Ropes & Gray's Investment Management Update: February 2013 - March 2013

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

§36(b) Claims Against BlackRock Raise Excessive Fee Allegations Over Securities Lending Arrangements

On January 18, 2013, two union pension plans sued BlackRock's exchange traded funds iShares Trust and iShares Inc. (the "Trusts"), the Trusts' investment adviser, affiliated securities lending agent and certain other affiliates (collectively, "BlackRock") as well as the Trust's directors and/or trustees (the "Directors"), alleging that the defendants violated their fiduciary duties by setting up an "excessive fee structure designed to loot securities lending returns properly due to iShares investors."[1] Specifically, the plaintiffs claim that the 60/40 securities-lending fee split is excessive and demonstrates a breach of fiduciary duty on the part of the defendants under Sections 36(a) and (b) of the Investment Company Act of 1940 (the "1940 Act"), and that the contracts between BlackRock and the Trusts obligating the Trusts to compensate BlackRock for securities lending transactions are unenforceable and voidable under Section 47(b) of the 1940 Act.

Plaintiffs allege that the securities lending arrangement affords BlackRock "a fee of 35% of the 'net amount earned on securities lending activities'" under the Director-approved contracts in addition to 5% representing "fees [believed to be] derived from securities lending…such as…fees charged by [BlackRock] for investing collateral," which sometimes allegedly involved the use of BlackRock-affiliated investment vehicles, amounting to an effective 60/40 securities-lending fee split. Moreover, plaintiffs claim that the Trusts also paid borrowers additional fees where securities loans were collateralized by cash, and that in some cases this revenue benefitted BlackRock affiliates.

The claim raises excessive fee allegations, typically litigated in the advisory fee context, in respect of securities lending fees. To prevail on their claim under Section 36(b), the plaintiffs must establish that the fees are "so disproportionately large that [they] bear[ ] no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[2] Plaintiffs' arguments in support of their excessive fee claim largely hinge on comparisons to other securities lending fee splits in the industry that are allegedly more favorable to funds and academic studies concluding that the conflicts of interest arising from affiliated securities lending arrangements diminish returns on the securities lent. BlackRock has claimed in public statements that their "securities lending program has delivered above average returns to…ETF shareholders over time."[3]

New Iran Threat Reduction and Syria Human Rights Disclosure Requirements Become Effective

Effective with reports required to be filed on or after February 6, 2013, registered investment companies (including open- and closed-end funds as well as unit investment trusts) are subject to new reporting requirements under the "Iran Threat Reduction and Syria Human Rights Act of 2012" (the "Iran Act"). The requirements are codified under Section 13(r) of the Securities Exchange Act of 1934 (the "1934 Act"). Under

[1] Complaint at 4, *Laborers' Local 265 Pension Fund, et. al. v. iShares Trust, et. al.* (M.D. Tenn. 2013) (No. 3:13-cv-00046). The full text of the complaint can be found here.
[2] *Jones v. Harris Associates*, 130 S. Ct. 1418 (2010).
[3] Beagan Wilcox Volz, *Long odds for suit over BlackRock securities lending*, Financial Times, Feb. 7, 2013.

Section 13(r), the reporting obligations are generally triggered by investing in, or engaging in business involving, Iranian petroleum resources, weapons of mass destruction, support for terrorist organizations, money laundering, facilitating Iranian banking activities, or conducting business with any person listed on the Specially Designated Nationals List of the U.S. Department of the Treasury's Office of Foreign Assets Control. Reporting is required if the investment company or any affiliate thereof engages in any of the relevant activities. For this purpose, the applicable definition of affiliate is found at Rule 12b-2 under the Exchange Act. It includes "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." According to SEC staff interpretations, there is no requirement for reports to affirmatively state there are no applicable activities to disclose. Only annual and quarterly reports filed under Section 13(a) of the Exchange Act are impacted, which generally includes Forms N-CSR, N-Q and N-SAR. If 13(r) activity is disclosed, the fund must also separately file with the SEC a notice containing further details about the activity, as described in Section 13(r)(2) of the Exchange Act. The SEC is instructed under the statute to transmit the report to the President and applicable committees of the Senate and House of Representatives as well as post the information on the SEC's website. Investment companies are advised to consult with legal counsel to discuss whether to adopt compliance policies and procedures to address the new reporting obligations under Section 13(r) and whether to include relevant questions in their director and officer questionnaires. The text of the Iran Act is available here.

