

FINANCIAL SERVICES ALERT

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ATTORNEYS GENERAL EXPAND INQUIRY INTO “PAY TO PLAY” ABUSES INVOLVING STATE PENSION FUNDS

[Goodwin Procter’s White Collar Crime & Government Investigations Practice Area](#) has been closely monitoring, and counseling clients regarding, the situation resulting from NY Attorney General Andrew Cuomo’s recent announcement that his office is partnering with 35 other attorneys general across the country to create a multi-state task force to investigate potential “pay to play” and other abuse involving government pension funds. Attorney General Cuomo’s office and the SEC have been investigating corruption relating to the NY State pension fund for the past two years, and have already filed several criminal and civil cases. The announcement reflects a broadening of this investigation to cover other government pension investments, and other states, and included a disclosure that more than 100 new subpoenas were issued to investment firms and intermediaries who brokered deals with public pension funds. Attorneys in Goodwin Procter’s White Collar Crime & Government Investigations Practice Area are actively advising clients on issues raised by this task force. If you have any questions or concerns about the investigation, please contact [Rich Strassberg](#) or any member of Goodwin Procter’s White Collar Crime & Government Investigations Practice Area, or your Goodwin Procter attorney.

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DEVELOPMENTS OF NOTE

SEC Votes to Propose Amendments to Adviser Custody Rule

At its open meeting on May 13, 2009, the SEC voted to propose amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended. Rule 206(4)-2 imposes certain requirements on a registered adviser that has custody of client assets, or is deemed to have custody of client assets by virtue of its access to them, *e.g.*, when the adviser has the authority to withdraw funds from a client account held by a third party custodian. According to an SEC press release describing the Commission's action, the proposal would make the following changes to the rule:

Surprise exam for all advisers with custody - All registered advisers with custody of client assets would have to undergo an annual "surprise exam" by an independent public accountant to verify those assets exist.

Annual SAS-70 requirement for advisers holding clients assets with an affiliated custodian - Advisers whose client assets are not held or controlled by an entity independent of the adviser would be required to retain a PCAOB-registered and inspected accountant to prepare a SAS-70 report that, among other things, would describe the controls in place at the custodian, tests the operating effectiveness of those controls, and documents the results of those tests. The review would have to meet PCAOB standards.

Reporting requirements - An adviser would be required to disclose in public filings with the SEC, among other things, the identity of the independent public accountant that performs its "surprise exam," and would have to amend those filings to report a change in that accountant. The accountant would have to report the termination of its engagement with the adviser and, if applicable, any problems with the examination that led to the termination of its engagement. An accountant would have to report to the SEC any material discrepancies found during a surprise examination.

Direct delivery of statements to clients - The proposed amendments would require all custodians holding advisory client assets to deliver custodial statements directly to advisory clients rather than through the investment adviser. Advisers opening custody accounts for clients would have to instruct the clients to compare the account statements they receive from the custodian with those they receive from the adviser.

In remarks at the open meeting, Commissioner Paredes, who indicated that he supported the proposal, asked for comment on the following particular issues, noting that in 2003 the SEC had considered measures similar to those being proposed and chose not to adopt them:

- (1) whether the surprise examination requirement should cover investment advisers with an independent qualified custodian or be targeted to instances where the investment adviser or a related person is the qualified custodian, given that non-affiliated custodians already serve as an important safeguard of client assets;
- (2) whether the rules should cover investment advisers who have custody only because they withdraw fees from client accounts;
- (3) the extent to which the new requirements could adversely impact competition if they are disproportionately costly and burdensome for smaller entities; and

- (4) the extent to which the new rules could foster moral hazard by promoting an undue sense of security that dissuades investors from doing their own diligence. Commissioner Paredes indicated that it was worth considering the circumstances under which active investor diligence may do more to deter and detect misconduct than certain regulatory demands.

The period for public comment on the proposal will run for sixty days from the date of the proposal's publication in the *Federal Register*. The *Alert* will provide additional coverage once the SEC makes the formal release describing the proposal publicly available.

