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INVESTMENT MANAGEMENT REPORT

THE NEW "BUSINESS AS USUAL" FOR PRIVATE FUND ADVISERS

With the March 30, 2012 registration deadline for previously unregulated advisers to hedge funds, private equity funds and similar vehicles (private fund advisers) having coming and gone, private fund advisers are now learning the ropes of operating as Securities and Exchange Commission (SEC) and/or state-registered entities. The SEC and its staff have offered guidance on how private fund advisers can ensure that they comply with the various requirements of the Investment Advisers Act of 1940 (the Advisers Act), including the new reporting obligations under Form PF and how private fund advisers can best prepare to be evaluated by the SEC in connection with its National Examination Program (the NEP). Following is a summary of key points advisers to private funds should take to heart.

Fundamental Advisers Act Considerations

In two recent speeches, Norm Champ, who is now the Director of the SEC's Division of Investment Management (DIM), and Carlo V. di Florio, Director of the SEC's Office of Compliance Inspections and Examinations (OCIE), have highlighted the key areas of operations that private fund advisers in particular should focus on when thinking about Advisers Act compliance[1]: the firm's overall compliance program, book and recordkeeping practices, advertising and marketing activities, conflicts of interest mitigation and risk management.

The Compliance Program

Rule 206-4(7), also known as the "compliance rule," requires registered advisers to:

- adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser and its supervised persons;
- conduct a review, no less than annually, of the adequacy of these policies and procedures; and,
- designate a chief compliance officer who is responsible for administering the policies and procedures.

In its December 2003 adopting release for the compliance rule, SEC staff explained that there are no "specific elements that advisers must include in their policies and procedures." Rather, "each adviser should adopt

[1] The full text of Director Champ's remarks is available at www.sec.gov/news/speech/2012/spch051112nc.htm.
The full text of Director diFlorios's remarks is available at www.sec.gov/news/speech/2012/spch050212cvd.htm#_ftn2.

policies and procedures that take into consideration the nature of that firm's operations" and that are tailored to the firm's particular business structure, clientele and other unique criteria. An "off-the-shelf" compliance program that does not reflect an adviser's actual operations could result in the firm inadvertently violating Rule 206-4(7) or other provisions of the federal securities laws.

The SEC has stated that, to the extent they are relevant to its business, registered advisers, including private fund advisers, should have, at a minimum, policies and procedures addressing the following topics.

- **Portfolio Management Processes and Trading/Best Execution Procedures –** Director Champ suggests that private fund advisers conduct regular reviews of client accounts and "trades for unusual performance relative to peers and markets." Director di Florio adds that private fund advisers should have procedures in place to avoid favoring side-by-side funds and preferred separate accounts over less favored funds and to prevent the pursuit of larger deals solely for the reason that they "can absorb more fees."
- **Disclosure Accuracy –** Statements made to investors, clients, and regulators, including account statements and advertisements, as discussed in greater detail below under "Advertising," must be accurate and free of any untrue or misleading information. Director di Florio says that private fund advisers should also make certain they are not "opaque with fee disclosures for fear that fund investors may not see extra fees as being in their best interest."
- **Proprietary and Personal Trading** – All registered investment advisers must have robust policies and procedures regarding proprietary trading by the adviser and personal trading by its supervised persons, as discussed in greater detail below under "Conflicts of Interest and the Code of Ethics."
- **Safeguarding Client Assets and Client Privacy** – Director Champ urges advisers to "be aware that examiners may verify some or all of [the firm's] assets . . . and reach out to third parties and possibly clients in this process," and that accordingly advisers should be sure they have done adequate due diligence to protect against conversion of client assets by third parties, including consultants and service providers. He also suggests that advisers routinely check their information technology security "to ensure that clients' assets and information are not at risk."
- **Maintenance of Required Books and Records** – As discussed in greater detail below under "Books and Records," private fund advisers should begin their operations as regulated entities with strong books and recordkeeping practices.
- **Valuation and Fee Assessment Practices** – Director Champ notes that, as fiduciaries, private fund advisers must allocate fees and expenses fairly among the firm and its clients and must exercise "particular caution . . . when deals are undertaken among funds under common management and affiliated entities. In cases where two funds managed by the same investment adviser co-invest in the same investment vehicle, expenses should be allocated fairly across both funds." Director di Florio points out that private fund advisers have "an incentive to maximize fees and minimize expenses." Director Champ explains that, as such, private fund advisers should have strong and clear policies and procedures in place to prevent the "conflicts of interest that may arise when an adviser has the incentive to allocate trades to the [private] fund at the expense of affiliated mutual funds because of the opportunity for the investment adviser to earn greater profits from its management of [private] funds."
- **Business Continuity/Disaster Recovery Planning** – Business continuity planning should involve close attention to secure back up facilities that safeguard client assets and ensure the firm's ability to continue to function in an emergency.

A private fund advisory firm's compliance program should be updated regularly in connection with any changes in the firm's activities or products and, importantly, responsibility for maintaining and implementing the firm's compliance policies and procedures should be assigned to specific persons/positions. In addition, Director Champ suggests that newly registered private fund advisers should periodically test and verify their procedures – for example, by testing and verifying valuation procedures and confirming that the firm consistently follows its valuation procedures, "especially for complex or illiquid securities" – in addition to the annual compliance program review required under Rule 206(4)-7.

