Recent Developments in Regulation of Investment Companies and Investment Advisers

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Selected Recent Regulatory Developments

A. Industry Developments

1. SEC OCIE Director Lori Richards Discusses Examination Issues

In October 2006, Lori Richards, Director of the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) gave a speech at the National Membership Meeting of the National Society of Compliance Professionals. Ms. Richards spoke on a variety of topics, including compliance and the current focus of examinations. With respect to the focus of examinations, she briefly outlined some of the current issues, including:

- **Insider trading and front-running**: One focus is a firm both sharing non-public corporate or order information with others, and also receiving that information and using that information to trade. For an adviser, a broker-dealer, a hedge fund, a clearing agency or a transfer agent, this area should be included in the firm’s risk assessment, and in the firm’s investigation and monitoring efforts.

- **What are you using your clients’ money for?** Firms should look at fund expenses and the use of advisory clients’ monies to ensure they are appropriate and that the money is used as intended and disclosed. This issue has come to the forefront given the number of “secret payments” cases the OCIE has seen. Firms should also be particularly alert to payments to affiliates and those that may be intended to increase assets under management under the guise of something else.

- **Seniors**: If a firm does business with seniors, the firm should be certain that it complies with applicable fiduciary and ethical principles, as well as suitability and disclosure standards, recognizing each senior’s age, objectives, capacity and needs.

- **Supervision**: Examiners are very focused on whether firms are adequately supervising employees, particularly in branch offices, on trading desks, with respect to big producers, solicitors, and others.

- **Trading issues**: Issues currently at the forefront are best execution in debt and equity securities, payments for order flow, soft dollars and use of brokerage, Reg SHO, and mark-ups.

- **Controls to prevent theft and misrepresentations**: Controls that will be examined include those over the creation and sending of account statements, as well as account and position valuations. Controls over theft or misuse of customer information by identity thieves are also a focus for examination.

- **AML**: The OCIE is also very interested in a firm’s AML compliance programs.
2. The President Signs the Credit Rating Agency Reform Act of 2006

In September 2006, President Bush signed into law the Credit Rating Agency Reform Act of 2006 (the “Rating Agency Act”). The Rating Agency Act is designed to introduce greater transparency, accountability and competition into the credit rating industry by creating a statutory registration and regulatory framework for credit rating agencies seeking to obtain “nationwide recognition as a statistical rating organization” (“NRSRO”) status. The staff of the SEC currently provides limited oversight of the credit rating industry by providing certain firms with an NRSRO designation. Under the Rating Agency Act, each credit rating agency that elects to be treated as an NRSRO must register with the SEC. At the end of each calendar year, each NRSRO must amend its registration, certifying that the information and documents in the application for registration continue to be accurate and must list any material change that occurred to such information during the previous calendar year.

The SEC has exclusive authority to enforce the provisions of the Rating Agency Act relating to NRSROs, although it is prohibited from regulating the substance of credit ratings or the procedures and methodologies by which NRSROs determine credit ratings. The SEC has until June 26, 2007 to review and amend or revise its existing rules and regulations which use the term “nationwide recognition as a statistical rating organization” or “NRSRO,” and to issue an application for registration in final form.

3. SEC Votes to Clarify Operation of Redemption Fee Rule

In September 2006, the SEC voted to adopt amendments to Rule 22c-2 to make it easier for mutual funds to comply with Rule 22c-2 by: (i) limiting the types of intermediaries with which funds must enter into shareholder information agreements; (ii) addressing Rule 22c-2’s application when there are chains of intermediaries; and (iii) clarifying the effect of a fund’s failure to obtain an agreement with any of its intermediaries. Rule 22c-2 requires, among other things, for most mutual funds to enter into shareholder information agreements with those intermediaries (e.g., broker-dealers) that hold shares on behalf of other investors, thus permitting those funds to identify market timers. As originally adopted, Rule 22c-2 had a compliance date of October 16, 2006. The SEC has extended the date for entering into shareholder information agreements by 6 months, until April 16, 2007, and the date by which funds must be able to obtain information from intermediaries under those agreements for one year, until October 16, 2007. The original compliance date of October 16, 2006 remains in effect for section 22c-2(a)(1), which requires a fund’s board to consider the adoption of a redemption fee.

4. FASB Issues a New Statement on Fair Value Measurements

In September 2006, the Financial Accounting Standards Board issued its Statement of Financial Accounting Standards No. 157 (“Statement”) that (1) defines fair value; (2) establishes a framework for measuring fair value in generally accepted accounting principles (“GAAP”); and (3) expands disclosure requirements for fair value measurements. The Statement does not require any new fair value measurements, but instead attempts to achieve greater consistency and clarity under pre-existing accounting pronouncements that require or permit fair value measurements. The Statement will change some current practices with respect to the definition
of fair value, the methods used to measure fair value, and expanded disclosures about fair value measurements. Investment companies and broker-dealers are among the entities whose accounting practices may be affected by the new Statement. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year or for interim periods within that fiscal year.

