Investment Management Industry News Summary - August 2003

AUGUST 31, 2003

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CFTC adopts final rules modernizing registration requirements of Commodity Pool Operators ("CPOs") and Commodity Trading Advisers ("CTAs")

August 18, 2003 3:47 PM

The CFTC continued to implement the Commodity Futures Modernization Act by adopting rule amendments and new rules intended to "rationalize requirements, remove unnecessary regulatory burdens and facilitate participation in the commodity futures and options markets." Specifically, the new rules provide exemptions from CPO and CTA registration for unregistered funds (e.g., hedge funds) which:

Have limited futures activities. New Rule 4.13(a)(3) provides an exemption from registration as a CPO to the operator of pools which:

- are offered privately in the U.S. pursuant to an exemption from registration under the Securities Act of 1933;

- at all times meet one of the following tests with respect to commodity positions (including securities futures): (A) the aggregate initial margin and premiums required to establish such positions do not exceed 5% of the liquidation value of the portfolio after taking into account unrealized profits; or (B) the aggregate net notional value of such positions does not exceed 100% of the liquidation value of the portfolio after taking into account unrealized profits;
- the operator of which must have a reasonable belief that each participant in the pool is one of the following: an "accredited investor" as defined in Rule 501 of Regulation D under the Securities Act of 1933; a trust that was formed by an accredited investor; a "knowledgeable employee" of the pool as defined in the Investment Company Act of 1940; or a "qualified eligible person" as defined in CFTC Rule 4.7 ("QEPs"); and
- are not marketed as vehicles for trading in the commodity futures or commodity options markets.

In accordance with comments received by the CFTC, the percentage limitations were increased (from 2% and 50%, as proposed) to 5% and 100% as adopted. The final rule also includes new Appendix A, which provides guidance on the application of Rule 4.13(a)(3) to fund-of-funds.

- Restrict participation to sophisticated purchasers. New Rule 4.13(a)(4) provides an exemption from registration as a CPO to the operator of pools which:
- are offered privately in the U.S. pursuant to an exemption from registration under the Securities Act of 1933; and
- are offered exclusively to participants that the operator has a reasonable belief are (A) if natural persons, QEPs and (B) if non-natural persons, QEPs or accredited investors.

Unlike Rule 4.13(a)(3) the final Rule 4.13(a)(4) has no limitation on the commodity futures activity in which any such pool may engage and contains no restriction how the pool may be marketed (which differs from the rule proposal).

In addition, the new rules and rule amendments:

- Eliminate percentage restrictions on use of futures by regulated entities (such as mutual funds) that are excluded form the definition of CPO under CFTC Rule 4.5. The final amendments, unlike the proposed amendments, also eliminate the "no marketing" criterion (*i.e.*, that a Rule 4.5 qualifying entity may not participations as a commodity pool or vehicle for trading commodity futures or commodity options). As amended, however, the rule still contains a disclosure requirement.
- Facilitate communications by CPOs and CTAs with prospective and existing pool participants and clients.
- Eliminate duplicative regulatory requirements for "master-feeder" structures.
- Address certain issues related to the calculation and presentation of past performance by CPOs and CTAs.

CFTC Release #4829-03 (August 4, 2003)

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SEC dismisses enforcement action that found fraud in connection with sale of Class B shares

August 18, 2003 9:35 AM

The SEC recently overturned on appeal an enforcement proceeding in which the administrative law judge (ALJ) had found that the respondents committed fraud in connection with the sale of Class B shares of mutual funds to investors. The SEC issued a brief opinion which simply stated that cases involving breakpoints and the sale of Class B shares involve important issues and that although the SEC will continue to pursue such cases, the case before the SEC did not contain sufficient evidence to support a finding of liability on the charges brought before the SEC.

In the administrative proceeding, the ALJ found that an investment adviser and two individuals associated with the investment adviser and a broker-dealer had violated several anti-fraud laws by failing to disclose all of the material facts regarding the advantages of various share classes of mutual funds that they were recommending to clients, such as availability of sales charge breakpoints for Class A shares and by misrepresenting the advantages of Class B shares. The clients were participants in a sophisticated investment strategy that involved market-timing through investments in various mutual funds. Despite the fact that the clients were intelligent and sophisticated, the ALJ had concluded the anti-fraud violations occurred as a matter of law. Nevertheless, the ALJ did not impose many of the sanctions sought by the SEC because of the clients' level of sophistication, satisfaction with their results and the lack of proof with respect to some of the SEC's allegations.

In re. Michael Flannagan et. al., SEC Rel. 34-48255 (July 30, 2003).

