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MEMORANDUM

TO Investment Adviser Clients, Fund Clients, and Independent Trustee Clients

FROM Ballard Spahr LLP

DATE January 3, 2013

RE **Recent Investment Management Developments**

Below is a summary of recent investment management developments that may affect registered investment companies, private equity funds, hedge funds, investment advisers, and others in the investment fund industry.

CFTC Changes Registration Requirements for Hedge Funds and Registered Funds

Last year, the Commodity Futures Trading Commission (CFTC) adopted rule amendments[1] that, among other things, rescinded an exemption from registration of certain entities as commodity pool operators (CPOs). The exemption has been widely used by hedge funds. The exemption, Rule 4.13(a)(4),[2] was available with respect to any pool that limited U.S. natural person investors to "qualified purchasers" (or met certain alternative criteria) and met certain other conditions. The U.S. Chamber of Commerce and the Investment Company Institute commenced suit to enjoin enforcement of the rule amendments, but the rule was upheld in December 2012. Although plaintiffs have announced plans to appeal the decision, unless the ruling is stayed, hedge fund managers must either (i) transfer out all U.S. investors (and accept no new U.S. investors), (ii) refrain from trading in exchange-traded futures contracts, (iii) secure an alternative CPO exemption, or (iv) register and become fully regulated as a CPO.

The CFTC also has limited an exemption from CPO registration formerly available to funds registered under the Investment Company Act of 1940 (the 1940 Act). Registered funds can still qualify for the exemption if they limit futures trading (at time of investment) to 5% of the fund (measured by margin plus premium) or 100% of the fund by notional amount. Similar exemptions are available to hedge funds under the new CFTC regime.

Money Fund Reform Update

Last year, then SEC Chairman Mary Schapiro stated that there was no longer a need to proceed with SEC proposals regarding money market reform.[3] She stated that three Commissioners, making up a majority of the SEC, informed her that they would not support a staff proposal to reform

the structure of money market funds. The rules would have proposed two alternatives: a floating net asset value; or a tailored capital buffer adjusted to reflect the risk characteristics of each money market fund, combined with a 30-day holdback provision for 3% of a given investor's entire fund holding.

With the SEC no longer pursuing money market fund reform, the Financial Stability Oversight Council (FSOC) has asserted control over such reform. In November, the FSOC proposed virtually the same reform rejected by the SEC.[4] The comment period on the proposal expires later this month. The FSOC acknowledges that the proposals would impose difficult economic burdens on money funds.

The push for reform follows the panic arising from the failure of the Reserve Fund at the height of the financial collapse. Critics say that the proposals will not prevent future money market runs.

SEC Sues Fund Directors over Valuation

In December, the SEC brought an administrative complaint[5] against eight former fund directors of the Regions Morgan Keegan Funds for failing to oversee adequately the valuation of subprime mortgage-backed securities during the financial crisis. The SEC charged the directors with failing to specify a fair valuation methodology or to supervise adequately the valuation process. The result, according to the charges, was a significant overstatement of asset value.

The complaint is consistent with the SEC's emphasis on valuation during the past five years, and follows the payment by the affected funds of $200 million for other violations.

The suit is the first brought by the SEC against fund directors in nine years; however, the SEC has been more active in pursuing fund directors recently. See the item below regarding Northern Lights Fund Trust.

Mary Schapiro Resigns as SEC Chair

In the first post-election announcement, SEC Chair Mary Schapiro resigned recently as Chair of the agency. Appointed by President Obama in January 2009, in the midst of the financial crisis, her tenure was among the longest of all SEC chairs. Commissioner Elise Walter is expected to serve as Acting Chair temporarily.

SEC Proposal for Uniform BD and IA Fiduciary Standard Moving Slowly

Last year, SEC Chair Mary Schapiro said staff was working on a request for data on the costs and benefits of imposing a uniform standard for investment advisers and broker-dealers and said the request would be out in the near future. Ms. Schapiro's announcement was in line with Section 913 of the Dodd-Frank Act, which recommended crafting rules to establish a uniform fiduciary standard for investment advisers and broker-dealers.