5. NYSE Releases Exchange Traded Funds (“ETFs”) Publication

In September 2006, the NYSE released the latest publication in its Informed Investor series entitled “What You Should Know About Exchange Traded Funds.” The publication highlights several questions investors should ask themselves and their brokers before buying an ETF. The publication addresses some of the distinct risks associated with investing in ETFs given the growth of the market and the fact that more individual investors are being exposed to ETF investment opportunities. These risks include greater volatility and higher transaction and tax costs as compared to mutual funds.

6. The President Signs the Pension Protection Act of 2006 Into Law

In August 2006, President Bush signed the U.S. Pension Protection Act of 2006 (the “Act”) into law. The wide-ranging law will affect U.S. investment companies in a number of ways. The Act:

- Allows higher 401(k) contribution limits and simplifies automatic enrollment in 401(k) plans. These provisions are expected to increase significantly the amount of assets invested in 401(k) plans.

- Broadens the types of assets that will not be subject to ERISA fiduciary rules; previously, if more than 25% of the total value of any class of equity interest in a fund was held by “benefit plan investors,” all of the fund’s assets were subject to complex ERISA fiduciary rules.

- Relaxes prohibitions on the provision of investment advice to benefit plan investors. Starting in 2007, pursuant to an “eligible investment advice arrangement,” investment advisers will be able to provide investment advice to (and receive fees from) plan investors.

- Creates new exemptions for transactions with plan service providers, block trades, transactions over an electronic communications network and certain foreign exchange transactions.

7. SEC Names New Director of the Division of Market Regulation

In August 2006, SEC Chairman Christopher Cox announced that Dr. Erik Sirri joined the SEC as the next director of the Division of Market Regulation, effective September 12, 2006. The Division had not had a permanent Director since last year, when Annette Nazareth was
confirmed as an SEC commissioner. As Director, Dr. Sirri will generally oversee the Division’s regulation of brokers, stock exchanges, the NASD, the Municipal Securities Rulemaking Board, and trade clearing and settlement agencies.

Dr. Sirri was formerly a finance professor at Babson College and a visiting scholar at Harvard Law School. In addition to his academic work, Dr. Sirri’s professional experience includes service as a member of the NASDAQ Stock Market Economic Advisory Board; as a Board Member of the Boston Options Exchange (Regulation); and as a Governor of the Boston Stock Exchange. He had also served as the SEC’s chief economist from 1996 to 1999 under former chairman Arthur Levitt.

8. SEC Amends Executive Compensation Rules

In August 2006, the SEC issued a release (i) adopting comprehensive amendments to its executive compensation and related person disclosure requirements for public companies and (ii) requesting additional comments on a provision that the SEC had initially proposed. The initial rule proposal received over 20,000 comments, which is a new record for the SEC. The amendments are intended to provide clearer and more complete plain English disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers, and the directors of a company. A fund could be affected by the amendments to the extent that its investment adviser is a public company. In addition, funds are affected because the amendments have raised the disclosure threshold from $60,000 to $120,000 for disclosing certain interests, transactions and relationships of disinterested directors on Form N-1A. The amendments have a compliance date of December 15, 2006.

9. SEC Releases Soft Dollar Interpretation and Guidance

In July 2006, the SEC issued interpretive guidance on client commission (“soft dollar”) practices under Section 28(e) of the Exchange Act. In addition to interpreting the scope of the Section 28(e) safe harbor, the SEC release provides guidance on (1) the responsibilities of money managers in determining that an expense is eligible for soft dollar commission reimbursement, (2) permissible commission-sharing arrangements, and (3) the tasks that must be performed by broker-dealers in order to be paid soft dollars for research and brokerage services. The SEC has granted a six-month phase-in period during which managers may rely on either the new interpretation or prior interpretations. Money managers may not rely on prior, inconsistent guidance after January 24, 2007.

10. Amendments to NASD “Text Box” Disclosure Requirements

In July 2006, the SEC approved proposed amendments to NASD Rules 2210 and 2211 (the “Amendments”) that require mutual fund communications with the public, other than institutional sales material and public appearances, that present non-money market fund performance data to disclose specified information about fund fees and expenses.

The Amendments are designed to help investors better determine the costs of purchasing and owning fund shares and facilitate the comparison of funds. They require mutual fund
communications with the public that contain investment company performance data ("Performance Communications") to prominently set forth the fund’s:

- Standardized performance information, calculated in accordance with Rule 482 under the Securities Act and Rule 34b-1 under the Investment Company Act;
- Maximum sales charge imposed on purchases or the maximum deferred sales charge; and
- Annual expense ratio, gross of any fee waivers or expense reimbursements.

