

# Investment Management Legal + Regulatory Update

## Regulatory Updates

### Senate Bill Would Raise Taxes on Derivatives Trades

Senator Carl Levin introduced a bill that would eliminate long-term capital gain treatment for trades of certain derivatives contracts. The current law provides that "Section 1256" contracts are taxed 60 percent as long-term capital gains or losses, and 40 percent as short-term capital gains or losses. Section 1256 contracts, under current law, include regulated futures contracts, foreign currency contracts, and non-equity options. The bill would amend the Internal Revenue Code of 1986 to provide for short-term treatment for these capital gains or losses. Senator Levin states that the purpose of the bill is to "end a tax loophole that subsidizes short-term speculation in derivatives."

Press Release, *Levin Introduces Legislation to End Tax Loophole that Subsidizes Short-term Speculation in Derivatives* (Jan. 23, 2012), available at <http://levin.senate.gov/newsroom/press/release/levin-introduces-legislation-to-end-tax-loophole-that-subsidizes-short-term-speculation-in-derivatives>; Proposed bill available at <http://levin.senate.gov/download/?id=4b64115c-9fe6-4702-850a-592dac6fda88>; see also *Derivatives Taxation Under Dodd-Frank*, Rimmelt Reigersman and Jared Goldberger (Jan. 9, 2012), available at [http://www.iinews.com/site/pdfs/DW\\_1\\_2012\\_MF.pdf](http://www.iinews.com/site/pdfs/DW_1_2012_MF.pdf).

### Senate Hearings Question Fund Investments in Commodity-related Investments

The Senate Permanent Subcommittee on Investigations held a hearing on January 26, 2012, to examine private guidance issued by the Internal Revenue Service (the "IRS") concerning commodity-related mutual fund investments.

To achieve preferential pass-through tax treatment, a mutual fund is required to derive at least 90 percent of its income from dividends, interest, and other "passive" income. Historically, returns from investments in commodities would not count towards this 90 percent source-of-income requirement. However, over the past six years, the IRS has issued many private-letter rulings that have allowed mutual funds to gain economic exposure to commodities through investment in futures and complex derivative instruments. The rulings held that the income received on certain commodity-related investments was "good" income for purposes of determining whether the funds qualify for pass-through income treatment under the Internal Revenue Code of 1986, as amended.

Mutual funds typically gain exposure to commodities in three ways: through direct investments and swaps, subject to specific limitations; through investments in controlled foreign corporations that in turn invest in futures contracts; and through investment in securities known as "hybrid instruments." Hybrid instruments, such as commodity-linked notes, provide returns that are linked to the value of commodities.

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These rulings permitted funds to treat income from these controlled foreign corporations as “good” income for purposes of satisfying the 90 percent source-of-income requirement. The rulings also held that income from the hybrid instruments constituted “good” income for purposes of the requirement.

Senator Levin has expressed concern about the “growing influence of speculators in the commodities markets” and that “excessive speculation can harm American families and businesses by increasing price volatility, overriding normal supply and demand factors, making price hedging more difficult, and in some cases, driving up commodity prices.” The senator has linked his concerns about speculative investing to mutual funds that gain economic exposure to commodities. In December 2011, he urged the IRS to permanently stop issuing such private-letter rulings.

*Senate Hearing on IRS Actions Allowing Mutual Funds to Skirt Tax Limits on Commodity Investments* (Jan. 25, 2012), available at <http://levin.senate.gov/newsroom/press/release/senate-hearing-on-irs-actions-allowing-mutual-funds-to-skirt-tax-limits-on-commodity-investments>.

## SEC Grants No-action Relief for Potential Section 10(f) Violations

On December 12, 2011, the Securities and Exchange Commission (the “Commission”) granted no-action relief in response to a letter from an investment adviser concerning certain registered investment companies that it advises. Specifically, the adviser asked the staff to confirm that it would not recommend enforcement action to the Commission if the funds acquired certain loan assignments and participations in primary transactions from various Citibank entities, because one of the funds’ trustees was an affiliated person of Citibank.

