Ropes & Gray's Investment Management Update: April 2013 - May 2013

The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

SEC Investor Advisory Committee Recommends Increased Disclosure for Target-Date Funds

The SEC's Investor Advisory Committee has recently recommended that the agency revise and expand on a 2010 SEC proposal to require increased disclosure to investors about the risks and fees associated with target-date retirement funds. Target-date retirement funds generally shift their portfolio holdings over time to less risky investments as investors approach retirement. The Committee notes that target-date funds have become a popular default option provided to employees joining defined contribution plans.

The Committee's recommendations would require that funds develop a glide path illustration based on risk as a replacement of, or supplement to, existing glide path illustrations based on asset allocation, employ standard methodology for all illustrations, disclose risk assumptions in fund prospectuses, warn investors that funds are not guaranteed and that losses are possible in marketing materials, and enhance fee disclosure of costs over the course of the investment. Although the SEC has made no indication regarding the timing for preparing a concrete new rule proposal in response to the Investor Advisory Committee's recommendations, SEC Commissioner Daniel Gallagher has said the recommendations are non-controversial. Consequently, action by the SEC on the recommendations may be forthcoming in the near future. The text of the Committee's recommendations is available here.

FINRA Approves the Use of Pre-Inception Index Performance Data in Marketing ETFs to Institutional Investors

The Financial Industry Regulatory Authority ("FINRA") has recently issued interpretive guidance clarifying that under certain circumstances, financial firms may use "pre-inception index performance" data ("PIP data") in marketing exchange-traded funds ("ETFs") to institutional investors without violating FINRA's standards on advertising communications with investors under FINRA Rule 2210. PIP data is sometimes used to model the performance of an exchange-traded product as though it existed prior to its launch. The hypothetical performance figures generated by this type of back testing can potentially be substantially better than actual results of an ETF after its launch, because portfolio managers have the benefit of market hindsight in selecting the components of the ETF index.

Financial firms have emphasized that PIP data is a valuable tool for analyzing potential fund performance, particularly for institutional investors that tend to better understand the drawbacks of such data. In its guidance, FINRA generally agreed with this position, but clarified that PIP data is appropriate only for institutional investors of passively-managed exchange-traded products and not retail investors. FINRA also noted that in presenting PIP data to institutional investors, firms must meet certain standards that include, among other things, clearly labeling communications as applying to institutional investors, offering to provide the methodology of the ETF index upon request, and delivering data that covers a period including multiple securities and market environments. The text of FINRA's guidance on communications regarding PIP data is available here.

SEC and CFTC Adopt Identity Theft Red Flags Rules

The SEC and the CFTC jointly issued final Red Flags Rules on April 10, 2013. While the Red Flags Rules issued by the SEC and the CFTC are largely similar to the Red Flags Rules adopted by the Federal Trade Commission ("FTC") under the Fair Credit Reporting Act ("FCRA") in 2007, the Commissions acknowledged that the adopting release and the final Red Flags Rules contain certain guidance, examples, and minor language changes which may lead some SEC- and CFTC-regulated entities that previously had concluded that the FTC Red Flags Rules were not applicable to them to now determine that the SEC and CFTC Red Flags Rules are, in fact, applicable to them. All SEC- and CFTC-regulated entities that determine they fall within the rules' scope must adopt and implement a red flags rules program intended to help detect identity fraud by November 20, 2013.

SEC- and CFTC-regulated entities to which the Red Flags Rules apply are those that may be considered "financial institutions" or "creditors" under FCRA. Those financial institutions or creditors that maintain "covered accounts" need to adopt identity theft red flags programs. The SEC has stated that SEC-regulated entities likely to qualify as financial institutions or creditors and maintain covered accounts include "most registered brokers, dealers, and investment companies, and some registered investment advisers." For instance, an investment adviser may be considered a "financial institution" subject to the Red Flags Rules if it: (a) has the ability to direct transfers or payments from accounts belonging to individuals to third parties upon the instructions of such individuals, (b) has the authority, by power of attorney or otherwise, to withdraw money from an individual investor's accounts and direct payments to third parties according to such investor's instructions, or (c) has the authority, pursuant to an arrangement with the private fund or individual, to direct such individual investor's investment proceeds to third parties. Institutions, including investment advisers, that offer margin accounts or accounts that permit wire transfers or other payments to third parties also may be subject to the Red Flags Rules.

