEC or the CFTC on or before May 7, 2012.

Identity Theft Red Flags Rules, SEC Release No. IC-29969 (Feb. 28, 2012), *available at* http://www.sec.gov/rules/proposed/2012/ic-29969.pdf.

Enforcement + Litigation

Court Reinstates Summary Judgment for Adviser in Excessive Fee Case

On March 30, 2012, the United States Court of Appeals for the Eighth Circuit reversed itself and granted summary judgment to Ameriprise Financial, Inc. and its affiliates ("Ameriprise") in a suit filed by shareholders of mutual funds advised by Ameriprise. The plaintiffs alleged that the adviser breached its fiduciary duty under Section 36(b) of the Investment Company Act of 1940 (the "1940 Act") with respect to fees charged to the funds.

The original complaint in *Gallus v. Ameriprise Financial, Inc*. alleged that the adviser breached its Section 36(b) fiduciary duties by charging excessive advisory fees to the mutual funds that it managed. Among other things, the plaintiffs claimed that Ameriprise charged its institutional clients substantially lower fees than it charged the other shareholders. In addition, they alleged that Ameriprise misled the board about these arrangements to prevent them from questioning the higher fees charged to the funds. The district court granted summary judgment to Ameriprise, applying the standards set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc*. That is, the court said that the plaintiffs failed to show a genuine issue of material fact that the fees Ameriprise charged "were so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

The Eighth Circuit reconsidered the Gallus case following the Supreme Court's decision in *Jones v. Harris Associates L.P.* "*Jones* has altered the way in which we determine whether an adviser has breached its fiduciary duty under § 36(b)," the Eighth Circuit said. After *Jones*, "a process-based

[1] Sections 1088(a)(8) and (10) of the Dodd-Frank Act, amending Section 615(e) and 621 of the FCRA, respectively.

failure alone does not constitute an independent violation of § 36(b)," the court said. Rather, any inquiry must be "sharply focused on the question of whether the fees themselves were excessive." In light of the *Jones* case, the Court of Appeals reversed the district court's ruling, holding that while the advisory fees passed muster under the Gartenberg test, the district court erred in rejecting a comparison between fees charged to institutional clients and other mutual fund clients, and that Ameriprise allegedly misled the fund's board. The rationale for the court's original holding was that excessive fees are not the only way that a board can breach its fiduciary duties to its shareholders under the 1940 Act. More specifically, the court held that "the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result. Unscrupulous behavior with respect to either can constitute a breach of fiduciary duty."

Gallus v. Ameriprise Financial, Inc., 2012 WL 1058976 (8th Cir., 2012); *see also Court Reinstates Summary Judgment for Adviser in Excessive Fee Case* (Apr. 5, 2012), Jay Baris, Luke Bagley, *available at* http://www.mofo.com/files/Uploads/Images/120405-Excessive-Fee-Case.pdf.

ICI and U.S. Chamber of Commerce Challenge CFTC Rule in Court

On April 17, 2012, the Investment Company Institute (the "ICI") and the U.S. Chamber of Commerce (the "Chamber") filed a joint lawsuit against the CFTC challenging the agency's final rule requiring certain registered investment companies to register with the CFTC as well as the SEC. In February, the CFTC amended Rule 4.5, which stipulates that some registered investment advisers of mutual funds and exchange-traded funds (ETFs) would qualify as CPOs and therefore would be required to register with the CFTC in addition to the SEC. The new rule reinstated the "5 percent threshold test," which the SEC eliminated in 2003. In a complaint filed with the U.S. District Court for the District of Columbia, the ICI and the Chamber alleged that the CFTC failed to satisfy its obligation to weigh the costs and benefits of the amended rule.

The ICI and the Chamber emphasized that investment companies and their advisers are already highly regulated and pointed to the CFTC's exclusion of investment companies from CFTC registration in 2003 on the basis that they were already "otherwise regulated" by the SEC. The complaint states that the CFTC's recent amendments reversed the determinations made in 2003 without providing any necessary support for how SEC regulation is insufficient. The ICI and the Chamber noted that the new rule is even more restrictive than the regime that the CFTC rejected in 2003, as it requires registration of certain advisers to investment companies on the basis of their trading in swaps or marketing the investment company as a vehicle for trading in the swaps markets.

Investment Company Institute v. United States Commodity Futures Trading Commission, 12-CV-00612 (D.D.C. filed Apr. 17, 2012), *available at* http://www.ici.org/pdf/12_commod_inv_complaint.pdf; *see also CFTC Tightens Commodity Pool Operator Exemption for Investment Companies* (Feb. 16, 2012), Jay G. Baris, Anna Pinedo, *available at* http://www.mofo.com/files/Uploads/Images/120216-Commodity-Pool-Operator-Exemption.pdf.
