K&L GATES

Investment Management Update

Lawyers to the investment management industry

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In this issue:

SEC Enforcement Ramping Up Cases Against Advisers

By Stephen J. Crimmins

The last quarter has seen a significant upsurge in SEC enforcement cases against investment advisers. Much of this can be explained by the fact that the SEC Enforcement Division's new Asset Management Unit, the largest of its new specialized units, is now fully staffed with 65 lawyers and industry specialists, and by the fact that the unit's leaders have stressed that they are working hand-in-glove with the examinations staff in looking for new cases. This article analyzes the SEC's asset management cases over the last quarter to seek to identify its core prosecutorial interests and to suggest areas for enhanced compliance focus.

Regulatory Issues

After the examination staff turned up deficient policies and procedures at an investment adviser and its parent broker-dealer – including policies not followed in practice, policies not contained in written policies, and policies so unclear that employees did not understand them – the SEC entered into settlement with the registrant imposing penalties totalling $125,000. Notably, the SEC also required the firm to comply with undertakings to (i) retain and pay for an acceptable consultant to prepare, and copy the SEC staff on, a written report on the firm's policies and procedures; (ii) adopt the consultant's recommendations; and (iii) have the consultant visit again in six months to prepare, and again copy the SEC staff on, another written report on the firm's revised policies and procedures.[1]

In another matter, where an investment adviser and its CEO failed to produce required books and records to SEC examiners, and thus made it necessary for staff to issue a subpoena for the materials, and where the examination revealed ADV misstatements relating to the firm's ownership structure and the nature of its customer base, the SEC entered into a settlement agreement revoking the firm's investment adviser registration and suspending its CEO from investment adviser association.[2]

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Compliance Corner

XBRL Update

By Kathy Kresch Ingber

SEC rule amendments requiring mutual funds to file and post on their websites their risk/return summary information in an interactive data format, using "eXtensible Business Reporting Language," commonly referred to as "XBRL," became effective on January 1, 2011. Mutual funds now are required to file their risk/return summary information with the SEC in XBRL format no later than 15 business days after the effectiveness of a registration statement or the filing of a prospectus supplement. Mutual funds must post their XBRL files on their websites no later than the end of the calendar day the XBRL file is submitted to the SEC or is required to be submitted to the SEC, whichever is earlier. Links to the most recent mutual fund XBRL filings are available on the SEC's website at http://www.sec.gov/Archives/edgar/xbrlrss.all.xml.

K&L Gates has been working with clients and the SEC staff to make the new required XBRL filings and resolve questions as they arise. Recently, we had a discussion with the SEC staff regarding the applicability of the XBRL filing and website posting requirements to new series and classes. The SEC staff confirmed their prior advice. There are no exceptions to the XBRL filing requirements. XBRL filings must be made for newly-registered series and classes within 15 business days of the effectiveness of a fund's registration statement.

However, the SEC staff has advised that there may be a limited exception to the website posting requirements for a new series or class. If a new series or class is offered in a stand-alone prospectus, which is filed with the SEC in a separate post-effective amendment filing, the XBRL file need not be posted on a fund's website until the date that the new class or series is offered for sale. In this case, an XBRL file will include information only for the new series or class. However, if a new series or class is included in a post-effective amendment with other effective series and classes that are offered for sale, the XBRL file will contain risk return summary information for all series and classes in that post-effective amendment, including the new series or class. In that case, the XBRL file must be posted on a fund's website.

XBRL filings are intended to improve the usefulness of risk/return summary information for investors. XBRL files will allow investors to download mutual fund cost and performance information directly into spreadsheets, and analyze the data using easily accessible software or investment models. Interactive data also will facilitate the comparison of mutual fund cost and performance information across different funds and classes of the same fund.

Financial Services Reform

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most dramatic revision of the U.S. financial regulatory framework since the Great Depression. The Dodd-Frank Act covers a broad range of topics, including (among many others) a reorganization of federal financial regulators; a process designed to ensure financial systemic stability and the resolution of potentially insolvent financial firms; new rules for derivatives trading; the creation of a consumer financial-protection watchdog; the registration and regulation of hedge and private equity funds; the regulation of credit-rating agencies; and new federal requirements for residential mortgage loans.

K&L Gates has been at the forefront of the industry in updating our clients on the Dodd-Frank Act and its impact on their business. We have followed the implementing rulemakings closely at all levels, and our partners have been in constant dialogue with the various regulators as the rulemaking process has unfolded. In addition, our Public Policy practice has followed Congressional oversight hearings addressing the implementation of the Dodd-Frank Act, and our relationships on Capitol Hill have allowed us to understand how Congress is likely to try to affect these regulations. In order to share our knowledge with our clients, our partners have authored over 50 client alerts, articles and newsletters on the Dodd Frank Act, which can be found on our website by clicking here. The firm has also hosted numerous seminars and webinars for our clients to allow them to ask our partners questions about the new regulatory changes.

Even though much of the Dodd-Frank Act has not been implemented yet, we have been providing our clients with advice on its likely impact and counseling on compliance with the likely provisions. We have been advising a number of non-U.S. investment advisers on the scope of the new "foreign private adviser" exemption, and for non-U.S. advisers that have concluded that they will have to register with the SEC, we have been assisting in preparing their Forms ADV and compliance programs. We also have been following the implementation of the Volcker Rule as well as regulatory initiatives that are intended to address the systemic importance of non-bank financial institutions such as fund managers, including FSOC proposals and the SEC's and CFTC's proposed Form PF. We are counseling our clients on the likely impact of central clearing in the over-the-counter derivatives markets and helping them to implement corresponding amendments to ISDA agreements. In addition, we have been assisting our clients in preparing letters commenting on regulatory proposals, reflecting their desire to try to shape important rulemakings pro-actively.

Standard & Poor's Market Value Securities Proposal . . . and the Ripple Effects on Closed-End Funds

By David P. Glatz

Credit rating agencies shouldered plenty of blame for the recent meltdown in the U.S. securities markets. The regulatory spotlight of the Dodd-Frank Wall Street Reform and Consumer Protection Act increased the heat on these entities, effectively changing the landscape in which they operate. Closed-end funds registered under the Investment Company Act of 1940 (CEFs), which frequently leverage their portfolios by issuing preferred stock and debt securities that are rated by credit rating agencies, have experienced the ripple effects of these changes. This article addresses Standard & Poor's proposed overhaul of its criteria and methodology for rating "market value securities," including rated CEF leveraged products, and analyzes the resulting impact on these funds.

Background

On August 31, 2010, Standard & Poor's published a request for comment on its proposed changes in methodology and criteria for rating *market value securities*, which are securities to be repaid or redeemed primarily from funds generated by open market sales of portfolio assets, rather than securities held to maturity. In its proposal, S&P targeted the following types of market value securities:

- securities issued by CEFs;
- market value collateralized debt obligations;
- structured investment vehicles; and
- certain extendible asset-backed commercial paper programs.

This article focuses on market value securities, such as preferred stock and debt securities, issued by CEFs. CEFs typically issue these securities to leverage their portfolios, or to refinance or redeem existing forms of leverage. The S&P proposal noted that CEFs are heavily regulated under the Investment Company Act, which limits the funds' ability to leverage and mandates asset coverage of 200% (for leverage in the form of equity) and 300% (for leverage in the form of debt). Furthermore, S&P observed that, in over 30 years of rating CEF securities, no CEF has ever issued a security that has been downgraded or has defaulted. However, as described below, this history did not spare CEFs from the consequences of S&P's proposed sea change in rating market value securities.

