Investment Management Legal + Regulatory Update

Regulatory Updates

IM Lifts ETF Ban; Steps Up Exams of "Strategically Important" Advisers and Funds

In December 6, 2012 remarks, Norm Champ, the Director of the Division of Investment Management, said that the Division will partially lift the two-year old moratorium on granting exemptive relief to actively-managed ETFs that make use of derivatives. As a condition to receiving an order exempting actively managed EFTs from a myriad of laws and rules that would otherwise prevent them from operating, the ETFs must agree:

- that the ETF's board periodically will review and approve the ETF's use of derivatives and how the ETF's investment adviser assesses and manages risk with respect to the ETF's use of derivatives; and
- that the ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant SEC staff guidance.

He said, however, that the staff would continue to not support new exemptive relief for leveraged ETFs and that the staff will continue its ongoing review of investment company use of derivatives.

The Division Director also announced that the recently created Risk and Examination Group, or REG, will "conduct rigorous quantitative and qualitative financial analyses of the investment management industry, including detailed analyses of strategically important investment advisers and investment companies." REG will coordinate with the SEC's Office of Compliance, Inspections and Examinations to make onsite visits to understand a firm's risk management activities.

CONTACTS

Jay G. Baris
(212) 468-8053
JBaris@mofo.com

Thomas M. Devaney
(212) 336-4232
TDevaney@mofo.com

Kelley Howes
(303) 592-2237
KHowes@mofo.com

Robert E. Putney, III
(212) 336-4451
RPutney@mofo.com

Isabelle Sajous
(212) 336-4478
ISajous@mofo.com

Steven J. Bleiberg
(212) 336-4228
SBleiberg@mofo.com

Luke T. Bagley
(212) 336-4379
LBagley@mofo.com

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FSOC, FSB Turn Up Heat on SEC on Money Market Fund Reforms

With the SEC deadlocked over whether or how to address concerns about money market funds ("MMFs"), the Financial Stability Oversight Council ("FSOC") voted unanimously to propose three MMF reforms. The November 13, 2012 vote was the FSOC's first exercise of its power under section 120 of the Dodd-Frank Act to recommend heightened regulatory standards to financial regulatory agencies. If finalized, the proposal will result in a recommendation that the SEC act on at least one of the reforms.

In a related action, on November 18, 2012, the Financial Stability Board (FSB) published "Strengthening Oversight and Regulation of Shadow Banking," a document summarizing specific areas in which the FSB believes policies are needed to mitigate potential system risks associated with "shadow banking," including money market funds. (The FSB is an international group formed to promote international financial stability by the finance ministers and central bank governors of the G20 countries.)

The FSOC proposal presents three options for MMF reform, two of which were before the SEC in August, and requests public comment during the 60 days following publication of the proposal in the Federal Register. The FSOC does not regard the three options as mutually exclusive and thus could recommend more than one to the SEC. The three options are as follows:

- *Option One: Floating Net Asset Value.* Under the first option, MMFs would be required to float the net asset value (NAV) and use mark-to-market valuation, like other mutual funds.
    - This option would underscore for investors that MMFs are not guaranteed and that they could lose money. The daily price of MMFs would reflect gains and losses.
    - In theory, by eliminating the potential of a fund to "break the buck," the likelihood of a run on an MMF would be reduced.
- *Option Two: Stable NAV with NAV Buffer and "Minimum Balance at Risk."* Under the second option, MMFs would keep the constant dollar NAV per share feature, but would tailor a capital buffer of up to one percent of fund assets, adjusted to reflect the fund's risk characteristics. The capital buffer would absorb day-to-day variations in the fund's NAV.
    - The buffer would be paired with a requirement for a minimum balance at risk ("MBR"). The MBR would be three percent of an investor's highest account value in excess of $100,000 during the previous 30 days. This amount would be held back for 30 days. Investors subject to the MBR requirement would be able to redeem up to 97 percent of their assets in the normal course of business.
    - The holdback amount would take a so-called "first-loss" position and could be used to provide extra capital to an MMF that suffered losses greater than its capital buffer during that 30-day period.
    - The capital buffer and its companion loss-absorption feature are designed to counteract the "first-mover advantage" that the regulators believe exacerbate a MMF's vulnerability to runs.
    - The MBR requirement would not apply to Treasury MMFs, nor would it apply to investors with account balances below $100,000.
- *Option Three: Stable NAV with NAV Buffer and Other Measures.* The third option would impose a risk-based NAV capital requirement of three percent, as well as other standards. Such standards would include more stringent investment diversification requirements, increased minimum liquidity levels, and more robust disclosure requirements. The FSOC said that it would be open to a lower capital standard if it can be "adequately demonstrated" that diversification requirements (and possibly other standards) would reduce the vulnerabilities of MMFs.

