Ropes & Gray's Investment Management Update: October 2011

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

Regulatory Matters

SEC Determines Not To Challenge D.C. Circuit Decision Regarding "Proxy Access" Rule; Amendments to Rule 14a-8 Go Into Effect

On September 6, 2011, the Securities and Exchange Commission ("SEC") announced that it will not seek rehearing of the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Business Roundtable and Chamber of Commerce of the U.S. v. Securities and Exchange Commission,* which struck down the SEC's proposed Rule 14a-11 under the *Securities Exchange Act of 1934* ("1934 Act"). The SEC also stated that it will not seek Supreme Court review of the D.C. Circuit's decision. Rule 14a-11 would have required companies that are subject to the proxy rules under the 1934 Act (including registered investment companies) to include the names of nominees submitted by qualifying shareholders, or groups of shareholders, on the company's proxy statement and proxy voting card, subject to certain limitations. Generally, under the rule a shareholder (or group of shareholders) would have qualified by holding at least 3% of a company's voting stock for at least three years. Among other things, the D.C. Circuit's decision criticized the SEC's cost-benefit analysis of proposed Rule 14a-11. It remains to be seen what effect the D.C. Circuit's decision may have on future SEC rule-making.

The SEC also announced on September 6, 2011 its decision to lift its voluntary stay of the effective date of its amendments to Rule 14a-8 under the 1934 Act. Although the amendments to Rule 14a-8 were not challenged in the *Chamber of Commerce* litigation, the SEC voluntarily stayed the effective date of these related amendments at the time it stayed the effective date of Rule 14a-11. The Rule 14a-8 amendments were originally adopted to permit qualifying shareholders to require companies to include a shareholder proposal regarding proxy access procedures in a company's proxy materials. Shareholders seeking to invoke the Rule 14a-8 amendments must have held continuously for at least one year the lesser of $2,000 worth or 1% of the company's voting securities. The SEC has indicated that the amendments to Rule 14a-8 will permit shareholders and companies the opportunity to establish proxy access standards on a company-by-company basis, rather than through a specified standard like that contained in Rule 14a-11. Although it may be possible to challenge the Rule 14a-8 amendments on the same grounds that Rule 14a-11 was vacated, the Chamber of Commerce has indicated that it has no current intention to bring such a challenge. The amendments to Rule 14a-8 took effect on September 20, 2011. The SEC's adopting release for Rule 14a-8 is available here.

The impact of the Rule 14a-8 amendments remains to be seen. The Rule 14a-8 amendments will likely dissatisfy corporate governance advocates who preferred the form of proxy access that would have been permitted under Rule 14a-11. As amended, Rule 14a-8 has the potential to open proxy access up to a larger group of shareholders because the amendments make it possible to submit a proposal that grants proxy access to shareholders holding fewer shares and for a shorter period of time than would have been required under Rule 14a-11. However, such proposals will also need to satisfy state corporate law requirements, which may be more restrictive. For example, in cases where shareholders do not have the power to amend bylaws, as is typically the case for most funds organized as Massachusetts business trusts, funds should be able to rely on Rule 14a-8(i) of the 1934 Act to force proponents to state their proposals in precatory form. This would

leave boards with the ultimate discretion as to whether and how proxy access proposals should be implemented even if approved by shareholders.

SEC's Office of Compliance Inspections and Examinations and Division of Enforcement Highlight Priorities for Mutual Funds at ICI Conference

SEC officials recently discussed the priorities of the SEC's Office of Compliance Inspections and Examinations ("OCIE") and the Division of Enforcement ("Division of Enforcement") as they relate to the fund industry. At the Investment Company Institute's Tax and Accounting Conference held September 11-14, 2011, Jaime Eichen, Chief Accountant of the Division of Investment Management, provided insight regarding potential areas of focus for OCIE and the Division of Enforcement, in particular funds' use of derivatives and the fees paid to certain fund service providers.

Ms. Eichen noted that OCIE is focusing on funds' increasing use of derivatives, and is investigating whether funds are employing personnel with the appropriate background to handle derivatives and whether a fund's practices and procedures are adequate to monitor the risks associated with derivatives use. She stated that the Division of Enforcement is also focusing on funds' use of derivatives, particularly when a fund's investments in derivatives appear inconsistent with a fund's goals as stated in its prospectus. This emphasis on derivatives by OCIE and the Division of Enforcement reflects the SEC's more general interest in the topic, as further evidenced by the SEC's recent concept release on funds' use of derivatives. Ms. Eichen also discussed OCIE's and the Division of Enforcement's ongoing investigations regarding whether fees paid by funds to their service providers are appropriate. For example, Ms. Eichen noted that OCIE was reviewing whether transfer agents who outsource work are retaining a fee that is not reasonable in relation to the work performed. Ms. Eichen commented on several other priorities, noting that OCIE has raised concerns about certain disclosure and filing issues and the adequacy of board oversight of a large number of unaffiliated funds. She also noted that the Division of Enforcement is investigating a variety of issues, including fund boards' oversight of the valuation of fund assets and the consequences of high risk products such as leveraged ETFs.