In order for a private fund adviser's compliance program to serve its purpose, firm employees must be adequately trained in the firm's policies and procedures and in their individual regulatory and fiduciary responsibilities. Private fund advisers, Director Champ says, should make sure their "employees

are knowledgeable about their work and . . . have enough expertise to oversee what goes on."

Books and Records

As part of their compliance programs, registered private fund advisers are required to make and keep true, accurate and current books and records relating to the firm's investment advisory business. Rule 204-2 under the Advisers Act specifies which such books and records must be kept; generally, these documents must be kept in an easily accessible location and format for five years from the end of the fiscal year in which they were last updated or disseminated. Depending on their recordkeeping practices prior to registration, private fund advisers may find this obligation particularly onerous. But once a process for maintaining proper books and records is in place, this requirement should be a relatively simple one to comply with.

The staff of DIM and OCIE explain in their article "Information for Newly-Registered Investment Advisers,"[2] that advisers "may store original books and records by using either micrographic media or electronic media. These media generally include microfilm or digital formats (e.g., electronic text, digital images, proprietary and off-the-shelf software, and email) . . . if email or instant messaging [is used] to make and keep the records that are required under the Advisers Act," the email, including all attachments that are required records, must be kept, "as examiners may request a copy of the complete record." Advisers must also take precautions to ensure that such electronic records "are secure from unauthorized access and theft or unintended destruction" and can be promptly retrieved and produced (generally within 24 hours) through an index, required by the Advisers Act, that allows for "easy location, access, and retrieval of any particular electronic record."

Advertising

Recently registered private fund advisers should make sure that their marketing staff is familiar with Rule 206-4(1) under the Advisers Act. In addition to prohibiting false or misleading statements in adviser advertising materials and subjecting advisers to the general anti-fraud provisions of the federal securities laws, Rule 206-4(1) sets forth detailed requirements regarding the use of past performance in advertisements. Director Champ notes that, as a general rule, if a firm wants to advertise performance data, it "should disclose all material facts necessary to avoid any unwarranted inferences" that could be deemed to be false or otherwise fraudulent or misleading.

More specifically, the staff of DIM and OCIE have stated that to avoid such a finding, in addition to meeting the basic requirements of Rule 206-4(1), registered advisers, including private fund advisers, displaying past performance in their marketing materials, should make certain that those materials:

- "disclose prominently that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material";
- "disclose the effect of material market or economic conditions on the results portrayed";
- "reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that accounts would have or actually paid";
- "disclose whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings";
- do not suggest or make "claims about the potential for profit without also disclosing the possibility of loss";
- disclose all material facts when comparing model or actual returns to those of "an index without disclosing all material facts relevant to the comparison (e.g., . . . that the volatility of the index is materially different from that of the model portfolio)"; and
- "disclose any material conditions, objectives, or investment strategies used to obtain the results portrayed."

Director Champ similarly advises that advisers should make sure that their advertisements include accurate and fulsome "disclosure about performance, arrangements, fees, affiliates and affiliated transactions." Advisers, Champ says, should review marketing documents, client communications and questionnaire responses to ensure information is truthful, accurate and not misleading, and should make sure they can trust the information, both external and internal, upon which they rely.

Conflicts of Interest and the Code of Ethics

It is important, Director Champ says, that private fund advisers keep in mind that they are fiduciaries to the funds they advise who must address potential conflicts of interest that could negatively impact clients. One such conflict of interest could arise when an adviser and its employees trade in the same securities as firm clients.

2 The DIM/OCIE article entitled "Information for Newly-Registered Investment Advisers" can be found at: www.sec.gov/divisions/investment/advoverview.htm.

Most private fund advisers will already have restrictions on the proprietary trading of their firms and employees vis-à-vis the trading done on behalf of clients. Rule 204A-1 under the Advisers Act, however, requires registered advisers to adopt a code of ethics that, as the adopting release for the rule explains, "sets forth standards of conduct expected of advisory personnel and addresses conflicts that arise from personal trading by advisory personnel. Among other things, the rule requires advisers' supervised persons to report their personal securities transactions." Rule 204A-1 does not explicitly prohibit registered advisers and their employees from trading in the same securities bought and sold for clients. But the staff of the DIM and OCIE note that where advisers allow proprietary/personal trading, their codes of ethics should impose conditions on such trading, including that all personal trades be pre-cleared in advance and that any new investment opportunity be offered to clients before the adviser or its employees.

Private fund advisers should also be aware of, and have detailed policies and procedures regarding, the purchase of securities by the firm's proprietary account from, and the sale of securities from the firm's proprietary account to, client accounts. Rule 206(3)-2 under the Advisers Act establishes the "explicit conditions" under which advisers may engage in such "agency cross" transactions.

One of the primary ways to address conflicts of interest is to be open and transparent about them. Private fund advisers, Director Champ says, should regularly "identify any conflicts presented by the type and structure of investments their funds typically make and ensure that such conflicts are properly mitigated and disclosed." For example, Director Champ urges that a private fund adviser should always notify a client if switching from one series of a fund to another would result in more commissions payable to the adviser and should also always disclose if the firm or any of its principals has an interest in an entity in which client funds will be invested.