If the Performance Communication is presented in print advertisements, it must provide the required information in a prominent text box.

Only fees and expenses that are disclosed in print advertisements are required to be presented in text boxes. Those that are disclosed through websites and other electronic media are excepted from this requirement. In addition to the disclosures that are required by the amended rules, text boxes in print advertisements may include such comparative performance and fee data as non-standardized fund performance, the performance of a relevant benchmark index, and a comparison of the fund’s expense ratio to the average expense ratio for similar funds. Information that must be included in a text box must be set forth clearly and prominently.

The Amendments become effective on April 1, 2007. To reduce compliance and filing costs, fund complexes will be permitted to file templates of performance materials – and thus will not be required to file individual pieces of Performance Communications – to show that similar Performance Communications will comply with the Amendments.

11. Court Overturns SEC Hedge Fund Rule; SEC Staff Issues No-Action Letter

In June 2006, the D.C. Circuit Court of Appeals vacated SEC Rule 203(b)(3)-2, which required hedge fund managers with 15 or more investors to register as investment advisers. The rule changed the definition of a hedge fund adviser’s “client” from the fund itself to the fund’s underlying investors. The rule in issue largely eliminated the statutory exemption for hedge fund advisers with fewer than fifteen clients. The SEC did not appeal or seek a rehearing of the court’s decision. In August 2006, the SEC staff issued a no-action letter to address concerns that the D.C. Court of Appeals ruling may have vacated other rules, interpretations and transitional provisions in the adopting release for Rule 203(b)(3)-2 that were designed to help newly-registered hedge fund advisers comply with the Investment Advisers Act and related SEC rules.

The no-action letter states that hedge fund advisers may withdraw their registrations if they do so by February 1, 2007, even if they temporarily held themselves out to the public as investment advisers or had more than 14 clients. The letter also allows registered advisers to continue to rely upon several exemptive rules that were adopted at the same time as the hedge fund rule amendments.
12. SEC Adopts New Fund of Fund Rules

In June 2006, the SEC adopted Rules 12d1-1, 12d1-2 and 12d1-3 under the Investment Company Act, enhancing the ability of funds to invest in the shares of other funds. The SEC has also adopted amendments to the forms used to register funds to require additional disclosure in the prospectus fee table regarding the expenses of the funds in which the funds relying on these rules invest.

Rule 12d1-1 will allow funds to purchase shares of money market funds free of the restrictions of Sections 12(d)(1)(A) and 12(d)(1)(B), provided they do not charge shareholders a sales charge or purchase fee in connection with the acquisition. It will also allow funds to invest in unregistered money market funds, so long as the funds meet requirements specified in the rule. At present, the Investment Company Act limits a fund’s ability to (1) hold more than 3% of an acquired fund’s voting stock, (2) invest more than 5% of its total assets in securities issued by any one acquired fund, and (3) invest more than 10% of its total assets in securities issued by all acquired funds.

Rule 12d1-2 will allow an affiliated fund of funds to make investments in funds that are not part of the same group of investment companies as long as the investments are made in accordance with Section 12(a)(1)(A) or Section 12(d)(1)(F) of the Investment Company Act. Rule 12d1-2 will also provide an exemption from Section 12(d)(1)(G) of the Investment Company Act to allow affiliated funds of funds to invest directly in stocks, bonds, and other securities. Finally, Rule 12d1-2 will allow affiliated funds of funds to invest in money market funds in accordance with Rule 12d1-1.

Rule 12d1-3 will provide funds greater flexibility in structuring sales loads. Section 12(d)(1)(F) of the Investment Company Act allows a registered fund to invest all of its assets in other registered funds if the acquiring fund would own no more than 3% of any acquired fund and the acquiring fund’s sales load is not greater than 1.5%. Rule 12d1-3 will allow sales loads to exceed 1.5% provided that the aggregate sales load an investor pays is not greater than the NASD established limits on sales loads for funds of funds.

13. NYSE Proxy Working Group Issues Report

In June 2006, a working group (the “Working Group”) assembled by the NYSE issued a report recommending changes to the NYSE rules governing the proxy voting process.

The Working Group focused on, among other provisions, Rule 452, which governs the circumstances under which a broker may vote uninstructed shares on “routine proposals.” The Working Group recommended that the NYSE amend Rule 452 to make the election of directors a “non-routine” matter for which brokers must obtain client instructions in order to vote their shares. Because classifying the election of directors as a “non-routine” matter may make it more difficult to obtain either a quorum for shareholder meetings or the required approval for directors (generally, a majority of outstanding shares), the Working Group has also recommended that the NYSE engage in a large scale education effort to inform shareholders about the mechanics of the proxy voting process and the importance of voting.
For mutual funds, which are not themselves NYSE listed companies, these developments are relevant because broker-dealer firms generally are required to comply with the NYSE requirements and often hold fund shares in street name.


