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SEC Issues Guidance to Boards Reviewing Certain Affiliated Transactions

Background
The staff of the Securities and Exchange Commission (“SEC”) recently published long-awaited guidance “clarifying” the responsibilities of mutual fund directors in making the determinations required by Rules 10f-3, 17a-7 and 17e-1 of the Investment Company Act of 1940 (“1940 Act”) in the form of a letter to the Independent Directors Council and the Mutual Fund Directors Forum. The letter marks the culmination of SEC Division of Investment Management Director Andrew “Buddy” Donohue’s “Director Outreach Initiative” and offers some relief for boards in reviewing transactions that qualify for exemptive relief under Rule 10f-3 (permitting a fund to purchase securities from an affiliated syndicate), Rule 17a-7 (permitting a fund to engage in certain cross-trading) or Rule 17e-1 (permitting a fund to use an affiliated broker). Among other things, these Rules require that the board of a fund that relies on the Rules undertake quarterly reviews and make certain determinations related to the potential conflicts of interest present.

In meetings with many fund boards during a period of about two years, Director Donohue received significant feedback from directors asking that the SEC allow the directors to delegate to third parties (such as a Fund’s CCO) certain determinations currently required by various rules under the 1940 Act. The SEC’s recent guidance stops short of allowing boards to delegate the required determinations to others. This could be due, in part, to the fact that the SEC is already busy responding to the recently enacted financial reforms, and rule changes would require time and resources which are currently taxed. The SEC’s letter does contain helpful guidance validating the ability of fund boards to base their determinations on reports and summaries prepared by third parties.

Specific Guidance
The SEC’s letter stated that the “clear wording of each rule . . . requires a fund board to make a determination, no less frequently than quarterly, that each transaction made during the preceding quarter was effected in compliance with procedures reasonably designed to provide that the transactions comply with the requirements of the relevant rule.” The SEC acknowledges, however, that the Rules “do not specify how fund boards should make such determinations” and noted that the Rules “do not specifically require the directors to review each transaction in order to make the required determinations.”

The letter explained that, depending on the circumstances, the SEC believes “that fund boards may, where consistent with the prudent discharge of their fiduciary duties, make these determinations in reliance on summary...
quarterly reports of the transactions effected in reliance on one or all of these rules in the prior quarter.” The letter outlined various ways a fund board may meet its responsibilities under these rules:

- **Via review of each transaction.** Some boards, such as “boards to those funds with fewer transactions[,] may determine to review each transaction,” though that is not specifically required.

- **Via compliance officer summaries.** Boards “may decide to make the required determinations based on summary quarterly reports (prepared by the fund’s [CCO] or other designated persons).”

- **Via information from other experts.** The SEC stated that “under appropriate circumstances, fund boards also would have the flexibility to tap other relevant expertise to assist in the quarterly review process (e.g., some combination of fund counsel, counsel to the independent directors, investment adviser personnel, and/or independent third parties).”

The letter also emphasized, however, that “[e]ven if boards rely on the CCO or others . . . to provide them with summary quarterly reports . . . boards still retain ultimate responsibility for making the quarterly determinations required by these three rules, and boards cannot delegate such responsibility.” As such, the SEC cautioned that, “even if the directors rely on others to investigate the details of each transaction, they need to be appropriately vigilant to ensure that they have sufficient information to be alerted to issues raised by these conflict transactions.”

**SEC Hosts CCO Outreach Broadcast on Valuation**

The SEC recently hosted a CCOOutreach Interactive Broadcast Seminar on valuation issues, its first in a proposed series of interactive webinars intended to provide guidance on the examination process and examples of lessons learned in various “hot topic” areas for investment advisers and CCOs. The panel, which included senior representatives from the SEC’s Office of Compliance Inspections and Examinations and the Division of Investment Management, noted that the program would focus on a broad spectrum of valuation concerns and challenges from “significant and extreme challenges of improper valuations to drive greater fees” to “compliance control related concerns around the absence of effective governance processes or transparency with regard to the valuation exercise.” The panel shared insights on difficult-to-value securities, discussed valuation challenges in volatile markets and addressed the CCO’s role in the valuation process.

**Importance of Valuation**

The first speaker stated that valuation issues are “important not only in the registered fund context, but with respect to any registered adviser,” because valuation impacts many of the processes and calculations that drive the investment industry. For example, the speaker noted that valuations of securities can greatly affect: (i) adviser fees; (ii) statistics for performance advertising; (iii) percentage restrictions on the types of investments to be made; (iv) account statements sent to clients; (v) redemption and purchase amounts; and (vi) compliance with 1940 Act provisions based on valuation, such as diversification, concentration and fund names rules.