The FSOC's vote begins a lengthy process that could entail two separate, full-blown notice-and-comment proceedings. Section 120 of the Dodd-Frank Act authorizes the FSOC to "recommend" to the SEC (or any other primary financial regulatory agency) enhanced regulation of a business, in this case the MMF business. Before issuing a recommendation, the FSOC must propose the recommendation and seek public comment—a process similar to the traditional rulemaking of federal agencies.

An FSOC recommendation is not binding or legally enforceable. Once the FSOC has approved a recommendation, the SEC must decide whether to initiate its own rulemaking. Such a process may seem duplicative, but the SEC can adopt a final regulation only on the basis of its own rulemaking. The SEC may choose not to proceed, but if so it must inform the FSOC in writing within 90 days of the FSOC's recommendation. The FSOC must report to Congress on the SEC's response to the recommendation.

How a final recommendation from the FSOC will in fact induce the SEC to implement further MMF reforms is far from certain. The FSOC cannot compel the SEC to take action, and an FSOC recommendation is not legally enforceable. The recommendation process, however, will certainly encourage agency action. Indeed, Secretary Geithner emphasized

that the FSOC would suspend its recommendation process should the SEC begin its own rulemaking on the proposed reforms.

Click here to read our Client Alert on the FSOC proposals.

In a related development, on December 5, 2012, Commissioner Luis A. Aguilar said he remained concerned that previous proposals for money market reform would be a catalyst for investors moving significant dollars from the regulated, transparent money market fund market into the "opaque, unregulated market." He welcomed the fact that the FSOC and the SEC staff recently identified this issue as one that must be considered in the context of any further MMF regulatory reforms.

SEC Staff: Beware of BDC Joint Transactions

The staff of the Division of Investment Management cautioned private funds that plan to elect status as business development companies (BDCs) on joint transactions with affiliated funds after the private funds obtain BDC status.

Here's the concern: a private fund ("Fund A") holds securities of an issuer ("Portfolio Company") that is controlled by another private fund advised by Fund A's investment adviser of an affiliate. After Fund A elects BDC status, it holds securities of a Portfolio Company that is controlled by a BDC affiliate. The staff warned that simply holding these securities may be a "joint transaction" contemplated by Section 57(a)(4) of the Investment Company Act and Rule 17d-1 under the 1940 Act, which is prohibited without an order from the SEC. This guidance hints that the staff may be focused on prohibited joint transactions not just involving BDC, but investment companies in general.

SEC Reports 3,000 Whistles Blown in FYI 2012

The SEC's Office of the Whistleblower ("OWB") reported that it received more than 3,000 tips originating from all 50 states and 49 foreign countries. In its first annual report required by Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the OWM said that the most common categories of complaints received included corporate disclosures and financials (18.2 percent), offering fraud (15.5 percent) and manipulation (15.2 percent).

In FY 2012, the SEC issued 143 enforcement judgments and orders that potentially qualify tipsters to receive a whistleblower award. The SEC made its first award—amounting to the maximum 30 percent of the amount collected—under the whistleblower program in August.

In addition to summarizing the volume and nature of tips received, the report discusses OWB's internal processes for evaluating both whistleblower tips and claims for possible whistleblower awards. The report also describes the procedures for the claims review process and objections to the proposed awards, including when such claims would be subject to SEC, rather than staff review.