In May 2006, the Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”) issued a final rule amending the regulations implementing the Bank Secrecy Act to require mutual funds to report suspicious transactions to FinCEN (“FinCEN Rule”). This suspicious activity reporting (“SAR”) by mutual funds is expected to provide highly useful information in law enforcement and regulatory investigations and proceedings, as well as in the conduct of intelligence activities to protect against international terrorism. The FinCEN Rule would not apply to closed-end investment companies, rather, it would apply only to open-end managed investment companies.

Under the FinCEN Rule, mutual funds will have the same SAR filing requirements as banks, registered broker-dealers and certain other financial institutions. Mutual funds will be required to file SAR-SFs regarding all suspicious transactions occurring after October 31, 2006 that are conducted or attempted by, at, or through a mutual fund that involve or aggregate at least $5,000 in funds or other assets. The FinCEN Rule not only directs mutual funds to report suspicious activities on Form SAR-SF, but sets forth filing procedures to be followed by mutual funds making such reports. Under the FinCEN Rule, a mutual fund is required to file a Form SAR-SF within 30 days after the fund becomes aware of any suspicious transaction that takes place after October 31, 2006. If the mutual fund does not identify a suspect on the date of detection, the fund may delay filing Form SAR-SF for an additional 30 days, but in any event must report the transaction within 60 days of the initial detection. In situations that require immediate attention -- such as the detection of a terrorist financing or ongoing money laundering schemes -- the mutual fund must contact an appropriate law enforcement authority by telephone in addition to filing Form SAR-SF. Funds may also, but are not required to contact the SEC’s Office of Compliance Inspections and Examinations in such situations. Mutual funds are required under the Rule to maintain copies of SAR-SFs and the original and copies of related documentation for a period of five years from the date the SAR-SF was filed.

15. Chairman Cox Plans to Expedite Exemptive Relief

In May 2006 before the U.S. House Committee on Financial Services, Chairman Christopher Cox acknowledged that many exemptive relief applications take more than a year to be approved. In comments following his testimony, Chairman Cox specifically noted that there are currently hundreds of outstanding exemptive relief applications from investment companies seeking to take loans from affiliated investment companies. In an effort to alleviate the delay in the review process, Chairman Cox encouraged the SEC to adopt a rule that would permit investment companies to engage in inter-fund loans without the burden of first having to obtain an exemptive order. The rule would most likely specify many of the safeguards that are provided when the SEC grants exemptive relief.
16. **SEC Receives First Fund Filing in XBRL**

In May 2006, Allegiant Funds (“Allegiant”) became the first registered investment company to file with the SEC in eXtensible Business Reporting Language (“XBRL”), a technology that inserts data tags into disclosure documents to enable search engines to extract data for research. Allegiant’s filing was its quarterly schedule of portfolio holdings on Form N-Q for Allegiant Advantage Fund. Allegiant is still evaluating whether to apply XBRL to its annual report.

The benefits of XBRL include providing shareholders with the ability to search and retrieve information in a more customized manner; enhancing accuracy in other databases; and enabling more detailed, systematic analysis on fund data. The use of XBRL remains limited to a few types of filings because there is not a widely available software application which would enable readers to access the data.

The SEC is simultaneously planning a roundtable to consider the use of interactive data to improve disclosure, and has launched a voluntary XBRL pilot program in which several asset management companies and service providers are participating.

17. **SEC Chairman Announces Andrew Donohue to Join SEC as Director of the Division of Investment Management**

In an SEC press release dated April 10, 2006, SEC Chairman Christopher Cox announced that Andrew Donohue will be sworn in as the SEC’s Director of the Division of Investment Management. Mr. Donohue is expected to concentrate on improving the usability of disclosures by ETFs, UITs, mutual funds, and closed-end funds and enhancing the accessibility and convenience of SEC information through technology. Mr. Donohue currently serves as the Global General Counsel for Merrill Lynch Investment Managers and as Chairman of Merrill Lynch’s Global Risk Oversight Committee. Mr. Donohue’s previous work experience includes serving as Executive Vice President, General Counsel, Director, and as a member of the Executive Committee for Oppenheimer Funds and serving as a corporate and securities law partner with a private law firm. Mr. Donohue received a J.D. from the New York University School of Law in 1975 and a B.A. in economics from Hofstra University in 1972.