Separately, Julius Leiman-Carbia, Associate Director of OCIE, recently announced that OCIE is engaging in an effort to understand the effect of ETF valuations and discount brokers on market volatility. Mr. Leiman-Carbia noted with respect to ETFs that OCIE is studying whether providers are maintaining their portfolios' net asset value in line with the value of underlying securities as part of its broader efforts to understand ETFs' role in market volatility. He also explained that discount brokers are under surveillance because they have the capacity to create a material market impact in the event of an error or mishap. According to Mr. Leiman-Carbia, OCIE will create a group comprised of five to ten examiners who will focus on discount brokers and the processes they have in place.

DOL Withdraws Proposed Rule Regarding Fiduciary Liability; Plans to Re-Propose Modified Version Following Additional Review and Comment

On September 19, 2011, the Employee Benefits Security Administration of the U.S. Department of Labor ("DOL") announced that it would withdraw a proposed rule that would have expanded the definition of "investment advice" for purposes of fiduciary liability under the *Employee Retirement Income Security Act* ("ERISA"). The proposed rule would have amended a DOL regulation dating back to 1975 to define a fiduciary as anyone who gives investment advice to plans for a fee or other compensation. The proposed rule had been heavily criticized for its potential costs and sweeping reach, drawing over 260 written comments.

The DOL plans to re-propose a modified version of the rule in early 2012. The DOL has suggested that, among other things, the modified rule is expected to

- Clarify that fiduciary advice is limited to individualized advice directed to specific parties, and does not apply to routine appraisals;
- Clarify the limits of the rule's application to arm's length commercial transactions, such as swap transactions;
- Add exemptions to address industry concerns about the impact on current fee practices of brokers and advisers; and
- Clarify that long-standing exemptions that allow brokers to receive commissions in connection with transactions in mutual funds, stocks and insurance products would continue.

The DOL has confirmed that it is committed to establishing a new fiduciary standard and has indicated that it will take the time necessary to "get this right."

PCAOB Issues Concept Release on Auditor Independence and Mandatory Audit Firm Rotation

On August 16, 2011, the Public Company Accounting Oversight Board ("PCAOB") issued a concept release ("Release") requesting public comment on its proposal to require mandatory audit firm rotation and other ways to enhance auditor independence, objectivity and professional skepticism. Although the PCAOB has requested comments on auditor independence in general, the Release primarily focuses on "whether mandatory auditor rotation would significantly enhance auditors' objectivity and ability and willingness to resist management pressure."

Similar to the current requirement under the *Sarbanes-Oxley Act of 2002* that imposes mandatory rotation for individual audit partners for listed companies, the PCAOB's proposal for mandatory audit firm rotation would limit the number of consecutive years that an audit firm could provide audit services to public companies, including registered funds. The Release indicates that requiring mandatory auditor rotation could allow a new incoming auditor to bring a "fresh viewpoint" to the audit process and generally increase an auditor's incentive to resist pressure from management. In addition to a general call for comments on auditor independence, the Release poses 21 questions intended to elicit comments on specific aspects of mandatory audit firm rotation such as the appropriate length of the auditor's term, the types of issuers to which rotation should apply, competition issues, and restrictions on an issuer's ability to remove the auditor without good cause prior to the end of the allowable term.

The PCAOB's proposal for mandatory audit firm rotation has been widely criticized for a variety of reasons, including: (i) loss of the knowledge base and efficiencies that are created over time by an audit firm each time a rotation is required, thereby increasing the costs of maintaining the same level of audit services, decreasing the quality of audit services and heightening the risk of fraud in the early years of an audit firm's engagement; (ii) management would be disrupted and would be required to expend resources to familiarize new auditors with their business; and (iii) companies in specialized industries or remote locations may have trouble finding audit firms that have the necessary expertise, staffing levels, and independence.

The Release is available here and comments on the Release are due by December 14, 2011. The PCAOB has also announced that it will hold a public roundtable on the Release in March 2012.

IRS Proposes New Regulations on Taxation of Swaps and Similar Agreements

On September 15, 2011, the Internal Revenue Service ("IRS") proposed regulations intended to clarify the U.S. federal income tax treatment of swaps and similar agreements under the *Internal Revenue Code of 1986* ("Code"). Among other things, the proposed regulations would implement Section 1256(b)(2)(B) of the Code, which was added to the Code by the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* ("Dodd-Frank Act"). The Dodd-Frank Act excluded from so-called "Section 1256 contract" treatment a variety of swaps and "similar agreements." Section 1256 contracts are marked to market at the end of each taxable year, with any gain or loss treated as a 60% long-term and 40% short-term gain or loss. The proposed regulations would create a bright-line rule, excluding from Section 1256 those contracts that are "notional principal contracts" as defined in Treasury Regulation § 1.446-3(c) ("NPCs") and options on such NPCs (rather than excluding "swaps" as defined in the Dodd-Frank Act). Under an ordering rule, a contract that qualifies as both a Section 1256 contract and an NPC would be treated as an NPC.