Of Special Note to Private Equity Advisers

Speaking specifically to private equity fund managers, Director di Florio suggests that conflicts be considered "in the context of the lifecycle of a private equity fund: [t]he Fund-Raising Stage, the Investment Stage, the Management Stage, and the Exit Stage . . . [as] there are a number of conflicts that arise at particular stages of that lifecycle." Director di Florio explains that:

- in the Fund-Raising Stage, potential conflicts may crop up "around the use of third-party consultants such as placement agents, and . . . between the private equity fund manager, the fund or its investors, around preferential terms in side-letters";
- in the Investment Stage, the potential for insider trading is high because "even if the portfolio company has been taken private, a fund manager serving on its board could learn material nonpublic information about public companies that the portfolio company does business with";
- in the Management Stage, there is "the potential for misleading reporting to current or prospective investors on PE fund performance by selectively highlighting only the most successful portfolio companies while ignoring or underweighting portfolio companies that underperform"; and
- in the Exit Stage, "which is typically set so that the fund has a 10-year lifespan, with scope to extend for up to three one-year periods (subject to investor approval) . . . the manager could claim to need more time to divest the fund of any remaining assets, but have an ulterior motive to accrue additional management fees."

Director di Florio also noted that in order to be best prepared for a visit from OCIE, a private fund adviser should have policies and procedures in place that:

- prevent the firm from negotiating more favorable discounts with vendors than it does for the funds it manages;
- limit the extent to which a fund's assets can be invested into both the equity and debt issued by a portfolio company, which "have conflicting interests, especially during initial pricing and restructuring situations";
- require robust disclosures to be made if the firm hires a related party to perform consulting or investment banking services; and
- impose "effective information barriers" where the potential exists for confidential information to be inappropriately shared, such as "where the public and private sides of the adviser's business hold meetings or telephone conversations regarding an issuer about which the private side has confidential information, or poor physical security during business hours over the adviser's office space such that employees of unrelated financial firms that have offices in the same building could gain access to the adviser's offices."

Risk Management

The SEC has become increasingly focused on ways that registered entities can better identify and manage the risks associated with their businesses. As discussed below under "The National Examination Program," risk management is one of the primary factors driving OCIE inquiries.

Director Champ and Director di Florio urge private fund advisers that in addition to identifying and properly addressing the conflicts of interest associated with their firms' activities, they must be vigilant and assertive in evaluating their risk management structures and processes. In order to accomplish this, Director Champ suggests that private fund advisers ask the following five key questions:

- "Do the [firm's various] business units manage risks effectively at the product and asset class levels in accordance with the tolerances and appetites set by the board and senior management of the organization?
- Are the key control, compliance and risk management functions effectively integrated into the structure of the organization while still having the necessary independence, standing and authority to effectively identify, manage and mitigate risk?
- Do the firm's internal audit processes independently verify the effectiveness of the firm's compliance, control and risk management functions?
- Do senior managers effectively exercise oversight of enterprise risk management?
- Does the organization have the proper staffing and structure to adequately set its risk parameters, foster a culture of effective risk management, and oversee risk-based compensations systems and the risk profiles of the firm?"

The National Examination Program

Under Section 204 of the Advisers Act, the books and records of registered investment advisers are subject to compliance examinations by the SEC staff. Director di Florio explains that as the SEC digests the information submitted by private fund advisers on the Form ADV and Form PF filings (see article following on New Form PF), OCIE will first identify the highest risk areas of private fund adviser operations and then embark upon "coordinated examination of a significant percentage of new registrants, focusing on highest risk areas of their business," in keeping with "the NEP mission to improve compliance, prevent fraud, inform policy and monitor industry-wide and firm-specific risks." The NEP, Director di Florio emphasizes, is "based around a risk-focused exam strategy" and is supported by OCIE's new unit created in 2011, the centralized Risk Assessment and Surveillance (RAS) Unit, which enhances the ability of the NEP "to perform more sophisticated data analytics to identify the firms and practices that present the greatest risks to investors, markets and capital formation."

Director di Florio notes that OCIE collects and inventories in "a continual, real-time process," in which the office makes "a top-down assessment of which firms appear to exhibit" the greatest risks and "a bottom-up assessment . . . as to which firms exhibit a higher risk profile given their business activities and regulatory profile." With respect to private funds in particular, Director di Florio says that basic risk characteristics tracked by OCIE include:

- "material changes in business activities such as lines of business or investment strategies";
- changes in senior management and other "key personnel";
- activities of the firm and its personnel outside of the investment advisory business;
- any "anomalies in key metrics such as fees, performance, disclosures when compared to peers or to previous periods"; and
- evidence of "possible financial stress or weaknesses."

If a private fund adviser receives a document request from, or is scheduled to be examined by, OCIE, Director di Florio explains that examiners will likely be looking to answer the following questions regarding risks at the firm:

- "Is the firm's process for identifying and assessing problems and conflicts of interest that may occur in its activities effective?
- Is that process likely to identify new problems and conflicts that may occur as the future unfolds?
- How effective and well-managed are the firm's policies and procedures, as well as its process for creating and adapting those policies and procedures, in addressing potential problems and conflicts?
- How clear are investor disclosures around ancillary fees (particularly those charged to portfolio companies), management fee offsets and allocation of expenses? How robust are the processes to ensure compliance with those disclosures?
- Does the firm have a complicated set of diverse products? If so, how are inter-product conflicts managed?