18. **SEC Chairman Cox Seeks Improved Disclosure through Technological Improvements at “SEC Speaks” Conference**

At the Practicing Law Institute’s annual “SEC Speaks” Conference held in Washington, DC in March 2006, SEC Chairman Christopher Cox advocated the use of technology to improve the quality of fund disclosure for ordinary investors, thereby eliminating inefficiencies and waste and empowering such investors to make more informed financial decisions. In particular, Chairman Cox urged the use of XBRL technology as a means of enhancing disclosure by tagging data with unique labels, thereby permitting investors to sort and search such data to extract information important to them.
Chairman Cox stressed that, while the current breadth and scope of company disclosure was necessary to permit the efficient operation of financial markets, investors should be given better tools to use and make sense of such information. XBRL tagging, coupled with the layering of information in which important information is provided at the beginning of electronic documents and links to less critical information are included, are meant to address these shortcomings. He also indicated his support for the SEC’s use of an interactive data test group, in which participating companies that agree to make filings in XBRL will receive in exchange expedited reviews of registration statements or annual reports.

In her address to the Conference, SEC Commissioner Cynthia Glassman indicated her support for the implementation of XBRL technology in SEC filings. Commissioner Glassman also reiterated her support for fund prospectus reform in general, stating that the SEC needs “to conduct a top-to-bottom, full scale review of the mutual fund disclosure regime.”

On a related note, the SEC issued a press release on March 9 announcing a series of roundtables in 2006 focusing on the implementation of new Internet tools to help provide better financial information about companies and funds and seeking written feedback investors, registrants, auditors and others on their experiences with interactive data and XBRL.

19. Internal E-mail Retention Could be Required Under Forthcoming SEC Guidance

With SEC guidance regarding e-mail retention anticipated by the industry, Douglas Scheidt, Chief Counsel and Associate Director of the SEC’s Division of Investment Management, addressed the topic during a panel discussion at the annual Investment Advisers Compliance Best Practices Summit in Washington, DC in February 2006. In his comments, Scheidt said that advisory firms need to retain all communications (including e-mails) sent by an advisor, suggesting that internal e-mails fall under the books and records rule (the “Records Rule”) under the Investment Advisers Act.

According to Scheidt, the Records Rule requires the retention of records related to recommendations made or proposed to be made to clients, as well as advice given or proposed to be given to clients. Because proposed recommendations and advice are regularly circulated via e-mails between advisory firms’ analysts and their supervisors, Scheidt stated that the Records Rule could be interpreted to require the retention of internal e-mails. Mr. Scheidt also rejected the view that e-mails are “casual” communications. In his view, even though the volume of communications conducted via e-mail has increased substantially, advisory firms should not be permitted to forgo retaining those records.

Scheidt’s comments at the Summit are particularly noteworthy because the SEC staff is expected to issue e-mail retention guidance in the coming months. According to Scheidt, staff from the SEC Division of Investment Management has met with the Office of Compliance Inspections and Examinations to discuss e-mail retention-related issues, and the staff will consult with the full Commission before issuing the guidance.
B. **Cases and Administrative Proceedings**

1. **SEC Charges Morgan Stanley with Failure to Maintain and Enforce Policies to Prevent Misuse of Inside Information**

   In June 2006, the SEC instituted and immediately settled an enforcement action against Morgan Stanley & Co., Inc., and Morgan Stanley DW Inc. (together, “Morgan Stanley”) for failure to maintain and enforce adequate written policies and procedures to prevent the misuse of inside information. The SEC alleged that for years Morgan Stanley had neither maintained nor enforced satisfactory written policies and procedures relating to misuse of material non-public information, with the result that a number of employee accounts at the firm went unmonitored. Specifically, employee accounts were not identified as such; no Watch List surveillance was conducted; and Morgan Stanley’s written policies regarding Watch List surveillance provided insufficient guidance to compliance officers.

   The SEC assessed a $10 million penalty against Morgan Stanley and entered an Order of Censure against it, and ordered the firm to cease and desist from committing or causing any violations of Section 15(f) of the Exchange Act and Section 204A of the Investment Advisers Act. Under that order, Morgan Stanley must now retain an outside consultant to review the firm’s policies and procedures related to inside information, and to help establish a review of employee trading accounts going back four years.

2. **Milberg Weiss Indicted for Conspiracy and Related Charges**

   In May 2006, Milberg Weiss Bershad & Schulman (“Milberg Weiss”), one of the top class action law firms in the United States and one of the most frequent filers of class actions against mutual funds, was indicted by a federal grand jury for conspiracy, racketeering, mail fraud, money laundering and filing false tax returns. The indictment claims that Milberg Weiss paid individuals to act as lead plaintiffs in class action cases, alleging that such kickbacks amounted to a total of $11 million. Two of Milberg Weiss’ founding partners, Bershad and Shulman, have taken a leave of absence from the firm.