The Rating Process

When a credit rating agency evaluates preferred stock or debt securities to be issued by a CEF, for the purpose of publishing a rating on these securities, the agency independently values each portfolio asset held by the fund. S&P observed that most of the assets held by leveraged CEFs have remaining maturities of more than 10 years. In the sample of 90 rated CEF leverage products that S&P tested, 41.75% of the assets had tenures of 10-20 years, and 39.97% had tenures greater than 20 years. By contrast, the leverage products sold by CEFs typically have maturities of much shorter duration (3-9 years). As part of the rating process, credit rating agencies customarily discount, or reduce, the current market value of each portfolio asset held by a CEF. This reduction in value or "haircut" accounts for the possibility that a CEF may be forced to sell the portfolio asset prior to its maturity, at the market price then in effect, in order to generate cash needed to redeem or retire a rated leverage product (preferred stock or debt securities).

Details of the S&P Proposal

The S&P proposal reflects drastic increases to the reductions in value, or "haircuts," S&P would apply to a CEF's portfolio assets in the process of rating a CEF market value security. The S&P proposal anchored these increased haircuts to the worst price declines experienced by each type of portfolio asset (e.g., municipal bonds, corporate debt, common equity) in any rolling six-month period during the past 30 years. S&P also tested the proposed revisions to its methodology and criteria by applying them to a sample of 90 AAA-rated securities issued by leveraged CEFs. Under the revised methodology and criteria, S&P found that:

- all 90 of the securities could withstand the proposed 'BBB' stress level;
- 86 (95.6%) could withstand the proposed 'A' stress level;
- 49 (53.4%) could withstand the proposed 'AA' stress level; and
- *only one* (1.11%) could withstand the proposed 'AAA' stress scenario.

The revised methodology and criteria reflected in the S&P proposal would apply to every outstanding market value security rated by S&P, as well as new issues of such securities that come to market after the revised methodology and criteria are finalized.

Timeline

S&P established a comment period that expired on October 29, 2010. As of January 2011, S&P staff is reviewing and assessing the comments received by industry participants. S&P has not published an expected effective date for the revised methodology and criteria. However, S&P staffers have indicated that they are sensitive to the changes in documentation and marketing efforts that will be required as a result of the new methodology and criteria. Given the extreme changes proposed, CEFs will need time to explain the new S&P rating criteria to their boards of directors, underwriters and stock exchanges.

Impact on Outstanding CEF Market Value Securities

Under the governing documents of most rated CEF leverage products (*i.e.*, statement of preferences for preferred stock; indenture for debt securities), a rating downgrade may result in an increase in the "coupon" (dividend rate on preferred stock or interest rate on debt securities) payable on the product. If a given leverage product is rated by more than one credit rating agency, the increased coupon may be activated upon a downgrade by any credit rating agency (single trigger) or only if more than one credit rating agency downgrades the product (double trigger). Furthermore, a downgrade caused by S&P's revised methodology and criteria may decrease secondary market pricing and reduce trading volumes for rated leverage products. Given the potential negative impacts of the S&P proposal, CEFs should consider disclosing the possible effects of a downgrade by S&P under the proposal.

Impact on New Issues of CEF Market Value Securities

CEFs with new issues of market value securities in the pipeline have a similar set of issues to consider. Similar to CEFs with currently outstanding market value securities, CEFs contemplating a new issuance of preferred stock or debt securities should consider disclosing the S&P proposal and its potential impacts in the prospectus or other offering documentation. This disclosure may address the possibility that:

- S&P's ultimate rating of the securities may not satisfy the conditions of the underwriting agreement, in which case the offering may fail;
- S&P may downgrade the securities after the offering is settled;
- the secondary market price of the securities may decrease if S&P downgrades the securities; and
- the fund may have to increase the coupon rate on the securities in the event of a downgrade by S&P (this may be a positive development for the purchasers of the securities in the offering, but it would be detrimental to the common shareholders).

In addition, CEFs should review board resolutions approving the issuance to determine if a "refresh" of the board approvals is required. For example, did the board approve the offering of preferred stock or debt securities on the assumption or condition that the securities would be AAA-rated by S&P? If so, management should explain to the board the S&P proposal and its potential effects on the preferred stock or debt securities offering, as well as the potential impact on the fund and its common shareholders.

Key Open Issues

Until S&P publishes the final criteria and methodology for rating market value securities, several open issues loom on the horizon for CEFs with outstanding market value securities, as well as CEFs contemplating new issues of such securities, including:

- how closely will the final revised criteria and methodology hew to the proposal?
- what, if any, influence will comments received by S&P have on the final criteria?
- how will other credit rating agencies react to S&P's final criteria – will they engage in a "rush of the lemmings" or exhibit true independence?
- what effect will the final criteria and methodology have on secondary market pricing and marketing efforts of CEF leverage products? Will AA be "the new AAA"? ■

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English Lessons for Dealings with the Islamic World

By Jonathan Lawrence

At first glance, a preliminary judgment in the English High Court of Justice presented a major stumbling block to the development of Islamic compliant transactions and dealings with Muslim clients throughout the world. The High Court dealt at first instance with all English high value and high profile commercial cases. Viewed purely on its merits, the case did not seem to have an immediate effect for non-English participants. However, the lessons that have been derived from the case are relevant to any investment management company, fund or investor in Islamic deals or any of those entities that deal with companies or individual investors who run their business dealings in accordance with Islamic principles. This article will provide an outline of this important case, including recent developments, describe the outcome and provide a guide to the lessons learnt for participants in the Islamic finance industry.

The dispute

The case of *The Investment Dar Company KSCC v Blom Development Bank SAL [2009] EWHC 3545 (Ch)* was the subject of a judgment on 11 December 2009. Dar is a Kuwaiti firm started in 1994 that specialises in consumer Islamic finance. Blom is an Islamic bank established in Lebanon in 2005. Blom had made various deposits with Dar pursuant to a master Wakala contract and individual contracts made purportedly pursuant to the terms of the main contract. The master contract and all individual contracts were expressly governed by English law. Wakala is a contract under which one party appoints another as its agent to manage an investment on its behalf. The investment manager will be considered an agent of the investor and will be entitled to a pre-agreed fixed fee, or a fee calculated as a percentage of the net asset value of the investment. The fee may be paid on account with a reconciliation made on a winding-up of the investment.

Dar is incorporated in Kuwait. Under its memorandum of association, the objectives of the company are Sharia compliant. None of the objectives of the company shall be construed and interpreted as permitting Dar to practice directly or indirectly any usury or non-Sharia complaint activities. In addition, Dar must carry out all financial transactions in a Sharia compliant manner.

Dar has a committee of distinguished Sharia scholars who appeared to satisfy themselves that the range of transactions undertaken by Dar were Islamic compliant. The Wakala contract also appeared to preclude Dar from taking any point on non-compliance with Sharia guidelines.

The result of the contract was that any deposit would be at a specified rate of return, for example, 5%. It could not be less than 5%. It could not be more than 5%. Dar was bound to pay that sum unconditionally, and Blom, under no circumstances, had the right to any more than that sum.