The adviser said that Citibank has a significant market presence in the covered participations. The funds were concerned that the trustee’s affiliation

with Citibank might result in violations of Section 10(f) of, and Rule 10f-3 under, the Investment Company Act of 1940 (the “1940 Act”) if the funds purchased covered participations from Citibank. Section 10(f) of the 1940 Act “was designed primarily to prevent an underwriter from ‘dumping’ otherwise unmarketable securities on a fund in order to stimulate the market in these securities or to relieve the underwriter or selling syndicate of securities that are otherwise unmarketable.”

The adviser argued that the trustee’s affiliation with Citibank was attenuated enough that the adviser and its subadvisers would have no incentive that might conflict with their obligation to make independent investment decisions with respect to the purchase of covered participations. In support of this argument, the adviser noted that Citibank is not an affiliated person, nor an affiliated person of an affiliated person, of the adviser or any subadvisers to the funds, or of the funds’ principal underwriters. Moreover, the adviser argued that Citibank could not cause any fund to purchase covered participations in the absence of such an affiliation, thus obviating any concerns that Citibank might “dump” covered participations on the funds.

Based on the facts and representations presented, the Commission said it would not recommend enforcement action if the adviser, on behalf of the funds, purchased covered participations from Citibank under the circumstances described in the letter.

*Columbia Funds*, SEC No-Action Letter (Dec. 12, 2011), available at <http://www.sec.gov/divisions/investment/noaction/2011/columbiafunds121211-10f3.htm>.

## FINRA Proposes to Amend Advertising Rules

The Commission published proposals by the Financial Industry Regulatory Authority (“FINRA”) that would update certain advertising rules. FINRA originally filed proposed rules and rule amendments with the Commission in July 2011 in order to consolidate and amend National

Association of Securities Dealers, Inc. (“NASD”) and New York Stock Exchange (“NYSE”) rules and interpretations governing member communications with the public. The Commission published for comment FINRA’s Amendment No. 1 to the proposal in November 2011 and FINRA filed Amendment No. 2 in December 2011 to further revise certain aspects of the proposal.

The proposal, in its original and its amended forms, seeks to redefine categories of communications, reducing the six categories under current NASD rules to the following three: (1) correspondence, (2) retail communication, and (3) institutional communications.

Among other changes to the original proposal, Amendment No. 2 would exclude internal communications intended to educate or train registered persons about products or services from the definition of “institutional communication” under Rule 2210.

FINRA also proposed amending Rule 2210 to exclude from FINRA’s filing requirements retail communications that are posted on online interactive electronic forums.

In response to comments received by the Commission, FINRA agreed to exclude closed-end fund press releases issued pursuant to Section 202.06 of the NYSE Listed Company Manual from pre-use principal approval and filing. In addition, pursuant to Amendment No. 2, any press release about a closed-end fund that does not make any financial or investment recommendation or otherwise promote a product or service of the member would not require filing or principal approval.

*Notice of Filing of Amendment No. 2 to Proposed Rule Change, as modified by Amendment No. 1, to Adopt FINRA Rules 2210 (Communications with the Public), 2212 (Use of Investment Companies’ Rankings in Retail Communications), 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings), 2214 (Requirements for the Use of Investment Analysis Tools), 2215 (Communications with the Public Regarding Security Futures), and 2216 (Communications*

with the Public About Collateralized Mortgage Obligations (CMOs)) in the Consolidated FINRA Rulebook, SEC Release No. 34-66049 (Dec. 23, 2011), available at <http://www.sec.gov/rules/sro/finra/2011/34-66049.pdf>; see also *FINRA Revises Proposal re Communications with the Public*, Lloyd Harmetz, Vernicka Shaw, and Anna Pinedo, available at <http://www.mofo.com/files/Uploads/Images/120119-Structured-Thoughts.pdf>.

