Ropes & Gray's Investment Management Update: June-July 2012

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

SEC Clarifies its Position Regarding Use of "International" and "Global" in Registered Fund Names

The Investment Company Institute (the "ICI") recently obtained informal clarification from certain members of the SEC staff with respect to the use of the terms "global" and "international" in fund names under the "names rule" (Section 35(d) of the Investment Company Act of 1940 and Rule 35d-1 thereunder). The SEC staff has, for several years, articulated its views with respect to such fund names on an informal basis and without publication, resulting in disparate treatment of registrants based on the identity of the SEC staff member primarily responsible for reviewing a registrant's filings. According to a memorandum published by the ICI on June 4, 2012, the SEC staff has reiterated earlier SEC statements that funds with "global" or "international" in their names "connote diversification among investments in a number of different countries throughout the world." The SEC staff communicated to the ICI that they expect funds using these terms will explain in their registration statements how their investments will be consistent with this connotation. For these purposes, the SEC staff did not distinguish between the two terms. For example, one way for a "global" or "international" fund to satisfy this guidance, according to the SEC staff, would be to state that a fund would invest, under normal market conditions, in at least three different countries, and invest at least 40% of its assets outside the United States or, if conditions are not favorable, invest at least 30% of its assets outside the United States. A statement to the effect that the fund will invest "primarily" or "a majority of its assets" in non-U.S. securities is also considered acceptable. In addition, the ICI memo states that if a fund indicates that it will invest "to approximately the same extent as the fund's benchmark index" in non-U.S. securities, SEC reviewers may question whether such formulations describe an appropriate level of investment outside the United States. The SEC staff noted that these formulations are not intended by the SEC staff to prevent a fund from taking "temporary defensive positions" in response to adverse market, economic, political, or other conditions. The ICI memorandum did not report further clarification from the SEC staff on related interpretive issues that arise in this context, such as whether securities issued by a particular company that has greater than 50% of its assets in the United States and derives greater than 50% of its revenues from outside the United States should be considered U.S. or non-U.S. securities for these purposes.

Supreme Court Declines to Review Dismissal of Claims Alleging Improper Redemptions of Auction Rate Preferred Securities

The U.S. Supreme Court declined to review a federal appeals court's decision to uphold a lower court's dismissal of a complaint alleging that Calamos Convertible Opportunities and Income Fund, its trustees, and its investment adviser, among others, breached their fiduciary obligations to common shareholders when the closed-end fund redeemed auction rate preferred securities ("ARPS") at par value in 2008 and 2009. The lower court's decision in *Brown v. Calamos*, which was affirmed by the Court of Appeals for the Seventh Circuit, held that the claims were barred by the 1998 Securities Litigation Uniform Standards Act ("SLUSA"), which prohibits class action plaintiffs from filing federal securities class actions in state courts as a means of circumventing the stringent pleading requirements applicable to cases filed in federal court. The plaintiffs argued that their claims were not barred by SLUSA because they were based on fiduciary duties arising under state law, rather than misrepresentation or fraud. In affirming the lower court's decision to grant defendants' motion to dismiss, the Court of Appeals for the Seventh Circuit concluded that the claims relating to breach of fiduciary duty would be difficult, if not impossible, to disentangle from claims of misrepresentation and fraud. The Seventh Circuit's decision and the Supreme Court's refusal to review the decision in *Calamos* appear to signal that common shareholders are unlikely to be successful in avoiding SLUSA by pursuing breach of fiduciary duty claims against closed-end fund boards and advisers in state courts.

The claims asserted by the plaintiffs in the *Calamos* case, involving differing treatment of common and ARPS shareholders, are similar to those asserted in other pending suits by common shareholders against closed-end funds that have redeemed ARPS at par value, including cases against John Hancock, Nuveen, Eaton Vance, BlackRock and Morgan Stanley, among others.

