

JANUARY 2010

INVESTMENT MANAGEMENT MARKETING**Violating Do-Not-Call Rules Could Trigger Major Fines
(And Even Sarbanes-Oxley Problems)**

ABSTRACTED FROM: *Compliance With Sarbanes-Oxley And Do Not Call Regulations Is Interdependent When Telemarketing Is A Core Part Of A Sales Strategy*

BY: Lisette Ruch, Pretect, Brookhaven NY

Journal of Investment Compliance, Vol. 10, No. 1, Pgs. 56-60

Telemarketers are skating on thin ice. Broker-dealers and other publicly traded investment firms that fail to comply with the government's do-not-call (DNC) regulations could also run afoul of the Sarbanes-Oxley Act, warns management consultant Lisette Ruch. The SEC's amended Rule G-39 requires broker-dealers to comply with the DNC rules of the Federal Trade Commission. The Municipal Securities Rulemaking Board's guidelines (which coordinate with G-39) also require DNC compliance, and 43 states have passed DNC laws of their own. The Federal Registry now lists over 140 million telephone numbers on DNC registries. A telemarketer lacking effective mechanisms for blocking calls to these numbers could be incurring fines and penalties unwittingly—and therefore is not disclosing them in its financial statements. The failure to disclose substantial fees and penalties could constitute a material misstatement that violates Sarbanes-Oxley's requirement of internal controls on financial reporting.

Violators get a chilly (and costly) reception. DNC violations can be very expensive, with fines running as high as \$25,000 for each violation. One company that called over 900,000 DNC telephone numbers was fined \$11,000 for each. Settlements between violators and regulators—the FTC, the FCC, plus state agencies—could greatly lower fines but could take years to reach. In the meantime, violators face the difficult task of estimating and reporting both the amount of the fines they must eventually pay and the expenses of defending against and appealing the fines. Regulators do not consider these expenses when negotiating settlements, the author points out. Consumers' power to sue violators for penalties and fines, as well as to recover court costs and lawyers' fees, increases the risk of undisclosed liabilities.

IN THIS ISSUE

INVESTMENT MANAGEMENT MARKETING	1
• Violating Do-Not-Call Rules Could Trigger Major Fines (And Even Sarbanes-Oxley Problems)	
INVESTMENT MANAGEMENT COMPLIANCE & REGULATION	2
• E-Sign Requirements And SEC Rules Not Always Consistent	
BRIEFLY...	3
• Redemptions can alter liquidity ratios; target-date funds scrutinized; fund expenses in Europe	

Controls for cold calling exist. The author counsels that an effective system for averting DNC violations by a broker-dealer should meet several goals: achieve automatic, real-time blocking of all DNC phone numbers that salespeople dial; prevent salespeople from evading the system by, e.g., dialing special codes; channel all calls so that they can be checked against the broker-dealer's database; prevent salespeople from making calls when the system is off-line; and create reports that permit oversight by managers not involved in sales and marketing. The system must also include training of those who administer and operate it; testing prior to first use, immediately after first use, and at least every quarter thereafter; and support by skilled communications professionals. Finally, the system must be cost-effective. While some big companies have created in-house solutions, providers are now marketing effective systems that cost under one cent for each call.

Abstracted from *Journal of Investment Compliance*, published by Emerald Group Publishing Ltd., Howard House, Wagon Lane, Bingley BD16 1WA, England. To subscribe, call 44(0) 1274 785281 or (888) 622-0075 (for North America); or visit <http://info.emeraldinsight.com/products/journals/journals.htm?id=joic>.

INVESTMENT MANAGEMENT COMPLIANCE & REGULATION

E-Sign Requirements And SEC Rules Not Always Consistent

ABSTRACTED FROM: *The Electronic Distribution And Marketing Of Mutual Funds*

BY: Alexander Gavis, Fidelity Investments, Boston MA

ALI-ABA Business Law Course Materials Journal, Vol. 33, No. 2, Pgs. 39-64

Funds may zip documents to investors. Because mutual fund companies rely heavily on the Internet to deliver information to investors, managers need to be aware of guidance from the SEC and the Financial Industry Regulatory Authority (FINRA). In particular, attorney Alexander Gavis highlights conflicts between the SEC's guidance and the 2000 law recognizing electronic signatures. Various SEC releases from 1995 to 2000 specify three vital but nonexclusive elements of valid electronic delivery: notice, access, and evidence of delivery. Investors must receive essentially the same quality of notice as paper delivery would afford; their access to and chance to retain documents must be similar to what paper would afford; and there must be evidence of delivery, such as the investor's informed written, electronic, or telephonic consent to receive documents electronically, although proof of actual delivery is not required. Informed consent may be global, encompassing all documents sent by any issuer. PDF delivery is permissible.

