

FUND ALERT

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No Rehearing for *Jones v. Harris Associates*

By Peter M. Hong

The U.S. Court of Appeals for the Seventh Circuit has denied a petition for rehearing en banc of its panel decision in *Jones v. Harris Associates*.¹ As described in our May 2008 *Fund Alert*, that decision ruled that courts should generally not second-guess the fees payable to mutual fund managers when there has been full disclosure of the fees and approval by the fund's trustees.² The court's opinion represented a rejection of the "reasonableness" test applied in *Gartenberg v. Merrill Lynch Asset Management*.

In the dissenting opinion, Judge Posner argued that the case merits the

attention of the full court. Judge Posner first refuted statements in the *Jones* opinion that the court had previously suggested that the *Gartenberg* approach "is wanting." He noted that none of the cases cited in the opinion suggested that *Gartenberg's* treatment of the issue of excessive fees is incorrect. Judge Posner also noted that "*Jones* is the only appellate opinion noted in Westlaw as disagreeing with *Gartenberg*," while there are a "slew of positive citations." In criticizing the court's rejection of *Gartenberg*, Judge Posner stated, "The panel bases its rejection of

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SEC Staff Issues *ComplianceAlert* and AML "Source Tool"

By Zachary T. Knepper

The SEC staff issued a *ComplianceAlert* in July 2008 that identifies topical compliance issues for investment advisers, investment companies, broker-dealers and transfer agents.¹ In August 2008, the SEC posted an online "source tool" designed to assist mutual funds in complying with anti-money laundering (AML) requirements.² This *Fund Alert* summarizes some of the key items in these two important resources, beginning with the SEC staff's recent *ComplianceAlert*. Website links to the full documents

containing all of the SEC's comments are referenced in the notes at the end of this article.

I. SEC Staff Issues *ComplianceAlert* Identifying Topical Compliance Issues

The *ComplianceAlert* discussed recurring compliance issues that the SEC staff had identified in its inspections of regulated entities. The *ComplianceAlert* should be heeded by compliance officers and investment professionals because it

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SEC Staff Issues *ComplianceAlert* and AML “Source Tool”

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identifies common compliance problems and areas of concern to the SEC staff.

Issues for Investment Advisers and Investment Companies

The *ComplianceAlert* identified four broad categories of issues relevant to the compliance policies and procedures of investment advisers and funds: (a) personal trading by advisory employees and access persons; (b) proxy voting; (c) asset valuation and liquidity of high yield municipal bond funds; and (d) soft dollar practices.

(a) *Personal Trading by Advisory Employees & Access Persons*

The SEC staff has found recurring deficiencies regarding personal securities trading by access persons and proprietary trading by investment advisers. Examples of these common deficiencies include:

- *Adviser’s code of ethics are incomplete* – advisers are not requiring access persons to seek pre-approval before engaging in private placements and certain other transactions;
- *Adviser’s code of ethics are not being adhered to* – compliance policies are not followed, especially regarding pre-clearance of securities trades and the use and control of material non-public information;
- *Internal reporting requirements are not being followed* – access persons are failing to submit reports of their personal securities transactions and investment advisory firms are failing to review personal trading activity; and
- *Adviser’s public disclosures contain inaccuracies* – the advisory firm’s public disclosures do not accurately reflect the firm’s actual internal policies and procedures.

In addition to enumerating these recurring problems to be avoided, the *ComplianceAlert* also identified common practices that the SEC staff considered to be generally effective. These common best practices include:

- *Internal compliance controls:*
 - compliance policies contemplate and address potential conflicts of interest;
 - restricted trading lists are kept up-to-date and “black-out” periods are enforced; and
 - any exceptions to the policies are reasonable and documented in writing.
- *Compliance review and reporting:*
 - pre-clearance trade requests are compared to employees’ actual securities transactions;
 - transaction records of employees’ personal accounts and of the firm’s proprietary accounts are maintained electronically (so as to allow for easy analysis of trading activity); and
 - investment performance of client accounts is compared to investment performance in employees’ personal accounts and a firm’s proprietary accounts.
- *Active involvement by compliance personnel:*
 - advisory firms with compliance personnel who actively implement the firms’ compliance policies and procedures seem to have the most effective internal controls.

