Investment Management Legal + Regulatory Update

Regulatory Updates

SEC Study: Americans Lack Financial Literacy

U.S. retail investors lack basic financial literacy, particularly among women, African-Americans, Hispanics, the elderly, and those who are poorly educated, according to the Securities and Exchange Commission (the "SEC") in a study published on August 30, 2012.

The Financial Literacy Study, required by Section 917 of Title IX of the Dodd-Frank Act, included a report from the Library of Congress aggregating and assessing existing studies regarding financial literacy, online investor surveys and focus groups conducted by a consultant, and a request for public comment on the issues.

The SEC also sought comment on the most effective private and public efforts to educate investors. Based on findings regarding the characteristics of effective investor education programs, the staff set forth goals for improving the financial literacy of investors:

- to develop joint investor education programs that target specific groups;
- to increase the number of investors who research investments or investment professionals before investing;
- to promote the SEC's www.investor.gov website as the primary federal government resource for investing information; and
- to promote awareness of the fees and costs of investing.

The report reviewed public comments received as well as data from the quantitative and qualitative research authorized by the Commission. The staff identified: (i) opportunities to improve the timing, content, and format of disclosures; (ii) information for investors to consider when selecting a financial professional or purchasing an investment; (iii) how to improve disclosure of expenses and conflicts of interest; and (iv) what information was most useful and relevant to retail investors when making informed decisions about financial intermediaries or investment products and services.

Timing. Commenters said that retail investors should receive disclosure either before or contemporaneously when they make an investment decision, a practice confirmed by data that showed that retail investors prefer to receive disclosure before making such a decision.

Content. Commenters expressed a preference for a "layered disclosure" framework, that is, a document that summarizes key disclosures and tells them where to find

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more detailed information. Commenters strongly supported plain-English summary disclosures, including information about objectives and risk, fees and expenses, eligibility, and conflicts. The empirical data suggested that retail investors value some information, such as price and unit numbers, over other information, such as the capacity in which third parties receive compensation.

Format. "Format," for purposes of the study, includes both delivery method and format of the disclosure document. Although most commenters preferred electronic delivery of disclosure material, they also wanted hard copies available. Investors, however, prefer hard-copy versions of adviser brochures, but prefer hypothetical point-of-sale documents by electronic delivery. The data showed that retail investors prefer graphics over narrative disclosure.

Transparency. Commenters suggested ways to increase transparency in disclosures concerning advertising, conflicts of interests and expenses. The empirical data demonstrated that retail investors do not, in fact, understand existing fee and compensation information.

Useful and Relevant. In general, commenters believed that retail investors want clear information about fees, performance, and investment strategy to make informed decisions about investments and financial intermediaries. Commenters suggested that investors found information about financial intermediaries, including background and disciplinary history, standard of care, conflicts and compensation, highly relevant. With respect to investment products, they particularly seek risk disclosures.

SEC Extends Temporary Rule for Adviser Principal Trades

The SEC has proposed to extend by two years a temporary rule that establishes an alternative means for registered investment advisers that are also registered as broker-dealers to meet the requirements of Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act") when they act in a principal capacity in transactions with certain of their advisory clients. Absent SEC action, Rule 206(3)-3T will sunset on December 31, 2012.

The SEC adopted Rule 206(3)-3(T) as a temporary rule in September 2007, as a consequence of the *Financial Planning Association v. SEC* decision (the "FPA Decision"). In the FPA Decision, the Court of Appeals for the D.C. Circuit threw out Rule 202(a)(11)-1 under the Advisers Act, which provided, among other things, that fee-based brokerage accounts were not advisory accounts and were thus not subject to the Advisers Act. The FPA Decision meant that investment advisers to fee-based brokerage accounts (such as "wrap" accounts) had to register with the SEC as investment advisers, and thus were subject to limitations on principal transactions with their clients and other fiduciary responsibilities.