SEC Approves New Individual Stock and Market-wide Circuit Breakers

In response to the extraordinary volatility of the stock market in recent years, the SEC announced on June 1, 2012, the approval of two new mechanisms to replace and revise existing circuit breakers. The first mechanism, which was discussed in a prior Update and is referred to as a "limit up-limit down" mechanism, replaces the existing single-stock circuit breaker by restricting trades in individual exchange-listed stocks to a specified price band. The price band is set based on a percentage—5% for liquid securities and 10% for other listed securities—above and below a security's average price over the preceding 5 minutes and would trigger a 5 minute trading pause when trading does not occur within the band for more than 15 seconds. The second mechanism revises the current market-wide circuit breakers by modifying the conditions under which market-wide trading halts are triggered, as well as the circuit breaker's inputs and outputs. In addition to replacing the Dow Jones Industrial Average with the broader S&P 500 Index as its pricing reference, the market-wide circuit breaker has been revised to (i) reduce the market decline percentage trigger from 10%, 20% and 30% to 7%, 13% and 20% as measured from the prior day's closing price; (ii) shorten the duration of permissible trading halts that do not trigger a full day's market closure from 30, 60 or 120 minutes to 15 minutes; (iii) reduce the number of trigger time periods from six to two (before and on or after 3:25 p.m.); and (iv) require the trigger thresholds to be recalculated daily rather than quarterly. Both mechanisms will go into effect February 4, 2013. The SEC release announcing the approval of these mechanisms is available here.

SEC Staff Permits Offset of Registration Fees in Master-Feeder Arrangements

The SEC staff recently issued no-action relief permitting master funds in registered, open-end master-feeder arrangements to offset registration fees paid by feeder funds for purposes of calculating the master funds' registration fees under Section 6(b) of the Securities Act of 1933 and Section 24(f) of the Investment Company Act. The relief, which was issued to GMO Trust (the master funds) in a letter dated May 24, 2012, permits GMO Trust to exclude the net sales price of shares of each master fund sold to corresponding series of GMO Series Trust (the feeder funds) when calculating GMO Trust's "aggregate sales proceeds" for purposes of determining its registration fees pursuant to Rule 24f-2 under the Investment Company Act. The SEC staff's position is based particularly on GMO Trust's representation that each feeder fund invests substantially all of its assets in a corresponding series of GMO Trust and, under normal circumstances, each feeder fund will invest at least 95% of its assets in shares of its corresponding master fund with any remaining assets being held as cash. The no-action relief is applicable only to those master funds that are registered under the Investment Company Act, as the requirement to pay Rule 24f-2 registration fees only applies to entities registered under the Investment Company Act. The position confirms that the SEC staff will not require registration fees to be paid twice on the same aggregate proceeds from investors in feeder funds. By contrast, the SEC staff reiterated its position that no offset is allowed for fund-of-funds arrangements because a fund-of-funds does not act as a conduit for investments in the other funds. The SEC staff did not address whether offset of registration fees is available in non-affiliated master-feeder arrangements.

The full text of the GMO Trust no-action letter can be found here.

SEC Settles Case Alleging Improper Disclosure of Use of Derivatives

On June 6, 2012, the SEC settled with OppenheimerFunds, Inc. ("Oppenheimer") and its sales and distribution arm in connection with charges that Oppenheimer had made misleading statements about two of its mutual funds struggling in the midst of the credit crisis in late 2008. In its order instituting cease-and-desist administration proceedings (the "Order"), the SEC stated, among other things, that Oppenheimer sold shares of a fund under a prospectus that highlighted the fund's cash investments in junk bonds without adequately disclosing the fund's practice of assuming substantial leverage through its use of derivatives.

The Order states that the Oppenheimer Champion Income Fund's prospectus (the "Champion Prospectus") was materially misleading insofar as it purported to describe the fund's "main" investments without adequately disclosing the fund's practice of assuming substantial leverage on top of those investments. The Order states that the Champion Prospectus did not adequately disclose that the fund could use derivatives to such an extent that the fund's total investment exposure could far exceed the value of its portfolio securities and its investment returns could depend primarily upon the performance of bonds that it did not own. In addition, the Order states that the Champion Prospectus did not adequately convey to investors the heightened risk of loss associated with the fund's use of leverage.