Statute permits push-button transactions. In 2000, Congress complicated matters by enacting E-Sign, the Electronic Signatures in Global and National Commerce Act, which recognizes electronic signatures, contracts, and other records in interstate and international commercial transactions. E-Sign spells out how to ensure that an electronic record will be sufficient if some other statute requires the records of a transaction to be retained or "in writing" (generally, by obtaining the recipient's consent). Federal and state regulatory agencies, as well as the self-regulatory organizations, can require electronic filings, and agencies that already have rulemaking power can issue rules and orders consistent with E-Sign. Federal agencies may unconditionally exempt categories of records from the consent test. E-Sign preempts a state's electronic-records law, the author notes, unless it is a specified version of the Uniform Electronic Transactions Act.

Loose ends to tie up. In 2001, the SEC began to reconcile its rules with the E-Sign requirements, when it permitted an insurer to register an offering for an electronic-only variable annuity. An SEC rule adopted in 2005 deems delivery of a final prospectus posted online to be complete if the investors have

Internet access, but the rule excluded mutual funds. Amendments to the proxy rules in 2006 allow companies, including mutual funds, to avoid paper delivery of proxy materials by posting them and notifying shareholders of their online accessibility. A rule approved in 2008 lets a fund post its statutory prospectus and provide investors with only a summary prospectus. However, the author cautions, SEC guidance still diverges from E-Sign in many respects. For example, E-Sign does not allow telephonic consent to receive documents electronically; it requires electronic consent (or confirmation of consent), so paper alone is insufficient. E-Sign requires consent even if there is proof of actual delivery, and it does not allow global consent. In addition, it lets an investor consent to any delivery method (even without notice) and buy securities without requiring a paper backup.

Rules pin down advertising do's and don'ts. SEC and FINRA regulation of mutual funds' online advertising and other public communications, much like regulation of their printed material, varies depending on the audience and the content. A fund's website is usually subject to the SEC's advertising rules and FINRA's Conduct Rules, the author reminds. FINRA bans hyperlinks to another site that the fund knows is displaying misleading information about its products and services. Funds originally had to file all linked information, but FINRA now provides a safe harbor, e.g., for links to educational sites that do not specifically refer to the fund. The SEC holds a fund liable under 1934 Act Section 10(b) for links to misleading information that is attributable to the fund, because either its prepublication involvement in generating the information amounted to entanglement or its implied or express post-publication endorsement of the information amounted to adoption. FINRA regulates the use of analytical tools (such as retirement planners) on a fund's website, while the site's chat rooms and other interactive features are subject to both FINRA regulation and federal antifraud laws. FINRA also requires updates of website information that has become inaccurate, although it does not call for periodic website updates. Under SEC Rule 482, the total-return performance figures on the website must reflect the fund's latest calendar quarter.

Abstracted from *ALI-ABA Business Law Course Materials Journal*, published by ALI-ABA Committee on Continuing Professional Education, 4025 Chestnut Street, Philadelphia PA 19104-3099. To subscribe, call (800) 253-6397; or visit www.ali-aba.org/aliaba/cmj.asp.

BRIEFLY...