Dar complained that the contract amounted to a non-compliant Sharia transaction because, in reality and substance, Dar was taking deposits and paying out interest. In effect, the Wakala contract provided that Blom appointed Dar as its agent (or Wakeel) and to invest/deposit with Dar its funds from time to time. For all intents and purposes, the commercial result was equivalent to that of a deposit that gained interest. This provision, on its face, therefore appears to offend against certain fundamental rules of Sharia law, namely that money should not be used as a means to increase money and that interest is not permissible.

Blom disputed that claim. Dar's Sharia committee had authorized and approved this form of contract. This was a strong indication that the contract was indeed Islamic compliant. However, Dar put forward evidence that, as its corporate entity was governed by the law of its place of incorporation, Kuwait, the fact that the master contract was governed by English law was not relevant. There was, therefore, a triable issue on that point. The High Court judge believed that expert evidence on Sharia matters was needed to resolve this issue and therefore the matter should go to trial.

The judge concluded that there was no trust claim that could be made by Blom against Dar. The payments to Dar were made to enable Dar to invest the monies in its treasury pool and to make payments out of that pool to satisfy its own contractual obligations in circumstances where the parties believed that the Wakala transactions were valid.

Ultimately, if the master Wakala contract was found to be within the parties' powers, the contract claim of Blom would succeed. If not, the restitutionary claim of Blom would succeed. Either way, Dar would be liable, for at least the whole of the principal amounts deposited. In those circumstances, the judge ordered an interim payment by Dar of the whole of the principal amount claimed. Dar would be allowed to appeal if an interim payment was made. The judge therefore ordered Dar to make the interim payment to Blom unconditionally in the amount of the judgement sum.

The outcome

Dar did not meet the May 25, 2010 deadline to pay the $10,700,000 into the High Court and an out-of-court settlement may now be sought. Dar is in financial difficulties and is restructuring all of its debt. Dar's Sharia board issued a statement on June 8, 2010 barring the Kuwaiti company from using arguments based on Islamic law, and the board advised Dar to drop the case. If the case had continued, there was concern in the Islamic finance market that other companies and investors could use a lack of Sharia compliance to avoid contractual obligations. The outcome of the case has been a reassessment of the parameters under which investment companies and firms should seek to enter into Islamic finance transactions. Market participants should ask their lawyers to review their agreements in this area with a greater regard for the risk of disgruntled parties citing lack of Sharia compliance as a reason for voiding a contract.

The lessons learned

- Do not view the judgment as undermining the Islamic finance market. The English High Court used its power to order an interim payment to allow Blom to recover its initial investment before the claim could proceed to trial.
- Lack of capacity is not a new legal risk and can arise on any transaction where a counterparty is incorporated with limited capacity and contracts outside that capacity are void.
- Ensure that you review the constitutional documents of any Islamic financial institutions with whom you deal and that you obtain appropriate local advice as to their meaning and scope.
- Confirm that in all your documentation, the representations and warranties confirm that the parties are satisfied with the Sharia compliance of the agreement.
- Include a provision in which each party agrees that it will not seek to challenge the enforceability of the agreement in the future for reasons of non-compliance with Islamic principles.
- Provide a governing law clause that confirms that the contract is governed only by the laws of a country jurisdiction (and not by reference to Islamic law).
- Obtain a legal opinion from the lawyers in the place of incorporation of your counterparty and request to see the opinion of your counterparty's Sharia board so that you know that the test of Sharia compliance has been passed.

Conclusion

Market confidence has been affected by this judgment. However, the practical resolution and discussion of issues has highlighted the need for extra steps to be taken in order to avoid the "Sharia risk" that can arise when dealing in the Islamic finance world or with counterparties who abide by Islamic principles. ■

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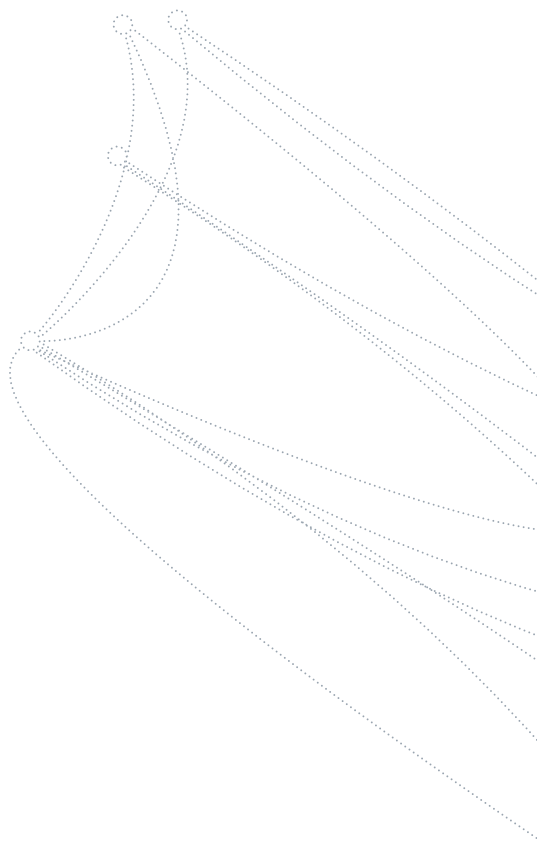

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Whistleblower Procedures: An Incentive for Internal Reporting

By Francine J. Rosenberger and Kathy Kresch Ingber

The Securities and Exchange Commission has proposed Regulation 21F ("Proposed Rules") to implement the new whistleblower program created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). The Proposed Rules raise a number of concerns for investment advisers and investment companies regarding the impact on internal reporting and investigation of whistleblower reports. In anticipation of the adoption of the Proposed Rules by the April 21, 2011 deadline, advisers and investment companies may wish to evaluate their internal reporting processes and adopt or enhance whistleblower procedures. Even though the Proposed Rules have not been adopted, the SEC already has seen an increase in whistleblower reports since the Dodd-Frank whistleblower program was created.

The Dodd-Frank Whistleblower Program

The Dodd-Frank whistleblower program provides a broad framework for the confidential reporting of potential violations of the federal securities laws to the SEC and the award of bounties to whistleblowers under certain circumstances. This program is codified in Section 21F of the Securities Exchange Act of 1934. Under the program, a whistleblower is eligible for a monetary award if the whistleblower voluntarily provides original information to the SEC about a violation that leads to an enforcement or judicial action with sanctions exceeding $1 million. Whistleblower awards will be significant, ranging from 10% to 30% of the monetary sanctions collected, or at least $100,000 to $300,000 for an action with $1 million in monetary sanctions. There is no cap on such awards, which will be funded by the newly created "Securities and Exchange Commission Investor Protection Fund."

To complement the creation of the whistleblower program, the Dodd-Frank Act includes provisions to protect whistleblowers from employer retaliation. An employer may not "discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistleblower in the terms and conditions of employment." The Dodd-Frank Act also provides a private right of action for whistleblowers who become the subjects of retaliation, allowing them to bring an action in federal court seeking double back-pay, reinstatement with appropriate seniority, attorney and expert costs and other relief.

The Proposed Rules

The Proposed Rules, like the statute, would authorize the SEC to pay a monetary award to one or more *whistleblowers* who *voluntarily* provide the SEC with *original information* that leads to *successful enforcement by the SEC* of a judicial or administrative action in which the SEC obtains *monetary sanctions* totaling more than $1 million.