The Order notes that in determining to accept the $35.4 million settlement, the SEC considered Oppenheimer's cooperation and its prompt remedial acts, including the replacement of senior management and portfolio management personnel, enhancements to Oppenheimer's risk management structure, enhancements to Oppenheimer's Legal Department capabilities, and the implementation of new controls and procedures relating to fund disclosures and marketing communications. A copy of the Order is available here.

Enforcement Actions Underscore that Registered Fund Advisory Contract Approval Processes Remain Under Close Watch

Two recent actions suggest that the SEC continues to subject the fund advisory contract approval process, and the resulting fees paid to advisers, to close scrutiny. These actions are consistent with SEC staff pronouncements since the *Jones v. Harris* case was heard by the Supreme Court in 2009, which have suggested that, where warranted, the SEC intends to use the power granted to it by Section 36(b) of the Investment Company Act more readily in the future than it has in the recent past. During oral argument in *Jones*, the attorney for the U.S. government admitted, in response to questioning from Justices Ginsburg and Scalia, that the SEC had not exercised its right to bring an action under Section 36(b) of the Investment Company Act since 1980, which admission was widely seen as an embarrassment to the SEC.

First, on May 30, 2012, Northern Lights Fund Trust (the "Trust") disclosed that the Trust, certain of its trustees and its chief compliance officer received a "Wells Notice" from the SEC staff, indicating that the SEC staff is gathering information in furtherance of potential proceedings against the named parties, in connection with the advisory contract approval process utilized by a small number of funds in the Trust and related disclosures. Notably, Northern Lights operates under a series trust structure, comprising a large number of funds that are advised by more than 60 different investment advisers, and that are overseen by trustees who serve on the boards of numerous Northern Lights funds and other mutual funds (in some cases, as many as 100 in total). As reported in the media, Bruce Karpati, Co-Chief of the Asset Management Unit of the SEC's Division of Enforcement, has recently indicated that such a structure raises concerns regarding whether the appropriate compliance infrastructure is in place to enable fund boards to properly oversee the funds.

Second, on June 26, 2012, the SEC announced that it had reached a settlement with AMMB Consultant Sendirian Berhad ("AMC"), a subadviser to the Malaysia Fund, Inc., which is advised by Morgan Stanley Investment Management, Inc. ("MSIM"). A separate settlement with MSIM relating to subadvisory services provided to the fund was discussed in a prior Alert, available here. AMC agreed to pay $1.6 million (which includes a $1.3 million disgorgement of subadvisory fees paid to it by the fund) to settle the SEC's charges that AMC breached its fiduciary duty under Section 36(b), misrepresented its services during the fund's annual advisory contract review process for each year for more than ten years, and collected fees for subadvisory services that it did not provide. The SEC release regarding the AMC settlement is available here, and the SEC's complaint is available here.

SEC Approves New FINRA Rules Governing Communications With the Public

In June, the SEC approved FINRA's proposed rule changes to adopt new FINRA Rules 2210 and 2212 through 2216 (collectively, the "Communications Rules"). The Communications Rules take effect on February 4, 2013, and are intended to streamline and clarify certain existing NASD rules, and to codify current rule interpretations. Several of the changes may be of particular interest to investment advisers and fund complexes.

Reorganization of Rules. New FINRA Rule 2210 reduces the number of current communication categories from six to three: institutional communication (which includes written communications that are distributed or made available only to institutional investors, but not a firm's internal communications), retail communication (which includes any written communication that is distributed or made available (including via social media) to more than 25 retail investors within any 30 calendar-day period), and correspondence (which includes any written communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period).

Predictions and Projections of Performance. While new FINRA Rule 2210 carries forward the current prohibition of performance predictions and projections, as well as the allowance for hypothetical illustrations of mathematical principles, the rule also explicitly permits two additional types of projections of performance in communications with the public. First, FINRA allows projections of performance in reports produced by investment analysis tools that meet the requirements of NASD IM-2210-6, "Requirements for the Use of Investment Analysis Tools," which the Communications Rules codify as FINRA Rule 2214. Second, FINRA has permitted research reports on debt or equity securities to include price targets under certain circumstances.

