IA WEEK

Regulatory news and compliance best practices.

■ INSIDE...

July 16, 2007

Securities and Exchange Commission approves hedge fund anti-fraud rule

The **SEC** unanimously approved a final rule giving it explicit authority to act against hedge fund advisers who mislead clients or prospective investors, or commit some other fraudulent activities. The new rule gives the Commission "an important tool to help police this market," chairman **Christopher Cox** said at an open meeting last week.

The rule, originally proposed in December, closes a loophole the Commission feared might have been created by the D.C. Court of Appeals' decision last year throwing out the SEC rule to register hedge fund advisers (*IA Week,* July 10, 2006). The court said that the fund was the client of the hedge fund adviser, not the investors in the fund.

In presenting the rule for final approval, SEC staff said it represents no new regulatory burden

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Raising the bar for accredited investors: Not yet

A hedge fund rule package proposed in December also included two rule proposals to create a new category of investor, the "accredited natural person," specifically eligible to buy into private investment vehicles such as hedge funds. The main difference in the new category from the "accredited investor" in Regulation D was the additional requirement of $2.5 million in investment assets along with the net worth or income requirements.

SEC staff noted that only 1.87% of U.S. households qualified as accredited investors in 1982, when the criteria were first set, but that grew to 8.47% by 2005, due to inflation and particularly the appreciation of residences. Adding the new criterion would bring the percentage back down to 1.3% of households qualifying and better ensure a financial sophistication to deal with an unregistered investment like a hedge fund.

This part of the proposal was not discussed at

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IPOs of alternative asset managers garner attention of SEC and Capitol Hill

Issues swirling around the recent IPOs of **Fortress Investment Group LLC** and **The Blackstone Group L.P.** required initial **SEC** scrutiny and attracted the spotlight of a Capitol Hill hearing last week. In Congressional testimony, the director of the Commission's Division of Investment Management **Andrew Donohue** discussed IPOs of investment managers of hedge and private equity funds. Donohue further revealed the process the SEC undertook to ultimately determine that the alternative assets managers were not investment companies.

In his appearance before the House Committee on Financial Services, Donohue focused on the question of whether alternative asset managers are investment companies subject to the Investment Company Act. Donohue noted that should they be

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Wachovia pays fine, restitution for fee-based account violations

NASD recently fined **Wachovia Securities** $2 million for failing to supervise fee-based brokerage accounts and ordered the firm to pay about $3 million in restitution to customers.

The case highlights some of the problems with the accounts. It comes as firms take steps to move customers out of them in the wake of a federal court ruling against the **SEC** exemption that allows brokers to charge a set fee for an account without registering as an investment adviser.

Between 2001 and 2004, NASD found, many clients were steered into Wachovia's "Pilot Plus" accounts even though it was not appropriate for them, either for the number of trades they conducted or for the amount they had invested.

"Wachovia failed to implement a system designed to ensure that an assessment of the appropriateness of the fee-based account occurred," said **James Shorris**, NASD's head of enforcement.

While the firm informed its brokers that a Pilot Plus account was not appropriate for customers who made a limited number of trades, buy-and-hold customers, or customers with assets below $50,000, it failed to implement procedures to supervise the appropriateness of the accounts.

NASD found that 594 Wachovia customers who conducted no trades in their Pilot Plus accounts for at least two consecutive years paid $1.9 million in fees. Also, 620 Pilot Plus customers held assets of less than $25,000 for at least one full year and paid the minimum annual fee of $1,000 – twice the top rate of 2 percent allowed under the Pilot Plus agreement. These customers paid a total of approximately $1 million in fees. All of these customers will be entitled to restitution under the settlement.

Virtually all of the customers with less than $25,000 in assets were signed up by "Red Carpet Club" reps – high producers who were subject to less supervision.

Two reps recruited from another firm became immediate members of the Red Carpet Club and brought 340 customers with them. They opened Pilot Plus accounts for these customers, telling them incorrectly that they were advisory accounts, not fee-based brokerage accounts. Wachovia failed to prevent this and then failed to correct it in a timely fashion once it discovered the error.

The firm itself got it wrong when it provided its brokers with an optional letter they could send to customers that inaccurately described Pilot Plus as "a fee-based, investment advisory service." In fact, Pilot Plus was not an advisory service or advisory account, but a fee-based brokerage account.

In addition, Wachovia charged more than 110 customers both a load and Pilot Plus fees on the purchase of Class A shares of mutual funds, contrary to the account agreement. These customers also will receive restitution. ■

Omnibus accounts render redemption fees useless in curbing market timing

Mutual fund groups can't stop market timing or other short-term trading abuses through the use of redemption fees without more transparency in omnibus accounts, a new survey has concluded.

The new study of the 50 largest mutual fund groups by the **Coalition of Mutual Fund Investors** found that fewer groups, 31 versus 35 in a 2005 study, are now using redemption fees to discourage short-term trading. All of the groups with redemption fees now disclose that they may have to waive the requirement in omnibus accounts or exclude them from enforcement.