The SEC has proposed the following definitions that build a framework to implement the whistleblower program:

A *whistleblower* is defined as an individual, who alone or jointly with others, provides the SEC with information relating to a potential violation of the federal securities laws. A company cannot be a whistleblower — only a natural person will be eligible for an award. A whistleblower will be deemed to have provided information *voluntarily* if the whistleblower provided the SEC with information before the whistleblower or the whistleblower's employer receives any formal or informal request, inquiry or demand from the SEC, Congress, any other federal, state or local authority, any self-regulatory organization or the Public Company Accounting Oversight Board.

Under the Proposed Rules, information will be deemed to be *original* if it is derived from a whistleblower's *independent knowledge or independent analysis*. This means that a whistleblower must be the first in the door at the SEC with information that the SEC does not already have. *Independent knowledge* is defined as information in the possession of a whistleblower that is not derived from publicly available sources. *Independent analysis* means the whistleblower's own analysis, whether done alone or in combination with others.

Under the Proposed Rules, information will not be considered to be derived from *independent knowledge or independent analysis* if it was obtained through a communication subject to the

attorney-client privilege, the legal representation of a client, or the performance of an engagement by an independent accountant. An exception would make attorneys eligible to report even privileged information, to the etent that they are otherwise permitted to do so, such as under applicable legal ethics or SEC rules, such as the SEC "up in the ladder" rules, which permit attorneys to report information to the SEC under certain circumstances.

Also excluded from the definition of "independent knowledge" will be information regarding a violation that was (1) communicated to a compliance officer, or other person with legal, audit, supervisory or governance responsibilities with the reasonable expectation that such individual will take steps to cause a company to respond appropriately to the violation, or (2) uncovered through a company's legal, audit or compliance process, *unless* the company does not disclose the violation to the SEC within a reasonable period of time or proceeded in bad faith. The Proposed Rules do not specify a period that would be considered to be "reasonable," but rather indicate that this determination will be made based upon a review of all circumstances, "after the fact."

The effect of these exceptions is that the following persons are generally, but not invariably, excluded from becoming whistleblowers: (1) an attorney who obtains information through privileged communications with a client or the representation of an individual or a firm; (2) an independent public accountant who obtains information in connection with the audit of a company's financial statements; (3) an officer (including a compliance officer), director or employee who learns of a potential violation as part of his or her corporate responsibilities with the expectation that such individual will take steps to address the violation; or (4) anyone who obtains information from each of the above individuals.

Information will be considered to have led to *successful enforcement* action if the information causes the SEC staff to open or reopen an examination or investigation and significantly contributes to the success of the action, or is essential to the success of an ongoing examination or investigation and would not otherwise have been obtained in the normal course of the examination or investigation. A *monetary sanction* would be defined as all moneys, including penalties, disgorgement, and interest ordered to be paid or deposited into a disgorgement fund or other fund created pursuant to the Sarbanes-Oxley Act of 2002 as a result of an SEC-related action.

Considerations for Determining a Monetary Award. While the statute requires that monetary awards be at least 10 percent, but no more than 30 percent, of the total monetary sanctions in a matter, the release accompanying the Proposed Rules ("Proposing Release") clarifies that the specific amount of a monetary award will be recommended to the SEC by the SEC's Whistleblower Office and designated SEC staff. The Proposed Rules enumerate the factors that will be considered in determining the amount of a monetary award to a whistleblower. The first three factors are in the statute. The fourth has been proposed by the SEC pursuant to the SEC's statutory authority to establish additional factors by regulation.

- The significance of the information provided to the success of the SEC action or a related action;
- The degree of assistance provided by the whistleblower and any legal representative in the SEC action or a related action;
- The programmatic interest of the SEC in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws; and
- Whether the award otherwise enhances the SEC's ability to enforce the federal securities laws, protect investors and encourage the submission of high quality information from whistleblowers.

In the Proposing Release, the SEC suggested that it may *also* consider additional factors in determining the amount of a monetary award, including, whether, and the extent to which, the whistleblower reported the potential violation through effective whistleblower, legal or compliance procedures before reporting a violation to the SEC.

Disincentive to Report Internally. In the Proposing Release, the SEC stated that the Proposed Rules include provisions "intended not to discourage whistleblowers who work for companies that have robust compliance programs to first report the violation to the appropriate company personnel." Having said this, however, the Proposed Rules do nothing to encourage whistleblowers to first report violations internally. They do not require a whistleblower to report a violation internally before reporting the violation to the SEC and do not reward a whistleblower for doing so. Furthermore, internal reporting may — but need not be — considered by the SEC in determining the amount of a monetary award. Where a whistleblower does first report internally, the Proposed Rules would preserve that whistleblower's "place in line" as the original source of the information if the whistleblower submits information to the SEC within 90 days after reporting the information to an internal legal or compliance officer, or another authority.

Anti-Retaliation Provisions. The Proposed Rules do not address the interpretation or implementation of the anti-retaliation provisions of the statute. However, the SEC solicited comment on whether rules should be promulgated and, if so, what specific rules the SEC should consider.

Investment Advisers and Investment Companies

The whistleblower program will affect advisers and investment companies, as well as public companies, brokers, dealers and securities exchanges. To stay one step ahead of potential whistleblowers, it will be important for advisers and investment companies to consider implementing procedures that establish clear guidelines for the internal reporting and investigation of violations and imposition of related sanctions. Dodd-Frank does not require the adoption of comprehensive whistleblower

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The SEC's New Pay-to-Play Rule: Practical Guidance For Investment Advisers

By Kay Gordon, David Dickstein and Richard Guidice

Introduction

On July 1, 2010, the Securities and Exchange Commission ("SEC") adopted Rule 206(4)-5 (the "Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to address pay-to-play practices under which direct or indirect payments by investment advisers to state and local government officials are perceived to improperly influence the award of government investment business.[1] This article provides some practical guidance for investment advisers who are required to comply with the Rule.[2] Given the broad coverage of the Rule and its extensive recordkeeping requirements, investment advisers are cautioned to dedicate sufficient time and resources to developing policies and procedures prior to the compliance date of March 14, 2011 (or September 13, 2011 for fund advisers).

Modeled on Municipal Securities Rulemaking Board ("MSRB") Rules G-37 and G-38, which address pay-to-play practices among municipal securities dealers, the Rule prohibits an investment adviser from (i) providing advisory services for compensation to a government entity client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates,[3] (ii) providing direct or indirect payments to any third party that solicits government entities for advisory business unless this third party is a registered broker-dealer or investment adviser itself subject to pay-to-play restrictions, and (iii) soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The Rule permits certain exemptions from the two-year time out, including, but not limited to, allowing individual covered associates (not advisers) to make aggregate contributions of up to $350 per election to an elected official or candidate for whom the individual is entitled to vote, and up to $150 per election to an elected official or candidate for whom the individual is not entitled to vote.[4] Although modeled on the corresponding MSRB rules, the Rule has a broader reach, and organizations subject to both regulatory regimes will need to carefully consider appropriate modifications to existing procedures under the MSRB rules for compliance with the new Rule.

Who Are an Adviser's "Covered Associates"?