In addition, the proposed regulations would expand the definition of NPC under Treasury Regulation § 1.446-3(c) to include credit default swaps and swaps on qualifying non-financial indices (e.g., weather-related swaps). Significantly, the proposed regulations also would narrow the scope of swap contracts considered to be "bullet swaps" (very generally, a swap providing for the settlement of all of the parties' obligations under the swap at its maturity and thus eligible for more favorable tax treatment under current law than swaps that are NPCs). Instead, certain common forms of bullet swaps would be treated as NPCs under the proposed regulations (e.g., total return swaps that provide for a single payment at maturity based on the change in value of a specified number of shares of stock, *adjusted for actual dividends paid* on the stock during the term of the contract). The proposed regulations raise a number of questions, including regarding how the NPC accounting rules would apply to payments made under these new classes of NPCs.

The proposed regulations would apply prospectively to contracts entered into on or after the date such regulations are ultimately published, and are available here. The IRS has invited comments regarding the proposed regulations, and a public hearing has been scheduled for January 19, 2012.

Recent Judicial and Administrative Decisions

Seventh Circuit and Third Circuit Appellate Courts Dismiss 401(k)-Fee Suits

In recent cases, *Loomis v. Exelon Corp.*, 2011 U.S. App. LEXIS 18480 (7th Cir. 2011) ("*Loomis*") and *Renfro v. Unisys*, 2011 U.S. App. LEXIS 17208 (3rd Cir. 2011) ("*Renfro*"), the Seventh and Third Circuit appellate courts, respectively, dismissed plaintiffs' claims that the administrators for 401(k) defined contribution plans had breached their fiduciary duties, finding that the respective district courts had correctly dismissed each case based on the pleadings. In both cases, participants in 401(k) defined contribution plans alleged a breach of fiduciary duty because plan administrators selected and retained only retail funds in the mutual fund investment options available to plan participants. Plaintiffs alleged that plan administrators should not have included retail funds available on the same terms to investors on the open market in the portfolio of possible investment choices, but rather should have opted for institutional funds or institutional classes of retail funds that were not available to the public and that offered lower fees. The *Loomis* and *Renfro* cases are part of a wave of lawsuits filed beginning in 2006 against retirement plan sponsors over 401(k) fees.

In *Loomis*, plaintiffs argued that the plan administrator should have selected institutional funds with lower expense ratios and should have covered the expenses of the retail funds, rather than requiring participants to bear that cost. The Seventh Circuit held that the mere possibility that "some other funds might have had

even lower ratios is beside the point; nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund . . ..." The court further stated that "…whether to cover these expenses is a question of plan design, not of administration." The court concluded that ERISA does not create a fiduciary duty for employers to make pension plans more valuable to participants, finding that "[w]hen deciding how much to contribute to a plan, employers may act in their own interests."

In *Renfro*, plaintiffs contended that the fees associated with each retail mutual fund in the plan, as well as the administrative fees governed by the plan administrator's agreement with a directed trustee for the plan, were excessive as compared to other, less expensive, investment options not included in the plan. The Unisys plan offered various options, including company stock, commingled funds (including retail funds with "a variety of risk and fee profiles"), and mutual funds comprising seventy-three different investment options. The Third Circuit held that, "[i]n light of the reasonable mix and range of investment options in the Unisys plan, plaintiffs' factual allegations about Unisys's conduct do not plausibly support their claims."

Reminder – Upcoming Deadline for Compliance with Rule 2a-7

The SEC's 2010 amendments to Rule 2a-7 under the *Investment Company Act of 1940* require that a fund (or its transfer agent) have the capacity to redeem and sell its securities at a price based on the fund's current net asset value per share, including the capacity to sell and redeem shares at prices that do not correspond to the stable net asset value or price per share. Advisers are reminded that the compliance date for funds and transfer agents to have this transaction processing capability is October 31, 2011.

Other Developments

Industry Publications

The Investment Company Institute and Independent Directors Council recently published a white paper intended to assist fund directors in understanding and carrying out their risk management oversight responsibilities. The white paper, entitled "Fund Board Oversight of Risk Management," provides an overview of risk management concepts and fund risks, discusses the respective roles of a fund's board and advisers, surveys risk management and oversight practices in the fund industry, and provides practical guidance for boards. The white paper is available to member organizations at http://ici.org.

Recent R&G Publications

Since our last IM Update we have also published the following item of interest to the investment management industry:

WaMu Court Allows Equity Committee to Pursue "Equitable Disallowance" of Noteholder Claims Based on Allegations of Insider Trading
September 22, 2011

Circular 230 Disclosure: To ensure compliance with Treasury Department regulations, we inform you that any U.S. tax advice contained in this communication (including attachments) was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. tax-related penalties or promoting, marketing or recommending to another party any tax-related matters addressed herein.

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 partner in the Ropes & Gray Investment Management group, listed below.

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