- How sophisticated and reliable are the processes used by the Fund? Is the valuation process robust, fair and transparent? Are there strong processes for compliance with the fund's agreements and formation documents? Are compliance and other key risk management and back office functions sufficiently staffed? What is the quality of investor communications? What is the quality of processes to ensure conflict resolution in disputes with or among investors?
- What is the overall attitude of management toward the examination process, its compliance obligations, and toward risk management generally, compared to its peers?"

Stressing that firms should be prepared for an OCIE examination or inquiry at any time, Director di Florio says that advisers should "know how to readily access data that our examiners are likely to want to see . . . having strong records to document your due diligence on transactions and on valuations will also help . . . greatly. It will also be enormously helpful . . . if you can show us that you have documented ongoing monitoring and testing of the effectiveness of your policies and procedures. Finally, it is important to be forthcoming about problems. Nothing could be worse than for us to find a problem, through an examination or through a tip, referral or complaint, that personnel in your organization knew about but tried to conceal." Examinations and information requests, Director di Florio and other OCIE staff have said, could focus on only one issue, such as fair valuation of illiquid securities, the use of third-party solicitors in marketing efforts or whether the firm chief compliance officer has full support and adequate resources.

But perhaps most important of all the advice offered by the SEC staff to the new breed of registered private fund advisers is the following from Director di Florio on how to avoid being examined by the SEC in the first place:

The best way to avoid attracting our attention would be to be very proactive and thoughtful about identifying conflicts, both the ones I have mentioned as well as others that you are aware of, and remediating those conflicts with strong policies, procedures and other risk controls, as well as making sure that your firm has a strong ethical culture from top to bottom.

FORM PF

In addition to the disclosures required by Form ADV, the uniform registration package for investment advisers, most private fund advisers with at least $150 million will be required to make periodic reports to the SEC on Form PF following the end of their first fiscal quarter that occurs after December 15, 2012. Private fund advisers with more than $5 billion in assets under management were required to make their first quarterly report on Form PF by August 29, 2012.

As the SEC has explained, the information disclosed on Form PF "will be used by the Financial Stability Oversight Council to monitor risks to the U.S. financial system and by the SEC to conduct risk assessments of private fund advisers." Moreover, as both Director Champ and Director di Florio explain, OCIE will use the information collected on Form PF to identify the highest risk areas of private fund adviser businesses and to determine how to "allocate examination resources across existing and new registrations." Private fund advisers should be certain to provide truthful and accurate information on Form PF in a timely manner.

The filing requirements for a private fund adviser depend on its client base and the amount of assets under its management; different disclosure items and filing deadlines apply to advisers to private equity funds, hedge funds and to liquidity funds, and to "large private fund advisers" with more than $1.5 billion in hedge fund assets under management. Director Champ urges advisers required to report on Form PF to be proactive in assessing and preparing for the Form PF compliance date. "Form PF may require voluminous data," and private fund advisers, Director Champ explains, "may find that they do not maintain or collect all of the information that is required. Much of the information may be located in various places throughout the firm and some effort may be required to collect and report the information." Accordingly, if they have not already, Director Champ warns, private fund advisers should begin immediately identifying the sources within their businesses where the data resides, determining how to best capture such data, collecting and compiling the data, and assuring its accuracy.

In working up to the fast-approaching Form PF deadlines, private fund advisers should also consult the Frequently Asked Questions on Form PF published by the SEC, which is available at www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml.

LIBOR AND THE ASSET MANAGEMENT INDUSTRY

With concerns about the accuracy of panel member reporting dating back to early 2008, the accusations of LIBOR rate-fixing came to a head in late June when Barclays Bank PLC admitted to U.S. and foreign regulators that its traders had manipulated LIBOR (the London Interbank Offered Rate). LIBOR is a series of benchmark interest rates for various currencies, including U.S. LIBOR, which is denominated in U.S. dollars. In its settlement, Barclays agreed to pay more than $450 million and confessed that it had engaged in a scheme to rig LIBOR that affects more than $300 trillion in loans and securities.

LIBOR is set on a daily basis by the British Banking Association (the BBA) using rates – that are intended to be representative of actual loan transactions or the "true costs of borrowing" – submitted by a panel of international banks, the so-called Panel Banks. LIBOR is currently used globally to calculate the interest rates applicable to trillions of dollars in personal and institutional loans, and therefore also to trillions of dollars worth of swap agreements and other credit-related derivatives. Speaking to the U.S. House Financial Services Committee in late July, U.S. Treasury Secretary Tim Geithner reported that the Financial Stability Oversight Council established by the Dodd-Frank Act, along with other regulatory agencies, was in the process of investigating the reach of the LIBOR scandal into the U.S. financial system, noting his belief that LIBOR is structured in a way that is vulnerable to misreporting.

At least 16 financial institutions have been accused – by regulators in enforcement actions and/or private investors in civil suits – of manipulating or colluding to manipulate LIBOR. The involved banks are alleged to have submitted artificially depressed rates to the BBA, which allowed the banks to profit by paying lower interest rates on LIBOR-based financial instruments than the rates at which they sold credit products to investors.

The current scandal over LIBOR could have very far-reaching consequences. First, as is well-known, LIBOR serves as the base for the calculation of interest owed and interest earned on a wide variety of debt instruments, including many commercial and consumer applications. If it develops that the Panel Banks deliberately provided quotes that had the effect of holding LIBOR down, that would mean that every borrower benefited in that it paid less than it would have paid, and every lender received too little for the time-value of the money that it lent.