Administratively, the Red Flags Rules require that (i) any red flags identity theft protection program be approved, if not already in place, by the board of directors, an appropriate committee thereof, or senior management of an entity if there is no board; (ii) there be high-level involvement in the oversight of the red flags program; (iii) staff be trained to implement the red flags program; and (iv) there be oversight of service provider arrangements with respect to red flags programs (i.e., compliance cannot be completely delegated to service providers). An organization's red flags program also should be appropriately tailored to the organization's size and complexity, minimally designed to (i) identify relevant patterns, practices, or specific activities that indicate possible identity theft, or red flags; (ii) detect red flags; (iii) respond appropriately to any red flags detected; and (iv) update the organization's red flags program from time to time to reflect changes in risks from identity theft. The full text of the Red Flags Rules is available here.

SEC Allows Funds to Exclude Shareholder Proposals from Proxy Statements

On May 10, 2013, the staff of the SEC issued two no-action letters granting relief under Section 14 of the Securities Exchange Act of 1934 and Rule 14a-8 thereunder to the College Retirement Equities Fund (the "Fund"), an open-end registered investment company, to allow the Fund to omit two shareholder proposals from its proxy materials for its 2013 shareholder meeting. One proposal requested that the Fund's Board of Trustees "end investments in companies that, in the trustees' judgment, substantially contribute to or enable egregious violations of human rights, including companies whose business supports Israel's occupation." Based upon the facts recited in the Fund's letter to the SEC, the staff granted no-action relief under Rule 14a-8(i)(10), which permits a company to omit from its proxy statement shareholder proposals that the company has already substantially implemented. In particular, the Fund had already adopted policies and procedures to address human rights violations, which provided for divesture of portfolio holdings under certain circumstances. The other shareholder proposal requested that the Fund "exclude health insurance companies from the portfolio fund of CREF-Social Choice, in accordance with reasonable expectations for social responsible investing." Given the facts cited by the Fund in its letter to the SEC, the staff granted no-action relief pursuant to Rule 14a-8(i)(7) as dealing with matters relating to the Fund's ordinary business operations (*i.e.*, "the selection and ongoing assessment of portfolio investments"). While the letters do not provide much discussion of the staff's reasoning for its determinations, the fact that the staff was willing to intercede in favor of the Fund's position is noteworthy in that it breaks from a trend over recent years during which the staff appeared to be taking a relatively non-interventionist posture with regard to disputed shareholder proposals.

United Kingdom's Treasury Proposes Amendments to the Draft Regulations for the Implementation of the Alternative Investment Fund Managers Directive

Following the circulation of guidance in the form of questions and answers on the implementation of the Alternative Investment Fund Manager's Directive ("AIFMD") in the United Kingdom, Her Majesty's Treasury confirmed through amendments to the draft Financial Services and Markets (AIFMD) Regulations 2013 that the transitional provisions which apply to UK managers ("AIFMs") will also apply to non-UK AIFMs who market alternative investment funds ("AIFs"). The amendments have the effect that any AIFM who immediately before July 22, 2013 manages an AIF or, in the case of a non-European AIFM, markets an AIF in an EEA State will not be required to comply with the AIFMD until, in the case of a European AIFM, the UK Financial Conduct Authority (FCA) authorizes the AIFM or, in the case of a non-European AIFM, it notifies the FCA. In either case, the authorization or notification will need to take place before July 22, 2014. Therefore, a US adviser marketing a private fund or other non-UCITS vehicle (such as a US registered investment company) in the UK prior to July 22, 2013 will have to comply with the UK financial promotion regime and limit its marketing to investment professionals or other eligible investors. However, it will not have to comply with the AIFMD disclosure or notification requirements until the applicable authorization or notification as described above.

