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DEVELOPMENTS OF NOTE

FINRA Fines Broker-Dealer for Improper Soft Dollar Payments

FINRA fined a broker-dealer \$400,000 after finding that the broker-dealer made more than \$1,000,000 in improper soft dollar payments to or on behalf of five hedge fund managers. FINRA also sanctioned the broker-dealer's soft dollar administrator, the supervisor of the broker-dealer's soft dollar operation and the broker-dealer's chief compliance officer. The parties neither admitted nor denied the charges, but consented to the entry of FINRA's findings, which are summarized in this article based on FINRA's [announcement](#) describing the sanctions.

Starting in 2004 the broker dealer set up soft dollar accounts for eight hedge funds. The broker-dealer collected a portion of the commissions generated by fund trades and used those amounts to pay invoices from fund managers or third parties for various services. The broker-dealer's policies required it to obtain and review a copy of the offering documents for its hedge fund clients, which described policies allowing commissions on fund trades to be used to pay research or brokerage-related expenses and, in certain cases, other expenses as permitted under a fund's organizing documents.

FINRA found that certain soft dollar payments made by the broker-dealer out of five of the hedge funds' commissions were improper because they were not allowed by fund documents, *e.g.*, payments for estate planning fees, administrative staff and accounting expenses, while other payments made directly to fund managers were improper because the broker-dealer did not receive written authorization from a third party evidencing that the payments were appropriate, as required under applicable fund documents. Among the payments deemed improper because the broker-dealer did not receive adequate documentation or conduct an adequate review to determine that the payments were authorized under fund documents were the following:

- Payments for “consulting fees related to research” where the invoices requesting the payments did not sufficiently identify who provided the research or what research was being provided.
- Payments to managers based solely on the manager’s representation that soft dollars would be used to “fund expenses in conjunction with our documents” without any clear or understanding of what expenses were being paid.

OFAC Finalizes Enforcement Guidelines

The U.S. Treasury Department’s Office of Foreign Assets Control (“OFAC”) published the final version of its “Economic Sanctions Enforcement Guidelines” (the “[Final Guidelines](#)”). The Final Guidelines amend and finalize OFAC’s interim final Enforcement Guidelines (the “Interim Final Guidelines”), which have been in effect since they were published in September 2008. The Interim Final Guidelines were described in the [September 16, 2008 Alert](#).

Under the Final Guidelines, OFAC will continue to apply the framework established by the Interim Final Guidelines when determining OFAC’s enforcement response to apparent violations of OFAC sanctions programs. Like the Interim Final Guidelines, the Final Guidelines provide that:

- OFAC may take one of seven types of enforcement actions depending on the facts and circumstances of each case. In response to an apparent violation, OFAC may issue (1) a no-action letter, (2) a request for additional information, (3) a cautionary letter, (4) a finding of a violation, (5) a civil monetary penalty, (6) a criminal referral to appropriate law enforcement agencies, or (7) other administrative actions (including license denial, suspension, or cease and desist order).
- OFAC will consider certain “General Factors” in determining the appropriate enforcement response to an apparent violation and, if a civil monetary penalty is warranted, in establishing the amount of that penalty. Included among the General Factors are (1) whether the conduct at issue involved a willful or reckless violation of the law; (2) awareness of the conduct at issue; (3) harm to sanctions program objectives; (4) the individual characteristics of the violating party, including (a) its level of commercial sophistication, (b) the size of its operations, (c) the total volume of its transactions compared to the apparent violations, (d) whether there is any history of violations, (e) the presence of a compliance program at the time of the violation, and (f) remedial steps taken in response to the violation; and (5) the violating party’s cooperation with OFAC, including in cases where the violation was not voluntarily disclosed.
- In determining the amount of any civil money penalty, OFAC will distinguish between “egregious” and “non-egregious” cases. Egregious cases are those representing the most serious sanctions violations, based on an analysis of all applicable General Factors, with substantial weight given to considerations of whether the violation involved willfulness or recklessness, awareness of the conduct giving rise to an apparent violation, harm to sanctions program objectives, and the individual characteristics of the subject person. OFAC will impose significantly higher penalties for egregious cases.