In additional to the usual lenders, i.e., commercial banks, all of the non-bank lenders in the shadow banking community are potentially involved, i.e., money market funds, private equity firms and hedge funds investing in debt, as well as individual savers. It also means that a broad swath of corporate America is involved since a number of operating companies have substantial "cash" balances that are probably invested in commercial paper or its equivalent. And corporate pension plans that are defined benefit plans and were invested in debt may also have been short-changed.

Second, almost all of the existing litigation has been brought under anti-trust laws and state consumer protection laws/theories, rather than the federal or state securities laws (where the statutes of limitation may have run), with a concomitant effect on legal issues like standing, nature of the claim, burden of proof, defenses, damages, and statutes of limitation, among other things.

Third, multiple regulators are potentially involved, including the federal and state banking agencies, the Department of Justice and SEC in the United States, and equivalent authorities in Europe.

The LIBOR rate-fixing has also likely resulted in mutual funds and private funds invested in debt securities and related derivative instruments receiving lower investment yields and producing lower returns than they would have absent the manipulation.

One of the first major fund complexes to pursue an action in court is Charles Schwab Corporation. Schwab filed suit in August 2011 and asserted that its money market funds and other vehicles invested in short-term debt and other fixed-income strategies were at a heightened risk of being harmed by fraudulent activity involving LIBOR.

According to Morningstar, Inc., a handful of alternative strategy mutual funds, including nontraditional bond funds, with roughly $24 billion in total assets, uses LIBOR as their primary benchmark, and accordingly may have a distorted relative performance history due to the depression of LIBOR.

In addition to the Charles Schwab plaintiffs, other institutional investors are currently pursuing LIBOR-related claims for losses related to:

- banks that made loans tied to rigged LIBOR numbers;

- the sale of over-the-counter derivatives and other financial instruments indexed to LIBOR, including but not limited to interest rate swaps;
- transactions in Eurodollar futures contracts and options on futures contracts traded on the Chicago Mercantile Exchange;
- investments in U.S. dollar-denominated debt securities, the payable interest on which was based on U.S. LIBOR;
- commodity banks with under $1 billion in total assets that issued loans tied to U.S. LIBOR; and
- the purchase of Barclay's-sponsored American Depository Receipts.

The full impact of the LIBOR scandal remains to be seen. But fund advisers and boards of directors should be sure to carefully consider the risks associated with investing in LIBOR-linked securities and with borrowings that have interest rates tied to LIBOR. They may also wish to examine their current insurance and any renewals, to be sure adequate and appropriate coverage is in place.

Perkins Coie has created a LIBOR task force to monitor the evolving U.S. LIBOR-related investigations and claims and to advise clients. Investors with questions regarding U.S. LIBOR-related claims should contact counsel to ensure their concerns are addressed. Answers to Frequently Asked Questions about the LIBOR crisis as well as ongoing updates from our LIBOR task force are available online at: **http://www.perkinscoie.com/libor_taskforce.**

NEW DOL DISCLOSURE RULES IMPACT MUTUAL FUND DISTRIBUTION

The New Rules

On February 3, the U.S. Department of Labor (the DOL) released new regulations under Section 408(b)(2)[3] of the Employee Retirement Income Security Act of 1974 (ERISA) that require, in relevant part, retirement plan sponsors/administrators (RPAs) to disclose to covered plan[4] participants information regarding the amounts paid by plans for recordkeeping and other plan administration services. This disclosure must be made as part of the fee and expense disclosure required by the DOL's so-called "participant-level disclosure regulations" that were adopted in October 2010 under Section 404(a) of ERISA and apply to most 401(k) plans.[5]

As stated in the statute, the purpose of the participant-level disclosure regulations is to ensure that retirement plan participants "are provided sufficient information regarding the plan, including fees and expenses, and regarding designated investment alternatives, including fees and expenses attendant thereto, to make informed decisions with regard to the management of their individual accounts." [6] The participant-level disclosure regulations require such disclosures to be made to participants upon joining a plan and annually thereafter.

While the new 408(b)(2) rules speak mostly to the disclosures that covered service providers[7] – such as recordkeepers and broker-dealers – and their affiliates and subcontractors must provide to RPAs, the DOL's Employee Benefits Security Administration (ESBA) explains that the service provider disclosures are intended to facilitate RPAs' full compliance with the participant-level disclosure regulations.[8] According to the ESBA, the new 408(b)(2) rules are necessary because "in recent years, arrangements for how services are provided to employee benefit plans and how services providers are compensated (e.g., through revenue-sharing and other arrangements) have become increasingly complex. Many of these changes have improved efficiency and reduced the costs of administrative services and benefits for plans and their participants. However, the complexity resulting from these changes has made it more difficult for many plan sponsors and fiduciaries to understand how, and how much, service providers are compensated." [9] The 408(b)(2) regulations in effect provide RPAs with

[3] 29 C.F.R. § 408b-2(c), as amended by 77 Fed. Reg. 5632 (Feb. 3, 2012).

[4] Plans covered by the new rules include defined benefit pension plans and defined contribution plans within the meaning of Section 3(2)(A) of ERISA, such as 401(k) plans, but not individual retirement accounts (IRAs) or other single member plans such as certain 403(b) annuity contracts and custody accounts, simplified employee pension plans (SEPs) and SIMPLE retirement accounts.