**Advice for Directors and CCOs**

Another speaker acknowledged that valuation can be challenging, particularly in times of market turmoil when there is limited information and a lot of volatility in the market. According to the speaker, when valuing securities, directors and CCOs should ultimately ask, “what would a hypothetical buyer pay for [this] security in an orderly transaction on the date of valuation?” After reviewing specific factors for considering how the “market is perceiving an asset” for particular investment types, including private label residential mortgage-backed securities, one-off loans, CDOs and CLOs, private equity and structured notes, the speaker stressed that it is important to use as many available relevant market-based inputs as possible, such as: (i) volatility; (ii) yield curves; (iii) stock prices; (iv) liquidity or risk premiums; (v) consensus risk or loss protections; (vi) related indices or
derivatives for correlation; and (vii) price direction and availability of credit default swaps. Conversely, the speaker noted that directors and CCOs should be wary of: (i) ignoring relevant market inputs (without careful assessment when making a decision to ignore a market input); (ii) assuming a more normal market; (iii) assuming that unfavorable market prices are incorrect or aberrant fire sale prices; and (iv) applying market-based inputs that do not apply to the asset being valued.

One panelist noted that advisers have incentives, amounting in some circumstances to an inherent conflict of interest with investors, to overvalue a security. For example, portfolio values impact advisory fees, the adviser’s performance history and the adviser’s relationships with clients, particularly in a bad market when there is an inclination to believe that the market is wrong.

The panel also addressed the meaning of “fire sale” prices, which it viewed as limited to situations involving a “forced liquidation or distressed sale.” This requires, in the panel’s view, an understanding of the seller’s motivation. In this connection, where there is a view that the other side of market transactions is limited to so-called vulture investors, it is important to consider whether vulture investors have come to define the market and be the new reality behind that asset class and provide a current price point.

Issues related to the use of pricing services were also discussed. It particularly was noted that obtaining a closing market price is different from a service providing its opinion of what the value of the asset would sell for in a current transaction. In the latter case, the price provided should be viewed as only a factor in the board’s fair value determination and not the final value in and of itself. In the context of an SEC examination, the staff may contact pricing services to understand what type of price the service is providing, particularly in harder to value securities, and to confirm that the CCO understands the process that the pricing service is using for it to be a relevant testing measure for the assets in the portfolio.

CCO Involvement in Valuation Activities and the Examination Process

According to one speaker, “good compliance is good business, and vice versa.” When evaluating valuation policies and procedures, CCOs should be able to explain what they are doing to monitor valuation and how they plan to prevent “blow-up” mistakes or fraud. The speaker stated that CCOs should be able to explain what they are doing “to minimize valuation risks,” including providing backup documentation or examples of how they test the effectiveness of valuation policies and procedures, examples of problems found and corrected, and changes to policies and procedures to reflect changes in the market or to address recent valuation issues. In that regard, this speaker suggested that, for an SEC examination, an adviser would be well served to “use a good communicator who can make good sense on a common sense level to show the CCO has it under control.”

The speaker added that SEC examiners will conduct forensic testing to evaluate whether: (i) valuation prices are “outdated or stale”; (ii) third-party pricing services are “affiliated” or “independent, truly, of your business”; and (iii) the CCO is applying “methodologies in a consistent manner” across the organization.

The speaker also warned that the CCO must remember that the “board of directors is the first line of defense for shareholders.” The speaker stressed that the CCO should provide the board with “sufficient valuation information to fulfill their responsibilities.” According to the panel, an examiner will review up to two years of board minutes and materials regarding valuation to evaluate the level of detail provided to the board. In the absence of sufficient information, the examination staff will “look to the adviser to be sure the board gets all of the necessary information.”

Possible Proposed Valuation Guidance

The staff noted that proposed SEC guidance on valuation issues, expected earlier this year, has been delayed in light of priorities imposed by the recent enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). According to Doug Scheidt,
Associate Director of the SEC’s Division of Investment Management, some of the questions expected to be addressed in that guidance, based on recommendations from the Division of Investment Management, include:

- the meaning of the statutory language “readily available market quotations” and “fair value;”
- the valuation of restricted securities, derivatives, illiquid securities (particularly those that had been liquid), foreign securities, securities denominated in foreign currencies and securities traded outside of the United States;
- whether there are differences in pricing money market funds;
- the responsibilities of the board of directors, including the extent to which they can delegate their responsibilities;
- what types of valuation-related policies and procedures funds should have;
- whether there is a materiality element to Rule 22c-1;
- the role of pricing services and the kind of information that they provide; and
- the use of block discounts to value large holdings.

