SEC Issues IM Guidance Update on Compliance with Exemptive Orders

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". The guidance update comes as part of the Division's response to a report issued by the SEC's Office of Inspector General (OIG) in June, 2011, that noted significant deficiencies in the SEC's process to monitor compliance with the representations and conditions of exemptive orders and no-action letters.

SEC Guidance Update and OIG Report

In the guidance update, the SEC points to the requirements that registered funds and advisers must adopt policies and procedures that are reasonably designed to prevent violations of securities laws, pursuant to Rule 38a-1 under the Investment Company Act and Rule 206(4)-7 under the Investment Advisers Act, respectively. The guidance goes on to say that "entities that receive and rely upon exemptive orders are at risk of violating the federal securities laws if they fail to comply with the representations and conditions of such orders." The SEC suggests, for example, that mutual fund boards adopt a specific policy or procedure to address conditions requiring board review or to consider whether the condition is covered in a board review of other matters when the fund it oversees relies on an SEC exemption.

The IM guidance does not include specific examples of how the failure by an adviser or a fund to comply with representations or conditions in an exemptive order has resulted in harm to investors. However, the IM guidance refers to the examples cited in the Inspector General's report of violations of exemptive orders found by the SEC's Office of Compliance Inspections and Examinations. Among other actions, the OIG report cited a registered fund board's failure to conduct an annual review of conditions related to an exemptive order, execution of securities lending activities by a fund that did not comport with its exemptive application, and an adviser's failure to make all disclosures required by a no-action letter.

Implications for Investment Advisers and Fund Complexes

The guidance update serves a general reminder that firms should continue to monitor their ability to rely on exemptive orders but offers little concrete guidance on the types of compliance questions that funds and advisers frequently face.

- Although the guidance update repeatedly references the need to comply with the "representations and conditions" in exemptive orders, it does not address the question of how to determine which representations are sufficiently material to jeopardize an entity's ability to rely on exemptive relief in the event that they become inaccurate amidst changed circumstances. The absence of any discussion of the materiality of representations may suggest that the SEC staff intends to take the position that the continued accuracy of all factual representations made in connection with an exemptive application is required for continued reliance on the exemptive order. While the nature and drafting of many exemptive orders contemplate the potential for certain changing circumstances, and it would seem unreasonable to expect slavish adherence to all minute factual representations in an order, investment advisers and funds may wish to consider a principled review of the relative significance of representations that underlie the conditions to their exemptive orders.
- The guidance encourages registered funds and advisers to build the representations and conditions made in exemptive orders into their compliance policies. However, care should be taken to avoid

inadvertently making conduct that is permitted even without an exemptive order into a violation of overbroad compliance policies.

- The guidance update makes clear that exemptive order compliance is likely to be a focus of upcoming SEC examinations. To the extent advisers and funds are conducting mock examinations or otherwise preparing for visits by regulators, they are encouraged to incorporate this topic into their preparations. For a full discussion of the SEC's exam priorities in 2013, including specific references to compliance with exemptive orders, see the Ropes & Gray Client Alert "SEC Announces 2013 Examination Priorities for the Investment Management Industry".
- Although the guidance update focuses on exemptive orders, funds and advisers may benefit from a similarly structured approach to mapping what no-action guidance they rely upon and how they meet the various criteria laid out in the relevant no-action letters.

To access the IM guidance update, click here. For a copy of the OIG Report, click here.

If you would like to learn more about the developments discussed in this Alert, 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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