Some insiders believe, however, that there is no consensus among the Commissioners on the draft proposal and, consequently, that the uniform standard may be inert unless it is jump-started by Congressional or Department of Labor action.

Second Circuit Rules on Extraterritorial Limits of U.S. Securities Laws

In *Absolute Activist Value Master Fund Limited v. Ficeto*, the Second Circuit addressed an issue involving the extraterritorial limits of U.S. securities laws.[6] This decision comes after the U.S. Supreme Court held, in *Morrison v. National Australia Bank Ltd.*, that Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) applies only to "transactions in securities listed on domestic exchanges and domestic transactions in other securities . . . ."[7] Regarding securities *not* registered on domestic exchanges, the Court in *Morrison* stated that "the exclusive focus [is] on *domestic* purchases and sales."[8]

In *Absolute Activist*, the court faced facts and allegations implicating the second part of *Morrison*'s test, which applies to securities *not* listed on a domestic exchange. In doing so, the court clarified what constitutes a "domestic" transaction. In *Absolute Activist*, a group of Cayman Islands hedge funds sued, among other persons, officers and employees of the plaintiff funds' investment manager and U.S.-based broker, based on violations of the anti-fraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated under that section.[9] The plaintiffs alleged that defendants, in a form of "pump and dump" scheme, caused the plaintiff funds to purchase shares of U.S.-based companies directly from those companies.[10] Defendants themselves also allegedly obtained shares and warrants from the issuers of these stocks.[11] Various defendants allegedly received brokerage commissions, as well as commissions for arranging the plaintiff funds' investments in these stocks.[12] According to the plaintiffs' allegations, defendants then artificially inflated the prices of these stocks by trading them, often between the plaintiff funds.[13] The stocks in these transactions were quoted on the U.S. over-the-counter market, but the plaintiff funds did not trade in this market.[14] The defendants' activities allegedly enabled them to profit from commissions and from selling these stocks to the plaintiff funds at inflated prices.[15]

Ultimately, the Second Circuit held that to allege sufficiently that a transaction in securities was domestic, when those securities were not listed on a domestic exchange, a plaintiff "must allege facts indicating that irrevocable liability was incurred or that title was transferred within the United States."[16] Thus, according to the court, transactions involving a security that is not traded on a domestic exchange may give rise to liability under Section 10(b) of the Exchange Act (and related Rule 10b-5), depending on where a party to the transaction incurs irrevocable liability to purchase or deliver the security, as well as on where title to the security is transferred. Because there had been ambiguity as to what constitutes a domestic transaction, the court granted leave for the plaintiffs to amend their complaint, based on this holding, to support their claim that the transactions at issue were domestic.[17]

Other circuit courts will likely be ruling on this issue in the wake of *Morrison*. In the meantime, *Absolute Activist* provides notice to foreign funds that their location overseas does not necessarily shield them from potential liability under U.S. securities laws. According to the rule set forth in *Absolute Activist*, foreign investors and foreign issuers of securities, in transactions involving securities not listed on a U.S. exchange, may be subject to civil liability under Section 10(b) and Rule 10b-5 when the parties to the transaction incur in the United States irrevocable liability to carry out the transaction or when title is passed the United States.

SEC Provides No-Action Relief to 529 Plans from Certain Requirements of the Advisers Act Custody Rule

The SEC's staff recently issued a no-action letter to the Investment Company Institute (ICI) that provides relief to investment advisers that manage Section 529 College Savings Plans (529

Plans) from the surprise inspection requirement of Rule 206(4)-2 of the Investment Advisers Act of 1940 (the Advisers Act).[18] Under this rule, an investment adviser that is deemed to have custody of client funds or securities is required to obtain a surprise annual audit of those funds and securities by an independent public accountant. The independent public accountant must verify all of the clients' funds and securities by actual examination at least once during the calendar year at a time that is chosen at random by the accountant without prior notice or announcement.