## SEC Issues Guidance on Adviser Use of Social Media

In its first “National Examination Risk Alert” publication, the Commission’s Office of Compliance Inspections and Examinations (“OCIE”) described how registered investment advisers can strengthen their compliance policies and procedures related to the use of social media.

OCIE highlighted certain factors that an investment adviser may consider when reviewing the portion of its compliance program governing social media, including: (1) usage guidelines; (2) content standards; (3) monitoring; (4) approval of content; (5) criteria for approving participation; (6) training; (7) compliance certifications; and (8) information security.

In particular, OCIE suggested that investment advisers have policies and procedures in place with respect to third-party postings on the advisers’ social media sites, as certain postings could constitute testimonials in violation of federal securities laws. The Risk Alert notes that in certain circumstances, “the use of ‘social plug-ins’ such as the ‘like’ button” could constitute a testimonial under the Investment Advisers Act of 1940 (the “Advisers Act”).

OCIE also recommended that investment advisers retain records of their social media communications to the extent they contain information that falls under the adviser’s Advisers Act recordkeeping obligations. According to the staff, an adviser reviewing its recordkeeping policies related to social media may consider, among other things: (1) the applicable retention period and

accessibility requirements; (2) the electronic or paper format of records; (3) training; (4) test checking for compliance with the recordkeeping requirements; and (5) recordkeeping by third parties.

*Investment Adviser Use of Social Media*, National Examination Risk Alert, SEC Office of Compliance Inspections and Examinations (Jan. 4, 2012), available at [www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf](http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf).

## SEC Adopts Net Worth Standard for Accredited Investors

The Commission amended the definition of “accredited investor,” as it appears in Rules 215 and 501 under the Securities Act of 1933, to exclude the value of a person’s home from net worth calculations. The changes were made to conform the definition to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The Commission’s definition of “accredited investor” includes persons with a net worth of at least \$1 million. The final rule amendments incorporate new language into Rules 215 and 501 to provide that in calculating net worth, a person’s primary residence will not be counted as an asset.

Under the amended rules, indebtedness secured by a person’s primary residence, up to the estimated fair market value of the primary residence, will generally not be treated as a liability in the net worth calculation. However, if the borrowing occurs in the 60 days preceding the purchase of securities in an exempt offering and is not in connection with the purchase of the primary residence, the debt secured by the primary residence will be treated as a liability. In any event, indebtedness secured by a person’s primary residence in excess of the property’s estimated fair market value will be treated as a liability.

The amended net worth standard will take effect February 27, 2012.

*SEC Adopts Net Worth Standard for Accredited Investors under Dodd-Frank Act*, SEC Press Release No. 2011-274

(Dec. 21, 2011), available at <http://www.sec.gov/news/press/2011/2011-274.htm>; *Net Worth Standard for Accredited Investors*, SEC Release No. 33-9287, File No. S7-04-11 (Dec. 21, 2011), available at <http://www.sec.gov/rules/final/2011/33-9287.pdf>; see also *One Down, One to Go: The SEC Completes the First Required Dodd-Frank Act Regulation D Rulemaking*, David Lynn, available at <http://www.mofo.com/files/Uploads/Images/120118-Dodd-Frank-Regulation-D.pdf>.

## Enforcement + Litigation

### SEC Charges Fund Adviser for Fund Pricing Violations

The Commission charged an investment adviser with failing to properly price portfolio securities in three advised mutual funds, resulting in a misstatement of the funds’ net asset value to investors.

Without admitting or denying the Commission’s findings, the investment adviser agreed to a censure and paid a \$300,000 penalty, and consented to a “cease-and-desist” order from committing future violations of Rules 22c-1 (valuation) and 38a-1 (compliance program) under the 1940 Act.

The Commission’s order charged that the investment adviser purchased, on behalf of the mutual funds, approximately 54 complex, fixed-income securities in June 2008 at an aggregate purchase price of approximately \$22 million. Most of the securities were subordinated tranches of non-agency, mortgage-backed securities, collateralized by “non conforming” loans (that is, collateral that did not conform to Ginnie Mae, Fannie Mae, or Freddie Mac requirements).