"The use of omnibus accounting continues to prevent mutual funds from uniformly enforcing their short-term trading policies," said **Niels Holch**, CMFI executive director. "Retail investors are not being protected from harmful arbitrage transactions and this regulatory problem should be addressed by the industry and its regulators," he concluded.

Calculating fees

The study also determined that mutual funds are not using the most effective accounting method to calculate redemption fees. Of the 31 groups with redemption fee policies, 26 use first-in, first-out, or FIFO accounting, rather than last-in, first-out, or LIFO, "despite the fact that it is the only accounting method that actually matches up market timing transactions (i.e., the most recent purchases matched with the most recent redemptions)," CFMI said.

New regulations requiring broker-dealers and other intermediaries using omnibus accounts to deliver transaction details to mutual fund groups when asked are not a practicable way to help fund groups get more transparency, the group said.

"The best process for uniformly protecting retail investors from arbitrage trading is to require intermediaries to disclose shareholder information on a daily basis so that funds can actively monitor shareholder transaction activity on a real-time basis," Holch said.

This the third study on the subject conducted by CFMI, an Internet-based shareholder advocacy organization representing the interests of individual mutual fund investors. ■

Financial reporting advisory committee created by SEC

The **SEC** has announced the formation of an advisory committee charged with examining the U.S. financial reporting system. Chief among the committee's responsibilities will be to make recommendations aimed at reducing unnecessary complexity and making information more understandable for investors.

It is expected that the SEC Advisory Committee on Improvements to Financial Reporting will recommend how to make financial reports clearer, consider how to reduce costs for preparers and better utilize advances in technology to enhance all aspects of financial reporting.

The chairman of Boston-based **MFS Investment Management Robert Pozen** will chair the committee, which will add 13 to 17 additional members with varied backgrounds within the next few weeks. ■

Registration now open for IA Week's fall compliance conference

Performance advertising and marketing and a slew of other hot topics for the advisory industry will be addressed at ***IA Week's* 7th Annual Fall Compliance Conference**, October 1, 2007 in Philadelphia at the Hyatt Regency at Penn's Landing.

Our expert panels will cover the future for books and records requirements and other areas, including:

- √ SEC exams;
- √ a regulatory developments update;
- √ soft dollars and best execution;
- √ the annual review; and
- √ forensic and transactional testing.

For more information on the conference agenda and our roster of speakers or to register, please visit **www.IAweek.com.** ■

Recent IPOs *(continued from page 1)*

deemed investment companies they would be subject to:

√ borrowing restrictions;

√ limitations on the ability to transact business with affiliates;

√ limitations on how the investment company must maintain custody of fund assets; and

√ the requirement to maintain specific books and records which can be examined by the SEC.

When determining whether an issuer is an investment company, Donohue said the Commission firts looks at whether the issuer is primarily engaged in the business of investing in securities. Also scrutinized is whether the issuer is engaged in the business of investing, reinvesting, owning, holding, or trading in securities and owns investment securities, the value of which exceeds 40% of its total assets.

Naturally a number of exclusions are available. "Many of the more complex Investment Company Act status determinations arise in the context of companies that view themselves as engaged in an operating business, and not in the investment company business," Donohue said.

When questions arise as to whether an operating company should be treated as an investment company, the SEC's Division of Corporation Finance will refer the issue to Donohue's division. Donohue reported that Corporation Finance staff did refer the issue in connection with the IPOs of Fortress and Blackstone.

SEC staff takes a look at the status of the relevant entity prior to offering, as well as giving effect to the offering. Investment Company Act status also is monitored on an ongoing basis. The Commission has a number of options in its handbag, including requiring risk disclosure to businesses if the company were required to register as an investment company. The SEC can also request that the entity either register as an investment company or restructure its business or securities holdings so as to no longer be an investment company.

In an "orthodox investment company" test, the focus is on the investment of the issuer's own assets, not the assets of others, Donohue noted. The Commission found that neither Fortress nor Blackstone is an orthodox investment company. The reasoning: the companies are engaged primarily in the business of providing asset management and financial advisory services to others and not primarily in the business of investing in securities with their own assets.

The Commission further examines the composition of a company's assets, sources of its income, the investment companies of its officers and employees, the company's public statements, and its historical development in order to compare the securities and non-securities businesses of the company. The SEC also traditionally considers the nature of the assets and income to be the most important factors in its analysis.

The Division concluded that the assets of Fortress and Blackstone are primarily indicative of an operating business. The finding was made that the firms' are engaged in a non-investment company business because:

√ their income and revenues are primarily derived from their asset management business and not their own investments;

√ they hold themselves out as money managers and not as investors or investment companies, and

√ they spend most of their time managing others' money, not their own.

In the context of both Fortress and Blackstone, the value of their limited partnership interests in the underlying funds that they manage and their other securities investments is less than 40% of total assets.

Other individuals testifying at the July 11 hearing included **Kevin Warsh,** Governor, **Federal Reserve Board**, **Robert Steel**, Treasury Under Secretary for Domestic Finance, **Jim Overdahl,** Chief Economist, **Commodity Futures Trading Commission** and **Erik Sirri,** Director of the SEC's Division of Market Regulation. ■

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and does not create a fiduciary obligation between the adviser and the end investor. It simply clarifies that the SEC can continue to do what it has done in the past in taking enforcement actions against hedge funds under its anti-fraud rules.