In its request for no-action relief, the ICI argued that investment advisers that manage 529 Plans and that execute a contract with a custodian to maintain the plan's assets are deemed to have custody of client funds. This means they are subject to the surprise annual inspection requirement. The ICI's no-action request argued that such a requirement is unnecessary because 529 Plans generally are administered exactly like mutual funds that enjoy the benefit of an exemption from the custody rule and the surprise examination requirement.

The staff agreed with the ICI, providing relief from the surprise examination requirement if the following criteria are met:

- The 529 Plan is a college savings plan;
- The 529 Plan's recordkeeper is registered with the SEC as a transfer agent pursuant to Section 17A of the Exchange Act;
- The 529 Plan's custodian is a "qualified custodian" as defined in Rule 206(4)-2;
- The assets of the 529 Plan are subject to annual audit as defined in Regulation S-X and the audit is conducted in accordance with generally acceptable auditing standards;
- The 529 Plan's annual audit is conducted by an independent public accountant that: (i) is registered with, and subject to regular inspection as of the commencement of the professional engagement period and as of each calendar year end, by the Public Company Accounting Oversight Board (PCAOB) in accordance with its rules; and (ii) meets the standards of independence in Rule 2-01(b) and (c) of Regulation S-X;
- The audited financial statements of the 529 Plan are prepared in accordance with generally accepted accounting principles;
- The annual financial statements are provided to the state agency or instrumentality responsible for oversight of the 529 Plan within 120 days of the end of the 529 Plan's fiscal year;
- The annual financial statements are made available to all existing 529 Plan accountholders on the 529 Plan's website; and
- The program manager ensures that 529 Plan accountholders are provided with written notification of the availability of the financial statements no later than the delivery of the accountholder's next regularly scheduled quarterly account statement. Such notice may be included with or on such statement or sent separately. The notice must advise the accountholder of a website where such financial statements

may be accessed and provide the accountholder information on how to contact the 529 Plan to obtain a hard copy of such financial statements in lieu of accessing them online. A hard copy must be provided by mail within three days of an accountholder's request.

Two Years after *Jones v. Harris*, NJ Federal Court Declines to Dismiss §36(b) Suit for VA Funds

In a recent attack on allegedly unreasonable investment management fees, the United States District Court for the District of New Jersey declined to dismiss a §36 complaint on the grounds that the separate insurance account rather than the individual investor was the "security holder" under the Investment Company Act.[19] Finding that the individual investor received the benefit of the investment—including dividends and capital gains—instructed the insurance company on how to vote the shares, paid taxes on withdrawals, and had the investments exposed to her creditors' claims, the Court overrode defendants' effort to defeat the claims at the pleadings stage based on a "standing argument."

IRS Issues Guidance Clarifying Effective Date of RIC Modernization Act Capital Loss Carryforward Rules

On September 26, 2012, the IRS issued Revenue Ruling 2012-29, which resolves uncertainty by providing that, for excise tax purposes, the changes created by the RIC Modernization Act[20] apply to net capital losses arising on or after November 1, 2010.

To eliminate disparate treatment between registered investment companies (RICs) and individuals, the RIC Modernization Act allows a RIC to carry forward net capital losses indefinitely and preserves the character of these losses. The changes are for income tax purposes (for the determination of both taxable income and earnings and profits) effective for net capital losses arising in taxable years beginning after December 22, 2010.