- Where OFAC determines that a civil penalty is appropriate, OFAC will determine a “base penalty amount,” based on two primary considerations: first, whether the conduct giving rise to a violation is egregious or non-egregious; and second, whether the case involves a voluntary self-disclosure by the subject person. The base penalty amount is significantly higher for egregious violations, but in all cases the base penalty amount will be reduced 50% or more if the apparent violation is voluntarily self-disclosed. Once the base penalty amount is determined, it may be adjusted upward or downward based on the General Factors; the resulting amount is the proposed civil money penalty. As a general matter, OFAC will reduce the base penalty amount by 25% to 40% if a subject person that did not voluntarily self-disclose substantially cooperates with OFAC and by 25% if the apparent violation is the subject person’s first violation.
- If OFAC concludes that a violation has occurred and a civil monetary penalty is the appropriate response, OFAC will issue a pre-penalty notice describing the alleged violation, identifying any relevant General Factors, and setting forth the proposed penalty. Subject persons may respond to pre-penalty notices prior to the imposition of a final notice.

The Final Guidelines reflect OFAC’s consideration of comments from the public on, and OFAC’s own review of, the Interim Final Guidelines. In the Final Guidelines, OFAC has clarified certain aspects of its enforcement approach. The changes in the Final Guidelines include revisions to address the following issues:

- *Risk Based Compliance.* One of the General Factors that OFAC will consider in determining the appropriate enforcement response is whether the subject person had a compliance program at the time of the violation. In issuing the Interim Final Guidelines, OFAC withdrew the 2006 Economic Sanctions Enforcement Procedures for Banking Institutions (the “Bank Guidelines”), which had emphasized the importance of a bank’s risk-based compliance program and included risk matrices in an appendix. In response to comments, OFAC clarified in issuing the Final Guidelines that the withdrawal of the Bank Guidelines should not be viewed as an indication that OFAC has changed its views regarding the importance of an institution’s risk-based compliance program. To further emphasize this point, the risk matrices from the Bank Guidelines were added as an appendix to the Final Guidelines.
- *Voluntary Self-Disclosure.* As described above, OFAC will reduce the base penalty amount by 50% or more if the subject person voluntarily discloses an apparent violation. In the Final Guidelines, OFAC clarifies certain aspects of its definition of voluntary self-disclosure. First, if a party other than the subject person is required to report an apparent violation to OFAC (such as a “blocked” or “rejected” transaction) but fails to report the transaction, a self-disclosure by the subject person to OFAC will still qualify as a voluntary disclosure. The Final Guidelines also address the treatment of disclosures to other government agencies. First, the Final Guidelines specify that a self-initiated disclosure to OFAC made at the same time as a disclosure to another government agency will qualify as a voluntary self-disclosure. In addition, OFAC will consider on a case-by-case basis whether a self-disclosure to another governmental agency that is not made simultaneously with a disclosure to OFAC also qualifies as a voluntary self-disclosure to OFAC.
- *Cooperation with OFAC.* Even in the absence of voluntary disclosure, OFAC may reduce the base penalty amount by 25% to 40% if the subject person substantially

cooperates with OFAC. The Final Guidelines further clarify how a subject person may benefit from such cooperation. First, although OFAC will not treat a subject person's notice to OFAC as a voluntary self-disclosure if, after the subject person has made its disclosure to OFAC, OFAC learns of the apparent violation from a third party required to report the transaction, OFAC explains that the subject person can benefit from providing such a disclosure to OFAC because such an action could be viewed as cooperation with OFAC. In addition, OFAC has amended the Final Guidelines to expressly provide that substantial cooperation with OFAC will be noted in OFAC's publication of any civil money penalties. The Final Guidelines also clarify that, although a subject person's willingness to enter into a tolling agreement may be considered a mitigating factor in assessing the person's cooperation with OFAC, OFAC will not view a refusal to enter into a tolling agreement as an aggravating factor.