(b) *Proxy Voting*

The SEC staff has found that most advisory firms have policies and procedures regarding proxy voting, as required by the SEC’s proxy voting rule.³ However, some advisory firms have not been adhering to their proxy voting policies, have failed to maintain proxy voting records, or have failed to keep their policies accurate and complete. The *ComplianceAlert* specifically identified several deficient proxy voting practices, including:

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- board oversight of proxy service providers is inadequate, resulting in investment companies lacking controls to confirm the validity of proxy service providers' recommendations or potential conflicts of interest;
- advisers are not documenting their assessments of proxy service providers, thereby preventing the SEC staff from evaluating whether an adviser has implemented measures reasonably designed to address potential conflicts of interest;
- Funds' Form N-1A disclosures inadequately describe the use of proxy voting services and insufficiently describe the funds' applicable policies and procedures; and
- advisers are allocating proxy service fees incorrectly, such as by assigning proxy service voting fees to funds for which no proxies have been voted.

(c) High Yield Municipal Bond Funds' Asset Valuation & Liquidity

The SEC staff performed targeted examinations of high yield municipal bond funds. Such funds commonly invest in illiquid securities, which may necessitate that the funds' boards determine fair market values for particular securities. Some of the issues the staff has identified include:

- *Disclosure* – some funds were not updating their disclosures to reflect heightened risks associated with increased levels of illiquid securities and securities not easily valued;
- *Third-party pricing services* – fund disclosure may be misleading where the disclosure states that third-party pricing services provide independent valuations but where the pricing services rely on fund management for necessary valuation information;
- *Cross trades* – funds may not be sufficiently documenting that cross trades between client

accounts were executed at prices that reflect true market value; and

- *Record retention* – funds may not be recording pricing histories in a way that facilitates easy review by compliance and valuation personnel or by boards of directors.

(d) Soft Dollar Practices

The SEC staff has recently reviewed advisers' soft dollar arrangements with the intent of examining how firms use soft dollars and disclose these practices to investors. The staff's findings regarding soft dollars include:

- *Best execution analysis* – some advisers accumulated large soft dollar credits – of up to millions of dollars in value – with particular broker-dealers, causing the SEC staff to examine whether the adviser overpaid for brokerage services;
- *Disclosures* – advisers may not be fully disclosing soft dollar practices that fall outside the Section 28(e) safe harbor⁴ and may not be adequately disclosing potential conflicts of interest related to soft dollar arrangements;
- *Compliance policies, procedures and controls* – effective soft dollar policies and procedures require the adviser to maintain reports of soft dollar transactions, reconcile commissions periodically, review mixed-use product allocation, and approve all soft dollar arrangements through the chief compliance officer or similar approving authority.

Issues for Advisers, Funds, Broker-Dealers and Transfer Agents

The SEC, FINRA and the NASAA have examined so-called free lunch sales seminars put on by broker-dealers and other entities.⁵ The *ComplianceAlert* identifies some of the staff's concerns about these seminars, including that the seminars may not be fulfilling suitability requirements for investors, particularly senior citizens,

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and that some seminars involve the use of misleading – or even fraudulent – sales literature. Given these concerns, the *ComplianceAlert* reminds financial services firms to:

- take appropriate steps to supervise sales seminars and ensure that all advertisements and sales literature are reviewed and approved as necessary;
- ensure that any investment recommendations made to investors, particularly senior citizens, are suitable in light of each customer’s investment objectives; and
- verify that supervisory procedures with respect to “free lunch” seminars are being implemented effectively.

Of note, the *ComplianceAlert* states that regulators will focus future efforts on ensuring that “free lunch” sales seminars targeted at senior citizens are conducted in accordance with all applicable laws and regulations.