The Commission found that after the purchases, all but six of the securities were valued at prices substantially higher than the transaction prices, including many at least 100 percent higher.



The adviser used valuations provided by broker-dealers or a third-party pricing service that did not appear to take into account the prices at which the funds had purchased the securities. Some of the supplied prices were based on quotes that were stale.

The adviser did not fair-value the securities until its Global Valuation Committee met more than two weeks after the adviser received “price-tolerance reports” alerting it to the discrepancies between the purchase prices and the valuations provided by the third parties. The adviser’s procedures required that the securities be valued at the transaction price until the adviser received a response to a price challenge based on the discrepancy identified in the price-tolerance report, or the adviser made a fair-value determination. The Commission charged that the adviser caused the funds to not follow their valuation procedures.

Given the small size of the penalty and the fact that the funds’ Net Asset Values (“NAVs”) were misstated for only “several days,” it is significant that the Commission commenced the enforcement proceeding. The case signals that the Commission will focus on fund valuation and how advisers comply with fund valuation procedures. Although the Commission did not charge the funds’ boards of directors with any violations, the case should serve as a wake-up call to fund directors to ensure that advisers are following fund valuation procedures.

*UBS Global Asset Management (Americas) Inc.*, Inv. Co. Act. Rel. No. 29920 (Jan. 17, 2012), available at <http://www.sec.gov/litigation/admin/2012/ia-3356.pdf>.

## SEC Charges Fund PM for Withholding Pricing Information

The Commission instituted enforcement proceedings against a fund portfolio manager who it claimed failed to inform a fund’s valuation committee that a collateralized debt obligation (CDO) held by the fund had defaulted.

The portfolio manager learned in February 2008 that the CDO experienced an event of default. In March 2008, she learned that as a result of the event of default, the CDO would no longer make payments to the fund. When the valuation committee, of which the portfolio manager was a member, learned of the event of default in June 2008, it wrote down the value of the CDO, resulting in a \$.10-per-share drop in the fund’s NAV. (This event set in motion a chain of events that eventually led to the fund’s liquidation.)

The Commission charged that the portfolio manager failed to notify the pricing committee of the default despite (a) knowing of the default, (b) her understanding that the fund adviser’s pricing procedures required the pricing committee to value the CDO, and (c) her understanding that she must notify the pricing committee when she believed that the assigned valuation did not reflect the fair value of the holding.

The Commission alleged that the portfolio manager willfully violated Sections 206(1) and 206(2) of the Advisers Act, two of the anti-fraud provisions, and also caused the fund to violate Rule 22c-1(a) under the 1940 Act, which requires funds to sell and redeem shares at the current NAV.

The case indicates that the Commission views fund pricing violations as an enforcement priority.

*Lisa B. Premo*, Order Instituting Administrative and Cease-and-Desist Proceedings, Inv. Co. Act. Rel. No. 29919 (Jan. 17, 2012), available at <http://www.sec.gov/litigation/admin/2012/ia-3355.pdf>.

## SEC Charges Three Investment Advisers for Failing to Implement Compliance Procedures

The Commission charged three investment advisers for failing to put into place compliance procedures. According to the Commission, the firms operated without a compliance program and, in the case of two advisers, without a code of ethics. The Commission also charged one adviser’s owner and chief compliance

officer, who allegedly performed “virtually no compliance responsibilities.”

SEC examiners had previously warned the advisers about their compliance deficiencies. Carlo di Florio, the OCIE director, said, “When SEC examiners identify compliance deficiencies, firms are expected to remediate them. The Commission will take enforcement action against registrants that fail to do so.”

The three charges stem from an initiative within the Commission’s Enforcement Division to prevent harm to investors by ensuring that investment advisers adopt appropriate compliance programs designed to prevent securities laws violations. The Advisers Act, as amended, requires investment advisers registered thereunder to implement written compliance policies and procedures.