[5] 29 C.F.R. § 2550.404a-5 (75 FR 64910, Oct. 20, 2010).

[6] 29 C.F.R. § 2550.404a-5(a).

[7] A "covered service provider" is any entity that enters into a covered plan for $1,000 or more in compensation for services rendered (1) as any fiduciary to a plan that makes direct equity investments; (2) as an investment adviser to a plan; (3) as a recordkeeper or broker-dealer to participant-directed, individual account plans (such as 401(k) plans) in connection with the offering, through a distribution platform, of designated investment alternatives for the plan; and (4) by parties receiving "indirect compensation" from sources other than plan assets for providing accounting, auditing, actuarial, appraisal, banking, consulting, custodial, insurance, investment advisory, legal, recordkeeping, securities or other investment brokerage, third party administration or valuation services.

[8] See ESBA Field Assistance Bulletin No. 2012-02, available at www.dol.gov./ebsa/regs/fab2012-2.html.

[9] See www.dol.gov/ebsa/newsroom/fs408b2finalreg.html

a great deal of administrative fee and expense information that is "within the control of, or reasonably available to" RPAs such that they must disclose it under the administrative expense provisions of the participant-level disclosure regulations.

Among other data, RPAs' administrative expense disclosure must, effective July 1, 2012, reflect:

- compensation paid directly from plan assets, including for services provided by RPAs;
- fees charged directly against the plan's investments on a transactional basis, such as commissions and sales charges;
- fees charged directly against the plan's investments that are reflected in the net value of the plan's investments, such as mutual fund Rule 12b-1 fees;
- "indirect compensation"[10] paid from sources other than plan assets for services provided to the plan;
- fee and expense information for all types of investments, such as mutual funds or investment contracts, that are "designated investment alternatives" of the plan, including the investment's annual operating expense ratio, as calculated in accordance with the participant-level disclosure regulations;
- in the case of recordkeepers and broker-dealers who make plan "designated investment alternatives," such as mutual funds, available through a distribution platform or other means, any and all fee and expense information about the investment of which the recordkeeper or broker-dealer is or should be aware; and
- all direct and indirect compensation paid for "recordkeeping services," even if the recordkeeper expects the services to be provided, "in whole or in part, without explicit compensation . . . or when compensation for recordkeeping services is offset or rebated based on other compensation received by the covered service provider, an affiliate, or a subcontractor."

Impact on Mutual Fund Distribution

Information on revenue sharing payments (i.e., compensation generated through the assessment of fees based on a percentage of plan assets that is paid among affiliated plan service providers – typically the investment adviser and recordkeeper or transfer agent/sub-transfer agent) may be embedded in each of the above information categories. RPAs have long used revenue sharing to cover plan administration costs. But as industry participants point out, this financing practice (in which plan participants with higher account balances and/or investments that produce higher revenue sharing payments essentially subsidize the administration costs for participants holding lower account balances and/or investments in underperforming investments) may likely come as an unwelcome surprise to plan participants reading the new 408(b)(2) disclosure for the first time.[11]

The DOL's enhanced disclosure obligations and the increased level of fee and expense transparency they create have caused many RPAs to find ways to lower the various costs of administering their plans. In response, many mutual fund complexes selling their products as designated investment alternatives now offer a variety of institutional share classes, with a variety of fee structures, designed to house retirement plan investments.

- Some institutional retirement plan share classes do not impose sales charges or Rule 12b-1 distribution fees and instead impose a high minimum initial investment, sometimes in the millions of dollars.
- Investment advisers typically pay low or no revenue sharing payments on institutional retirement plan share classes.
- And as RPAs have started to move away from revenue sharing toward per-transaction fees paid directly by plan participants, funds have begun offering institutional retirement plan share classes that carry a cap on recordkeeping or transfer agent/sub-transfer agency fees. This option, in which the RPA covers plan administration costs with fees charged directly to individual participant account balances, allows RPAs to "use the lowest cost investment vehicle and/or share class, for which a plan qualifies," for each of the fund complexes in which the plan invests.

These trends, industry participants note, continue to push the costs of beneficial shareholder services outside the fund expense ratio, while at the same time increasing the number and type of channels through which fund shares are sold.[12] Fund boards of directors should take this into account when considering share class and other proposals related to the DOL's new disclosure rules and related trends. Similarly, fund complexes

[10] See n.7 above.

[11] See "Financing Your 401(k) Plan," at p. 1, a white paper published by Gosselin Consulting Group, LLC (July 2011, as updated February 2012).

[12] See "A Perspective on an Evolving Mutual Fund Marketplace: Investments, Distribution, Share Classes and More," a white paper published by Asset International

should be proactive in making room in their share class lineups for RPAs seeking ultra-low cost investment options so as to gain the greatest distribution exposure appropriate.

REGULATORS AND LAW ENFORCEMENT MAINTAIN FOCUS ON INSIDER TRADING

It has been five years since the SEC and the FBI launched an insider trading probe of expert network firms, investment advisers, analysts and traders, but their efforts to stem the illegal business of tipping and trading on material nonpublic information show no signs of slowing down.

The most common type of insider trading involves a corporate insider or tippee profiting by buying shares of a company targeted to be acquired before announcement of the planned acquisition and selling the shares after the rise in value associated with the merger. But there are many ways in which material nonpublic information can be shared and used, and each insider trading case brought by federal and/or state officials offers a cautionary tale on how those in the asset management industry can avoid even the appearance of engaging in insider trading.