Additional Changes Relating to Fund Complexes. The new rules change the "concurrent with use" filing requirements, including a new requirement that *all* retail communications concerning closed-end registered investment companies, including retail communications that are distributed after a closed-end fund's initial public offering ("IPO") period, be filed with FINRA. Under the existing rule, firms are required to file only the advertisements and sales literature that are distributed during the fund's IPO period. The filing requirements relating to advertisements and sales literature concerning continuously offered (interval) closed-end funds generally remain unchanged. New FINRA Rule 2210 creates a new filing exception for press releases issued by closed-end investment companies listed on the NYSE that are subject to the "immediate release policy" under the NYSE Listed Company Manual, such as dividend announcements. The new rules make no substantive changes to the general content standards currently imposed. Similarly, the standards with respect to the use of investment company rankings in retail communications and bond mutual fund volatility ratings generally remain unchanged.

The text of FINRA Regulatory Notice 12-29, discussing the Communications Rules, is available here. The text of the new rules is available here.

Regulatory Priorities Corner

A summary of regulatory priorities that have been brought to our attention recently:

- *OCIE Focusing Risk Analytics on Branch Offices.* The SEC's Office of Compliance Inspections and Examinations ("OCIE") is shifting the focus of its risk analytics to branch offices of registrants, including registered investment advisers, according to a speech given by Director Carlo di Florio on June 26, 2012. Di Florio spoke at an enforcement panel at the Insured Retirement Institute's 2012 Government, Legal and Regulatory Conference in Washington, D.C. and said that branch offices that generate a disproportionate number of complaints, or that appear to have more problems than other branches, will draw increased regulatory scrutiny. At the panel, di Florio also said that focus areas for SEC examiners are:

    - fraud, including microcap fraud and problematic disclosure practices;
    - the "retailization" of complex products, such as principal protected notes, or complex products wrongly marketed to the elderly as safe;
    - conflicts of interest;
    - valuation and pricing; and
    - risk management, supervision, and compliance practices.

- *Microcap Stocks Face Increased Regulatory Scrutiny.* On June 4, 2012, the SEC brought charges against nine so-called "penny stock" companies (generally, companies with small capitalizations that issue equity securities traded over-the-counter for a few dollars a share or less) and their chief executive officers and three penny stock promoters involved in various schemes in which bribes and kickbacks were allegedly paid to build up microcap stocks and generate public sales. The SEC's complaints, which allege violations of 17(a)(1) of the Securities Act of 1933 and Section 10(b) and 10(b)(5) of the Securities Exchange Act of 1934, seek financial penalties, disgorgement of gains and permanent injunctions against the defendants. The complaints suggest that the SEC continues to believe that the market for microcap securities is particularly vulnerable to fraud and manipulation, in part because the stocks of many microcap companies trade over-the-counter and are not subject to the same level of regulatory oversight as other companies, such as exchange-traded companies.

- *Update on Money Market Reform Proposal.* As reported in the media, a draft of the SEC staff's money market reform proposal was issued to SEC commissioners in late June. The commissioners have 30 days to review the initial draft; three of five commissioners must endorse the proposal before it is released for public comment. In addition, Robert Plaze, Deputy Director of the SEC's Investment Management Division, said at a panel in Washington, D.C. on July 10, 2012 that the SEC is considering requiring money market funds to hold a capital buffer of less than 1% of fund holdings. We will continue to monitor and report on developments regarding the proposed reforms; our previous Update regarding the reforms is available here.

- *SEC Appoints New Director of Division of Investment Management.* The SEC announced on July 5, 2012 that Norm Champ would succeed Eileen Rominger, who has retired, as the Director of the Division of Investment Management. Mr. Champ had served as Deputy Director of OCIE since June 2010, and had joined the SEC staff in January 2010. Prior to that, he had served as general counsel, member of the executive committee and partner at Chilton Investment Company, a multinational adviser to private funds and managed accounts. The SEC release announcing Mr. Champ's appointment is available here.

Other Developments

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

SEC and CFTC Adopt Final Swap Product Definitional Rules, Which Will Trigger Compliance Dates for Multiple Dodd-Frank Act Rules
July 12, 2012

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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