Investment Management Industry News Summary - February 2010

FEBRUARY 28, 2010

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SEC Issues Policy Statement and Announces Other Initiatives to Encourage Cooperation in Investigations

February 5, 2010 12:22 PM

On January 13th, the SEC announced measures to encourage greater cooperation in investigations and enforcement actions, and to improve the quality, quantity, and timeliness of information and assistance the SEC receives. The SEC published a policy statement that for the first time described the way the SEC will evaluate whether and how it will credit cooperation by individuals. The policy is similar to the "Seaboard Report" that was issued in 2001, which detailed the factors the SEC considers when evaluating a company's cooperation. The policy statement describes the following considerations:

- The assistance provided. The SEC will consider the value and the nature of the cooperation.
- The importance of the matter in which the individual cooperated. The SEC will consider the

character of the investigation and the dangers to investors or others that the underlying violations present.

- The societal interest in ensuring the individual is held accountable for the misconduct. The SEC will consider the severity of the misconduct, the individual's culpability, the degree to which the individual tolerated illegal activity, the efforts to remediate the harm, and the sanctions imposed by other authorities and industry organizations.
- The appropriateness of cooperation credit based upon the individual's risk profile. The SEC will consider the individual's history of lawfulness, the degree to which the individual accepted responsibility, and the individual's opportunity to commit future violations of the federal securities laws.

The SEC also streamlined the process for submitting witness immunity requests to the Justice Department, and the Division of Enforcement authorized its staff to use additional tools to encourage cooperation. A revised version of the Division's enforcement manual describes these tools, which include formal written cooperation, deferred prosecution and non-prosecution agreements that were not previously available in SEC enforcement matters.

For more information, please see:
http://www.sec.gov/rules/policy/2010/34-61340.pdf
http://www.sec.gov/news/press/2010/2010-6.htm

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SEC Settles Actions Against Investment Advisers and an Adviser's Principals for Unlawful Short Selling Practices

February 5, 2010 12:11 PM

On January 26th, the SEC settled actions with two investment advisory firms and one firm's principals for engaging in improper short selling of securities before their participation in a company's secondary offering. These are the first actions the SEC filed under amended Rule 105 of Regulation M, which prohibits a person from selling short a security that is the subject of a registered offering and purchasing the security from an underwriter or broker-dealer participating in the offering if the short sale is effected during the shorter of the period: (1) beginning five business days before the pricing of the offered securities and ending with the pricing; or (2) beginning with the initial filing of the registration statement and ending with the pricing.[1] This conduct is prohibited irrespective of the short seller's intent in effecting the short sale. The amended rule does not apply if the person sold short during the restricted period in a different account than the account that purchased the shares in the offering, provided that decisions regarding the transactions for each account were made separately without coordinating trading or cooperating in another way. In determining to settle the actions, the SEC considered remedial acts undertaken by the respondents and their cooperation with the SEC staff.

The SEC alleged that a hedge fund manager registered with the SEC violated Rule 105 when three of its funds sold short 50,000 shares of a company's stock for $53.51 per share on September 18, 2008, and received 50,000 shares of the company's stock at $49 per share in a secondary offering on September 24, 2008. The hedge funds made a profit of $225,500, the SEC alleged. Without admitting or denying the SEC's charges, the firm consented to cease and desist from committing further violations of Rule 105, to be censured, and to pay $225,500 in disgorgement, $10,901.58 in prejudgment interest, and $105,000 in a civil money penalty.

The SEC also alleged that a state-registered investment adviser and its principals violated Rule 105 before and after the SEC's rule amendments in connection with their management of an investment fund for the principals' assets and another private investment fund primarily for outside investors.[2] The SEC alleged that in April 2007, respondents violated Rule 105 then in effect[3] when the principals' fund earned an alleged profit of $16,450 by selling short 173,632 shares of a company at an average price of $2.57 per share during the five-day restricted period and then covering its short position with shares that the outside investors' fund purchased in the secondary offering for $2.10 per share. The SEC also alleged that in June 2008, the outside investors' fund purchased 200,000 shares of a company in a secondary offering at $8.08 per share and the principals' fund sold short 16,200 shares of the company during the restricted period at an average

price of $8.45 per share, which resulted in a difference of $7,290. The principals' fund also earned $14,704 by participating in the secondary offering. The SEC alleged that the transactions resulted in a total of $23,740 in improper profits. Although the two funds had different prime brokers, different trading strategies, and separate profit and loss statements, the SEC's order found that the principals' close collaboration fell outside of the exception in Rule 105 for transactions in separate accounts. The SEC alleged: (1) the principals allocated shares from the outside investors' fund to cover a short position in the principals' fund; (2) each of the principals had authority to place trades for both funds (one of the principals placed most of the trades for one fund and one-third of the trades for the other fund); (3) respondents did not maintain information barriers to separate the funds or prevent information sharing about their securities positions and investment decisions; and (4) the principals often discussed and shared trading ideas. Without admitting or denying the SEC's charges, the respondents consented to cease and desist from committing further violations of Rule 105, to be censured, and to pay $38,444 in disgorgement, $2,921 in prejudgment interest, and $20,000 in a civil money penalty.