Under the Rule, a "covered associate" of an adviser means (i) any general partner, managing member or executive officer, or other individual with a similar status or function, (ii) any employee who solicits a government entity for the adviser and any person who supervises, directly or indirectly, such employee,[5] and (iii) any Political Action Committee ("PAC") controlled by the adviser or by any persons described in clauses (i) or (ii).[6] The term "executive officer" includes any senior officer of the adviser, as well as anyone in charge of a principal business unit, division, or function (e.g., sales, administration, or finance), and any other officer of the adviser or person who performs a "policy-making function," whether or not an employee of the adviser. The SEC has indicated that whether a person is an executive officer depends on that person's "function, not title" and that the Rule is intended to apply to "those officers of an investment adviser whose position in the organization is more likely to incentivize them to obtain or retain clients for the investment adviser (and, therefore, to engage in pay-to-play practices)." Because the nature of their status alone creates a strong incentive to engage in pay-to-play practices, all executive officers of advisers should be considered covered associates under the Rule, even if such officers are not directly involved in advisory or solicitation activities.

Contributions by any of the adviser's covered associates are required to be recorded. However, contributions to PACs generally would not trigger the two-year time out under the Rule, unless designed to circumvent the Rule via indirect actions that would result in a violation of the Rule if done directly. For example, if a PAC is soliciting funds for the purpose of supporting a limited number of government officials, then, depending upon the facts and circumstances, contributions to the PAC might well result in the same prohibition under the Rule as would a contribution made directly to the official. Accordingly, as part of

its compliance program, an adviser or covered associate that receives a general solicitation to make a contribution to a PAC should consider inquiring about how the collected funds would be used to determine whether the PAC is closely associated with a government official to whom a direct contribution would subject the adviser to the two-year time out.

Careful analysis of the individuals that may be deemed covered associates under the Rule will be necessary to prevent potential violations of the prohibition on contributions to officials and to comply with the Rule's recordkeeping requirements. Identifying covered associates, particularly in large, multi-tiered organizations, may prove to be especially challenging for many advisers. For example, persons who are employed by an affiliate or parent of an adviser may fall within the definition of a "covered associate" of the adviser if they have a "policy-making" role with respect to the adviser or supervise any sales efforts for the adviser involving public funds.[7] As stated above, the focus should be on the individual's function and not his or her title or placement in the adviser's organizational structure.

Establishing a Compliance Program

Generally, advisers will have until March 14, 2011 to develop policies and come into compliance with the Rule, except for advisers to registered investment companies that are covered investment pools, who will have until September 13, 2011. We recommend that investment advisers develop and implement, as soon as possible, a program to establish compliance with the Rule that includes, at a minimum, the following elements:

- A system for identifying the adviser's covered associates should be developed and each such person should be promptly informed of his or her status as a covered associate.
- Similarly, a system for identifying the adviser's government entity clients and potential government entity clients should be developed, and legal counsel should be consulted to better understand the legal considerations that may be applicable to certain clients and potential clients in light of such clients' legal structures and the Rule's requirements.
- Policies and procedures should be developed governing the political contributions of covered associates, including prohibiting such persons from making contributions to certain political candidates and internally reporting and coordinating permitted contributions or political fundraisers.
- Advisers should develop procedures that are reasonably designed to track and monitor permitted political contributions not only by covered associates, but also by individuals being considered for hire and promotion into restricted positions, to ensure that they have not made political contributions in violation of the Rule during the two-year period prior to the hire or promotion. For example, advisers should consider whether to require pre-clearance and reporting of political contributions in a manner that is similar to the requirements advisers have in place regarding personal trading.
- Training should be provided to all covered associates concerning the requirements of the Rule and the firm's program, as well as the consequences of non-compliance.
- Advisers must modify their recordkeeping policies and procedures to ensure that they maintain required records under recent amendments to Rule 204-2 under the Advisers Act which relate to the enactment of the Rule.[8]
- Advisers that control a PAC (including via their covered associates) should consider implementing procedures and amending the PAC's governing documents to include a statement to the effect that contributions to the PAC will not be used for evading the Rule.
- Advisers should re-examine their relationships with third parties, including any referral and solicitation arrangements, to inadvertently avoid running afoul of the Rule, MSRB rules or state law, as applicable.

Advisers (and their affiliates) that solicit government entities should be cognizant of relevant state laws as well (which may have different requirements and restrictions from the Rule concerning covered associates, contributions, time-out periods, etc.), and ensure that their compliance programs also take into account those laws. For example, California recently passed a unique law in this area (i.e., Assembly Bill 1743), which requires (with limited exceptions) that placement agents (which may include third-party solicitors and an adviser's own employees and affiliates) who solicit California state public pension systems for advisers and their managed funds (including hedge, venture capital and private equity funds) register as lobbyists and comply with the California Political Reform Act of 1974.[9] AB 1743 also prohibits placement agents from accepting contingent fees in connection with investments by California state public pension systems.

Dodd-Frank Act Amendments to the Rule

The SEC recently proposed three amendments to the Rule in response to the enactment of the Dodd-Frank Act. First, the SEC proposed to amend the scope of the Rule to make it apply to exempt reporting advisers and foreign private advisers.[10] Second, the SEC proposed to amend the provision of the Rule that prohibits advisers from paying persons (*e.g.*, "solicitors" or "placement agents") to solicit government entities unless such persons are "regulated persons" (*i.e.*, registered investment advisers or broker-dealers subject to rules of a registered national securities association, such as FINRA, that restricts its members from engaging in pay-to-play activities). In particular, in accordance with the proposal, the SEC would permit an adviser to pay a "regulated municipal advisor" to solicit government entities

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New Regulation of Municipal Advisors: Solicitors of Municipal Entities Beware

By Nicholas S. Hodge and Pablo J. Man

Following an extended honeymoon period of what SEC Chairperson Mary Schapiro characterizes as largely unregulated "dubious arrangements between fund managers and municipal officials"[1] that are believed to have resulted in municipal bankruptcies and other scandals affecting the municipal securities market, the SEC recently proposed and adopted rules requiring the registration of "municipal advisors" and regulating investment advisers' pay-to-play practices. Prior to the proposal and the SEC's adoption of these rules, the SEC and state authorities had brought numerous enforcement actions, especially with respect to pay-to-play arrangements, the details of which have been widely reported. However, municipal advisors had not been required to register under federal law and had been only minimally regulated. As can often be the case after a series of scandals receive national attention, the ensuing regulations are expansive and will affect a broad spectrum of industry participants. This article seeks to underscore some of the more noteworthy provisions in these regulations, including a possible trap for unwary solicitors.

Section 975 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") amended Section 15B of the Securities Exchange Act of 1934 (the "Exchange Act") to make it unlawful for an unregistered municipal advisor "to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person." Section 975 of Dodd-Frank provided for an effective date of October 1, 2010, so the SEC adopted interim final temporary rule 15Ba2-6T and Form MA-T under the Exchange Act to enable municipal advisors to register. Then, on December 20, 2010, the SEC proposed Rules 15Ba1-1 through 15Ba1-7 under the Exchange Act (the "Proposed Rules" and each a "Proposed Rule") that would establish a permanent registration regime and impose certain record-keeping requirements. Comments on the Proposed Rule were due to the SEC on February 22, 2011.

The registration requirement is intended to "strengthen oversight of municipal securities and broaden current municipal securities market protections to cover, among other things, previously unregulated market participants." [2] In addition, the information provided to the SEC under the Proposed Rules will become publicly available and is intended to assist municipal entities and others when dealing with municipal advisors.[3] Municipal advisors will be subject to examination by the SEC and will also need to register with the Municipal Securities Rulemaking Board.

