

Regulatory & Legislative Update: 2nd Quarter 2011



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With the U.S. debt ceiling crisis seemingly behind us (although the possibility of a downgrade on U.S. Government securities is still looming), let's take a minute to reflect on some of the regulatory and legislative events that occurred during the second quarter. For the investment management industry, the biggest event was the Securities and Exchange Commission's (the "SEC's") approval and issuance on June 22nd of final rules regarding the registration of investment advisers to private funds. The final rules delayed the initial registration deadline of July 21, 2011 that had been established under Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") until March 30, 2012, absent the adviser's ability to rely upon one of three available exemptions. Based upon the new compliance deadline, advisers required to register for the first time will need to file Form ADV with the SEC no later than February 14, 2012, in order to allow for the SEC's 45 day review period.

In other regulatory developments, the Internal Revenue Service (the "IRS") issued guidance in June regarding cost basis reporting on the redemption of mutual fund shares purchased after January 1, 2012. The guidance (Notice 2011-56) provided sought after relief for mutual funds by permitting fund shareholders to change basis methods more easily when a fund has chosen average cost as its default method. Under the initial regulations, a shareholder could not revoke average cost for prior purchases

when it was used as a fund's default method, since it had not been actively elected by the shareholder. However, the IRS clarified in the June guidance that shareholders can change a share's basis back to its original cost by revoking average cost as their basis method, as long as the change is requested by the earlier of: (i) one year after receiving notice of average cost as the fund's default method; or (ii) the date of the first sale, transfer or other disposition of fund shares. A fund can extend the one year period, as long as it doesn't extend beyond the date of the first sale, transfer or other disposition of the shares. As a result, the number of funds now choosing average cost as their default method has increased substantially, representing 90% of the default methods chosen by funds thus far, according to a recent informal survey conducted by the Investment Company Institute (the "ICI"). Now that these pieces have begun to fall into place, funds are planning shareholder communications and updates to account applications and disclosure documents in the late third and early fourth quarters of this year.

The SEC has also been extremely busy during the second quarter as it prepared to meet many of the requirements imposed by the Dodd-Frank Act by its one year anniversary. While the missed deadlines have been well publicized, the SEC has made significant process through several new finalized rules and numerous rule proposals. For example, on May 25th, the SEC adopted a final rule implementing the whistleblower provisions created under Section 922 of the Dodd-Frank Act. The rule, which becomes effective on August 12th, provides for a bounty to be awarded to individuals who voluntarily provide the SEC with original information that leads to a successful enforcement action, court or administrative, in which the SEC obtains monetary sanctions exceeding \$1 million. The amount of the award ranges from 10% to 30%, depending on various factors defined within the rule. In one of the most controversial aspects of the rule, a whistleblower is not required to report possible violations via a company's internal compliance process prior to reporting the information to the SEC. However, the final rule did incorporate certain provisions that were intended to strengthen incentives for employees to utilize his/her internal compliance programs before reporting information to the SEC, including: (i) increasing the amount of an award based upon participation in the company's internal compliance system and, likewise, decreasing the award amount for interfering with the company's compliance program; (ii) giving a whistleblower who reports original information to a company's compliance program credit for all information provided by the company to the SEC, regardless of whether or not the information was part of the whistleblower's original report to the company; and (iii) giving a

whistleblower credit for reporting the information to the SEC as of the date he/she reported it to the company, as long as the whistleblower or the company reports the information to the SEC within 120 days of the initial internal report.

Of the upcoming compliance dates over the next six months, none stands out more than the September 13th deadline for investment advisers' adherence to Rule 206(4)-5 under the Investment Advisers Act of 1940 (the "Advisers Act") addressing pay-to-play practices of advisers that are managing (or seeking to manage) money for participant directed plans of state or local government entities, such as public plans, retirement plans and 529 plans, through mutual funds they advise. The industry's efforts to delay implementation of the rule because of the difficulties in identifying such plans, whether held directly in the fund or held through the accounts of financial intermediaries, have been substantial but, so far, unsuccessful. In the meantime, investment advisers have been busy identifying covered accounts within the funds they manage and attempting to solicit enough information from their selling group members to also identify covered accounts within these omnibus and networked accounts. The Financial Industry Regulatory Authority ("FINRA") issued an Information Notice on June 6th encouraging members to assist investment advisers with their requirements under the pay-to-play rule, although, apparently, little assistance has been provided. In this regard, the ICI has represented to the SEC staff that no investment advisers will be in compliance with the rule by its September 13th deadline under current conditions.

Other important developments occurring in the second quarter included: (i) FINRA's \$1 million fine of Wells Fargo Advisors on May 5th for delays in delivering fund prospectuses and other reporting violations; (ii) the SEC rule proposal on May 10th to implement Dodd-Frank Act requirements regarding the review and indexing of new dollar amount thresholds for the ability of investment advisers to charge performance fees; and (iii) the June 13th U.S. Supreme Court decision in the Janus Capital Group, Inc. vs. First Derivative Traders case regarding the scope of primary liability in private actions brought under Rule 10b-5 under the 1934 Act. In the Wells Fargo action, even though the mutual funds involved were not cited for a failure to comply with the delivery requirements, all funds would be well served to note the warning signs, and procedural breakdowns, ignored by Wells Fargo within their own fulfillment process. The SEC rule proposal to change the limits for assessing performance based fees through

amendments to Rule 205-3 under the Advisers Act would revise investor net worth tests from \$750,000 in AUM with the adviser or total net worth of \$1.5 million to \$1 million and \$2 million, respectively. The proposal also sets forth a formula for future inflation adjustments to the investor net worth tests and certain grandfather provisions for fee arrangements that were permissible at the time the client had entered into the advisory agreement. Finally, in the Janus Capital decision, the Court, in a five to four decision, took a narrow view of the private right of action under Rule 10b-5 and determined that the investment adviser to the Fund could not be primarily responsible for false statements within the Fund's disclosure documents because they did not have "ultimate authority over the false statement." This ruling, while acknowledging the separation of the mutual fund structure from that of the investment adviser, could also be viewed as placing fund officers and directors on notice of their primary responsibility regarding such claims.

As you can tell, this year continues to be a hot bed for regulatory developments. More and more regulatory agencies and courts are considering financial matters than ever before. There are positives and negatives to this process. Regardless of your view on the pros and cons, we are in it for the long haul and market forces, government intervention and investor demands will ultimately strike equilibrium for our industry to operate effectively.