Scheidt suggested that the guidance “hopefully” would be out “before too long.”

SEC Director Outlines New Division of Enforcement Initiatives Following Dodd-Frank Act

The director of the SEC’s Division of Enforcement, Robert Khuzami, recently testified before the Senate Judiciary Committee about recent initiatives in the Division of Enforcement, including those launched under new authority provided by the Dodd-Frank Act.

Dodd-Frank Act Whistleblower Provisions

The new whistleblower provisions of the Dodd-Frank Act entitle persons who provide original information leading to a successful securities enforcement action to payment of as much as 10% to 30% of the amounts recovered by the SEC; since many enforcement actions end in settlements of tens or hundreds of millions of dollars, these potential payments can be enormous. Given these significant financial incentives, there likely will be a dramatic increase in the number of whistleblowers providing information to the SEC.

Khuzami testified that the SEC is staffing a new Whistleblower Office within the Division of Enforcement’s Office of Market Intelligence and is systematically triaging and assigning tips, complaints and referrals. He also testified that the Division of Enforcement is drafting a Whistleblower Program, with rules setting forth procedures for whistleblowers to provide information to the SEC and for the SEC to grant awards to whistleblowers for that information. In creating both the Office and the Program, Khuzami noted that the SEC is “mindful of competing interests, including: (i) a desire to encourage whistleblowers to provide the Commission with high-quality tips regarding potential violations of the federal securities laws, and (ii) a need to avoid creating undue burdens on the Commission and the constituencies that we protect and regulate that could result from groundless whistleblower submissions.”

Additional SEC Initiatives

Khuzami’s testimony also, among other things, reviewed streamlining and investigative process reforms within the Division of Enforcement and identified new fraud-detection and risk-based initiatives instituted by Division of Enforcement staff to achieve its “top priority of being more nimble and proactive.” Some highlights of his testimony include the following:

- **New Asset Management Unit.** Last May the Division of Enforcement established specialized units focused on five key areas: Structured and New Products, Market Abuse, Municipal Securities and Public Pensions, Asset Management and Foreign Corrupt Practices Act Violations. These units are hiring industry experts and are being used as “a platform to enhance training for . . . investigative staff.” The Asset Management Unit is focused on mutual funds, private funds and investment advisers.
• **Mutual Fund Fee Initiative.** The Asset Management Unit has established a Mutual Fund Fee Initiative to “develop analytics, along with other SEC Divisions, for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees.” Khuzami testified that he expects these analytics to “result in examinations and investigations of investment advisers and their boards of directors concerning duties under” the 1940 Act.

• **Fund Performance and Valuation Disclosures.** The Division of Enforcement, in collaboration with other SEC divisions and offices, is targeting disclosure, performance and valuation by funds and their advisers, and has launched a Bond Fund Initiative based on risk analytics that “identify red flags for further investigation, such as misrepresentations of leverage, outlier performance and problematic valuations.”

• **“Problem” Investment Advisers.** In conjunction with the SEC’s examination staff, the Asset Management Unit has launched a Problem Adviser Initiative, based on a “risk-based approach to detecting problem investment advisers through on-going due diligence reviews of advisers’ representations to investors related to their education, experience and past performance.”

• **Risk-Based Investigative Initiatives.** The Division of Enforcement, including its Regional Offices, is launching coordinated risk-based investigative initiatives that utilize information received from the Office of Compliance, Inspections and Examinations and other SEC offices and divisions, “hiring talent with particularized market expertise, and reaching out to academia, law enforcement, and the regulated community.”

• **SEC Analysis of Trading Data.** The Division of Enforcement has enhanced its ability to systematically search its database of individual securities trading to enable it to review clearing activity on an aggregate basis and identify “possible relationships among traders who may be acting in a coordinated fashion.” By analyzing large volumes of trading data through its so-called Bluesheet System, the SEC can now identify “traders who are common to multiple securities involved in market-moving events, [and] isolate relationships indicative of the misuse of material non-public information.”

• **Researching New Product Offerings.** The Structured and New Products Unit Initiatives will include “a review of products such as reverse convertible notes, auto-callable notes, principal protected notes, and total return swaps.” The SEC “is engaged in a detailed assessment of the history of the product, various iterations of the product, institutions that market and/or sell the product, the nature of the investors in the product and the product’s potential risks to those investors.”

