Investment Management Industry News Summary - September 2002

SEPTEMBER 30, 2002

This Summary, which draws from a wide range of sources, endeavors to condense important investment management regulatory news of the preceding week into one, easily digestible source. This Summary is not intended as legal advice. Readers should not act upon information contained in this Summary without professional legal counsel. This Summary may be considered advertising under the rules of the Supreme Judicial Court of Massachusetts.

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SEC proposes rules relating to analyst certifications

September 16, 2002 1:53 PM

The SEC recently proposed Regulation Analyst Certification ("Regulation AC") to address concerns regarding research analyst independence and objectivity. Proposed Regulation AC is the latest action taken by the SEC to address conflicts of interest affecting research issued by securities firms and is intended to complement other rules governing these conflicts of interest, including rules recently adopted by the New York Stock Exchange and the National Association of Securities Dealers.

Proposed Regulation AC would require, among other things, that any research report disseminated by broker-dealers include certifications by research analysts that the views expressed in the research report accurately reflect the analysts' personal views, and whether the analysts received compensation or other payments in connection with their specific recommendations or views. Research analysts also would be required to provide certifications and disclosures in connection with public appearances.

The release does not explicitly discuss the applicability of proposed Regulation AC to portfolio managers. However, in its general request for comment, the SEC requests comment on the proposed definitions of “research report” and “research analyst” (which, as proposed would not include an investment adviser, such as a mutual fund portfolio manager, who is not principally responsible for preparing research reports). The SEC also requests comment on whether there are certain classes of persons associated with a broker-dealer that should not be subject to the rule, and whether the rule should explicitly exclude investment advisers.

DOL issues advisory opinion on commissions paid by plans to unaffiliated brokers

September 16, 2002 10:12 AM

The DOL recently issued an advisory opinion (the “Advisory Opinion”) which clarifies that the prohibition on sales commission payments contained in Prohibited Transaction Exemption (“PTE”) 77-4 does not apply to commissions paid by a plan to an independent broker that executes the plan’s purchase or sale of shares of open-end investment companies registered under the Investment Company Act of 1940 (the “1940 Act”).The request at issue in the Advisory Opinion involved the purchase and sale of Exchange Traded Funds (“ETFs”) on a securities exchange.

Provided that a number of conditions are met, PTE 77-4 exempts from the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Internal Revenue Code transactions for the purchase or sale by an employee benefit plan of mutual fund shares where the investment adviser for the fund is also a fiduciary with respect to the plan (or an affiliate of such fiduciary) and is not an employer of employees covered by the plan. One condition for the exemption is that the plan must not pay a sales commission in connection with the purchase or sale.

In the Advisory Opinion the DOL concluded that the term “sales commission” does not include commissions in connection with purchases or sales of shares of registered open-end investment companies if the broker is unaffiliated with the fund, its principal underwriter, investment adviser or any affiliate thereof. The DOL noted that the primary intent of the sales commission restriction in PTE 77-4 is to avoid the potential abuses that could arise if a mutual fund, its adviser or an affiliate were to receive a commission or load in a transaction with a plan. The DOL cautioned, however, that if a plan fiduciary that is an investment adviser to a fund causes the plan to pay commissions to affiliated broker-dealers, the receipt of commissions would constitute a separate prohibited transaction under ERISA section 406(b), for which no relief would be available under PTE 77-4.

The DOL observed that ETFs are a more recent development in the securities markets and that their trading procedures differ from those of traditional open-end investment companies. In particular, the DOL noted the distinction between direct purchases and redemptions of ETFs (generally in large blocks called “creation units”) effected through an in-kind tender of securities, versus trades of individual ETF shares between investors on securities exchanges that result in brokerage commissions being paid to brokers who may or may not be related to the fund, its investment adviser, or their affiliates. Additionally, the Advisory Opinion stated that PTE 77-4 would not apply to the in-kind purchase or sale of ETF creation units by employee benefit plans.

SEC staff provides guidance on types of criminal offenses covered by Investment Advisers Act of 1940 (the "Advisers Act")

September 16, 2002 10:06 AM

The staff of the SEC's Division of Investment Management released a staff no-action letter in response to a telephone inquiry regarding whether Section 203(e)(3) of the Advisers Act applies only with respect to "felony" offenses. The staff stated that Section 203(e)(3) covers all crimes punishable by one or more years' imprisonment regardless of whether a state or federal statute refers to a violation of a particular law as a "felony." The staff also noted that Section 203(e)(3) covers offenses that may result in actual criminal sanctions involving imprisonment for less than one year (or no imprisonment at all) as long as the person convicted of the crime could have been imprisoned for one year.

Section 203(e)(3), which was passed by Congress in 1996 in connection with the National Securities Market Improvement Act, gives the SEC authority to institute proceedings to deny or revoke the registration of an investment adviser if the adviser (or any person associated with the adviser) has been convicted of a crime punishable by imprisonment for one or more years. Although a Senate report discussing the section uses the term "felony," the staff indicated that it believes the reference was merely shorthand.

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Treasury Department may curtail tax benefits to hedge funds using insurance arrangements

September 12, 2002 10:17 AM

According to a recent Wall Street Journal article, the Treasury Department (the "Treasury") is threatening a crackdown on certain sophisticated insurance arrangements used to avoid taxes on hedge fund investments. Such arrangements include:

- Investors buying hedge funds through insurance policies that invest the premiums in one or more hedge funds in order to achieve tax-free gains and, in some cases, avoid estate taxes; and
- Hedge fund operators and other financial services firms establishing offshore insurance companies that invest in hedge funds and allowing investors to buy shares in the insurance company to get the benefit of the hedge fund and also pay the lower capital-gains tax rate on the earnings, rather than the higher rate for ordinary income.

Among the issues the Treasury may be exploring are whether offshore insurance companies established by hedge fund operators are taking on real insurance risk, and whether insurers are giving investors too much control over their investments. Some investment advisers predict that the government will eventually more strictly regulate the insurance "wrappers."

In a statement this week, the Treasury's acting assistant secretary, Pam Olson, said department officials are "well aware" of the hedge-fund strategies [to avoid taxes]. "We have under way several projects addressing their proper tax treatment – projects we expect to release shortly," she said.

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Investment Company and Investment Advisers Act Developments

September 2, 2002 10:23 AM

New Rules for Registered Investment Companies: Under the Sarbanes-Oxley Act of 2002.

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