Treasury Proposes Framework for Regulating OTC Derivatives

In a letter to Senator Harry Reid (D. Nevada) Timothy Geithner, the Secretary of the Treasury (the "Treasury") proposed a regulatory framework for regulating over-the-counter ("OTC") derivatives. The OTC derivatives market, noted the Treasury currently is largely unregulated. The Treasury stated that regulation of the OTC derivatives market, including the market for credit default swaps, should be aimed to achieve four broad objectives: (1) preventing OTC derivatives activities from posing systemic risk to the financial system; (2) making the OTC derivatives market more efficient and transparent; (3) preventing market manipulation, fraud and other market abuses; and (4) seeing that OTC derivatives are not marketed to unsophisticated purchasers.

(1) *Preventing activities within the OTC markets from posing systemic risk to the financial system.* The Treasury suggested that the Commodity Exchange Act (the "CEA") and federal securities laws be amended to require clearing of all *standardized* OTC derivatives through regulated central counterparties ("CCPs"). Standardized OTC derivatives generally are "plain vanilla trades" and are characterized by standard contract terms and structures. The Treasury stated that regulators will need to make certain that CCPs impose strong risk controls and margin requirements, and Treasury also noted that regulators will have to ensure that *customized* (as opposed to standardized) OTC derivatives are not utilized solely as a means of avoiding use of a CCP. Customized derivatives are those with characteristics that are transaction specific and are typically complex. The Treasury further stated that if an OTC derivative is accepted for clearing by one or more regulated CCPs, "it should create a presumption that it is a standardized contract and thus required to be cleared."

The Treasury further stated that, to control systemic risk, OTC derivatives dealers and other firms with large exposures to specific counterparties should be subject to prudential supervision and regulation, including conservative capital requirements, business conduct standards, reporting requirements and initial margin requirements on counterparty exposures on both standardized and customized contracts.

(2) *Promoting efficiency and transparency within the OTC markets.* The Treasury stated that the CEA and federal securities laws should be amended to authorize the CFTC and the SEC to impose recordkeeping reporting requirements on OTC derivatives and to require maintenance of a documented audit trail. CCPs and trade repositories, said the Treasury, should be required to make aggregate data on open positions and trading volumes publicly available. Furthermore, according to the Treasury, CCPs and trade repositories should be required to make a specific counterparty's trades in positions available on a confidential basis to the CFTC, the SEC and the counterparty's primary regulators.

The Treasury also stated that it was important that the standardized part of the OTC derivatives market be moved to regulated exchanges and transparent electronic trade execution systems. According to the Treasury, these changes would allow market participants to see prices and would make markets more transparent. Moreover, the Treasury added, a system should be developed for timely reporting of trades and prompt dissemination of prices and other trade information.

(3) *Preventing market manipulation, fraud and other market abuses.* The Treasury stated that the CFTC and SEC should be given clear and unimpeded authority to police fraud, market manipulation and other market abuses involving OTC derivatives. Moreover, the CFTC should have authority to set position limits “on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.”

(4) *Ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.* The Treasury said that, although current law attempts to protect unsophisticated parties against the risk of entering into inappropriate derivatives transactions by limiting the types of counterparties that may participate in these markets, the limits need to be made more stringent. The Treasury stated that the CFTC and the SEC are reviewing current limits and will make recommendations concerning the tightening of those limits, additional disclosure requirements and/or standards of care for marketing derivatives to less sophisticated counterparties, such as municipalities.

Furthermore, the Treasury stated that it needed to work closely with regulators in other jurisdictions to promote implementation of complementary systems so that U.S. enhanced controls and regulations are not undermined by the movement of OTC derivatives transactions to less highly regulated jurisdictions. It is generally recognized that implementation of the Treasury’s proposals, in the aggregate, will, in all likelihood, make it more expensive for issuers, dealers and purchasers to participate in the derivatives market. The Treasury also stressed that changes to the OTC derivatives market should do nothing that would call into question the enforceability of OTC derivatives contracts. Finally, the Treasury’s proposal sets forth policy objectives and some details regarding implementation of a program, but many elements of the Treasury’s program will be amended, altered or refined by Congressional actions as well as by the regulators in the development of implementing regulations.