"It restores an important weapon" for the agency, said commissioner **Annette Nazareth** in voicing her approval for the rule.

The Commission did not take any action on a second part of the original proposal – to raise the bar on what kind of investors are able to invest in hedge funds (see related story on page 1).

The types of fraud envisioned by the rule's prohibition of misleading statements include those regarding the value of a fund's assets, fund performance, or about the background of the fund advisers, said **Robert Plaze**, associate director of the Division of Investment Management. These statements to investors or prospective investors could be made without a transaction taking place, so they are not covered by other anti-fraud provisions already on the books, he said.

Roadmap to avoidance

A second part of the rule prohibits any action that might be fraudulent because it is misleading, deceptive or manipulative. The rule does not specify any particular activities, as requested by some commenters on the rule proposal. "Being specific would provide a roadmap" on how to avoid the rule, explained Plaze. The rule would require constant updates as fraudsters found new ways to circumvent any specific prohibitions, he said.

Types of fraud covered by the second part of the rule would include an adviser collecting fees from investors that were not due to them or stealing investment funds collected, Plaze said.

The rule covers all pooled investment vehicles – hedge funds, private equity funds, venture capital funds, and registered investment companies. Plaze said that while a number of anti-fraud provisions apply to investment companies, there may be some types not covered elsewhere that this new rule would now cover.

Who's on first?

Although he approved the rule, commissioner **Paul Atkins** complained that the second part of the rule – the general prohibition of fraud – didn't really add anything to the Commission's mandate to deter fraud and was a kind of "Who's on first" joke that defines deception and fraud by saying it's anything that's deceptive and fraudulent. ■

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last week's open meeting, nor was any explanation offered for its absence. SEC spokesman **John Nester**, when asked, said those rules weren't ready for action yet, while the anti-fraud rule was. "No reason to hold up the one rule just because the other one isn't ready," he said. "Take them as they come."

Chairman **Christopher Cox** recently said that the rest of the proposal would be finalized "reasonably soon." The vague timeframe has some thinking changes may be afoot. **Karen Barr**, general counsel at the **Investment Advisers Association**, says they have heard "rumblings" that this part may be re-proposed.

For one thing, Barr says, there was a lot more adverse comment regarding the higher threshold for investment than there was for the anti-fraud proposal. Commenters complained the new threshold was too high. Plus, the proposal added yet another variation on qualifications for investors for specific vehicles, further complicating the challenge for compliance as firms try to parse which rules apply to which investors.

For another thing, the SEC's Division of Corporation Finance separately proposed some further revisions to the definition of accredited investor under Regulation D in an open meeting May 23, adding another category of qualified purchaser. This proposal was approved but has not yet been published for comment, fueling speculation that the proposals might be combined and re-proposed in a more comprehensive effort to rationalize the various investor categories.

And when would that be? "Reading the tea leaves," says Barr, "it doesn't sound imminent." ■

IAA seeks clarification on uniform registration proposal in Canada

Canada's plan to adopt uniform registration requirements for investment advisers across its 13 jurisdictions is a "significant step forward," even if it falls short of the efficiencies that would come with pan-Canadian federal legislation, the **Investment Advisers Association** said in a comment letter on the proposed harmonization.

The U.S. group, which numbers registered Canadian advisers in its membership and whose U.S. members engage in advisory activity in Canada, urged the various jurisdictions to adopt the measure as it stands and "to resist the temptation to retain any distinctive local rules or variations."

Given the increasing globalization of investment advisory services, streamlining the regulations in Canada is helpful in easing the regulatory burden on firms registered in the U.S., the UK and the European Union that do business in Canada, the IAA said.

The letter, authored by IAA counsel **Paul Glenn**, asked for clarification on several points and recommended some additions.

The U.S. group suggested establishing a clear *de minimis* threshold for exempting a foreign firm from registration, adopting the current Ontario standard of five clients rather than allowing a "patchwork" of different requirements.

The IAA also recommended expanding the types of "permitted clients" – exempt investors who do not count against this *de minimis* threshold – from the seven in the proposal to the 14 currently allowed in Ontario. These are various types of professional or qualified investors, including registered charities and individuals with net worth exceeding $5 million, among others.

The U.S. group also suggested clarifying the ban on solicitation so that non-compensated referrals of permitted clients from existing permitted clients, or responding to an RFP from a permitted investor be clearly exempt. IAA also asked that a U.S. firm acting as sub-advisor to a Canadian firm be allowed to respond to client questions without that being considered a "contact" disqualifying them for exemption.

The IAA also recommended two changes: to lengthen the transition period for the adoption of the uniform requirements from 120 days to 12 months or even 15 months and to allow the whole registration process to be done electronically.

Two final points for clarification sought by IAA: What level of change in ownership would trigger the need for a new registration and who is responsible for it? And what type of presence in Canada would disqualify an international adviser from exemption – e.g., is a part-time consultant an "agent" that would be a disqualification? ■

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