The following recent enforcement cases illustrate some of the circumstances under which the SEC has alleged insider trading to have occurred.

- In *SEC v. Moshayedi,*[13] the SEC charged the CEO of a technology company with selling shares of his company in order to take advantage of the then high share price before it dropped substantially in connection with the announcement by one of the company's primary customers that its demand for the company's products had decreased significantly. Generating approximately $134 million in proceeds, Mr. Moyshayedi sold his shares in advance of the release of his company's third quarter revenue guidance, which he knew the company would not be able to meet due to the decreased demand of its major customer. This, the SEC contended, was tantamount to a fraudulent scheme to deceive.
- U.S. Attorney Preet Bharara has filed a number of cases that show the continued risk to asset management professionals of using expert network firms. In *United States v. Ebrahim,*[14] a former AT&T executive pleaded guilty to relating detailed information on AT&T's product sales to an expert networking firm that then widely disseminated the information to its clients through "consultation calls" spanning a period of at least two years. In *SEC v. Nguyen,*[15] the SEC asserted that the owner of an equity research firm "frequently traded in the securities of Abaxis, Inc. based on inside information he received from a close relative employed at Abaxis. Nguyen repeatedly traded for himself in advance of the company's quarterly earnings announcements while in possession of key data in those announcements, reaping tens of thousands of dollars in illicit profits. Nguyen also passed that same information to hedge fund clients of Insight Research, who used the inside information to make millions of dollars in profits from trading Abaxis securities." In its press release regarding Mr. Nguyen's case, the SEC reported that it had "charged 23 defendants in enforcement actions arising out of its expert networks investigation, which had uncovered widespread insider trading at several hedge funds and other investment advisory firms. The insider trading alleged by the SEC has yielded illicit gains of more than $117 million, chiefly in shares of technology companies."
- In April, the SEC announced that Goldman Sachs & Co. had agreed to settle charges of failing "to implement policies and procedures that adequately controlled the risk that research analysts could preview upcoming ratings changes with select traders and clients."[16] According to the SEC, this risk arose in the "weekly huddles" that Goldman held from 2006 to 2011 that were sometimes attended by sales personnel and "in which analysts discussed their top short-term trading ideas and traders discussed their views on the markets." In 2007, Goldman began a program in which "analysts shared information and trading ideas from the huddles with select clients," and according to the SEC, this program "created a serious risk that Goldman's analysts could share material, nonpublic information about upcoming changes to their published research with . . . clients and the firm's traders."
- Emphasizing how even the most casual of conversations can result in charges of illegal insider trading, over this past summer, the SEC charged a Massachusetts man with insider trading based on material nonpublic information he learned regarding a pending acquisition "from a close friend at a social event,"[17] and also "charged the close friend of a CEO with insider trading in the stock of a

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[13] Civil Action No. CV12-1179 JST (C.D. Cal. July 19, 2012).

[14] No. 1:12-cr-00471-JPO (S.D.N.Y June 18, 2012).

[15] See www.sec.gov/news/press/2012/2012-121.htm.

[16] See Securities Exchange Act Release No. 66791, File No. 3-14845 (April 12, 2012).

[17] See www.sec.gov/news/press/2012/2012-151.htm.

[18] See www.sec.gov/news/press/2012/2012-143.htm.

Houston-based employment services company by exploiting confidential information he learned while they were spending time together."[18]

SEC COMMISSIONER PUSHES BOARDS TO DEBATE, DISSENT BEFORE ACTING

Speaking in July at the Society of Corporate Secretaries and Governance Professionals, SEC Commissioner Troy A. Paredes gave his opinion of "what makes for an effective" board in the context of the expanded power of the federal government over the economy resulting from the enactment of the Dodd-Frank Act in 2010.[19]

According to Commissioner Paredes, "the goal of good corporate governance is to promote good corporate decision making," and "boards of directors are expected to improve decision making by spurring deliberation." Directors, Paredes said, bring to the board room "different perspectives, experiences, sensibilities and expertise . . . the expectation is that as the group works through a range of ideas and arguments, the decision that is made will be better as a result of the directors' collective efforts." In his remarks, set forth below, Paredes urged that such collective efforts should be undertaken with energy, focus and good intentions:

The active engagement of directors is the lynchpin of meaningful deliberation. Decision making should improve when directors — whether interacting with each other or with management — engage in open and frank discussions, even if it means being critical and disagreeing. When assessing some course of action, directors should ask probing questions and follow-ups of each other and of management; should identify and challenge key assumptions; should offer competing analyses; and should develop competing options to ensure that alternatives are considered and not cast aside too readily.

Put differently, directors should be willing to dissent, and disagreement from others should not be discouraged or suppressed. When it leads people to engage rigorously, disagreement helps ensure that the unknown is identified; that potential conflicts are spotted; that information is uncovered; that overconfidence and other biases are managed; that "outside the box" thinking is sparked; and that challenges and opportunities are assessed in a more balanced way. More to the point, directors cannot become complacent or too deferential to management just because the CEO has been making the right calls and the company has been on a good run. Whether the company is successful or struggling, the tough questions need to be asked to help ensure that the best decisions are made going forward. Indeed, a board may want to consider designating one or two directors, perhaps on a rotating basis, whose explicit charge it is to be skeptical and to press when needed.