Fourth Circuit Reverses District Court Dismissal of Class Action Securities Fraud Claims Against Mutual Fund Investment Adviser

On May 7, 2009, the U.S. Court of Appeals for the Fourth Circuit (the “Fourth Circuit”) reversed a decision by the U.S. District Court for the District of Maryland (the “District Court”) in which the District Court dismissed plaintiffs’ shareholder suit brought against the adviser to a family of mutual funds (the “Adviser”) and its publicly traded parent (the “Parent”) for failing to state a claim under Section 10(b) of, and Rule 10b-5 under, the Securities Exchange Act of 1934 (the “1934 Act”) against either defendant or a claim under Section 20(a) of the 1934 Act against the Parent. The plaintiffs, who were stockholders of the Parent, alleged that the Adviser and the Parent were responsible for certain false disclosures regarding restrictions on frequent trading appearing in prospectuses for a number of individual funds. The plaintiffs alleged that they had bought shares of the Parent at inflated prices, which fell when the market timing practices actually allowed by the

Adviser were publicly disclosed. (The Adviser settled SEC enforcement proceedings in 2004 related to market timing in certain of the funds.)

Section 10(b) Primary Liability. The Fourth Circuit held that the plaintiffs sufficiently pled all six elements of a private Section 10(b) securities fraud claim against the Adviser, but failed to sufficiently plead a Section 10(b) claim against the Parent. The Fourth Circuit focused most of its attention on whether the plaintiffs had met their burden of proving that they had relied on the defendants' alleged misrepresentation, and in particular, on the sole issue under the fraud-on-the-market doctrine disputed by the parties: whether the statements regarding frequent trading restriction in the funds' prospectuses were sufficiently attributable to the defendants to be treated as public statements by them. Noting that the courts of appeal "have diverged over the degree of attribution required to plead reliance," the Fourth Circuit held that a plaintiff seeking to avail itself of the presumption of reliance under the fraud-on-the-market doctrine "must ultimately prove that interested investors (and therefore the market at large) would attribute the allegedly misleading statement to the defendant. At the complaint stage a plaintiff can plead fraud-on-the-market reliance by alleging facts from which a court could plausibly infer that interested investors would have known that the defendant was responsible for the statement at the time it was made, even if the statement on its face is not directly attributable to the defendant." Noting (a) statements in fund prospectuses and statements of additional information regarding the Adviser's day-to-day role in managing fund affairs, (b) the fact that the funds, the Adviser and the Parent held themselves out to the public as a single entity, and (c) the fact that the defendants and the funds maintained a single website that was used to disseminate fund prospectuses, the Fourth Circuit concluded that interested investors would have inferred that if the Adviser had not itself written the frequent trading disclosure in fund prospectuses, it must at least have approved the disclosure.

As to the Parent, however, the Fourth Circuit observed that while an investment adviser "is well known to be intimately involved in the day-to-day operations of the mutual funds it manages," it is not necessarily "apparent to the investing public that the investment advisor's parent company, which sponsors a family of funds, participates in the drafting or approving of prospectuses issued by the individual funds." In a concurring opinion, one member of the three-judge panel argued that since the Parent was alleged to have made the fund prospectuses available on its website, the prospectus disclosures should be attributed to the Parent; therefore, a claim of primary liability under Section 10(b) and Rule 10b-5 had been properly pled against the Parent.

Section 20 Control Liability. Although it found that the plaintiffs failed to allege a Section 10(b) claim of primary liability against the Parent, the Fourth Circuit nevertheless held that plaintiffs had sufficiently pled a claim of control person liability against the Parent under Section 20(a) of the 1934 Act. In general terms, Section 20(a) provides for joint and several liability of any person with any persons it directly or indirectly controls for the controlled persons' violations of the 1934 Act and its rules. The Fourth Circuit held that the plaintiffs' allegations adequately pled the Parent's control of the Adviser because the plaintiffs alleged that (a) the Parent wholly owns the Adviser, (b) the Parent and Adviser shared a common director who was also a portfolio manager at the Adviser during the class period; (c) the CEO and President of the Parent during part of the class period, who had previously served as a senior officer of the Adviser, spearheaded publicly discussed efforts by the Parent to combat market timing; and (d) employees of the Parent had publicly discussed market timing policies and actions taken to prevent timing in a manner indicating presumptive control over those efforts.

The Fourth Circuit reversed the motion to dismiss as to both defendants and remanded the case to the District Court.