SEC No-Action Relief Permits Certain Amendments to Investment Advisory Agreement Without Shareholder Approval

On February 27, 2013 the staff of Securities and Exchange Commission (the "SEC") issued a no-action letter granting relief under Section 15(a) of the Investment Company Act to EGA Emerging Global Shares Trust, an open-end investment company offering exchange-traded funds (the "Trust"), and its sub-adviser, Emerging Global Advisors, LLC ("EGA") to allow amendments to certain provisions of the investment advisory agreement between EGA and the Trust (the "EGA Agreement") without obtaining shareholder approval. The need for relief arose when the Board considered a proposal to terminate the Trust's primary investment adviser and change EGA's role from a sub-adviser to the sole investment adviser to the Trust. EGA and the Trust sought to amend the EGA Agreement to remove all references to the terminated adviser and introduce a "unified fee structure," pursuant to which EGA would pay from its advisory fee a portion of the Trust's ordinary operating expenses. According to the no-action request letter, the unified fee structure would not represent an increase in advisory fees to EGA and there would not be any diminution in services provided to the Trust.

Section 15(a) of the Investment Company Act prohibits any person from serving as an investment adviser to a registered investment company except pursuant to a written contract that has been approved by fund shareholders. Under applicable SEC guidance, material changes to an advisory contract trigger the shareholder approval requirement. The no-action relief permitted the proposed amendments without requiring shareholder approval, given that (i) the amendments would not reduce or modify in any way the nature and level of advisory services EGA provided to the Trust and (ii) the total advisory fees paid to EGA under the amended EGA Agreement would not exceed the advisory fees paid under the current agreement.

DOL Issues Advisory Opinion on Cleared Swaps

The Department of Labor (the "DOL") has released a much-anticipated Advisory Opinion on the treatment of cleared swaps for ERISA plans. Advisory Opinion 2013-01A, issued in response to a request on behalf of the Securities Industry and Financial Markets Association (SIFMA), provides favorable answers to questions raised in connection with key functions in the central clearing system established pursuant to the Dodd-Frank

Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Specifically, the Advisory Opinion resolves concerns raised by central clearing counterparties (CCPs) and clearing members that performing clearing services or functions for a plan, account or fund subject to ERISA might cause them to be subject to ERISA in performing those services or functions.

Generally, a "clearing member" is a member of a CCP through which customers (including ERISA plans and other accounts holding plan assets), hold their cleared swaps with the CCP and post their cleared swaps margin. In connection with its clearing functions, the clearing member is generally required to guarantee the customer's swap obligations to the CCP, and would have certain remedies against the customer in the event of default by the customer or certain other circumstances with respect to the customer, including the right to liquidate a customer's positions in order to cover its obligations. The Advisory Opinion was requested because it was unclear how these actions would be viewed by the DOL, which is charged with enforcing the fiduciary and prohibited transaction rules under ERISA.

The DOL addressed similar concerns some 30 years ago in Advisory Opinion 82-49A, issued in response to a request on behalf of the Futures Industry Association. In that Advisory Opinion, the DOL addressed the treatment of initial and maintenance margin in the context of futures contracts. The DOL concluded that assets received from an ERISA plan as margin would not be treated as "plan assets," that the plan's asset in this situation consisted of the contractual rights embodied in the futures contract and in its agreement with its futures commission merchant, and that the holder of assets pledged as margin was not an ERISA fiduciary with respect to those assets. However, in the wake of Dodd-Frank, banks and brokers expressed uncertainty whether the DOL would take a similar position with respect to cleared derivatives. The effect of this uncertainty has been to stall negotiations on arrangements to provide clearing services to ERISA plans and other accounts holding plan assets.