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There is a word of caution, however. Disagreement and spirited deliberation should not give way to hostility. Distrust and disharmony can threaten an enterprise; boards need collegiality and cooperation and a well-functioning relationship with management. Dissent will be most constructive, then, when conflicting viewpoints and pointed resistance do not trigger defensiveness, but instead are encouraged by board members and the CEO alike as the way to reach better decisions.

Commissioner Paredes, acknowledging the persistent uncertainty and volatility in the markets, also asked directors to work hard to avoid "being too cautious and hesitant. A dynamic and prosperous economy," he said, "depends on the rewards that materialize when enterprises are willing and able to take the risks that spur innovation and propel growth."

LEADERSHIP CHANGES AT THE SEC

A number of high-level position changes have occurred at the SEC this year, including the following.

- Norm Champ, who had been serving as Deputy Director of the SEC's Office of Compliance Inspections and Examinations (OCIE), replaced retiring Eileen Rominger as the Director of the agency's Division of Investment Management (DIM). Director Champ, who has voiced his enthusiasm for interviewing mutual fund independent directors as part of OCIE's inspections process, assumed his new role effective July 9.
- Effective in early September, Andrew Bowden, who began serving as the National Associate Director of OCIE's investment adviser and investment company examination program in 2011, took over Director Champ's former role as Deputy Director of OCIE. Director Bowen will work with Director diFlorio to head up OCIE.
- Robert Plaze, a well-known member of the SEC staff for more than 30 years, retired from the agency at the end of August. Plaze had most recently served as the Deputy Director of the DIM and filled many roles in the Division and contributed to a variety of SEC rule-making and interpretive guidance. According to the SEC's news release, Deputy Director Plaze "was most recently responsible

[19] The full text of Commissioner Paredes's speech is available at: www.sec.gov/news/speech/2012/spch071312tap.htm.

for rulemaking for money market mutual funds and to implement a Dodd-Frank Act requirement for hedge fund and other private fund advisers to register with the SEC. He also played a critical role in rulemaking to improve mutual fund governance practices, to include fee tables in mutual fund prospectuses, to standardize the method of calculating mutual fund performance used in advertisements, to require mutual funds and investment advisers to adopt compliance programs, to require investment advisers to deliver a plain-English brochure to clients, and to protect pension funds and other investors from pay to play practices."

- Paula Drake, who most recently served as the General Counsel and Chief Operating Officer at Oechsle International Advisors, LLC was appointed in July to serve as Chief Counsel and Chief Compliance and Ethics Officer for OCIE, beginning August 6.
- Thomas Butler was appointed in June to serve as Director of the SEC's new Office of Credit Ratings that was created by the Dodd-Frank Act and is responsible for overseeing the nine Nationally Recognized Statistical Rating Organizations (NRSROs), including Standard & Poors, Moody's and Fitch.
- Diane C. Blizzard was named in April as the Associate Director for Regulatory Policy and Investment Adviser Regulation in the DIM, responsible for supervising two offices that develop recommendations for rulemaking and other policy initiatives under the Investment Company Act and the Investment Advisers Act, including those relating to private fund advisers.
- In early August, John Cross was appointed Director of the SEC's Office of Municipal Securities (the OMS). The OMS, which was previously part of the SEC's Division of Trading and Markets, was created in response to a call in the Dodd-Frank Act for the creation of a stand-alone office that reports directly to the Chairman and administers SEC rules regarding advisers, issuers, broker-dealer practices, and investors in the municipal securities market. The office will coordinate with the Municipal Securities Rulemaking Board (the MSRB). Mr. Cross will join the SEC staff in September. Most recently, he has served as the Associate Tax Legislative Counsel in the Office of Tax Policy at the U.S. Treasury Department.

The SEC has also launched the new Investor Advisory Committee (the IAC), which was required by the Dodd-Frank Act "to advise the Commission on regulatory priorities, the regulation of securities products, trading strategies, fee structures, the effectiveness of disclosure, and on initiatives to protect investor interests and to promote investor confidence and the integrity of the securities marketplace." The IAC has 21 members, each of whom was nominated by the SEC's five sitting Commissioners. A list of the members of the new IAC is available at www.sec.gov/news/press/2012/2012-58.htm.

Speaking at the IAC's inaugural meeting in June, SEC Chairman Mary Schapiro noted that "the participation of retail investors in our capital markets is crucial to [the United States'] economic success," and requested that the IAC "focus on the needs of retail investors" who "continued to withdraw cash from U.S. equity funds in 2011, continuing a trend that has seen a total outflow of a half trillion dollars from domestic equity funds since 2006." [20]

RECENT PUBLICATIONS

In addition to the topics covered in this issue of our newsletter, Perkins Coie attorneys have recently written about a variety of matters arising in the financial services industry. These publications include:

- "The Effect of the JOBS Act on Private Investment Companies: Foreseen Consequences?," by Martin E. Lybecker, published in the May 2012 issue of the ABA's *Business Law Today*.
- "Tackling Mutual Fund Risk in the Omnibus Channel," by Gwendolyn A. Williamson, published in the July 2012 issue of *The Investment Lawyer*.
- "Insurers May Play Hardball on Libor Claims Against Funds," by Timothy W. Burns, published in the August 9, 2012 issue of *Ignites!*.

[20] The full text of Commissioner Schapiro's speech is available at: www.sec.gov/news/speech/2012/spch061212laa.htm.