Section 15B and the Proposed Rules have cast a wider net than may at first be apparent. While the definition of "municipal advisor" excludes certain categories of persons,[4] including a registered broker-dealer serving as an underwriter and a registered investment adviser providing only investment advice, it extends well beyond persons providing advice to municipal entities with respect to municipal products or the issuance of municipal securities. In particular, broker-dealers that solicit municipal entities on behalf of fund managers are required to register as municipal advisors. Likewise, third-party solicitors that solicit municipal entities on behalf of investment advisers are required to register as municipal advisors. The SEC noted in its Proposed Rules Release that "unless an exclusion applies, any third-party solicitor that seeks business on behalf of a broker, dealer, municipal securities dealer, municipal advisor or investment adviser from a municipal entity must register as a 'municipal advisor.'"[5] Moreover, there is no *de minimis* exception from the registration requirement: "a solicitation of a single investment of any amount in a municipal entity" would require registration as a municipal advisor. This is a possible trap for broker-dealers and third-party solicitors who solicit municipal entities but who otherwise have no dealings with municipal entities.

In addition, if the SEC adopts its proposed amendment to Rule 206(4)-5 (the "Pay-to-Play Rule"), dated November 19, 2010, affiliated entities of an investment adviser that are compensated by the adviser to solicit government

entities would be required to register as municipal advisors. Section 975 of Dodd-Frank[6] requires only finders and solicitors that are *unaffiliated* with the investment adviser on whose behalf they solicit for compensation to register as municipal advisors. Under the proposed amendment to the Pay-to-Play Rule, however, an investment adviser would be permitted to pay for solicitation of government entities only if the party receiving payment, including an affiliated entity of the adviser, were registered as a municipal advisor. The SEC has taken the position under the Proposed Rules that such affiliated entities, although not required to register under Dodd-Frank, would be permitted to register voluntarily as municipal advisors under the Proposed Rules. Thus, taken together, this means that affiliated entities of an investment adviser seeking to solicit government entities for compensation will be required to register as municipal advisors if the proposed amendment to the Pay-to-Play Rule is adopted.

It remains to be seen what changes the SEC will make to the Proposed Rules before they are adopted. In the meantime, a large number of industry participants must register as municipal advisors pursuant to Rule 15Ba2-6T and Form MA-T. ■

providing engineering advice"(emphasis added). Further, under Proposed Rule 15B1-1, an accountant "preparing financial statements, auditing financial statements, or issuing letters for underwriters for, or on behalf of, a municipal entity or obligated person" also is excluded.

[5] Release No. 34-563576, at 29.

[6] Solicitation of a municipal entity "means a direct or indirect communication with a municipal entity or obligated person made by a person, *for direct or indirect compensation*, on behalf of a broker, dealer, municipal securities dealer, municipal advisor, or investment adviser…that does *not* control, is *not* controlled by, or is *not* under common control with the person undertaking such solicitation for the purpose of obtaining or retaining an engagement by a municipal entity or obligated person of a broker, dealer, municipal securities dealer, or municipal advisor for or in connection with municipal financial products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of a municipal entity" (emphasis added).

[1] Speech by SEC Chairperson Mary L. Schapiro at the SEC Open Meeting, June 30, 2010.

[2] Release No. 34-62824, at 35.

[3] Release No. 34-563576, at 206.

[4] Under Section 975 of Dodd-Frank, "municipal advisor" "does *not* include a broker, dealer, or municipal securities dealer serving as an underwriter . . ., any investment adviser registered under the Investment Advisers Act of 1940 or persons associated with such investment advisers who are providing investment advice, any commodity trading advisor registered under the Commodity Exchange Act or persons associated with a commodity trading advisor who are providing advice related to swaps, attorneys offering legal advice or providing services that are of a traditional legal nature, or engineers

As can often be the case after a series of scandals receive national attention, the ensuing regulations are expansive and will affect a broad spectrum of industry participants.

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SEC Enforcement Ramping Up Cases Against Advisers

Performance Reporting

The SEC charged that the manager of a $30 million hedge fund ran up a $8.3 million loss in a single month at the beginning of the year, and then spent the balance of the year trying to "make up" the loss, all the while misstating the fund's performance and assets in communications with fund investors. The SEC settled for a five-year adviser bar and a $40,000 penalty.[3] In a litigated case, the SEC charged two hedge fund managers with allegedly making fraudulent misrepresentations to investors concerning past performance and anticipated future returns, as well as concerning use of investor funds and investment strategies.[4]

Valuation

The SEC charged a hedge fund manager with allegedly misstating the acquisition price of his funds' largest investment and then using it to overvalue the position.[5] In another matter, the SEC charged hedge fund advisers with allegedly overvaluing illiquid fund assets that had been placed in a "side" pocket that segregated them from the remainder of the fund. The SEC's accompanying release announced that the "Asset Management Unit has been probing whether funds have overvalued assets in side pockets."[6] In still another matter, the SEC pursued a manager for reallocating assets between his fund's two portfolios in order to stabilize one portfolio's NAV at $1 per share and avoid "breaking the buck"; the case settled for a three-year bar and a $65,000 penalty.[7]

Conflicts

Undisclosed conflicts are plainly a high priority for the SEC's Asset Management Unit. Its co-head Bruce Karpati termed conflict disclosure "one of the most basic duties that investment advisers owe" their funds. Karpati's comments came in a settled case charging two portfolio managers with taking undisclosed "credit monitoring fees." The settlement order included disgorgement of the fees, penalties of $75,000 and $50,000, and five-year and one-year bars.[8] In another matter, the SEC targeted undisclosed conflicts and self-dealing in a settled case where advisers used their hedge fund's cash to personally buy a finance company that was the sole supplier of the subprime auto loans that made up a substantial portion of the fund's portfolio; the settlement order included penalties ranging from $75,000 to $175,000, five- and three-year bars, and a suspension.[9] The SEC charged an adviser with failing to tell clients that it would receive additional commissions if they switched from one series of a fund to another; the case settled with a censure, disgorgement of approximately $395,000 in commissions, and a $60,000 fine for the adviser's president.[10] Finally, the SEC charged an adviser and its principals with failing to disclose conflicts, contrary to statements in the adviser's Form ADV, arising from their investment of client funds in entities in which the adviser's principals had interests; the case settled with revocation of the adviser's registration and a bar of its principals.[11]

Regulation M Compliance

The SEC filed a series of cases charging that advisers violated Rule 105 of SEC Regulation M, which generally forbids purchasers in an offering from engaging in short sales during a five-day window preceding the pricing of the offering. In a litigated case, the SEC charged an adviser with selling short during Rule 105's five-day window in three separate offerings.[12] In a settled case the adviser sold a single stock short within the five-day window and then covered a portion of its short position with shares from the offering. The SEC said that at the time of the short sales, the adviser had "no policies, procedures or controls in place designed to detect or prevent Rule 105 violations," but that the adviser has since "developed and implemented policies, procedures and training programs" on Rule 105 compliance. The settlement order required disgorgement of $928,000 in profits and a $375,000 penalty.[13]

In another settled Reg M case, the adviser short-sold two stocks within Rule 105's five-day window, and the settlement order required $183,000 in disgorged profits and a $100,000 penalty.[14] Finally, the SEC charged a hedge fund adviser with Reg M violations for purchasing securities from multiple public offerings after having sold short the same securities, including one instance where the portfolio managers who sold short and bought in the offering were different individuals. The adviser undertook remedial measures, including enhanced policies and procedures and installation of an automated system to help prevent future Reg M violations, and the matter settled for disgorgement of $2.3 million in gains and avoided losses and a $260,000 penalty.[15] In all three of the settled Reg M cases, the SEC explicitly noted that it gave the advisers credit for their remedial efforts upon discovering their problems.