Over 1500 Private Fund Advisers Registered with SEC since Enactment of Dodd-Frank

On October 19, 2012, the SEC staff reported that approximately 1,500 advisers to hedge funds and other private funds have registered with the agency since the passage of the Dodd-Frank Act.

The Staff said that the total number of SEC-registered private fund advisers is now up to more than 4,000, which represents 37% of all SEC-registered advisers.

Registered investment advisers must comply with the Advisers Act and are subject to SEC examinations. On October 9, 2012, the SEC's Office of Compliance Inspections and Examinations ("OCIE") notified recently registered investment advisers to private funds of a new initiative to conduct focused, risk-based examinations of the advisers over the next two years.

The SEC also notified close to 300 advisers that they may no longer be eligible for SEC registration because they manage less than $100 million in regulatory assets under management. The Dodd-Frank Act required mid-sized advisers (those managing less than $100 million of assets) to move from federal to state registration by June 28, 2012. The Staff reported that, to date, more than 2,300 mid-sized advisers have transitioned to state registration.

SEC Confirms Status of Investment Adviser Solely to Foreign Insurance Companies

The SEC staff said that it would not recommend enforcement action if an investment adviser solely to a foreign insurance company did not register under Section 203(a) of the Advisers Act.

Section 203(b)(2) of the Advisers Act exempts advisers solely to "insurance companies" from the registration requirements of Section 203(a). The issue is whether a "foreign insurance company," as contemplated in Rule 3a-6 under the Advisers Act, falls within the Adviser Act definition of an "insurance company."

The investment adviser argued that the Section 203(b)(2) exemption should apply whether its client is a domestic or foreign insurance company since in either case it provides advice to a company engaged in the business of writing insurance that is regulated by local insurance regulators. The Adviser said that the SEC's interest in protecting domestic insurance companies and their customers is inconsistent with its rules that exempt advisers to domestic insurance companies from registration but do not exempt investment advisers whose only clients are foreign insurance companies.

In granting the relief, the staff emphasized its guidance did not extend to the

meaning of "insurance company" for any other purpose under the Advisers Act, including the definition of "dealer" under Section 202(a)(7). In addition, although the issue was raised by the incoming letter, the staff did not address how it would view an investment adviser whose clients were both domestic and foreign insurance companies for purposes of the Section 203(b)(2) exemption.

CFTC Issues Fund of Funds Relief from CPO Registration

The staff of the Commodity Futures Trading Commission (CFTC) said that it would not recommend enforcement action to the CFTC if fund of funds operators that may be required to register as commodity pool operators (CPOs) by December 31, 2012 did not so register until the staff issues revised guidelines.

In a letter dated November 29, 2012, the CFTC's Division of Swap Dealer and Intermediary Oversight (DSIO) said that it is appropriate to provide limited relief for CPOs that may have to register as a result of their indirect exposure to commodity interests. This "no-action" relief is effective only until the later of June 30, 2013 or six months from the date that the CFTC issues revised guidance on the application of the calculation of *de minimis* thresholds in the context of Regulations 4.5 and 4.13(a)(3).

The relief is not self-executing. That is, fund of funds operators must file a claim with the CFTC attesting to their compliance with the provisions of the relief. The claims are due to the CFTC no later than December 31, 2012 and will be effective upon filing.

CFTC Clarifies How CPO Exemption Applies to BDC Operators

On December 4, 2012, the DSIO clarified how the CFTC Rule 4.5 exclusion from registration as a CPO applies to BDCs.

The Division said that since BDCs are exempt from registration under the 1940 Act pursuant to Section 54 of the 1940 Act, their operators cannot rely on the Rule 4.5 exclusion from registration as a CPO. Accordingly, entering into even one swap contract can trigger the registration requirement for the BDC's operator.

The Division said that it would not recommend enforcement action against a BDC operator if the BDC:

- elects such BDC status under Section 54 of the 1940 Act;
- does not market participation interests to the public as a means for trading in futures, options or swaps; and
- limits its use of futures, options and swaps to the same extent as a registered investment company relying on Rule 4.5.

The relief is not self-executing. Thus, BDC operators must file a claim with the CFTC attesting to compliance with the provisions of the relief no later than December 31, 2012.