- *Violations and Sanctions History.* OFAC revised the language in the Final Guidelines to clarify how it will treat the subject person's history of past violations and sanctions. First, in determining whether a subject person's violation is a first violation (and therefore eligible for a 25% decrease in the base penalty), OFAC (a) will consider a group of substantially similar violations as a single violation, (b) will treat a violation as a first violation if the subject person has not received a penalty notice or finding of violation from OFAC during the five years prior to the violation, and (c) may consider a violation to be a first violation if the subject person has received a prior penalty notice or finding of violation during the preceding five years, but the previous violation involved conduct of a substantially different nature. With respect to past sanctions, the Final Guidelines specify that, in considering a subject person's sanctions history, which is a General Factor for purposes of determining OFAC penalties, OFAC will consider the subject person's entire sanctions history, not just instances in which OFAC made a formal finding of sanctions violations. In addition, the Final Guidelines state that, as a general matter, consideration will be given only to a subject person's sanctions history during the five years preceding the apparent violation.

Calculation of Civil Money Penalties. OFAC also made amendments in the Final Guidelines to clarify how certain civil money penalties will be calculated. First, the base penalty grid in the Final Guidelines was revised to reflect the fact that the maximum statutory penalties for violations of OFAC sanctions adopted under the Trading With the Enemy Act are lower than the statutory maximums for violations of OFAC sanctions adopted under the International Emergency Economic Powers Act and other statutes. In addition, to make the penalty for recordkeeping failures consistent with the penalty for a failure to comply with an OFAC information request, the Final Guidelines increase the maximum penalty for a failure to maintain records in conformance with OFAC requirements to \$50,000 per violation.

Director of SEC Division of Investment Management Speaks at Independent Directors Council Conference

The Director of the SEC's Division of Investment Management, Andrew J. Donohue, spoke at the November Independent Directors Council Investment Company Directors Conference. [His speech](#) examined issues regarding (1) recapture arrangements included in expense limitations implemented by mutual fund advisers; (2) managed distribution plans for closed-end funds; (3) fund mergers; (4) fulcrum fees; and (5) the use of certain anti-takeover tactics by closed-end funds. A brief overview of Mr. Donohue's remarks with respect to each of these topics follows.

Expense Recapture. Mr. Donohue discussed the practice of “expense recapture” as a part of undertakings by advisers to limit the expenses of funds they manage. Under an expense recapture, once fund expenses fall below the level of the expense limitation, the fund’s adviser becomes entitled to be reimbursed by the fund for the fees it waived and the expenses it paid in maintaining the expense limitation, with the amount of reimbursement determined by the extent to which the fund’s expenses fall below the expense limitation threshold. Mr. Donohue cautioned that the SEC staff has taken the position that when an adviser increases an expense limitation after the initial year of a fund’s operations, the adviser may only recapture waived fees in accordance with the original recapture arrangements with the fund. “A subsequent increase in the expense cap does not create an opportunity for the adviser to recapture waived fees from a previous period that are below the higher cap,” he observed.

Mergers. Mr. Donohue cautioned fund directors to be vigilant when reviewing merger proposals. He cited a number of considerations in the closed-end fund context, focusing on issues related to the existence of any discounts for the funds involved in a merger. More broadly, he referenced issues such as a merger’s impact on investment strategy, post-merger expense levels and tax consequences. He also called attention to the accounting survivor analysis that determines the performance record of the surviving entity: “In some cases, it appears to Division staff that a newer fund or the fund that was chosen to be the accounting survivor had only a few months of operations, had net assets that were much smaller than the target, and that the shareholders were affiliated with the adviser. In contrast, the fund that was being merged away had a significantly longer track record, much more assets and its shareholder base was not made up of affiliated entities. However, due to market declines, particularly those experienced in 2008, the merged away fund’s performance was very poor.”

Fulcrum Fees. Mr. Donohue emphasized that fund directors should understand the calculation and ramifications of a fulcrum fee before approving such an arrangement. He noted that “a fulcrum fee is a performance based fee that an adviser charges a fund when the adviser achieves a return above a certain benchmark”, indicating that such an arrangement can be beneficial to the extent it aligns the adviser’s and shareholders’ interests. Rule 205-2 under the Investment Advisers Act of 1940 requires the incentive portion of a fulcrum fee be calculated using the fund’s average net assets over a rolling performance measurement period. However, Rule 205-2 also provides the fund with the option either to apply the rate to the average net assets over the rolling measurement period or to apply the rate to current level average net assets, i.e., the “most recent sub-period” which represents the period between payments. “Once the fund has selected which option to apply it must be applied consistently”, said Donohue. He observed that many fulcrum fee structures opt to pay the adviser with the base portion of the fee being calculated on current level net assets, as permitted by the rule. He then cautioned that “[w]hat advisers sometimes fail to realize, however, is that when the base fee is calculated on current level net assets, the adviser runs the risk of having to reimburse the fund when there is a significant decline in assets coupled with poor performance.” He explained that the SEC staff had seen certain structures attempting to limit an adviser’s downside risk by implementing a “floor total fee.” He indicated that “[t]he problem with this approach, however, is that a floor only limits the downside without proportionally limiting the adviser’s upside. As such, a floor is not permissible because the incentive adjustments must be symmetrical — hence the term ‘fulcrum.’”