General Risk Disclosure

The SEC charged an adviser and its parent company with marketing a fund as a cash alternative with the risk level of a money market fund when the fund allegedly was over-concentrated in private-issuer mortgage-backed and other securities with significantly different maturities and credit quality. The SEC also charged that the adviser failed to get shareholder approval for deviating from the fund's concentration policy, and also charged failure to maintain and enforce policies and procedures to prevent misuse of material non-public information. The case settled for $52 million in disgorged fees and interest, and penalties of $52 million (adviser) and $5 million (parent company). The settlement also involved undertakings for corrective disclosure relating to fund concentrations, and engagement of a consultant relating to policies and procedures for handling nonpublic information. The SEC is litigating against a former investment officer and against an executive and former fund trustee.[16]

The SEC charged a chief investment officer and a product engineer with playing "an instrumental role in drafting" communications to fund investors that allegedly failed to adequately disclose the

fund's concentration in subprime investments, and likewise allegedly failed to disclose the impact of subprime market turmoil on the fund.[17] Failure to adequately disclose investment risk likewise figured as an element in various other recent asset management cases discussed in this article.

Interlocking Insider Trading Rings

The SEC continued recent efforts to network across interlocking rings of insider traders to bring related cases. In the much-discussed Galleon Management matter, the SEC brought a new case charging a former managing director of hedge fund adviser Lanexa Management with causing Lanexa to trade on inside information from a hedge fund consultant and former Galleon employee about impending takeovers of Hilton and Kronos and about Google quarterly earnings.[18] And in a separate complaint by a different SEC investigative team, the SEC charged the same managing director and Lanexa itself with trading for a Lanexa hedge fund on inside information about an acquisition of 3Com. The second complaint sprang from an earlier case following alleged tipping by two former Ropes & Gray lawyers.[19]

Emergency Relief Approach

The SEC has, as expected, vigorously pursued recent cases against advisers alleging misrepresentations[20] and misappropriation.[21] However, in some cases, the SEC recently has also resorted to court-ordered asset freezes and other so-called "emergency" relief. Thus, on virtually the eve of Christmas, the SEC rushed to court and obtained a "limited" asset freeze, an order directing an immediate accounting of the disposition of all funds raised, and other relief in a case charging that defendants pooled investor funds for a "covered-call" program guaranteeing 8% to 12% returns. The SEC alleged that a reserve account for the program lacked sufficient funds to cover investor losses.[22] In another case just two weeks later, based on information obtained in an examination, the SEC got an asset freeze in a matter charging a hedge fund adviser with diverting investor funds through self-dealing transactions.[23]

Conclusion

The SEC Enforcement Division's large new Asset Management Unit will likely continue its high volume case production during 2011, as well as its aggressive settlement stance. And it is also likely that the themes it has staked out in these early days will continue to be its key prosecutorial targets. Ongoing attention to these areas in compliance efforts will obviously be the best defense. ■

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[1] *Matter of The Buckingham Research Group, Inc.*, Exch. Act Rel. 63323 (Nov. 17, 2010). Copies of the cases discussed in this article are available on the SEC's website, www.sec.gov, under the headings "Litigation Releases" and "Administrative Proceedings." In all of these cases, the defendants either settled without admitting the SEC's factual and legal allegations or are challenging the SEC's allegations in litigation.

[2] *Matter of Thrasher Capital Management, LLC*, I.A. Act Rel. 3108 (Nov. 16, 2010).

[3] *Matter of Godbole*, I.A. Act Rel. 3117 (Dec. 1, 2010).

[4] *SEC v. Mack*, SEC Lit. Rel. 21731 (Nov. 4, 2010).

[5] *SEC v. Southridge Capital Management*, Lit. Rel. 21709 (Oct. 25, 2010).

[6] *SEC v. Mannion*, Lit. Rel. 21699 (Oct. 19, 2010).

[7] *Matter of Busse*, Sec. Act Rel. 9159 (Nov. 22, 2010).

[8] SEC Press Rel. 2011-5 (Jan. 7, 2011). *Matter of Young*, Exch. Act Rel. 63675 (Jan. 7, 2011); *Matter of Albright*, Exch. Act Rel. 63676 (Jan. 7, 2011).

[9] *Matter of American Pegasus LDG, LLC*, Sec. Act Rel. 9167 (Dec. 21, 2010).

[10] *Matter of Valentine Capital Asset Management*, I.A. Rel. 3090 (Sept. 29, 2010).

[11] *Matter of Sierra Financial Advisors, LLC*, I.A. Rel. 3087 (Sept. 23, 2010).

[12] *Matter of Fontana Capital, LLC*, Exch. Act Rel. 63672 (Jan. 7, 2011).

[13] *Matter of Gartmore Investment Limited*, Exch. Act Rel. 63460 (Dec. 8, 2010).

[14] *Matter of New Castle Funds LLC*, Exch. Act Rel. 63358 (Nov. 22, 2010).

[15] *Matter of Carlson Capital LP*, I.A. Rel. 3086 (Sept. 23, 2010).

[16] *SEC v. Charles Schwab Investment Management, Inc.*, Press Rel. 2011-7, Lit. Rels. 21805, 21806 (Jan. 11, 2011).

[17] *Matter of Flannery*, SEC Press Rel. 2010-177 (Sept. 30, 2010). The matter related to a settled case filed earlier this year involving the individuals' former employer. *See Matter of State Street Bank and Trust Company*, SEC Press Rel. 2010-21 (Feb. 4, 2010).

[18] *SEC v. Hardin*, Lit. Rel. 21740 (Nov. 15, 2010).

[19] *SEC v. Lanexa Management LLC*, Lit. Rel. 21741 (Nov. 15, 2010).

[20] *SEC v. Harrison*, Lit. Rel. 21781 (Dec. 16, 2010).

[21] *SEC v. Ludlum*, Lit. Rel. 21785 (Dec. 20, 2010).

[22] *SEC v. Burnt*, Lit. Rel. 21789 (Dec. 22, 2010).

[23] *SEC v. Kowalewski*, Lit. Rel. 21800 (Jan. 7, 2011).

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Whistleblower Procedures: An Incentive for Internal Reporting

procedures, and, to date, most advisers and investment companies have not been required to do so.

Open-End Investment Companies: Open-end investment companies are not required to adopt whistleblower procedures, and most have not done so.

Closed-End Investment Companies: Closed-end fund audit committees are required by Section 301 of the Sarbanes-Oxley Act of 2002 and related SEC rules to maintain procedures for (1) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters, and (2) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

Investment Advisers: Although investment advisers are not required to adopt whistleblower procedures, investment advisers are subject to a reporting obligation under their codes of ethics. In this regard, Rule 204A-1(a)(4) under the Investment Advisers Act of 1940 requires investment advisers to include in their code of ethics provisions requiring supervised persons to (1) comply with the federal securities laws, and (2) report violations of the code of ethics. To the extent that a supervised person bypasses the internal reporting required by an adviser's code of ethics and, instead, reports a violation to the SEC, the supervised person arguably will have violated the adviser's code of ethics.