The SEC staff has also performed targeted examinations of broker-dealers that employ registered representatives to serve as “solicitors” for an investment adviser. In these situations, the registered representative/solicitor acts as the investment adviser’s salesperson and often provides investment advice to the investment adviser’s customers. However, the SEC staff has found that these solicitors are often insufficiently supervised and that, for example, suitability determinations are not being properly conducted. In addition, sales literature used by the solicitors may be false or misleading.

Finally, with respect to transfer agents, the *ComplianceAlert* provides guidance on the use of third-

party search firms to locate “lost” securityholders.⁶ The SEC staff has been reviewing this issue, and the *ComplianceAlert* states that some transfer agents are receiving part of the fee that third-party search firms are charging to securityholders when the securityholder was found on a third (or subsequent) search. The *ComplianceAlert* states that such fee-sharing poses a potential conflict of interest to the transfer agent because it potentially encourages transfer agents not to locate the securityholder on either of the first two (free) searches. In addition, the *ComplianceAlert* states that some search firms are improperly charging securityholders for performing either of the first two free searches.

II. SEC Posts Online Source Tool for Mutual Fund AML Compliance

On Aug. 7, 2008, the SEC posted a new page to the SEC Website containing background materials related to AML compliance for registered investment companies.⁷ This “source tool” cautions that it cannot be relied upon as comprehensive of all AML requirements. However, the webpage is broad in scope and contains many helpful links to additional resources. Compliance professionals seeking to review or update their AML policies can use this new resource for helpful background information and source material. ■

¹ The *ComplianceAlert* is available at: www.sec.gov/about/offices/ocie/complialert0708.htm.

² See www.sec.gov/about/offices/ocie/amlmfsrcetool.htm (OnLine Source Tool).

³ Investment Advisers Act Rule 206(4)-6, 17 C.F.R. § 275.206(4)-6.

⁴ Section 28(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(e).

⁵ A “free lunch” sales seminar, which may be open to the public or by invitation only, is any of a variety of marketing tools that broker-dealers and other entities use to attract prospective clients. These seminars are often held at hotels, restaurants, retirement communities or golf courses and are designed to encourage new customers to open accounts with the firm sponsoring the “free lunch” seminar.

⁶ A “lost” securityholder is any owner of a security that, due to a change of residence or other circumstance, a transfer agent can no longer locate. Under transfer agent rules, a recordkeeping transfer agent must conduct at least two searches for the securityholder at no charge. Any additional searches beyond the first two can result in a charge to the securityholder. See SEC Rule 17Ad-17, 17 C.F.R. § 240.17Ad-17.

⁷ See Online Source Tool, *supra* n.2.



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Gartenberg mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation.” He argued that competition in product and capital markets can’t be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds.

Judge Posner also noted the court’s acknowledgment in *Jones* that the level of compensation could be “so unusual that a court will infer that deceit must have occurred, or that the persons responsible for [the] decision have abdicated.” However, Judge Posner argued that “the governance structure that enables mutual fund advisers to charge exorbitant fees is industry wide, so the panel’s comparability approach would if widely followed allow

those fees to become the industry’s floor.” Thus, *Gartenberg*’s “so disproportionately large” standard is rightly not based on comparability but rather on the principle that “unreasonable compensation can be evidence of a breach of fiduciary duty.”

Having strongly criticized the *Jones* opinion, Judge Posner argued that a rehearing en banc is warranted because the *Jones* opinion created a circuit split. In support of his argument, Judge Posner cited a number of law firm articles summarizing the Seventh Circuit’s rejection of *Gartenberg*. The first article cited was Stradley Ronon’s “*Fund Alert: Seventh Circuit Rejects Gartenberg Approach to Determining the Appropriateness of Mutual Fund Management Fees*,” (May 2008). ■

¹ *Jones v. Harris Associates L.P.*, No. 07-1624 (7th Cir. Aug. 8, 2008) (per curiam).

² *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008).