3. **Merrill Lynch to Pay $2.5 Million in Penalty For Alleged Failure of Prompt Production and Proper Retention of E-mails**

   In March 2006, the SEC filed and settled an order instituting public administrative and cease-and-desist proceedings against Merrill Lynch for, among other things, failure to furnish promptly to the SEC e-mails and to retain properly certain e-mails related to its business, in violation of Section 17(a) of the Exchange Act, and the rules and regulations thereunder. In anticipation of the enforcement proceedings, without admitting or denying the findings of the order, Merrill submitted an Offer of Settlement, which the SEC accepted.

   According to the order, from October 2003 to February 2005, the SEC staff requested that Merrill produce e-mails in connection with various investigations and inquiries. While Merrill complied with certain requests, it failed on several other occasions to promptly furnish e-mails responsive to SEC’s requests. In response to one SEC request for the production of e-
mails of six Merrill employees, Merrill was unable to produce any of the requested e-mails until nearly seven months after the request. In response to two other SEC requests, Merrill failed to furnish promptly e-mails for over five months.

The order also stated that, prior to November 2004, Merrill failed to properly retain certain e-mails. Specifically, prior to that time, Merrill’s backup systems failed to capture or retain certain e-mails that were not in a user’s mailbox at the time of the next scheduled backup. For example, Merrill’s e-mail systems did not capture certain e-mails that had been moved from a user’s mailbox to a folder or a medium outside the e-mail system, certain e-mails that had been deleted, and certain “bcc” recipient addresses. The order further stated that Merrill’s inability to promptly produce e-mails contradicted statements Merrill made to the SEC that its e-mail retention systems were in compliance with Section 17(a) of the Exchange Act.

Under the offer of settlement, Merrill will, among other things, (i) pay a civil penalty of $2.5 million; (ii) retain, at Merrill’s expense, an independent consultant to review Merrill’s systems, policies, and procedures as they relate to compliance with the federal securities laws and rules concerning the retention and prompt production of e-mails to the SEC; (iii) adopt and implement, within 120 days of receiving the independent consultant’s report, all recommendations set forth in such report, unless unduly burdensome; and (iv) certify in writing to the independent consultant and the SEC that Merrill has established systems, policies, and procedures reasonably designed to achieve e-mail production and retention compliance within 14 days of the adoption of any such systems, policies and procedures.
American Bar Association
Section of Business Law
Committee on Federal Regulation of Securities
Sub-Committee on Investment Companies and Investment Advisers

Commission Guidance Regarding Client Commission Practices
Under Section 28(e)
December 1, 2006

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I. Introduction

• SEC published interpretive guidance on client commission practices on July 18, 2006 (the “Release”).

A. What the Release Does:

• Establishes a framework for analyzing whether a particular service falls within the “brokerage and research services” safe harbor of Section 28(e);

• Establishes eligibility criteria for “research” and “brokerage”;

• Addresses mixed-use items;

• Expands approach to commission-sharing arrangements; and

• Limits eligibility of mass-market publications, proxy voting services.

B. What the Release Does NOT:

• Exclude third-party research from the safe harbor, as many would fear would happen.
• Make compliance with the safe harbor’s requirements mandatory for all client commission transactions.

II. Framework for Analyzing “Brokerage and Research Services”

The Release reaffirms a three-step analysis of whether a particular product or service falls within the Section 28(e) safe harbor:

• Is the product or service eligible “research” or “brokerage” under Section 28(e)(3)?

• If yes, does the eligible product or service provide “lawful and appropriate assistance” to the money manager in the performance of its investment decision-making responsibilities?

• If yes, has the manager made a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided?

III. Eligible Research

A. Nature of research

1. Eligible research must consist of “advice,” “analysis” or “reports” within the meaning of Section 28(e)(3); and

2. reflect the expression of reasoning or knowledge relating to the subject matter identified in Section 28(e)(3)(A) and (B)

B. What’s In and What’s Out?

1. Examples of eligible research

• Traditional research reports analyzing the performance of particular stocks or companies

• Discussions with research analysts

• Meetings with corporate executives to obtain oral reports on the performance of a company
• Software that provides analyses of securities portfolios

2. Mass-marked publications

• Mass-marketed publications (newspapers, magazines, general circulation publications) are not eligible.

• Ask: Does the publication marketed to a narrow audience, directed to readers with specialized interest in particular industries, products or issues, and have high cost.

• Financial newsletters and other financial and economic publications not targeted to a wide, public audience may be eligible.

3. Inherently tangible products and services

• Products or services that do not reflect the expression of reasoning or knowledge, including products with inherently tangible or physical attributes are not eligible.

• Examples: telephone lines; office furniture and equipment; travel; entertainment; meals associated with attending seminars; travel and related expenses associated with arranging trips to meet corporate executives or analysts that provide research; rent; accounting fees and software; website design; e-mail software; internet service; legal fees; personnel management; marketing; utilities; golf membership dues.

• Certain tangible products may qualify if they relate to trade execution under the “temporal” standard (see below).
4. **Market research**

- Market research may be eligible if it otherwise satisfies the standards for research.