Managed Distribution Plans. Mr. Donohue emphasized the importance of adequate disclosure regarding distributions for closed-end funds that maintain managed distribution plans designed to provide a predictable distribution rate. He emphasized that investors should receive disclosures that enable them to understand such a strategy involves the risk that they will receive returns of capital. He also noted the importance of explaining any discrepancies between disclosures in the explanatory notices that accompany distributions as required by Rule 19a-1 and other fund disclosures about distributions, e.g., those on fund websites. He also urged that funds make an effort to ensure that Rule 19a-1 notices regarding distributions reach the beneficial holders of fund shares, not just the financial intermediaries that hold fund shares of record on their behalf.

Closed-End Fund Anti-Takeover Measures. Mr. Donohue discussed certain tactics that closed-end funds employ to discourage takeovers. Mr. Donohue acknowledged that certain tactics and strategies in this regard may be in the interest of a fund's long-term investors, but appeared generally skeptical of the appropriateness of the various anti-takeover measures he discussed.

Mr. Donohue first addressed the adoption of a "shareholder rights agreement", commonly referred to as a "poison pill." Mr. Donohue called into question whether the use of poison pills was consistent with Section 18 of the Investment Company Act of 1940 (the "1940 Act"), particularly whether a poison pill constitutes a "ratable" issuance that would fit within Section 18(d)'s parameters for the issuance of warrants. If a poison pill were not a ratable security, he observed that a fund would not be able to comply with the terms of Section 23(b) of the 1940 Act governing the sale of closed-end fund shares at less than net asset value. Second, Mr. Donohue discussed reliance on state law provisions that restrict the voting rights of a person deemed to own "control shares" of a closed-end fund, i.e., shares owned in excess of a designated proportion of outstanding shares such as 10%. In his view, restrictions on a shareholder's ability to vote shares based on the number of shares owned was "likely inconsistent" with Section 18(i) of the 1940 Act. In conjunction with his remarks on poison pills and shareholder rights agreements, Mr. Donohue noted that a federal district court in Maryland has held that a closed-end fund's serial use of poison pills was valid and consistent with the 1940 Act, and that a dissident shareholder's ability under the Maryland control shares statute to vote its control shares was capped at the number of shares the shareholder held at the time that the fund opted into that statute.

Mr. Donohue expressed doubt about the appropriateness of three other tactics related to director elections, also typically having their basis in a fund's by-laws. In the first, directors use their ability to change the date of shareholder meetings to postpone annual meetings, thereby delaying an insurgent shareholders ability to exercise its voting power to elect new directors. In the second, a fund adopts a requirement that director elections be by an affirmative vote of a majority of outstanding shares so that when neither incumbents nor insurgents receive the required vote, the incumbents hold over under the law of the fund's state of organization. In the third, a fund board adopts a requirement that directors must have certain qualifications, while exempting existing directors. Closing his remarks on the topic of anti-takeover measures, Mr. Donohue advised a board considering whether to adopt such various measures that "[t]he question you must always ask yourself is not just whether the action is legal under state and federal law, but whether it is truly in the best interests of fund shareholders."

Treasury and FRB Extend Effective Date to June 1, 2010 for Implementation of Compliance Requirements of Final Rule Restricting Internet Gambling

The Department of the Treasury and the FRB extended to June 1, 2010 the effective date for financial services providers to implement the compliance requirements of a final rule (the “Final Rule”) that imposes restrictions on online gambling pursuant to the Unlawful Internet Gambling Enforcement Act of 2006 (the “Act”).