Prior to the ruling, however, it was not clear which "taxable year" was relevant for applying the new rules for purposes of the excise tax under section 4982. Regardless of the taxable year used by RICs for income tax purposes, the accounting period for the excise tax is generally the calendar year. As an exception to its general use of a calendar year, however, the excise tax includes in its tax base net capital gain or loss recognized within the one-year period ending on October 31. If the new capital loss carryforward rules first applied for excise tax purposes beginning with the 2012 calendar year (i.e., including only net capital gain or loss recognized after November 1, 2011), a net capital loss carryforward from the one-year period ended October 31, 2011, would have been subject to the old carryforward rules for excise tax purposes even if a corresponding net capital loss carryforward for income tax purposes had the benefit of the new unlimited carryforward rule. RICs would face an unavoidable excise tax liability if a RIC's capital loss carryforward from its 2011 taxable year had expired for excise tax purposes while a capital loss carryforward from a 2011 calendar (or 2012 fiscal) taxable year was allowable in determining earnings and profits. In that situation, a RIC could have insufficient earnings and profits to meet its excise tax distribution requirements, which can be satisfied only by the payment of dividends from earnings and profits that have been realized for income tax purposes.

SEC Proposes Rules to Eliminate Prohibition on General Solicitation and Advertising

The SEC has proposed rules under the Jumpstart Our Business Startups Act (the JOBS Act)[21] to eliminate the current prohibition against general solicitation and advertising in certain securities offerings pursuant to Rule 506 of Regulation D and Rule 144A promulgated under the Securities Act of 1933, as amended (the Securities Act).[22] If adopted, the proposal will apply to hedge funds and private equity funds, among other offerors, and will permit such offerors to obtain investors through broad advertising plans. All purchasers, however, must be "accredited investors" (Regulation D) or persons whom the seller reasonably believes are "qualified institutional buyers" (Rule 144A).

The SEC release made clear that hedge funds and private equity funds that choose to rely on general solicitation and advertising under the proposed rule will not be precluded from continuing to rely on exemptions from registration contained in Sections 3(c)(1) and 3(c)(7) of the 1940 Act.

The SEC proposal has been criticized by funds registered under the 1940 Act that believe the new rule will allow unfair and improper competition for retail investors from hedge funds and private equity funds. In November, seven Senators[23] also criticized the SEC regulatory approach as failing to require the issuers to take reasonable steps to ensure that only accredited investors participate in private offerings. The Senate letter calls for a revised regulatory scheme.

JOBS Act to Loosen Certain Securities Law Requirements for Hedge Funds, Other Private Funds, and Emerging Growth Companies

In addition to proposed rule changes regarding the ban on general solicitation discussed above, the JOBS Act:

- Loosens the applications of certain securities laws (including several created by the Sarbanes-Oxley Act of 2002)[24] concerning "emerging growth companies," those with less than one billion dollars of annual gross revenues during their most recently completed fiscal year;

- Permits underwriters to publish reports about emerging growth companies that are the subject of a proposed public offering of common equity securities;

- Permits emerging growth companies to engage in communications with potential investors who are accredited investors[25] or qualified institutional buyers;[26] and

- Requires the SEC to review Regulation S-K to update, modernize, simplify, and reduce the costs of the securities registration process.

The SEC has remarked that it requires additional resources to be able to implement and supervise the securities law changes created by the JOBS Act.

SEC Names Norm Champ as Director of Division of Investment Management

On July 5, 2012, the SEC announced that Norm Champ would assume the role of Director of the SEC's Division of Investment Management.[27] Mr. Champ had been serving as Deputy Director of the SEC's Office of Compliance Inspections and Examinations. Mr. Champ succeeds Eileen Rominger in his new role.

Mizuho and Others Settle with SEC over Involvement in Collateralized Debt Obligation; Criminal Charges Still Possible for Mizuho?; Wells Notice for Standard & Poor's

On July 18, 2012, the SEC announced a settlement of charges against Mizuho Securities USA Inc., the U.S. investment banking subsidiary of the Japan-based Mizuho Financial Group. In 2007, Mizuho Securities USA arranged an offering of a collateralized debt obligation (CDO) known as "Delphinus CDO 2007-1." Delphinus involved the offering of securities that represented bundles of mortgage bonds, which were themselves bundles of home loans. The CDO went into default only six months after it was created. The SEC alleged that Mizuho Securities USA misled investors by obtaining and using misleading credit ratings to close the transaction and to sell notes to investors.[28] According to the SEC's allegations, Mizuho employees learned that Standard & Poor's (S&P) had changed its credit rating criteria, and that this change required certain categories of subprime residential mortgage-backed securities to be adjusted downward for purposes of calculating their default probability. Mizuho employees thereafter e-mailed multiple alternative portfolios to S&P. These portfolios contained dummy assets that were superior in credit quality to the assets that actually had been acquired for the CDO.