Because the potential for substantial monetary awards likely will increase the incidence of whistleblowing, we encourage advisers and investment companies to establish internal reporting mechanisms and whistleblower procedures that establish a clear framework for the confidential reporting, investigation and resolution of violations. Establishing an internal reporting and investigation structure will send a message that management wants and expects potential violations to be reported internally. Such a structure can also serve to eliminate the need for advisers and investment companies to "make it up as they go" when faced with a whistleblower report, and will also provide advisers and investment companies with a mechanism to investigate and resolve potential violations either before or in connection with an SEC investigation into a whistleblower report.

Whistleblower Procedures. Whistleblower procedures necessarily vary in length and complexity depending upon the structure of an organization. There is no "one size fits all." However, there are certain customary provisions that advisers and investment companies may wish to consider as they develop whistleblower procedures:

- *Designated Officer.* Procedures typically designate a contact person with whom reports of potential violations should be filed and enumerate that individual's responsibilities with respect to the handling and investigation of those reports.
- *Accountability to the Board.* Procedures could address reporting and accountability of the contact person to the entity's governing body, such as its board or a committee of the board, such as the audit committee. Reports could include quarterly reports regarding whistleblower activity as well as specific reporting on whistleblower investigations.
- *Hotline.* A whistleblower hotline is a dedicated telephone number or other method for investment company management, adviser employees and other potential whistleblowers to report concerns on an anonymous basis.
- *Anti-Retaliation Provisions.* Anti-retaliation provisions encourage internal reporting by assuring employees that an investment company or adviser will not retaliate or tolerate any retaliation against anyone who reports a violation.
- *Certifications.* Adviser and investment company employees may be asked to certify on a periodic basis that they have no knowledge of any violation of the federal securities laws that has not been reported internally. Some advisers may already be seeking such certifications to comply with their codes of ethics.

Whistleblower procedures may include a requirement that employees report to the chief compliance officer any potential violations of the federal securities laws. An internal reporting requirement would not eliminate the possibility that an employee also would submit a report to the SEC under the Dodd-Frank whistleblower program.

Internal Reporting Culture. The effective implementation of whistleblower procedures can promote a culture of compliance that supports internal reporting. A necessary component of this culture is whistleblower training to educate management and adviser personnel about the internal reporting and investigation process.

Providing financial rewards for internal reporting also could encourage internal reporting. While investment companies and advisers clearly cannot offer the same remuneration as the SEC, they could offer financial or other awards to encourage internal reporting. Eligibility for a Dodd-Frank award will not be easy to establish; nor will an award be certain. Hence, it may not be unreasonable to use financial incentives to enhance a culture of compliance committed to rewarding whistleblowers and rectifying reported violations.

The best defense to the new whistleblower regime will be a strong offense. Whistleblower procedures that provide clear guidelines for the internal reporting and investigation of potential violations and the imposition of sanctions will evidence a compliance culture committed to encouraging, facilitating and rewarding internal reporting. ■

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The SEC's New Pay-to-Play Rule: Practical Guidance for Investment Advisers

on its behalf. A "regulated municipal advisor" under the proposal would be a person that is registered under section 15B of the Securities Exchange Act of 1934, as amended, and subject to pay-to-play rules adopted by the MSRB under a new regulatory regime created by the Dodd-Frank Act to cover such advisers. Finally, the SEC proposed a minor amendment to the definition of covered associate to clarify that a legal entity, not just a natural person, that is a general partner or managing member of an investment adviser would be deemed a covered associate.

The Rule is expected to have a far-reaching effect on the manner advisory services are solicited by and provided to government entities and their agents, and, accordingly, it is particularly important to consider the practical considerations and implications of the Rule in the unique circumstances of an adviser's operations. ■

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[1] Currently, the Rule applies to advisers that are registered under the Advisers Act and to those that are exempt from registration in reliance on Section 203(b)(3) of the Advisers Act, the "private adviser" exemption (which will be eliminated effective July 21, 2011 by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")), but does not apply to advisers exempted from registration in reliance on exemptions other than the "private adviser" exemption. Recently, however, in response to the enactment of the Dodd-Frank Act, the SEC has proposed to amend the scope of the Rule so that it would also apply to certain other advisers that will be exempt from registration under the Dodd-Frank Act, including advisers that advise solely one or more "venture capital funds," private fund advisers with assets under management in the United States of less than $150 million and foreign private advisers.

[2] Certain investment advisers may also be subject to MSRB Rules G-37 and G-38 depending on the scope of their business activities. This article does not address compliance with those rules.

[3] While the focus of the Rule is primarily on state and local entities, contributions to a federal campaign also are covered under the Rule if the candidate for federal office has influence over the hiring of investment advisers as a function of his or her current office.

[4] For an in-depth summary of the Rule, including its requirements, exemptions and effective dates, which is beyond the scope of this article, please see our July 2010 Alert entitled "SEC Adopts 'Pay-to-Play' Rules for Investment Advisers."

[5] Generally, an employee would not be a covered associate if he or she provides limited factual information to a government official along with contact information for a covered associate.

[6] The SEC regards an adviser or its covered associate to have "control" over a political action committee if the adviser or its covered associate has the ability to direct or cause the direction of the governance or operations of the PAC.

[7] The SEC cited, in footnote 179 of the release adopting the Rule, to similar positions under the related MSRB Rule G-37 where "placing an executive who supervises the activities of a broker, dealer or municipal securities dealer outside of the corporate governance structure of such broker, dealer or municipal securities dealer does not prevent the application of MSRB Rule G-37 to that individual's conduct."

[8] For example, under amended Rule 204-2, a registered adviser that provides advisory services to a government entity or to a covered investment pool in which a government entity invests must maintain records of the names, titles and business and residence addresses of all covered associates of the adviser, and a list of those government entities to which the adviser provides, or has provided, advisory services in the past five years (but not prior to September 13, 2010). An adviser also must maintain records of all direct or indirect contributions made by the adviser or any of its covered associates to an official of a government entity, or direct or indirect payments to a state or local political party or a PAC. In addition, each registered investment adviser is required to maintain records of the name and business address of each regulated person to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for advisory services on its behalf.

[9] Placement agents acting in connection with potential investments by California local public pension systems will be required to register as lobbyists if required by a local government agency, as well as comply with other requirements developed by the local government agency. Investment advisers and placement agents that intend to conduct business with local public pension systems should determine whether the applicable local government agency has adopted such a law.

[10] See *supra*, endnote 1.

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Mark D. Perlow: Alternative Mutual Funds and Investments, NICSA West Coast Regional Meeting, April 21, 2011, Los Angeles, CA

Lawrence B. Patent: Regulation of Futures, Derivatives and OTC Products, 33rd Annual Law and Compliance Division Conference on the Regulation of Futures, Derivatives and OTC Products, May 5, 2011, National Harbor, MD

Martin W. Cornish and Philip J. Morgan: Hedge Fund Re-domiciliation for Managers and Funds 2011, Informa plc, May 24, 2011, London, UK and June 28, 2011, Geneva, Switzerland

Ndenisarya M. Bregasi: IA Examinations Process (Internal and External), NSCP East Coast Regional Meeting, June 6, 2011, New York, NY

Michael S. Caccese: Hedge Fund Examinations Process (Internal and External), NSCP East Coast Regional Meeting, June 6, 2011, New York, NY

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Speakers:
Stuart E. Fross
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