Section 206(3) of the Advisers Act prohibits registered investment advisers from engaging in principal transactions with their clients unless they obtain written consents for each individual principal transaction. Without an alternative means of compliance with this restriction, many advisers refrained from engaging in principal trades with their clients, including those in fee-based advisory accounts (which, in light of the FPA Decision, were now subject to the Advisers Act), due to the impracticality of promptly obtaining written consents before market action changed the appropriate trading price. A practical consequence of this ruling was that wrap-fee clients could not access securities held in the principal accounts of their advisory firms. To access these securities, clients would have to open a traditional commission-based brokerage account, instead of trading through an advisory account with an asset-based fee.

Rule 206(3)-3T provided an alternative means for investment advisers to comply with the limitations of Section 206(3). Among other things, the adviser must make certain disclosures to clients about conflicts of interest and obtain written, revocable consents that prospectively authorize principal transactions. Under these circumstances, the Rule then permits the investment adviser to obtain either written or oral consent from the client with respect to each individual principal transaction. The availability of oral consent facilitates prompt decisions before there are changes in the market price of the security.

The SEC proposed the amendments to Rule 206(3)-3T on October 9, 2012. The comment period ends 30 days after the publication of the notice in the Federal Register.

California Adopts New Private Fund Adviser Exemption

California narrowed its exemption from state registration to investment advisers of "qualifying" private funds.[1]

The new rules, adopted on August 27, 2012 by the California Department of Corporations (the "Department"), require that private fund advisers that wish to rely on this new exemption file a notice with the Department and pay a filing fee by October 26, 2012. Additional requirements for certain private fund advisers (depending on the type of private funds advised as well as the qualifications of the investors in those private funds) apply under this new exemption and are summarized below.

The new exemption is only available to investment advisers that advise solely "qualifying private funds." A "qualifying private fund" is any fund relying on the exemptions from registration found in Sections 3(c)(1), 3(c)(5) and/or 3(c)(7) of the Investment Company Act of 1940, as amended (the "1940 Act"). In addition, a private fund adviser can only rely on the new exemption if: (1) neither the private fund adviser nor its advisory affiliates are subject to certain "bad actor" disqualifica-

[1] Historically, most private fund advisers in California have relied on a self-executing exemption from investment adviser registration in California, which provided an exemption for an adviser that (i) did not hold itself out to the public as an investment adviser, (ii) had fewer than 15 "clients" in the preceding 12 months, (iii) did not advise either a registered investment company or business development company, and (iv) either had assets under management of at least $25 million or advised only "venture capital companies."

tions; (2) the private fund adviser files a truncated version of Form ADV with the Department online and provides amendments to Form ADV on an ongoing basis; and (3) the private fund adviser pays the Department's initial and annual filing fees.

If a private fund adviser manages at least one 3(c)(1) and/or 3(c)(5) fund that is not a "venture capital fund" (a "Retail Buyer Fund"), however, it must comply with certain additional requirements for each of the Retail Buyer Funds it advises[2] (unless the Retail Buyer Fund qualifies for the grandfathering provision described below). If the private fund adviser advised an existing Retail Buyer Fund prior to August 27, 2012 with respect to which all the beneficial owners are not "accredited investors," and/or that charges a performance fee (e.g., carried interest) to any beneficial owners that are not "qualified clients," the new exemption provides "grandfathering" relief on existing funds so that the private fund adviser can still rely on the new exemption.

A more complete discussion of the new Rule 260.240.9 and its requirements can be found here.

Robert Plaze Retires

Robert E. Plaze, Deputy Director of the SEC Division of Investment Management, retired at the end of August 2012 after almost 30 years at the SEC. Mr. Plaze has not announced any future plans.

Mr. Plaze had a distinguished career and is highly regarded both inside the SEC and by the investment management industry. He has been a key architect of rules governing investment advisers, investment companies, and private fund advisers. While focused on investor protection, he has consistently engaged in meaningful dialogue with the investment management industry in seeking to shape rules that were responsive to real world concerns.

