

Regulatory & Legislative Update: 3rd Quarter 2011



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The third quarter was quieter than prior periods as it relates to regulatory and legislative developments affecting investment companies and investment advisers. In general, there did not seem to be an abundance of new rules finalized, controversial new rule proposals or significant compliance dates during the period. That said, there are still many noteworthy events that occurred and are summarized below.

Most importantly, a number of existing rules had impending compliance dates that occupied significant resources and attention during the period. Probably the most significant of these was the compliance date for amendments to Rule 206(4)-5 (the “Pay to Play Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”) on September 13th. The ability to review and identify state and local government accounts subject to the rule’s requirements involved a substantial effort by investment advisers and the mutual funds they advise. The industry received an eleventh hour reprieve of sorts in the form of a no-action letter from the Securities and Exchange Commission (the “SEC”) on September 12th that provided relief from a related recordkeeping aspect of the Rule (Rule 204-2(a)(18) under the Advisers Act) that would have required investment advisers to obtain similar account information on underlying government plan accounts held in omnibus and networked accounts invested in mutual

funds advised by the investment adviser. Regardless of the relief, by now investment advisers should have identified all government accounts covered by the Pay to Play Rule for which they provide investment advisory services (directly or through covered investment pools) and have made plans on how they will maintain and update those lists for any new government account they advise in the future.

The second most significant regulatory issue faced by mutual funds during the third quarter was the upcoming cost basis reporting requirements on shares purchased on or after January 1, 2012. The relief provided by the Internal Revenue Service in June (Notice 2011-56) has made average cost a lot more customer friendly as a default method. Consequently, most funds have elected to use average cost as their default method, even though funds must notify their customers of this decision. Despite the IRS Notice regarding average cost, first-in, first-out (“FIFO”) and last-in, first out (“LIFO”) have remained popular default choices as well, based upon a fund’s facts and circumstances. By this time, most funds should have chosen a default basis method and begun solicitation of new Form W-9 information to identify S corporations that must now have cost basis information reported to them and the IRS beginning in 2012. In addition, funds should have commenced, or made plans for, communications with their customers, either through direct correspondence, statement messages, updates to their websites, or some combination of these. Funds must also consider any updates to their account applications to, at a minimum, identify new S corporation accounts, as well as disclose the fund’s default basis method and, if desired, provide an opportunity for investors to elect a different method. Funds will also want to examine their disclosure documents, such as the prospectus, and update them accordingly.

Another development that demanded significant attention during the third quarter was the Financial Industry Regulatory Authority (“FINRA”) registration and qualification examination requirement for backoffice broker-dealer personnel. The requirement under FINRA Rule 1230(b)(6), approved by the SEC on June 26th, was another outgrowth of the Bernard Maddoff case which had alleged that Mr. Maddoff had relied upon employees with little or no securities experience to generate fraudulent documents. Consequently, the new rule requires broker-dealers to identify Covered Persons, as defined within the rule, whether employed by the broker-dealer, an affiliate or a third party service provider, by October 17, 2011 and request registration as an Operations Professional via Form U4 on or before December 16, 2011. These Covered Persons will then have until October 17, 2012 to pass

the corresponding qualification examination. Any new person identified as an Operations Professional after December 16, 2011 will have to pass the qualifying examination prior to commencing any such covered functions.

The final requirement under the 2010 amendments to Rule 2a-7 under the Investment Company Act of 1940 also required a certain amount of attention from mutual funds and their boards during the quarter. The last requirement under the new money market fund amendments was for a fund's board to make a determination by October 31, 2011 that its money market funds and transfer agent have the ability to process transactions at a price other than \$1.00. While seemingly simple in theory, practical implications on same day settlement of shareholder transactions and tax reporting requirements for redemptions, at a price other than cost, among other issues, had to be considered and understood as part of the determination.

Noticeably absent from third quarter developments was substantive rulemaking provisions related to derivative securities, most significantly swaps and asset-backed securities. While the Commodity Futures Trading Commission ("CFTC") had indicated that they still expected to finalize several pending rules during the final quarter of 2011 and the first quarter of 2012, the SEC has not yet provided any indication as to when it will finalize its corresponding rulemaking. That said, the SEC issued a concept release on August 31st, requesting comments on the use of derivatives by investment companies and on companies engaged in the business of acquiring mortgages and mortgage-related instruments that are relying on the exemption from registration as an investment company provided in Section 3(c)5(C) of the Investment Company Act of 1940. The comments, which must be submitted on or before November 7th, are certain to be used by the SEC in future rulemaking efforts surrounding these types of investments.

In conclusion, while the third quarter appeared relatively quiet compared to previous quarters, it still had its moments in terms of significant industry angst and potential pitfalls. Maybe we are just getting used to a hyperactive state of regulatory and legislative activity or, alternatively, enjoying the eye of the hurricane.