SEC Settles Administrative Proceeding with Investment Adviser and its former COO over Use of Third-Party Proxy Voting Service

The SEC settled administrative proceedings with a registered investment adviser (the “Adviser”) and the Adviser’s former chief operating officer (the “COO”) over the Adviser’s use of a third-party proxy voting guidelines in its proxy voting procedures, which the SEC found had not complied with paragraphs (a) and (c) of Rule 206(4)-6 under the Investment Advisers Act of 1940. Rule 206(4)-6(a) requires an adviser’s written policy for proxy voting to address material conflicts of interest that may arise between the investment adviser’s interests and those of its clients. Rule 206(4)-6(c) requires an adviser to provide its clients with a description of its proxy voting policy.

The Adviser’s Choice of Proxy Voting Service. According to the SEC findings, in deciding how to vote client securities the Adviser chose to rely upon the recommendations of Institutional Shareholder Services (“ISS”), a third-party proxy voting service. After several months of using the ISS-General Guidelines, the Adviser switched to the ISS-PVS Guidelines, which followed the voting recommendations of the AFL-CIO. According to the SEC settlement order, the Adviser believed this change could improve its score on the AFL-CIO Key Votes Survey (the “AFL-CIO Survey”), a survey that placed investment advisers into one of three tiers based upon the percentage of votes the advisers cast that were consistent with AFL-CIO voting recommendations on key voting issues. The order also states that union-affiliated clients had communicated displeasure with some of the Adviser’s votes made while the Adviser used the ISS-General Guidelines, and that the Adviser believed other prospective union-affiliated clients might use the AFL-CIO Survey as a factor in selecting an investment adviser. The Adviser also believed that the ISS-PVS Guidelines applied a reasonable standard for enhancing shareholder value as it related to corporate governance matters.

Violations of Rule 206(4)-6. The SEC found that the Adviser violated Rule 206(4)-6(a) because the Adviser’s proxy voting policies failed to address its potential conflict of interest in following the ISS-PVS Guidelines for all clients while the Adviser sought to attract union-affiliated clients. The SEC also found that the Adviser failed to adequately describe its proxy voting policies and procedures to clients in violation of Rule 206(4)-6(c) because the Adviser failed to disclose that the ISS-PVS Guidelines followed AFL-CIO voting recommendations. In addition, the policies and procedures sent to clients indicated that the Adviser did not expect any conflicts of interest to arise under the proxy voting policies and procedures because the Adviser used a third party proxy voting service. The COO reviewed and edited counsel’s drafts of the proxy voting policies and procedures, and executed the cover letter accompanying the policies and procedures sent to clients, which also indicated that use of a third party voting services was expected to prevent any conflicts from arising. The SEC found that in his capacity as such, the COO had a duty to evaluate whether the procedures created conflicts of interest between the Adviser’s and its clients’ interests. The COO was found to have willfully aided and abetted and caused the Adviser’s violations of Rule 206(4)-6.

Subsequent Changes to Proxy Voting Policies. The SEC order describes the Adviser’s subsequent revisions to its procedures to bring them into compliance with Rule 206(4)-6. The Adviser disclosed to its clients that the Adviser had chosen as its standard voting policy

third party voting guidelines based on AFL-CIO voting recommendations and that this choice could result in the Adviser retaining and obtaining Taft-Hartley or other union-affiliated clients. The Adviser also offered clients the choice of voting proxies pursuant to ISS guidelines that were more management-friendly. In addition, “although not required by [Rule 206(4)-6],” the Adviser subsequently allowed clients to choose from several voting recommendations. The Adviser also changed its default voting policy from the ISS-PVS Guidelines to recommendations based on client type.

Penalties. Under the settlement, the Adviser must pay a \$300,000 civil money penalty and the CCO must pay a \$50,000 civil money penalty.

Treasury Reopens CPP Application Window for Banks with \$500 Million or Less in Total Assets

In his speech to the Independent Community Bankers of America, Treasury Secretary Geithner announced that the Treasury will re-open the Capital Purchase Program (“CPP”) application window for banks with total assets under \$500 million and raise from 3% of risk-weighted assets to 5% the amount for which qualifying institutions can apply. The application window is being reopened for all term sheets – public and private corporations, Subchapter S corporations, and mutual institutions. For further discussion of the CPP, please see the [October 14, 2008](#), [October 21, 2008](#), and [October 27, 2008 Alerts](#) for discussion of the CPP generally and for public institutions, the [November 18, 2008 Alert](#) for a discussion of the CPP for private institutions and the [April 14, 2009](#) and [April 21, 2009 Alerts](#) for discussion of the CPP for mutual institutions. Current CPP participants will be allowed to reapply, and will have an expedited approval process. The Treasury will also extend the deadline for small banks to form a holding company for the purposes of the CPP. Both the window to form a holding company and the window to apply or re-apply for CPP will be open for six months. The Treasury plans to fund these additional capital investments under the CPP using the proceeds of the repayments it expects to receive from some of the largest banks.