He was most recently responsible for implementing a Dodd-Frank requirement for hedge fund and other private advisers to register with the SEC, and developing a proposal for consideration by the Commissioners of significant structural reforms for money market funds. Among his many other accomplishments are improving mutual fund governance practices, including the addition of fee tables to fund prospectuses, standardizing performance calculations in fund advertisements, mandating the implementation of compliance programs for mutual funds and investment advisers, requiring investment advisers to deliver a plain-English brochure to clients, and protecting investors from "pay-to-play" practices.

His prior roles have included serving as an attorney, Special Counsel, Assistant Director, and Associate Director for Regulatory Policy. During his tenure at the SEC, he received the SEC's Distinguished Service Award and twice received the SEC's Law and Policy Award.

Mr. Plaze has not indicated his future plans. In the meantime, he has accepted various speaking engagements to discuss various issues that he was responsible for while at the SEC.

SEC Proposes Rules Lifting the Ban on General Solicitation

On August 29, 2012, the SEC proposed amendments to Rule 506 of Regulation D under the Securities Act of 1933 to implement Section 201(a) of the Jumpstart Our Business Startups (JOBS) Act. The proposed amendment to Rule 506 would eliminate the prohibition against general solicitation and general advertising contained in Regulation D with respect to offers and sales of securities made pursuant to Rule 506, provided that all purchasers are "accredited investors."

The SEC's proposed rules implement a bifurcated approach to Rule 506 offerings, pursuant to which an issuer may still conduct a private offering in reliance on Rule 506 without using general solicitation, in the same manner as before.

In addition, however, an issuer may conduct a Rule 506 offering using a general solicitation, so long as (i) the issuer takes reasonable steps to verify that the purchasers of the securities are accredited investors; (ii) all purchasers of securities are accredited investors or the issuer reasonably believes such purchasers are accredited investors at the time of the sale of the securities; and (iii) all terms and conditions of Rule 501 and Rules 502(a) and 502(d) have been satisfied.

One of the most controversial aspects of the proposed rule is the investor verification process. The SEC proposal provides for a flexible approach to investor verification, and acknowledges that "reasonable efforts" to verify investor status may differ depending on the facts and circumstances. To that end, the SEC provides a non-exhaustive list of factors that may be appropriate to consider, which includes the nature of the purchaser and the nature and amount of information about the purchaser. Simply put, the SEC states that "the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa."

The SEC attempted to strike a balance between respecting investors' privacy and the need to demonstrate that investors qualify as accredited investors. The release stops short of requiring that individuals submit financial statements, and instead suggests that reasonable steps may include relying on publicly available information or independent verification of a person's status as an accredited investor by a third-party agent, so long as there is a reasonable basis to rely on the third-party verification. Moreover, the SEC noted that the nature of the offering may be relevant in determining the reasonableness of steps taken to verify status.

[2] In general, the private fund adviser shall (1) advise only those Retail Buyer Funds whose outstanding securities are beneficially owned entirely by persons who are "accredited investors"; (2) provide a disclosure document containing all of the material information regarding services the private fund adviser provides and all duties owed by the private fund adviser to the fund; (3) obtain and deliver annual audited financial statements from an independent certified public accountant, registered with and examined by the Public Company Accounting Oversight Board, to each beneficial owner of the Retail Buyer Fund within 120 days after the end of each fiscal year; and (4) not enter into or extend an investment advisory contract that provides for performance fees based on the investment profit (e.g., carried interest) attributable to a beneficial owner of a Retail Buyer Fund that is not a "qualified client."

In particular, the SEC noted that a "check a box" indication of accredited investor status would not be sufficient for general solicitations to the public.

Lifting the ban on general solicitations and advertising in Rule 506 offerings would represent a significant shift in the way the federal securities laws regulate private placements. Although the release does not provide precise directives regarding investor verification, it reflects the Staff's understandable caution with respect to implementing Congress' directives in this regard.