The Final Rule requires, among other things, that non-exempt financial institutions that participate in payment systems that may be used to transfer money for purposes of unlawful Internet gambling “establish and implement written policies and procedures that are reasonably designed to identify and block or otherwise prevent or prohibit unlawful Internet gambling transactions restricted by the Act.” Specifically, the designated payment systems include automated clearing house systems; systems for credit, debit, pre-paid or stored-value cards; check collection systems; wire transfer systems and certain money transmitting businesses.

The Final Rule, which was published on November 18, 2008 and discussed in the [November 25, 2008 Alert](#), became effective January 19, 2009, but compliance with the Final Rule is delayed from December 1, 2009 to June 1, 2010. The delay in the effective date will give banks and other covered financial services providers more time to comply with what the Treasury and FRB described as the “challenging” definition of “unlawful Internet gambling” and will also give members of Congress, including House Financial Services Committee Chairman Barney Frank, the time they have requested to prepare and enact amendments to the Act that would reduce the regulatory burden on financial institutions.

SEC Inspector General Issues Report Recommending Changes to Processes for Selecting Investment Advisers and Investment Companies for Examination

The SEC’s Office of Inspector General (the “OIG”) issued a [report](#) detailing the results of its review of the SEC’s processes for selecting investment advisers and investment companies for examination. The review’s objectives were to determine why the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) had not inspected Bernard Madoff Investment Securities (“BMIS”) shortly after its registration as an investment adviser given the information gathered in prior examinations of BMIS by OCIE’s broker-dealer inspection staff and investigations by the SEC’s Division of Enforcement, and to make recommendations designed to strengthen the SEC’s selection process for regulatory examinations. Most of the report’s recommendations are aimed at improving OCIE’s processes for determining whether and how frequently to conduct an examination through (i) more thorough review of an adviser’s Form ADV, particularly when it learns of negative information about an adviser, and (ii) consideration of other information collected or made available to the SEC about an adviser. The report also recommends that OCIE and other divisions develop better information compilation and sharing mechanisms so that, for example, an adviser might receive a higher risk rating, and be subject to more frequent inspection, based on negative information resulting from an examination or inspection of its non-advisory activities (*e.g.*, as a broker-dealer). In terms of the risk ratings used to determine the frequency with which an adviser is inspected, the report recommends that OCIE assign progressively higher risk ratings to an adviser as its assets under management

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and number of clients increase. Other specific recommendations in the report include the following:

Revisions to Form ADV. The report recommends that investment advisers be required to report additional information in Form ADV, such as (a) performance information (so OCIE can assign higher risk factors to performance outliers), (b) information about hedge fund service providers such as custodians, administrators and auditors (so if OCIE detected a problem with a service provider at one adviser it could easily determine which other advisers were using the same service provider and administrator), (c) a hedge fund's current auditor and any subsequent changes of auditor, and (d) auditors' opinions (so OCIE would have independent information regarding the safety of client assets).

Mandatory Filing of Form ADV Part II. In 2008, the Commission proposed a number of amendments to Part II of Form ADV (as discussed in the [April 22, 2008 Alert](#)), which, to date, have not been finalized. Unlike Part I of Form ADV, which is electronically filed with the SEC and used by OCIE to assign risk ratings to advisers, Part II is maintained in an adviser's files and must be provided to the SEC only upon request. The report recommends that the SEC finalize the proposed amendments, which would, among other things, required mandatory electronic filing of the Part II with the SEC. Before adopting final amendments, the report suggests that OCIE and the Division of Investment Management consider what, if any, additional requirements relating to Part II, such as electronic data tagging like that used in other filings made with the SEC, might assist OCIE in efficiently and effectively reviewing and analyzing information provided in Part II.

Third Party Verification. The report's final recommendation calls for OCIE to develop policies and procedures for verifying that client assets are properly accounted for, including obtaining third party verifications of client assets.

OCIE concurred with all of the report's recommendations, noting that gathering and coordinating information regarding registrants in a Virtual Data Warehouse is one of the SEC's information technology priorities. The Divisions of Enforcement and Investment Management concurred with the report's recommendations pertaining to their processes, but did not provide any formal response. A corrective plan of action to address the recommendations is due to OIG within 45 days.