- Example: pre-trade and post-trade analytics, software and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies.

- Example: advice from broker-dealers on order execution, including advice on execution strategies, market color, and the availability of buyers and sellers (and related software) may be eligible.

5. **Data**

- Data services, including market data, would be eligible if they reflect “substantive content related to the subject matter categories identified in Section 28(e).

- Market data and economic data services could be eligible “reports” provided that they satisfy the subject matter criteria and provide lawful and appropriate assistance in the investment decision-making process.

- Services providing stock quotes, last sale prices, trading volumes are eligible “reports concerning . . . securities.”

6. **Proxy services**

- Proxy services that assists managers in deciding how to vote proxy ballots are not eligible.

- Proxy services that handle mechanical aspects of voting are not eligible.
• Proxy services that provide reports and analyses on issuers, securities, and the advisability of investing in securities that are eligible.

• Managers may treat proxy services as “mixed use” items, as appropriate.

IV. Eligible Brokerage

A. Nature of Eligible Brokerage

1. The safe harbor of Section 28(e) covers brokerage services that effect securities transactions incidental functions (including clearance, settlement and custody).

2. Covered post-trade services include post-trade matching of trade information; other exchanges of messages among broker-dealers, custodians and institutions related to the trade; electronic communication of allocation instructions between institutions and broker-dealers; routing settlement instructions to custodian banks and clearing agents; and short-term custody related to effecting particular transactions in relation to clearance and settlement.

B. Temporal Standard

1. The SEC adopted a “temporal standard” to distinguish between eligible “brokerage services” and other services, such as overhead, that are not eligible.

2. Brokerage begins when the money manager communicates with the broker-dealer to transmit an order for execution and ends when funds or securities are delivered or credited to the account (or its agent).

3. Communications relating to execution, clearing and settlement of securities transactions and other services incidental to effecting transactions are eligible.
4. Examples:

- connectivity service between the money manager and the broker-dealer and custodians, including
  - dedicated lines between the broker-dealer and the money manager’s order management system;
  - lines between the broker-dealer and order management systems operated by a third party vendor;
  - dedicated lines providing direct dial-up service between the money manager and the trading desk; and
  - message services used to transmit orders to broker-dealers for execution;
- trading software used to route orders to market centers;
- software that provides algorithmic trading strategies;
- software used to transmit orders to direct market access systems.

C. Ineligible Overhead

1. Hardware, including telephones and computer terminals (including those used in connection with order management systems and trading software) are not eligible because they are not sufficiently related to execution and fall outside of the temporal standard.

2. Software functionality used for recordkeeping or administrative purposes (such as managing portfolios), and quantitative analytical software used to test “what if” scenarios related to adjusting portfolios, asset allocation,
or portfolio modeling are not eligible as “brokerage” because they fall outside the “temporal” standard articulated in the Release.

3. Compliance-related expenses are not eligible.

4. Error correction trades or related services are separate transactions and are not eligible.

D. Custody

1. Section 28(e) limits the scope of the safe harbor to custody that is incidental to effecting securities transactions.

2. Short-term custody is eligible; long-term custody is not eligible.

V. Lawful and Appropriate Assistance

The Release confirms the SEC’s position that in order for a product or service to be within the safe harbor, eligible research must satisfy the statutory criteria and must provide the money manager with lawful and appropriate assistance in making investment decisions. Thus, in evaluating whether a particular product or service is eligible, investment managers must look at how they use the product or service.

VI. “Mixed-Use” Items

• The SEC re-affirmed that it accepted the “mixed-use” concept.

• When money managers obtain products or services with client commissions that have a mixed use, they must reasonably allocate the cost of the product according to its use.

• Money managers must keep adequate books and records concerning allocations to document the basis of the required good faith allocation.
VII. Good Faith Determination as to Reasonableness

- The SEC reminded readers that Section 28(e) requires money managers seeking to rely on the safe harbor to make a good faith determination that the commissions paid are reasonable in relation to the value of brokerage and research services received.

- Example: A money manager can satisfy this obligation if it uses client commissions to pay for eligible research that it uses formulating an investment decision. Another money manager who does not use the eligible research to formulate an investment decision may not rely on the safe harbor.

VIII. Third-Party Research and Client Commission-Sharing Arrangements

A. Overview

1. The Section 28(e) safe harbor is available only when a broker dealer providing eligible research is also involved in effecting the trade.

2. The origin of the safe harbor was to prevent “give-ups.”

- In the days of fixed commissions, a “give-up” typically was a payment to another broker-dealer of a portion of the commission required to be charged by the executing broker-dealer.

- Managers used them to direct client commissions to broker-dealers for providing money managers with services that benefited them, not the clients.

- The broker-dealer receiving the give-up often did nothing in connection with the securities trade to benefit investors. Thus, the SEC found they violated securities laws.