US Treasury Excludes FX Swaps and Forwards From Dodd-Frank Swaps Rules

On November 16, 2012 the Secretary of the Treasury issued a determination ("Determination") to exempt foreign exchange swaps and foreign exchange forward contracts from regulation as swaps under the Commodity Exchange Act. The Secretary's action, which was taken under section 721 and 722 of the Dodd-Frank Act, is not unexpected but will be welcomed by the financial services industry.

Click here to read our Client Alert for a more complete description of the Treasury's action, and what it means for the financial services industry.

Rule 4.5 and Rule 4.13(a)(3) CPO Exemption Notice Filing Deadline – December 31, 2012

On February 24, 2012, the CFTC issued final rules revising the requirements for determining which persons should be required to register as a CPO under Rule 4.5 and rescinding the exemption under Rule 4.13(a)(4) from CPO registration available to persons offering a pool whose participants are limited to qualified eligible persons.

The amended Rule 4.5 reinstates, with some modifications, a pre-2003 trading threshold and marketing restriction for advisers to mutual funds and RICs claiming an exclusion from the definition of CPO, and thereby from CFTC regulation. Compliance with the amended Rule 4.5 for registration purposes is required by December 31, 2012. However, compliance with the recordkeeping, reporting and disclosure requirements will not be required until 60 days following the effectiveness of a final rule implementing the CTFC's proposed harmonization effort.

The CFTC decided to rescind the 4.13(a)(4) exemption because these pools are not limited in the amount of commodity interest trading in which they can engage. Persons that currently operate a pool pursuant to the 4.13(a)(4) exemption must either register and be in compliance with applicable CFTC regulations or file notice of a different applicable exemption by December 31, 2012.

For more on Rule 4.5, please see the description of the recent case described below.

Enforcement + Litigation

Hedge Fund Advisory Firm Charged in Largest Insider Trading Scheme Ever Charged

On November 20, 2012, the SEC charged a Stamford-based hedge fund advisory firm and its former portfolio manager, together with a medical consultant for an expert network firm, for their roles in a $276 million insider trading scheme involving a clinical trial for an Alzheimer's drug being jointly developed by two pharmaceutical companies. The SEC said that the illicit

gains generated in this scheme make it the largest insider trading case it has ever brought.

The SEC alleged that a consultant provided by an expert network improperly disclosed to the portfolio manager information about specific unsuccessful drug trials conducted jointly by two medical companies, instead of limiting his observations to general medical issues, as required by the expert network.

After receiving this material non-public information, the portfolio manager sold large positions and took short positions in the securities issued by the medial companies. The SEC alleged that when the prices of those stocks dropped precipitously, the hedge fund and its affiliates made profits and avoided losses totaling $276 million.

The SEC brought civil charges against the portfolio manager and the consultant. The consultant agreed to settle the SEC action and cooperate in this and related SEC actions. The SEC seeks disgorgement, prejudgment interest, financial penalties, and an order permanently enjoining future violations of these provisions of the federal securities laws. The SEC's investigation is continuing.

In addition, the U.S. Attorney's Office for the Southern District of New York filed criminal securities fraud charges against the portfolio manager and reached a non-prosecution agreement with the consultant, who is 80 years of age.

SEC Charges Purported Investment Adviser with Fraud for Spending Investor Funds on Drugs, Gambling, Cigars and Travel

On November 19, 2012, the SEC charged a purported investment adviser with defrauding investors in connection with various investment schemes. In particular, the alleged "fraudster" raised approximately $3 million in investments for four start-up companies, and convinced investors to give him more than $1 million to invest in the markets on their behalf. In order to raise the money, he made a number of blatant misrepresentations to his investors, including that he was trading on their behalf when he was not and that he attended Nyack College—in reality, he had not even graduated from high school. According to the complaint, the respondent did not run any of these businesses, but rather spent approximately $1 million of investor funds on, among other things, "illegal narcotics, gambling, and personal travel."

The SEC charged respondent with violations of the anti-fraud provisions of the federal securities laws. The US Attorney's office for the Southern District of New York is pursuing criminal charges against respondent in a parallel action.