COMPLIANCE & REGULATION

REDEMPTIONS CAN ALTER A FUND'S ILLIQUIDITY RATIO

When the stock markets decline, a mutual fund may inadvertently violate SEC rules by holding a larger percentage of illiquid securities than it has disclosed. Defining an illiquid security as one that takes more than seven days to cash out (such as private equity, venture capital, or PIPE holdings), the SEC stipulates that illiquid securities cannot comprise more than 15% of a fund's net asset value. While it does not want to compel managers to sell at a disadvantage, the SEC will press for reductions if the portfolio's illiquidity is too high. It has fined funds whose stated illiquidity ratios were wrong. These ratios change constantly, notes Gail Liberman, so managers must watch for once-liquid holdings that have become illiquid (e.g., credit default swaps), particularly when fulfilling redemption requests. If market data alone cannot quantify the illiquidity percentage, the SEC requires the fund's directors to make a good-faith determination based on the fair value of all the assets.

Abstracted from "How Liquid Are Client Mutual Funds?" by Gail Liberman. *Financial Advisor*, Vol. 10, No. 9, Pgs. 86-87. Article available at www.fa-mag.com/component/content/article/1-features/4428.html?Itemid=56.

TARGET-DATE FUNDS UNDER SCRUTINY

A target-date fund is not the secure retirement-savings tool it may seem, according to witnesses at a hearing held by the Department of Labor and the SEC (as summarized in *Managing 401(k) Plans*). Target-date funds are designed to adjust investment strategy automatically over many years, becoming more conservative as a participant's retirement date nears. Yet sudden deep losses amid the market downturn, most painfully for those just about to retire, have led regulators to question how these funds are operated, regulated, and presented. Some experts at the hearing criticized the funds for carrying imprudently high concentrations of equity too close to the target date. In one speaker's opinion, as many as 61% of target-date funds make false promises, such as claiming that the investment is "guaranteed" or that participants can retire on a date certain. Finding that the funds inadequately state their risks, witnesses called for heightened disclosure and regulation. One expert disagreed, suggesting that the funds carry an adequate regulatory burden, and some observers blamed overly complacent investors. Another area of concern to regulators is the use of target-date funds as a plan's default option.

Abstracted from "Target-Date Funds At Highest Risk At Retirement And Thereafter, Speakers Say." *Managing 401(k) Plans*, Vol. 9, No. 8, Pgs. 1-4.

FUND OPERATIONS & MANAGEMENT

DISTRIBUTOR FEES DRIVE UP FUND EXPENSES IN EUROPE

American fund firms doing business in Europe should be prepared to pay more expenses there than they do at home, emphasize researchers Ed Moisson and Jonathan Kreider. Fund expenses in Europe are consistently higher than those in the United States. The simple average total expense ratio (TER) in America is 1.32%, compared to 1.57% in Germany, for example, or 1.66% in the United Kingdom. For funds operating across borders in Europe, simple TER climbs to nearly 2%. The contrast is even starker when TER is weighted by fund assets: in the United States, it slims to just 0.91%, but in Europe, it falls only slightly. For example, cross-border funds show a simple TER of 1.98% and a weighted TER of 1.89%. The pattern is similar when funds of like sizes are compared. The researchers explain that funds in Europe, especially cross-border funds, pay at least twice as much for distribution channels as those in the United States do.

Abstracted from "Fund Expenses: A Transatlantic Study" by Ed Moisson and Jonathan Kreider. Research report published by Lipper, September 2009. Available at www.lipperweb.com.

Published and distributed by Bowne & Co. Inc., as a special service for asset management professionals. The *Bowne Brief* editors select significant, useful, timely articles to abstract, which analyze fund operations, compliance, marketing, and accounting in the asset management industry. Contact the periodicals abstracted for copies of the featured articles. Visit www.bowne.com/securitiesconnect/ to request *Brief* subscriptions and obtain archive issues. The *Bowne Brief* is researched and written by Brumberg Publications, Inc., 124 Harvard Street, Brookline, MA 02446, 617-734-1979. Bruce Brumberg Esq., editor; Susan Koffman Esq., executive editor; Marla Brill, Terry Cabot, Patricia Crowe, Vance Koven Esq., Howard Levenson Esq., Ilissa Povich Esq., and Elliott Poretz CPA, contributing editors; Matt Simon, assistant editor. The *Bowne Brief* may not be reproduced in whole or in part without the publisher's written consent and is distributed with the understanding that the publisher is not engaged in rendering financial, accounting, investment, or legal advice. © 2010 Bowne & Co. Inc. (ISSN 1945-7626)