Eliminating the Prohibition Against General Solicitation and Advertising in Rule 506 and Rule 144A Offerings, Rel. No. 33-9354 (August 29, 2012), *available at* http://www.sec.gov/rules/proposed/2012/33-9354.pdf; *see also Solicitation Emancipation: Proposed Rules Relating to the Relaxation of the Prohibition on General Solicitation*, *available at* http://www.mofo.com/files/Uploads/Images/120829-Solicitation-Emancipation.pdf.

Enforcement + Litigation

U.S. District Court Denies Motion to Dismiss in Sivolella Case

The US District Court for the District of New Jersey denied a defendant's motion to dismiss a pending action under Section 36(b) of the 1940 Act, holding that a participant in a variable annuity program has standing to bring the action. Section 36(b) limits those who may pursue a claim to the SEC or a security holder on behalf of a mutual fund that is allegedly charged excessive fees. The term "security holder" is not defined in the 1940 Act.

Plaintiff is a participant in a variable annuity program that entitles her to receive certain insurance benefits. Plaintiff's variable annuity contributions, together with those of other program participants, are placed in a separate account and plaintiff is credited with units of the separate account. The defendant insurance company is the legal owner of the assets in the separate account and invests those assets in the shares of underlying mutual funds selected by program participants. Plaintiff alleges that the underlying mutual funds incurred excessive fees because the investment adviser, which contracted with sub-advisers to provide portfolio management services, maintained most of the investment management fees while providing only supervisory input.

Rather than addressing the issue of whether or not the fees paid by the mutual funds are excessive for Section 36(b) purposes, defendants argued that plaintiff does not have standing to bring the case. Specifically, since plaintiff owns units of the separate account, rather than shares of an underlying mutual fund, she is not the legal or record owner of the fund and therefore is not a "security holder" for purposes of Section 36(b). Plaintiff argued that the term "security holder" refers to the equitable or beneficial owner of a security.

The court referenced the broad definition of "security" in the securities laws and said that it makes little sense to construe "security" broadly while limiting the "reach of 'holders' to entities that lack any economic interest or stake in the transaction." The court found that, because plaintiff and similarly situated variable annuity investors have all the incidents of ownership of the underlying fund shares, and accordingly all the economic stake in the investment, plaintiff has standing to bring a Section 36(b) case on behalf of underlying mutual funds in which a separate account invests. The court distinguished this from a fund-of-funds case, in which the plaintiffs did not enjoy the incidents of ownership in the underlying funds.

Sivolella v. AXA Equitable Life Insurance Co., No. 3:11-cv-04194 (D.N.J. Sept. 25, 2012)

SEC Charges Investment Bank in Connection with In-Kind Pay-to-Play Contributions

On September 27, 2012, the SEC charged a large investment banking institution and one of its employees with "pay-to-play" violations regarding campaign donations that were not disclosed to Timothy P. Cahill, who was, at the time, a candidate for governor of Massachusetts.

Pay-to-play restrictions are meant to curb payments by industry to government officials that are in a position to award contracts to private industry. This action is the first charge by the SEC involving in-kind contributions to a political campaign.

The SEC's order states that a vice president at the investment bank solicited business from Mr. Cahill, as well as participating in Mr. Cahill's political campaigns, sometimes conducting campaign-related business from his offices at the investment bank. Specifically, the SEC is charging that use of the investment bank's valuable resources while conducting campaign-related business constitutes in-kind contributions to the campaign, which should have disqualified the firm from receiving underwriting business attributable to Mr. Cahill. Nonetheless, the investment bank engaged in significant such underwriting activities.

SEC Charges Goldman Sachs and Former Vice President in Pay-to-Play Probe Involving Contributions to Former Massachusetts State Treasurer, SEC Press Release No. 2012-199 (September 27, 2012), *available at* http://www.sec.gov/news/press/2012/2012-199.htm.