SEC Sanctions Investment Advisory Firms for Impeding Investigations, One Inflating AUM in Order to Register with the SEC

On November 20, 2012, the SEC sanctioned two investment advisory firms for impeding examinations performed by the SEC staff. One of the advisory firms failed to furnish the books and records of their business following the SEC's request for them in December of 2010. Only upon learning that the SEC intended to pursue enforcement action did the firm fully comply with the SEC's request, in September of 2012. Without admitting or denying any findings, the advisor agreed to pay a $20,000 penalty and to censures and cease and desist orders.

The other adviser allegedly did not merely delay compliance with the SEC's investigation, but rather deliberately misled the SEC with respect to the firm's assets under management. In that case, the firm had approximately $2.628 million under management. When asked for a list of clients, a principal at the firm allegedly manually modified a spreadsheet by changing the decimal places of each investor's account balances, thus increasing the firm's total apparent assets under management tenfold to $26.28 million. The purported purpose of the misrepresentations to the SEC was to allow the firm to inflate the firm's assets under management such that it would be allowed to register with the SEC under the Investment Advisers Act of 1940. The principal in question agreed to be barred from the securities industry and from associating with investment companies, with the right to reapply after two years. The firm consented to cease and desist orders, was censured, and will be required to provide a copy of the proceeding with the SEC to its clients, post a copy to its website, and disclose the proceeding in an amended Form ADV filing.

SEC Fines Adviser for Deficient Variable Annuity Disclosures

On November 15, 2012, the SEC fined an investment adviser for failing to sufficiently disclose the potential negative impact of a "cap" on an optional guaranteed minimum income benefit ("GMIB") offered with a variable annuity product.

The optional GMIB rider set a minimum floor for a future amount that could be applied to an annuity option. The GMIB value increased by a compound annual interest rate specified in the rider, subject to a cap. Although the variable annuity's prospectus disclosed cap, the SEC said that the prospectus did not adequately explain the effect of certain withdrawals.

Specifically, an investor could withdraw from the GMIB during the accumulation phase of a contract. Once the GMIB value reached the stated cap, however, withdrawals from the GMIB could cause pro-rata reductions in the GMIB value and the value of an investor's variable annuity contract. In certain cases, the value of a variable annuity contract and the related GMIB could decline to zero. The SEC asserted that neither investors nor sales personnel understood the risks.

Subsequent to the inception of the enforcement proceeding in this matter, the investment adviser revised the prospectuses to more accurately reflect the effect of post-cap withdrawals on the overall economics of the product. The adviser further revised the GMIB program to eliminate the cap entirely, eliminating the possibility that investors that purchased the GMIB option will be faced with a retirement annuity reduced to zero.

The SEC entered a cease and desist order against the investment adviser and fined it $1.625 million, noting that the relatively small size of the fine took into account the remedial steps taken by the adviser prior to finalization of the matter.

Federal Jury Acquits Prime Reserve Fund Managers of Fraud Charges

On November 12, 2012, a federal jury acquitted the managers of the Primary Reserve Fund of fraud charges. The SEC charged the portfolio managers for defrauding investors in the hours following the September 15, 2008 collapse of Lehman Brothers, as they tried to claim that the money market fund would not "break the buck."

The failure of Lehman Brothers triggered significant redemptions, and highlighted the challenges to the board and to management in fair valuing the debt instruments. The fund held $785 million of Lehman debt, consisting of about one percent of the fund's assets. Although the fund ceased operations shortly after September 16, 2008, when it broke the buck, investors eventually recovered more than 99 cents on the dollar on their investments, and there was no claw-back of redemption proceeds received by early redeemers.

The jury found that one of the mangers was negligent, and the management company made fraudulent statements to investors.

Although the fund's trustees were not charged in the proceeding, it was widely expected that the SEC would call them as "star witnesses." The SEC removed the trustees from the witness list days before the trial, presenting only limited testimony from one trustee.