For more information, please see:

http://www.sec.gov/news/press/2010/2010-13.htm

http://www.sec.gov/litigation/admin/2010/34-61421.pdf

http://www.sec.gov/litigation/admin/2010/34-61422.pdf

[1] The amended rule was effective October 9, 2007.

[2] The principals also owned a small portion of the outside investors' fund.

[3] Before October 9, 2007, Rule 105 prohibited covering a short sale with offered securities purchased from an underwriter or broker-dealer participating in the offering if the short sale occurred during the period beginning five business days before the pricing of the offered securities and ending with the pricing.

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Chairman Schapiro Speaks at CCOutreach National Seminar

February 5, 2010 12:06 PM

On January 26th, Chairman Schapiro spoke at the SEC's CCOutreach National Seminar. Chairman Schapiro noted that this was the first joint seminar for compliance officers of broker-dealers, investment advisers and investment companies. Moving toward a harmonized approach in thinking about compliance makes sense, she said, and matches the SECs efforts to harmonize compliance examinations and to seek greater collaboration between the broker-dealer and adviser examination programs. She said that an SEC examiner should have the right skill sets to do the job regardless of the firm's title (e.g., investment adviser or broker-dealer). Investors do not know the difference between investment advisers and broker-dealers, the services provided by each are often indistinguishable, and the broker-dealer and investment adviser industries have merged, she explained. As a result, Chairman Schapiro supports a common fiduciary standard for investment advisers and broker-dealers that is at least as strong as the fiduciary duty under the Investment Advisers Act of 1940, as well as equivalent regulatory requirements for all securities professionals.

Chairman Schapiro explained that because the SEC is a relatively small agency, the SEC has been seeking ways to leverage third parties to protect investors, such as requiring independent accountants to verify assets and review custody controls, encouraging corporate insiders to cooperate in enforcement matters, and seeking legislation to enable the compensation of whistleblowers. The SEC is also increasing its "human intelligence" by seeking staff with expertise in particular areas, bolstering its training programs, and determining areas where risk-targeted examination sweeps may uncover fraudulent activities or provide insight on strong compliance practices. For example, the staff is conducting examination sweeps of more than 50 registrants in the U.S. and U.K. focusing on how advisers have managed CDOs, hedge funds, and other vehicles that hold asset-backed securities and other structured products during the credit market crisis.

Chairman Schapiro emphasized that compliance officers have an obligation to provide investors

with added security. In order to succeed, she said that compliance officers must understand the rules, approach their roles with sufficient skepticism, diligently root out wrongdoing, and remain committed to investors. She also said that compliance officers should evaluate the impact of regulatory developments, market changes and industry practices on compliance, communicate developments regularly to the firm's business units, regularly review conflicts, and regularly review communications involving employees and officers to ensure they are following the rules. Additionally, Chairman Schapiro indicated that a compliance officer should understand: (1) the firm and its clients, investment strategies, and employees; (2) the firm's business partners (including custodians, administrators and prime brokers) and how they are selected; (3) who the firm trades with and its counterparty risk; and (4) how money moves at the firm, including potential conflicts and the effect of compensation on decision-making. She emphasized that compliance officers have the most meaningful impact making sure the firms comply with the law and preventing problems before they occur.

For a copy of the speech, please see: http://www.sec.gov/news/speech/2010/spch012610mls.htm

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SEC Adopts Rule Amendments for Money Market Funds

February 5, 2010 11:57 AM

On January 27th, the SEC voted 4 to 1 to adopt new rules, amendments to Rule 2a-7, and a new form under the Investment Company Act of 1940 governing money market funds. It appears that several amendments will be as proposed in June 2009,[1] but the SEC made important changes to some of its proposals and added additional amendments. The provisions tighten the maturity and credit quality standards, add new liquidity standards, require additional disclosures of portfolio information, and address large-scale redemptions. The provisions also require each money market fund's board of directors to designate at least four nationally recognized statistical rating organizations ("NRSROs") that the board considers to be reliable for use by the fund to satisfy the minimum ratings requirements. The current requirement that money market funds invest in asset-backed securities only if they are rated by an NRSRO will be eliminated. Money market funds will be permitted to invest in repurchase agreements only if the collateral consists of cash items or government securities and the money market fund (or its adviser) evaluates the creditworthiness of the repurchase counterparty. The rules will be effective 60 days after publication in the Federal Register, and compliance will be phased in throughout the year.

For a summary of the open meeting, please see:
http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=9389

For the webcast of the open meeting, please see:
http://www.sec.gov/news/openmeetings.shtml

For copies of the statements by the Chairman and Commissioners, please see:
http://www.sec.gov/news/speech.shtml

For the SEC press release regarding the adopted provisions, please see:
http://www.sec.gov/news/press/2010/2010-14.htm

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[1]For WilmerHale's summary of the June 2009 proposal, please see: http://www.wilmerhale.com/publications/periodicals/investment_management/blog.aspx?entry=2375.

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