The SEC also announced settlements with three former Mizuho employees, the firm that served as Delphinus's collateral manager, and the person at the collateral manager who was the portfolio manager. Everyone charged by the SEC agreed to the settlements without admitting or denying the charges. Mizuho consented to the entry of a final judgment requiring payment of $10 million in disgorgement, $2.5 million in prejudgment interest, and a $115 million penalty. The firm that served as the collateral manager consented to the entry of an order requiring the firm to disgorge its fees and to pay prejudgment interest as well as a penalty in an amount equal to the disgorgement.

Authorities have also considered bringing criminal charges against Mizuho based on its involvement in the Delphinus matter.[29] Prosecutors leading an investigation into Delphinus in New York have not decided whether to file any charges, according to people close to the criminal probe.[30]

In connection with S&P's role in rating Delphinus, McGraw-Hill received a Wells notice from the SEC on September 22, 2011. S&P is a part of the McGraw-Hill Companies. According to the Wells notice, the SEC staff was considering recommending that the agency institute a civil injunctive action against S&P.[31] The contemplated action would allege violations of federal securities laws with respect to S&P's ratings for Delphinus. The staff could recommend that the SEC seek civil money penalties, disgorgement of fees, and other equitable relief. S&P analysts were aware of the collateral substitution and of the adverse effect on the credit quality of the pool, and reported the matter to superiors.[32] Nonetheless, S&P failed to change what had been a tentative AAA rating on the pool. Like the John Paulson pool for which Goldman Sachs was criticized, the sponsor of this pool also allegedly bet against the pool's success. The SEC has asked S&P to waive its right to seek dismissal of any civil suit against it on grounds that alleged misconduct occurred beyond the five-year statute of limitations in the federal laws under which the SEC would file a civil lawsuit against S&P.[33] A target of an SEC investigation may enter into such a "tolling agreement" with the SEC in a bid to avoid formal enforcement action.[34] Talks between the SEC and S&P about possible charges are ongoing.[35] If the SEC proceeds with the action, it would be the first such action against a rating agency for work it did in evaluating mortgage securities.

SEC Issues Wells Notices to Individual Mutual Fund Directors

On June 8, 2012, the Northern Lights Fund Trust, a mutual fund series trust, disclosed in a regulatory filing that a number of its current and former trustees, its chief compliance officer, and the

trust itself received a Wells notice from the staff of the SEC.[36] According to the June 8 filing by the trust, the Wells notice concerns "the process by which certain investment advisory agreements between [the Northern Lights Fund Trust] (on behalf of a small number of funds in the Trust) and their advisers were approved, and the disclosures regarding" those investment advisory agreements. The filing states that the funds involved are no longer sold by the trust. The Wells notice also concerns "separate books and records and compliance violations." The Northern Lights Fund Trust disagrees with the SEC's potential allegations, and "believes its actions complied with existing rules."

It is an unusual but increasingly common occurrence for a fund director or a chief compliance officer to receive a Wells notice.[37] This disclosure by Northern Lights Fund Trust comes after Bruce Karpati, co-chief of the Asset Management Unit in the SEC's Division of Enforcement, stated in a speech in January 2012 that the SEC staff was reviewing the meeting minutes of fund boards to ensure directors are performing their oversight duties.[38] Mr. Karpati has stated that he is particularly concerned about series trusts, such as the Northern Lights Fund Trust, because such trusts can involve a single board with the responsibility for overseeing a large number of different advisers offering different types of investment advice.[39]

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1 Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012) (to be codified at 17 C.F.R. pts. 4, 145, and 147).