The case serves as a reminder that in a fast-unfolding crisis involving fair valuation fund trustees should:

- stay fully informed,
- meet frequently,
- collect and act on facts not speculation or assumptions,
- keep their counsel in the loop, and
- continuously monitor redemptions and liquidity.

SEC Sanctions BDC and its Principal Officers for Fair Valuation Errors

The SEC settled an administrative proceeding against a publicly-traded fund regulated as a BDC and three of its executive officers. The fund allegedly materially overstated its assets during the 2008 global financial crisis because it did not account for market-based activity when fair valuing debt securities and collateralized loan obligations ("CLOs") in its portfolio. The fund's net asset value was overstated by approximately 27% as of December 31, 2008.

The fund allegedly failed to comply with FAS-157, which requiresfunds to disclose fair value measurements and to take into consideration an "exit price" when fair valuing securities. The exit price is the price that a fund would receive if it sold the asset in an orderly transaction between market participants at the measurement date. In addition, the SEC alleged that the fund's internal controls were not properly designed to address the effect of market inputs on fair valuation, or to ensure accurate financial reporting.

During the fourth quarter of 2008, the fund classified all debt securities in its portfolio as illiquid, although there were quotes and actual trades available for some of the securities. The fund calculated the fair value of these debt securities with reference to the enterprise value of a security's issuer, which does not result in an exit price for the securities. As a result, the fund overstated the fair value of the debt securities in its portfolio by 9%.

At the same time, management fair valued the two largest CLOs in the fund's portfolio (representing more than 70% of the CLO portfolio) at cost, without regard to market conditions. The fund did not disclose this valuation methodology. Rather, it disclosed a discounted cash flow valuation model used for the minority of the CLO portfolio. As a result of the variations in valuation methodologies, the fund overstated the value of its CLO portfolio by 64%.

In May 2010, the fund restated its financial statements for the fiscal year ended December 2008 and the first two fiscal quarters of 2009.

Notwithstanding the restatement of its financial statements, the SEC found that the fund violated the Exchange Act's record keeping and financial requirements. In addition, the SEC found that principal officers falsely certified to the adequacy of internal financial reporting controls designed to provide reasonable assurance regarding the reliability of financial reports. Without admitting or denying the allegations, the fund and each officer agreed to cease and desist from violations of the Exchange Act, and to pay a fine.

Federal Court Tosses ICI Challenge to Rule 4.5

On December 12, 2012, a federal district court dismissed a challenge by the Investment Company Institute and the Chamber of Commerce to amendments to Rules 4.5 and 4.27 adopted by the CFTC.

The ICI and the Chamber filed a joint lawsuit in April 2012 challenging the CFTC's amendment to Rule 4.5 requiring certain registered investment companies

to register with the CFTC as well as the SEC. In February 2012, the CFTC amended Rule 4.5, which stipulates that some registered investment advisers of mutual funds and exchange-traded funds ("ETFs") would qualify as commodity pool operators ("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 CFTC eliminated in 2003. In their complaint, the ICI and the Chamber alleged that the CFTC acted in an arbitrary and capricious manner and failed to satisfy its obligation to weigh the costs and benefits of the amended rule.

After hearing oral arguments, the Court granted the CFTC permission to file an additional brief and allowed the ICI to file a reply brief on the implications of the invalidation of the position limits rule for the definition of "bona fide hedging" used in Rule 4.5. The CFTC filed its supplemental brief on October 15, 2012. In the brief, the CFTC focused on the language in Rule 4.5 that, in determining eligibility for exclusion from the definition of CPO, a registered investment company need not count any position used for "bona fide hedging purposes…" The CFTC also filed a "clarification" regarding a statement its counsel made at the oral argument regarding the alternative net notional test.

In dismissing the challenge, the court said that "there was nothing arbitrary and capricious about the CFTC's decision to amend the rules, while assessing possibilities for harmonization of reporting requirements with the SEC. In addition, the court held that the CFTC met its specific obligations to consider and evaluate the costs and benefits of the final rule.

The plaintiffs "have thrown everything in the proverbial kitchen sink at the CFTC in their effort to stop" the CFTC's rules. The court said that it "is not persuaded by their arguments."

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