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SEC proposes rules requiring disclosure of nominating committee functions and communications between security holders and boards

August 18, 2003 9:32 AM

The SEC recently proposed new rules that would increase disclosure concerning the nomination and election of new directors. All of the new disclosures, which would apply to both traditional operating companies and registered investment companies, would be required to be included in proxy statements. In applying the proposed rule to investment companies, the SEC reasoned that, similar to operating companies, the enhanced disclosure requirements may benefit fund security holders by improving the transparency of the nominating process and board operations, as well as increasing security holders' understanding of the funds in which they invest.

Nomination committees and the nomination process. The proposals would require companies to disclose:

- whether they have a separate nominating committee, and if not, why not and who determines director nominees;
- whether the members of the nominating committee satisfy independence requirements;
- their process for identifying and evaluating director candidates and establishing minimum qualifications;
- whether they accept candidates put forward by shareholders and their processes for doing so; and
- whether they have rejected candidates put forward by long-term institutional shareholders.

Communications between shareholders and directors. Companies also would be required to disclose:

- whether they have a process for shareholder communications to directors, and if not, why not;
- their procedures for communications between shareholders and directors;
- whether shareholder-director communications are screened, and by what process; and
- whether material actions have been taken as a result of shareholder communications in the previous fiscal year.

In its proposing release, the SEC sought comments (due by September 15, 2003) on the following questions relating to investment companies:

- Should the proposed amendments that would require disclosure regarding the operations of board nominating committees apply to investment companies?
- Should the proposed amendments that would require new disclosure concerning the means by which security holders may communicate with members of boards apply to investment companies?
- Are there any aspects of the proposed amendments that should be modified in the case of investment companies?
- Should the SEC apply the “interested person” standard of Section 2(a)(19) of the Investment Company Act in requiring disclosure regarding the independence of members of a fund’s nominating committee or should it instead apply a different standard to investment companies, such as the listing standards of national securities exchanges or national securities associations?

Release Nos. 34-48301; IC-26145; File No. S7-14-03

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SEC and Department of Treasury(“DOT”) issue guidance on customer identification programs for mutual funds; clarify that funds must obtain board approval by October 1, 2003

August 18, 2003 9:29 AM

The staffs of the SEC and the DOT issued a letter containing four questions and answers (“Q&As”) clarifying issues raised by the final CIP rule. The following are summaries of these Q&As:

- The first Q&A clarifies that mutual fund complexes do not have to perform customer identification procedures on exchanges and new purchases by existing shareholders, as long as the fund complex offers exchange privileges to its shareholders and has a reasonable belief that it knows their true identities. The first Q&A also notes that this “reasonable belief” requirement would apply only with respect to shareholders that were not identified and verified pursuant to a fund’s CIP (*i.e.*, those shareholders in existence before October 1, 2003).
- The second Q&A clarifies that the intermediary that opens an account with a mutual fund through the NSCC Fund/SERV system would be the fund’s customer for purposes of the CIP rule and the intermediary’s customers would not be the fund’s customers. In addition, the Q&A makes no distinction based on whether the account is subject to a networking arrangement.
- The third Q&A states that the SEC staff would not object to a mutual fund’s closing of an account and redemption of an investor’s shares after reasonable efforts to verify his or her identity have failed, if the shares are valued in accordance with the net asset value next calculated after the mutual fund decides to close the account. The Q&A also notes that a mutual fund may want to consider whether the circumstances surrounding the failure to verify the customer’s identity would warrant the filing of a Suspicious Activity Report (SAR).
- The fourth Q&A clarifies that mutual funds must obtain board approval of their CIPs by

October 1, 2003. The Q&A states, however, that SEC and DOT staff would not object if the fund were to obtain approval by a committee of the board by that date and obtain approval by the full board at the next regularly scheduled board meeting.

Questions and Answers Regarding the Mutual Fund Customer Identification Program Rule (31 CFR 103.131) (August 11, 2003)

New York Attorney General investigates illegal trading in mutual fund shares

August 18, 2003 9:27 AM

New York Attorney General Eliot Spitzer announced an investigation of allegations that mutual fund companies engaged in illegal after-hours trading arrangements with large customers, such as hedge funds. The investigation has already resulted in a settlement with one hedge fund manager that allegedly arranged with a mutual fund company to engage in late trading and market-timing in return for providing other business to the mutual fund company and its affiliates. Mr. Spitzer stated that future charges against mutual fund companies are “almost certain.” Reportedly, in addition to late trading, the investigation is focused on complicity by mutual fund advisers and distributors with market-timers whose in-out investment strategies generate increased costs to other fund shareholders.

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