*SEC Penalizes Investment Advisers for Compliance Failures*, SEC Press Release No. 2011-248 (Nov. 28, 2011), available at <http://www.sec.gov/news/press/2011/2011-248.htm>.

## NY Court of Appeals: Martin Act Does Not Preempt Common Law Causes of Action

The New York Court of Appeals on December 20, 2011, affirmed a ruling from the Appellate Division holding that New York’s securities law, the Martin Act, does not preempt common law causes of action.

The plaintiff originally sued an investment management firm for breach of fiduciary duty, gross negligence, and breach of contract. The trial court dismissed the plaintiff’s action because common law causes of action “would be inconsistent with the Attorney General’s exclusive enforcement powers under the [Martin] Act.”

The Court of Appeals, however, found no evidence that the legislature intended to grant the attorney general exclusive enforcement authority with respect to claims falling under the purview of the Martin Act. The court recognized case law that supported preemption for claims “predicated solely on a violation of the

Martin Act . . . [that] would not exist but for the statute.” When a plaintiff brought otherwise valid claims, however, “mere overlap between the common law and the Martin Act is not enough to extinguish common law remedies.”

*Assured Guaranty (UK) Ltd. Etc. v. J.P. Morgan Investment Management* (2011 NY Slip Op 09162, Dec. 20, 2011), available at <http://www.courts.state.ny.us/CTAPPS/Decisions/2011/Dec11/227opn11.pdf>.

### **SEC Enforcement Director Criticizes Court's Refusal to Approve Consent Judgment in Citigroup Case**

The director of the Commission's Division of Enforcement, Robert Khuzami, criticized a federal district court's refusal to approve a consent judgment between the Commission and Citigroup. The district court in that case declined to approve a \$285 million settlement proposal because the underlying allegations were “unsupported by any proven or acknowledged facts.”

In a December 15, 2011 statement, Mr. Khuzami said that the Commission believed the court committed a legal error in requiring an admission of facts, or a trial, as a condition to approving a settlement. The statement argued that settlements in cases like this protect investor interests, even without an admission of wrongdoing, by avoiding the costs and risks inherent in litigation. “The court's new standard is at odds with decades of court decisions that have upheld similar settlements by federal and state agencies across the country.” Mr. Khuzami was careful to note, however, that the Commission is willing to litigate,

and has a record of litigating, cases where proposed settlements fail to achieve the right outcome for investors.

*SEC Enforcement Director's Statement on Citigroup Case*, SEC Press Release No. 2011-265 (Dec. 15, 2011), available at <http://www.sec.gov/news/press/2011/2011-265.htm>.

### **SEC Charges Hedge Fund Managers with Fraud as Part of Initiative to Investigate Suspicious Returns**

On December 1, 2011, the Commission announced enforcement actions against three hedge fund advisory firms and six individuals for various types of misconduct. The Commission alleges that these firms and managers engaged in fraudulent valuations of portfolio holdings, misuse of fund assets, and material misrepresentations to investors, among other things.

Although the Commission's allegations themselves are not unusual, the Commission used a relatively novel method to identify these firms and individuals. The actions arise as part of a recent initiative by the Enforcement Division's Asset Management Unit called the Aberrational Performance Inquiry. Under this initiative, the Commission uses proprietary risk analytics to evaluate performance returns from hedge funds, and to flag funds with unusual performance for further scrutiny. “We're using risk analytics and unconventional methods to help achieve the holy grail of securities law enforcement—earlier detection and prevention,” says Mr. Khuzami.

*SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting*

*Suspicious Investment Returns*, SEC Press Release No. 2011-252 (Dec. 1, 2011), available at <http://www.sec.gov/news/press/2011/2011-252.htm>; complaint available at <http://www.sec.gov/litigation/complaints/2011/comp-pr2011-252.pdf>.

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