SEC Files Suit Alleging Insider Trading in Credit Default Swaps

The SEC initiated an action in federal district court against a portfolio manager at an investment adviser to a hedge fund and a salesman at an investment bank alleging that they had violated Section 10(b) of, and Rule 10b-5 under, the Securities Exchange Act of 1934, by engaging in insider trading in credit default swaps (“CDSs”). According to the SEC, this action is the first such action brought by the SEC alleging insider trading in those types of instruments.

In its complaint, the SEC alleges that the salesman had learned from investment bankers at his firm that a company his firm was advising would be offering a new tranche of bonds in a restructured offering, and that those bonds were intended to be covered by existing CDSs referencing the company’s bonds. The SEC also alleges that upon the closing of the restructured offering, the increase in the supply of the company’s bonds that were covered by existing CDSs would increase the exposure and demand for those CDSs, thus increasing their market prices. The complaint further alleges that the salesman, in violation of his firm’s insider trading policies, passed the information concerning the new tranche to the portfolio manager, along with additional confidential information relating to the orders his firm already had lined up for that tranche, and that the portfolio manager in turn purchased for the hedge fund CDSs referencing the company’s bonds. The complaint then alleges that

when the news of the restructured bond offering became public, the price of the company's CDSs increased as expected, the hedge fund closed its positions in those instruments, making a profit of approximately \$1.2 million. The SEC has asked the court to permanently enjoin the defendants from further violations of Section 10(b) and Rule 10b-5, and order them to disgorge their unlawful trading profits plus interest and pay civil penalties.

Goodwin Procter represents one of the defendants in this case.

FinCEN Semi-Annual SAR Review Discusses the Securities and Futures Industries

The current issue of the Financial Crimes Enforcement Network's ("FinCEN") semi-annual SAR Activity Review (the "Review") focuses specifically on the securities and futures industries and includes a number of articles pertaining to SAR filings by securities broker-dealers, futures commission merchants, and introducing brokers in commodities.

Not surprisingly, the Review points out that the number of SAR filings from the securities and futures industries has increased every year. According to the Review, in calendar year 2008, the securities and futures industries filed more than 15,000 SARs to address a broad range of suspicious activity, including structuring activities (designed to evade tax, Bank Secrecy Act, and other reporting requirements), the use of securities and commodities trading accounts for purposes other than investments, and the alleged use of charitable organizations for possible terrorist financing activities.

The Review includes articles authored by the staffs of the SEC and the Financial Industry Regulatory Authority ("FINRA"). Of particular note, the two staffs collaborated on a useful piece describing examination expectations and providing guidance for enhancing the effectiveness of broker-dealer anti-money laundering ("AML") programs and SAR-filing approaches. The article points out that examiners generally focus on four key items:

- Whether AML policies and procedures are adequately designed to meet the risks posed by a firm's business, size, customers, and products.
- Whether written policies and procedures are, in fact, being implemented; that is, whether firms are actually following what is written.
- Whether transaction monitoring is reasonably designed to identify potentially suspicious activity.
- Whether a firm's SAR decision-making processes are adequate to ensure accurate, timely, complete, and confidential SAR filings.

The article then notes some common examination findings. The SEC and FINRA staffs specifically note that many firms fail to identify and report potentially suspicious transactions involving so-called "penny stocks." As the article notes, transactions in such very low-priced and thinly traded securities can, in certain circumstances, be red flags for fraud and market manipulation and require thorough investigation.

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OTHER ITEM OF NOTE

SEC Staff Posts Standardized Request for Confirming Account Balances as part of Examinations

The SEC staff posted the standardized request letter that all examiners will use going forward if they seek confirmation of account balances from customers/clients of securities firms or investment advisers in connection with examinations of those entities.

http://www.sec.gov/about/offices/ocie/routine_account_information_confirmation.pdf