2 17 C.F.R. § 4.13(a)(4).

3 Mary L. Schapiro, SEC Chairman, Statement on Money Market Fund Reform (Aug. 22, 2012), *available at* http://www.sec.gov/news/press/2012/2012-166.htm.

4 Fin. Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69,455 (Nov. 19, 2012).

5 In re Alderman, Investment Company Act Release No. 30,300, Administrative Proceeding, File No. 3-15127 (Dec. 10, 2012); SEC Charges Eight Mutual Fund Directors for Failure to Properly Oversee Asset Valuation, SEC Press Release No. 2012-259 (Dec. 10, 2012), *available at* http://www.sec.gov/news/press/2012/2012-259.htm.

6 677 F.3d 60 (2d Cir. 2012).

7 130 S. Ct. 2869, 2884 (2010).

8 *Id.* at 2885.

9 *Absolute Activist*, 677 F.3d at 63, 64-65.

10 *Id.*

11 *Id.*

12 *Id.* at 63-64.

[13] *Id.*

[14] Thus, the Second Circuit, in *Absolute Activist*, did not address whether securities traded on the over-the-counter securities markets satisfies the first part of the *Morrison* test, which applies Section 10(b) to transactions in securities listed on domestic exchanges. *See Absolute Activist*, 677 F.3d at 66 n.3.

[15] *Absolute Activist*, 677 F.3d at 64.

[16] *Id.* at 62; *see also id.* at 68, 69.

[17] *Id.* at 71.

[18] Investment Company Institute, SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 77,009 (Sept. 5, 2012).

[19] CA 11-4194 (September 21, 2012).

[20] Regulated Investment Company Modernization Act of 2010.

[21] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (to be codified in scattered sections of 15 U.S.C. § 77a to 78o-6 nt.).

[22] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, (proposed Aug. 29, 2012), *available at* http://www.sec.gov/rules/proposed/2012/33-9354.pdf.

[23] Senators Levin, Durban, Harkin, Lautenberg, Franken, Akaka, and Reed.

[24] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

[25] 17 C.F.R. § 230.501(a).

[26] *Id.* § 230.144A(a)(1).

[27] Press Release, SEC, SEC Names Norm Champ as Director of Division of Investment Management (July 5, 2012), *available at* http://www.sec.gov/news/press/2012/2012-129.htm.

[28] SEC Charges Mizuho Securities USA with Misleading Investors by Obtaining False Credit Ratings for CDO, SEC News Dig., Issue 2012-138 (July 18, 2012), *available at* http://www.sec.gov/news/digest/2012/dig071812.htm.

[29] Kara Scannell, *US Raises Criminal Stakes in Mizuho Probe*, Fin. Times, (May 3, 2012, 10:02 PM), http://www.ft.com/cms/s/0/a746063a-946e-11e1-8e90-00144feab49a.html#axzz1vjNTyc4b (reporting that the U.S. Attorney's Office in Manhattan and the Federal Bureau of Investigation are leading the criminal investigation into the sale of Delphinus).

[30] Jean Eaglesham, Jeannette Neumann & Reed Albergotti, *Clock Is Ticking on Crisis Charges*, Wall St. J., July 12, 2012, at C1.

[31] McGraw-Hill Cos., Current Report (Form 8-K) (Sept. 26, 2011).

[32] Louise Story, *S.&P. Target of Inquiry in Securities*, N.Y. Times, Sept. 27, 2011, at B1.

[33] Eaglesham et al., *supra* note 12.

[34] *Id.*

[35] *Id.*

[36] Northern Lights Fund Trust, Prospectus Supplement Dated June 8, 2012 (Form 497) (June 8, 2012).

[37] Greg Saitz, *Wells Notice to Directors Could Signal Shift in SEC Approach*, BoardIQ (June 19, 2012).

[38] *Id.*

[39] Saitz, *N. Lights Wells Notice Prompts Question: How Big Is Too Big?*, BoardIQ (July 3, 2012).