- Section 28(e) addressed give-ups by providing that money managers could pay commissions to one
broker-dealer for services performed by another broker-dealer.

- SEC believes that broker-dealers receiving payments should provide benefit to advised accounts.

3. SEC believes that separation of **effecting** and **provided by** functions is beneficial to clients, and that arrangements that promote functional allocation of these services are not the same as “give-ups.”

**B. Effecting Transactions**

1. For a money manager to rely on the safe harbor, a broker-dealer that is **effecting** a trade must perform **at least one of four** minimum functions:

   - Taking financial responsibility for all customer trades until the clearing broker-dealer has received payment or (securities);

   - Making and/or maintaining records relating to customer trades required by the SEC;

   - Monitoring and responding to customer comments concerning the trading process; and

   - Generally monitoring trades and settlements.

2. This standard departs from the Proposing Release, which required introducing brokers to provide **all four** of the functions described above.

3. Of course, a broker-dealer would be **effecting** trades if it is executing, clearing or settling trades. Introducing broker-dealers typically do not provide these services.
C. Research Must Be *Provided By* the Broker-Dealer

1. The SEC re-affirmed its policy that broker-dealers *provide* research if they:
   - Prepare the eligible research themselves; or
   - Are financially obligated to pay a third party for the research.

2. Broker-dealers may also satisfy the *provided by* standard when they pay for eligible research and brokerage services when they are not directly obligated to pay if they pay the research preparer directly and take steps to assure themselves that client commissions that the money managers direct to it to use to pay for such services are used only for eligible brokerage and research.

3. The SEC significantly expanded the scope of arrangements in which broker-dealers are considered to be *providing* research. Prior interpretations required broker-dealers to be financially obligated to pay for third party research.

4. The SEC said that the following “attributes” will help determine whether the broker-dealer that is *effecting* the trade has satisfied the *provided by* element:
   - The broker-dealer pays the research preparer directly;
   - The broker-dealer reviews the description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are outside of the safe harbor; and
   - The broker dealer develops and maintains procedures so that research payments are properly documented and paid.
IX. Effective Dates

The SEC’s interpretations became effective on July 24, 2006. Money managers may rely on the 1986 interpretations for not more than six months after that date.
Andrew J. “Buddy” Donohue is the Director of the Division of Investment Management at the U.S. Securities and Exchange Commission. Mr. Donohue was sworn in by Chairman Christopher Cox on May 15, 2006. He is among the most senior financial services regulators in the United States, with principal oversight for the $30 trillion investment management industry. As Director, Mr. Donohue is responsible for developing regulatory policy and administering the federal securities laws applicable to mutual funds, ETFs, closed-end funds, variable insurance products, UITs and investment advisers.

Prior to becoming Investment Management Director, Mr. Donohue was Global General Counsel for Merrill Lynch Investment Managers. In that position, he oversaw the firm's legal and regulatory compliance functions for over $500 billion in assets including mutual funds, fixed income funds, hedge funds, private equities, managed futures, and exchange funds. He was also Chairman of the firm's Global Risk Oversight Committee. Prior to his service at Merrill Lynch Investment Managers, Mr. Donohue spent more than a decade as Executive Vice President, General Counsel, Director, and member of the Executive Committee for OppenheimerFunds, one of the nation's leading retail mutual fund management companies, with managed assets of over $150 billion.

Previously, Mr. Donohue was a corporate and securities law partner with the firm of Kraft & McManimon (now McManimon & Scotland, LLC) in Newark, N.J. and Senior Vice President, General Counsel, and Director for First Investors Corporation. Mr. Donohue earned his J.D. from New York University School of Law in 1975 and his B.A., cum laude, with high honors in Economics from Hofstra University in 1972.

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Robert A. Robertson is a partner in the financial services group. He practices in the areas of investment management and SEC defense. With nearly 20 years’ legal experience, he regularly counsels investment advisers, mutual funds, closed-end funds, business development companies, fund boards of directors, and private funds.

Background
Mr. Robertson served as an attorney with the Securities and Exchange Commission from 1990 through 1997, where his most recent position was counsel to Commissioner Isaac C. Hunt, Jr. Before joining Dechert, he was in private practice in New York City. He also served as an attorney with the Office of the Counsel to the President at The White House during the George H.W. Bush Administration.

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Mr. Robertson is a frequent lecturer and has written a treatise and numerous articles on securities law topics.

Treatise:

Articles:
- “Mutual Fund Customer Identification Programs in Operation,” The Investment Lawyer, November 2003


“In Search of the Perfect Mutual Fund Prospectus,” The Business Lawyer, February 1999


“Private Investment Funds: The SEC Adopts Rules to Implement Section 3(c)(7),” The Investment Lawyer, April 1997


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