Cease-and-Desist Proceedings Instituted Against Adviser for Misleading Investors

The SEC instituted cease-and-desist proceedings on September 5, 2012 against Raymond J. Lucia, Sr. and Raymond J. Lucia Companies, Inc. ("Respondents") for alleged misleading presentations to prospective and existing investment advisory clients. Mr. Lucia has hosted a long-running daily nationally syndicated radio show, The Ray Lucia Show, and is featured on two websites. In addition, he was the featured speaker at regular seminars hosted by his company across the country, which were used to promote the radio show and website. In addition, he has written three books on retirement

investing featuring his "Buckets of Money" (BOM) retirement investment strategy.

According to the allegations, in an effort to win investment advisory clients, the Respondents claimed the BOM strategy would generate inflation-adjusted income to retirees for life while protecting, and even increasing, their retirement savings. Respondents' various public statements contain numerous references to their backtesting of the BOM strategy and to the results which Respondents claim validate the BOM strategy. Although Respondents claimed to have extensively "backtested" their claims, in actuality, they performed scant, if any, backtesting. Asked to provide the claimed documentation, they produced only two two-page spreadsheets, neither of which supported the claims made. Their claims of "numerous" backtests and a "proven" BOM strategy are not supported by the evidence.Extremely favorable numerical investment results touted by the Respondents were based upon an unrealistically low hypothetical inflation rate and a high hypothetical investment return rate for REITs, rather than real rates, which materially inflated projected returns from the purported backtesting. Furthermore, Respondents failed to make any provision for advisory fees in their spreadsheets, failed to follow the purported strategy by reallocating assets as claimed, and failed to disclose these facts to investors, further inflating projected returns in a materially misleading manner. Respondents also failed to maintain required records supporting their claims. Proceedings in the matter are anticipated in the coming months.

SEC Charges Oregon-Based Investment Adviser for Failing to Disclose Revenue-Sharing Payments

On September 6, 2012, the SEC issued a settled administrative proceeding against two investment advisory firms, located in Portland Oregon, and their owner. The proceeding involved a failure by the adviser to provide appropriate disclosure with respect to revenue sharing and other conflicts of interest. The proceeding stemmed from an SEC investigation that uncovered a number of violations, in particular with respect to a lack of disclosure on revenue-sharing payments from a brokerage firm to mutual funds recommended by the adviser that provided the adviser with an incentive to recommend those mutual funds.

SEC Charges Oregon-Based Investment Adviser for Failing to Disclose Revenue Sharing Payments, SEC Press Release No. 2012-180 (September 6, 2012), *available at* http://www.sec.gov/news/press/2012/2012-180.htm.

SEC Charges Adviser in Connection with Incorrect Performance Disclosure

On August 31, 2012, the SEC charged an investment adviser employee with willfully aiding and abetting violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1), 206(2) and 207 of the Advisers Act by investment advisory firms with which he was affiliated.

According to the order, the employee was hired in 2003 by a registered investment adviser (now in receivership) to track and calculate the performance of mutual fund allocation programs. The employee also created client pitchbooks including historical performance of the allocation strategies dating back to 2000. In 2004, the employee began calculating hypothetical historical performance that assumed the asset allocations in place in 2004 were also in place as of 2000. Presentations in client pitchbooks compared the historical performance favorably to returns on the S&P 500. In 2006, other employees expressed concerns about the validity of the historical returns and a consultant was hired to evaluate the difference between the advertised performance and actual client returns.

Despite the consultant's findings that actual returns were significantly less than the advertised returns, and the lack of records upon which to test the calculations made by the employee, client pitchbooks continued to use pre-2005 unverified performance data alongside post-2005 audited performance data. In 2007, the pitchbooks were further modified to label the performance as "historical" rather than "hypothetical" and to include disclosure to the effect that performance figures prior to 2005 were not audited. The SEC also alleges that, as early as 2005, the employee falsely represented himself as a Chartered Financial Analyst to his employer, which listed him as a CFA in presentations, pitches, and required regulatory filings.

In the Matter of Jason A. D'Amato, File No. 3-15004, Rel. No. 34-67777, IA-3455, IC-30192 (August 31, 2012), *available at http://www.sec.gov/litigation/admin/2012/34-67773.pdf*.

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