**SEC Chairman Outlines New Disclosure and Voting Initiatives**

In a recent speech during the NACD Annual Corporate Governance Conference, SEC Chairman Mary Schapiro discussed several initiatives the SEC will undertake with regard to proxy voting, shareholder disclosures and SEC communication as it “moves forward on the agenda that Congress created” through passage of the Dodd-Frank Act.

**Review of Voting Infrastructure – Proxy Plumbing**

Stating that the SEC is interested in “breaking down barriers that may prevent effective engagement, and affect investor confidence and, ultimately, financial performance,” Schapiro said that the SEC is in the preliminary stages of developing a proxy initiative, which she referred to as “proxy plumbing.” She provided an overview of the initiative’s focus areas:

• **Voting.** Schapiro said that the SEC wants to “move towards a more accurate and inclusive voting structure.” To that end, she said that the SEC:
is “interested in knowing the extent to which there is under- and over-voting of shares”;  
“would like to find a reasonable way to confirm votes”;  
would like to know whether “parties who have lent shares need earlier information about the content of upcoming shareholders’ meetings”;  
is “extremely interested in whether and how we can facilitate greater participation by retail investors in proxy voting”; and  
has asked “if the phenomenon of ‘empty voting’ is widespread and damaging enough to warrant a regulatory response.”  

**Communications.** Schapiro said the SEC is concerned with “ongoing communication between the board and the shareholders” and wants to know if there is “a way to bring greater competition — and possibly lower price and better service — to the industry” in the context of proxy distribution practices.  

**Proxy Advisory Firms.** Schapiro said the SEC will examine the role of proxy advisory firms, particularly regarding whether they “may be subject to undisclosed conflicts of interest” or they “may fail to conduct adequate research, or may base recommendations on erroneous or incomplete facts.”  

**Enhanced Disclosure to Investors**  
Schapiro stated that the SEC will promulgate rules required by the Dodd-Frank Act that “will significantly increase disclosure requirements.” Among those, she stated, were rules designed to improve the communications between boards and their investors.  
She highlighted current regulation that requires boards to disclose how they address risk and explain how they oversee risk. She noted that the Dodd-Frank Act “takes this issue further, and requires financial regulators to adopt regulations or guidelines that prohibit incentive-based compensation arrangements that encourage inappropriate risk-taking.”  

Schapiro said that the SEC is working to develop these new standards.  

**Improved Director-SEC Interaction**  
With regard to these new proposals, Schapiro stated that the SEC has “created an infrastructure that supports communication between directors and the SEC,” noting that the SEC has “established a series of e-mail boxes on the SEC website to which comments can be addressed even before rules are proposed and formal comment periods begin.” She added that “SEC staff have been instructed to make every effort possible to accept requests for face-to-face meetings and . . . to seek out meetings with those affected by our proposals.”  

**SEC Stays Effectiveness of Controversial Proxy Access Rules**  
The SEC has stayed the effective date of its recently enacted proxy access rules pending judicial review of a legal challenge brought by the Business Roundtable and the U.S. Chamber of Commerce alleging, among other things, that the new rules are “arbitrary and capricious.” Absent this stay, the rules would have taken effect November 15, 2010. Although the SEC and petitioners will seek expedited review, and the SEC expects that “questions about the rules’ validity will be resolved as quickly as possible,” the rules appear unlikely to go into effect in time for the 2011 proxy season. This rulemaking is of particular import to closed-end funds, which are required to hold annual shareholder meetings to elect directors and have long attracted activist shareholders hoping to wage proxy contests against fund management.  

**Basis of the Court Challenge**  
The Business Roundtable and the U.S. Chamber of Commerce filed a motion with the SEC to stay the effectiveness of the rule amendments. The petitioners argued, among other things, that the new rules “would impose unnecessary costs and allow special interest groups to disrupt corporations’ focus on long-term sustainable growth . . . and would divert the energies of
In support of their legal challenge, the petitioners allege a number of procedural and substantive violations by the SEC in adopting the rules, including that it erred in appraising the costs that proxy access would impose; ignored evidence and studies highlighting the adverse consequences to companies if proxy access is imposed; mishandled existing state laws, in an arbitrary and capricious manner; claimed to empower shareholders, while preventing them from adopting alternative limits on proxy access; and violated the First Amendment by forcing corporations and shareholders to carry and fund election speech by special interest candidates, even when a majority of shareholders oppose it.

