

## Regulatory & Legislative Update: 1st Quarter 2011



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We are now beginning to feel the full affects of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). The first quarter provided for a substantial number of final rules, rule proposals and mandated studies being issued in response to some of the Dodd-Frank Act’s specific requirements. The Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”) have been working at an unprecedented pace in order to meet some of its requirements and regulatory deadlines.

A significant compliance date mandated by the Dodd-Frank Act relates to the July 21, 2011 deadline for SEC registration of certain investment advisers to private funds. Although the July 21st date is set under the Dodd-Frank Act, Bob Plaze, Associate Director in the SEC’s Division of Investment Management, provided some hope of a delay in a letter dated April 8, 2011 to the North American Securities Administrators Association. In the letter, Mr. Plaze indicated that the SEC staff expected the SEC to “consider extending the date by which these advisers must register and come into compliance with the obligations of a registered adviser until the first quarter of 2012.”

Another relevant compliance date related to the Dodd-Frank Act is the amendment to section 17Ad-17 of the Securities Exchange Act of 1934 (the “Exchange Act”), which also has a compliance date of July 21, 2011. This amendment deals with requirements within the Exchange Act for paying agents to provide written notification to each missing security holder sent a check that has not been negotiated within seven months of being mailed. The underlying rules to implement this change were proposed on March 18, 2011, but have not yet been finalized.

The SEC also issued two important (and controversial) studies during the quarter that had been mandated by the Dodd-Frank Act. The first was issued on January 14<sup>th</sup> and dealt with enhancing investment adviser examinations. The study emphasized the resource constraints faced by the SEC staff noting that the number of exams had decreased from 18% of all RIAs in 2004 to only 9% in 2010. In the study, the SEC staff recommended three options to strengthen the examination program: (i) impose user fees on RIAs to fund the examination program; (ii) authorize one or more self-regulatory organizations (“SROs”) to examine RIAs; or (iii) authorize the Financial Industry Regulatory Authority (“FINRA”) to examine the advisory activities of dually registered broker-dealers and investment advisers. A week later, on January 21<sup>st</sup>, the SEC staff issued a report to Congress that dealt with the obligations of brokers, dealers and investment advisers. In the study, the SEC staff concluded that: (i) investors are confused about differences between brokers and advisers; (ii) investors are unsure of their rights and protections when they receive advice about securities; and (iii) investors do not readily distinguish between an RIA’s fiduciary standard and a broker-dealer’s suitability standard. As a result, the study recommended that similar regulatory protections be provided to investors when brokers and advisers are performing substantially similar services and that brokers be held to a fiduciary standard.

Of the significant number of rule proposals issued during the first quarter to satisfy requirements within the Dodd-Frank Act, one of the most significant for investment companies and advisers was the March 3<sup>rd</sup> proposal to eliminate references to credit ratings within rules 2a-7 and 5b-3 under the Investment Company Act of 1940 (the “1940 Act”). This proposal would eliminate the objective standard provided by credit ratings for defining eligible and first-tier securities and replace it with a more subjective determination regarding a security’s credit risk. Eligible securities would be securities that represent minimal credit risks determined based upon factors pertaining to its credit quality and the issuer’s ability

to meet its short-term financial obligations. The determination of a first-tier security would be based upon the determination that the issuer had the highest capacity to meet its short-term obligations.

Two additional Dodd-Frank Act related rules proposed during the first quarter were the CFTC's proposal on January 26<sup>th</sup> to narrow the exclusion for registered investment companies within the definition of a commodity pool operator under CFTC Rule 4.5 and the SEC's January 26<sup>th</sup> rule proposal to require advisers to hedge and other private funds to report systemic risk information on new Form PF for use by the Financial Stability Oversight Council ("FSOC"). The rule proposal to narrow the commodity pool operator exclusion under Rule 4.5 would require certain funds to register as commodity pool operators, which would entail significant registration, reporting and disclosure burdens. In addition, requirements for systemic risk reporting on Form PF would subject investment advisers to substantial quarterly and annual reporting burdens regarding the types of assets, leverage, counterparty risk and other detailed information related to the investment advisers' business.

Despite this flurry of regulatory activity surrounding the Dodd-Frank Act, most of the actual compliance dates that will occur over the next two quarters are unrelated to Dodd-Frank. For example, effective April 11, 2011, amendments to the Bank Secrecy Act (the "BSA") began requiring mutual funds to create, retain and transmit certain information when sending or receiving funds as part of a cross-border transaction or extension of credit. Another important compliance date coming up, also not related to the Dodd-Frank Act, is September 13, 2011. This is the compliance date for new rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Advisers Act"). The rule is designed to address pay to play practices when an investment adviser or certain "covered associates" make political contributions or gifts to state and local government officials or candidates in circumstances that could suggest an attempt to influence the selection of the investment adviser to manage money on behalf of government entities. While the rule had a compliance date of March 14<sup>th</sup> for investment advisers to non-mutual funds, investment advisers to mutual funds have until September 13<sup>th</sup> to comply.

In an AML related item, the Financial Crimes Enforcement Network ("FinCEN") issued final regulations with respect to the Report of Foreign Bank and Financial Accounts ("FBAR") on February 24<sup>th</sup>. The final rule was effective March 28<sup>th</sup> and applies to reports required to be filed by June 30, 2011. Reports

filed for prior years that are taking advantage of the voluntary disclosure (amnesty) program may also rely upon the new regulations. FBAR filings are required for any U.S. person, including investment companies, that hold a financial interest in or signature or other authority over a foreign financial account with an aggregate value exceeding \$10,000 at any time during a calendar year. While the filing requirements for investment companies remained consistent with previous regulations, the exclusion for U.S. persons with signing authority, but no beneficial interest over a foreign financial account, was expanded to include, among other things, an officer or employee of an authorized service provider to a registered investment company. The regulations define an authorized service provider as an entity that is registered with and examined by the SEC. Accordingly, employees of a registered investment adviser with signing authority for an account owned or maintained by the investment company would not be required to file an FBAR unless such employee held a beneficial interest in the account.

The first quarter offered much insight into the future of financial services' regulatory reform. Although, at this time, most of this insight is in the form of rule proposals lining the walls at the SEC and CFTC waiting for enactment. If the SEC and CFTC are already feeling stress with respect to the number of rules and studies required under the Dodd-Frank Act, which some of the industry articles and studies suggest, it is hard to imagine how investment companies and advisers will be able to deal with the massive amount of anticipated regulations and reporting requirements