Regulatory Priorities Corner

The following brief updates exemplify trends and areas of current focus of relevant regulatory authorities:

SEC Names Co-Directors to Lead SEC Enforcement

On April 22, 2013, the SEC announced that George Canellos and Andrew Ceresney would serve as co-directors of the SEC's Division of Enforcement, representing the first time two individuals have led the division.

More Funding for Investment Adviser Examinations Requested

In her testimony before the U.S. House of Representatives Committee on Financial Services on May 16th, SEC Chairman Mary Jo White said that the SEC's main priorities include an increase in the number of investment adviser examinations it handles every year. The SEC is seeking a budget increase of 27 percent in part to hire additional investment-adviser examiners. The text of Ms. White's testimony is available here.

SEC Names Ropes & Gray Partner Keith Higgins as new Director of Division of Corporation Finance

On May 15, 2013, the SEC announced that Keith F. Higgins will be the new director of the agency's Division of Corporation Finance. Mr. Higgins comes to the SEC from the law firm of Ropes & Gray LLP where he is a partner in its Boston office with 30 years of experience advising public companies about securities offerings, mergers and acquisitions, compliance, and corporate governance.

Other Developments

Since the last issue of our IM Update we have also published the following separate Client Alerts of interest to the investment management industry:

SEC Issues IM Guidance Update on Compliance with Exemptive Orders

May 21, 2013

On May 6, 2013, the SEC's Division of Investment Management issued a guidance update for registered funds and investment advisers that rely on exemptive orders emphasizing the importance of ensuring "compliance with the representations and conditions of such orders."

SEC Settles with Service Providers and Trustees of two Mutual Fund Trusts for Inaccurate Disclosures Regarding Section 15(c) Advisory Contract Approval Process

May 6, 2013

On May 2, 2013, the SEC filed an order instituting settled administrative proceedings against the trustees and certain service providers of two "turnkey" open-end series investment companies, Northern Lights Fund Trust and Northern Lights Variable Trust, relating to advisory contract approval process under Section 15(c) of the Investment Company Act and the approval by the Trustees of certain sub-advisers' compliance programs.

New Disclosure Requirements for Massachusetts Pension Investments

April 26, 2013

The Commonwealth of Massachusetts has started implementing pension reform legislation enacted in 2011 that imposes demanding contracting and disclosure requirements on state and local pension fund boards. The new pension fund rules – particularly those requiring disclosure of service provider compensation – are sweeping in their scope and may present compliance challenges to investment managers and other investment service providers.

Exemptive Relief filed for New "Exchange-Traded Managed Fund"

April 12, 2013

On March 27, 2013, Eaton Vance applied to the SEC for exemptive relief for a new type of exchange-traded fund, which it calls an exchange-traded managed fund.

2013 Mutual Funds and Investment Management Confere

April 9, 2013

Ropes & Gray's memorandum summarizing the general and workshop sessions at the 2013 Mutual Funds and Investment Management Conference sponsored by the Investment Company Institute and the Federal Bar Association.

SEC Staffer Highlights Private Fund and Private Equity Broker-Dealer Issues

April 9, 2013

On April 5, 2013, David Blass, Chief Counsel of the SEC's Division of Trading and Markets (which regulates broker-dealers), gave an important speech highlighting two "significant areas of concern" about broker-dealer registration which private fund sponsors should consider: the sales of interests in private funds and the payment of investment banking fees to private equity fund sponsors.

SEC Provides Guidance on the Use of Social Media to Disseminate Investor Information

April 5, 2013

On April 2, 2013, the SEC issued a report clarifying existing guidance to confirm that public companies may use social media outlets, such as Facebook and Twitter, to announce key information in compliance with Regulation FD of the Securities Exchange Act of 1934, so long as investors have been alerted in advance about which social media outlets will be used to disseminate such information.

If you would like to learn more about the developments discussed in this Update, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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