The Business Roundtable and Chamber of Commerce also suggest that the new proxy access rules, as adopted, could have a number of unintended consequences, including:

- an increase in corporate and shareholder “short-termism”;
- use of proxy access rules by activist shareholders as a tool to advance an agenda in conflict with the interests of the majority of shareholders;
- undermining of recent state law changes permitting shareholders to make choices as to whether and on what terms to authorize proxy access at their companies;
- increased costs contributing to lower corporate profits and smaller investor return; and
- weakened effectiveness of boards of directors.

In addition to challenging the substance of the new rules, the petitioners also allege that the SEC erred in making them applicable to investment companies. They argue that “at minimum, the SEC should have separately evaluated the benefits of proxy access for investment companies against the baseline protections established by the [1940] Act.” The petitioners also argue that the SEC “gave insufficient attention to the differences in the operation of investment companies and other public companies, including the significant costs that a director elected under the rules would impose on investment companies’ unitary and cluster boards.”

In granting the petitioners’ request to stay effectiveness of the rules, the SEC stated that, “among other things, a stay avoids potentially unnecessary costs, regulatory uncertainty and disruption that could occur if the rules were to become effective during the pendency of a challenge to their validity.”

Overview of New Rules

The proxy access rules, if declared effective without change, would include significant revisions to the June 2009 proxy reform proposal, discussed in our August 2009 newsletter. At the heart of the proxy access rules is new Rule 14a-11, which “will require companies to include information about shareholder nominees for director in company proxy statements, and the names of the nominee or nominees as choices on company proxy cards.”

Shareholder eligibility requirements. To have nominees included in a company’s proxy materials, a shareholder or group of shareholders would have to meet certain requirements, including an “ownership threshold of at least 3% of the voting power of the company’s securities entitled to be voted at the meeting.” In addition, the nominating shareholder (or each member of a nominating shareholder group) must have “held the qualifying amount of securities continuously for at least three years” as of the date that the shareholder gives notice of intent to use Rule 14a-11.

Shareholders using Rule 14a-11 only may nominate one director to the board or a number of directors representing no more than 25% of the board, whichever is greater. Shareholders must give notice of intent to use Rule 14a-11 on new Schedule 14N “no earlier than 150 days prior to the anniversary of the mailing of the prior year’s proxy statement and no later than 120 days prior to this date,” or, if no meeting was held in the prior year or the meeting date has changed by more than 30 calendar days, within a reasonable time before the company mails its proxy materials.

Shareholder nominee requirements. The new rule places certain limitations on the shareholder nominees required to be included in a fund’s
A shareholder director nominee may not be an “interested person” of the fund or a person having certain types of business relationships with the fund or its adviser. Notably, Rule 14a-11 does not prohibit a director nominee from being a nominating shareholder, a member of the immediate family of any nominating shareholder, or a partner, officer, director or employee of a nominating shareholder or any of its affiliates.

Applicability to Investment Companies
Despite comments from the fund industry that there was no evidence of widespread fund governance problems, the SEC determined that the new rules should cover closed-end and open-end funds based on findings that “the separate regulatory regime” to which funds are subject “emphasizes the importance of [fund] directors in dealing with the conflicts of interest created by the external management structure” of most funds. The SEC also found that fostering “competition in the board nomination process may improve efficiency by providing additional leverage for boards in negotiations with the investment adviser” on matters such as the approval of advisory contracts and fees.

SEC Grants Money Market Funds Temporary Relief from NRSRO Designation Requirements
On August 19, 2010, the SEC staff issued a no-action letter to the Investment Company Institute (“ICI”) temporarily relieving money market fund boards from the requirement to designate at least four nationally recognized statistical rating organizations (“NRSROs”) whose ratings the fund would use to determine the eligibility of portfolio securities under Rule 2a-7. The NRSRO designation requirement was included in the amendments to Rule 2a-7 adopted earlier this year, which also required money market funds to disclose the NRSROs designated by their boards in their statements of additional information before December 31, 2010. The recent enactment of the Dodd-Frank Act, however, cast doubt on the effect of the designation requirement by asking the SEC to, among other things, review its regulations, remove any reference to or requirement of reliance on credit ratings, and substitute a standard of creditworthiness that the SEC deems appropriate.

Funds relying on the ICI no-action letter must continue to comply with the obligations for determining and monitoring eligible securities set forth in Rule 2a-7 as in effect before May 5, 2010 (other than the limitation on holding unrated asset backed securities rescinded by the 2010 rulemaking). The full text of the no-action letter, which reflects the SEC staff’s temporary position pending the SEC’s review required by the Dodd-Frank Act, is on the SEC’s website at http://www.sec.gov/divisions/investment/noaction/2010/ici-nrsro081910.htm.