In Advisory Opinion 2013-01A, issued on February 7, the DOL concludes that a clearing member will not be treated as a fiduciary under ERISA when exercising agreed account liquidation and related rights following a default by a pension plan on its obligations under a cleared swap. The new Advisory Opinion generally follows the reasoning of the 1982 Advisory Opinion and, in addition, refers several times to the DOL's understanding that when Congress enacted the Dodd-Frank Act, it did not intend for clearing members to be performing their functions in a fiduciary capacity. The DOL also concludes, however, that while the CCP would not be considered a service provider to an ERISA plan by reason of performing its functions, the clearing member *would* be performing its functions as a service provider and therefore would be a party in interest to the ERISA plan. To address clearing members' concerns about possible prohibited transactions, the Advisory Opinion states that when an investment manager enters into cleared swaps using the QPAM exemption, the exemption generally would extend to cover (as "subsidiary transactions") any clearing-related actions undertaken by the clearing member pursuant to contractual authorizations negotiated by the QPAM, including extensions of credit to the ERISA plan (such as a guarantee of the plan's obligations) and any exercise of contractual rights in connection with a default.

While clearing members will need to review their forms to be certain they comport with the expectations set out by the DOL in the Advisory Opinion, they can now proceed to negotiate cleared swap arrangements with ERISA plans and accounts holding plan assets with confidence that an appropriately negotiated agreement will not cause them to become subject to ERISA. Managers of funds and accounts holding plan assets should, as a consequence, see an end to the freeze on cleared swap negotiations for ERISA investors.

SEC Issues Guidance regarding Inclusion of 3.8% Tax on Net Income in After-Tax Performance Figures

Effective for taxable years beginning on or after January 1, 2013, the Health Care and Education Reconciliation Act of 2010 imposes a 3.8% Medicare contribution tax on net investment income ("3.8% tax") of certain higher income taxpayers. The SEC staff recently issued guidance on whether the 3.8% tax should be included in determining the highest individual marginal federal income tax rate used to calculate after-tax returns required to be disclosed in Form N-1A. The SEC's view is that because investors that are subject to the highest marginal rate on taxable income are also subject to the 3.8% tax, registrants should include the 3.8% tax in after-tax return calculations. The SEC further indicated that the 3.8% tax should also be included in calculating the tax on qualified dividend income and long-term capital gains or any tax benefit resulting from capital losses that are required to be reflected in after-tax returns. The text of the SEC's Guidance can be found here.

Regulatory Priorities Corner

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

SEC to Conduct Sweep Examinations on Fund Fees and the Use of Alternative Investments in Registered Funds

The Deputy Director of the SEC's Office of Compliance Inspections and Examinations ("OCIE") announced on March 8, 2013 that OCIE intends to commence two sweep examinations. The first will gather information on payments made to fund distributors, including revenue-sharing, fees paid to industry conference sponsors and so-called 12b-1 fees, to understand better recent developments in the uses of these fees as well as board oversight of the payments. The second sweep will focus on the use and appropriateness of certain alternative strategies by registered investment companies, including a review of compliance with leverage, liquidity and valuation regulations and the proper staffing and funding of boards, compliance personnel and back offices. Payments for distribution and the use of alternative strategies in registered funds featured on OCIE's list of "new and emerging risks," as reported in our February 28, 2013 Alert "SEC Announces 2013 Examination Priorities for the Investment Management Industry."

SEC to Increase Pursuit of "Irresponsible" Gatekeepers

At a PLI conference on February 13, 2013, acting Enforcement Director George Canellos stated that the SEC is working on a number of cases involving the role of so-called gatekeepers, including attorneys, accountants and compliance professionals, who act "irresponsibly" in facilitating violations of the securities laws. Under Section 929P of the Dodd-Frank Act, the SEC now has authority to fine individuals who "cause" violations that they do not themselves commit. A sanction that can be imposed on the basis of negligent, rather than intentional, misconduct and called the procedural changes stemming from Section 929P as a "very important" new form of secondary liability for gatekeepers.

SEC Issues Guidance to Investment Companies on Social Media Filings

The SEC's Division of Investment Management released the first in its "IM Guidance Update" series, to provide guidance on the obligations of mutual funds to file materials posted on their social media sites with FINRA. The IM Guidance Update indicates that SEC staff believes that many mutual funds are filing material on their social media sites with FINRA unnecessarily. In order to address this problem, the staff provides a series of examples of the types of interactive communications that it believes do not need to be filed and those for which filing is required. As examples of communications that should be filed, the staff included the following: "a discussion of fund performance that provides specific mention of some or all of the elements of

a fund's return (e.g., 1, 5 and 10 year performance) or promotes a fund's returns;" and, "a communication initiated by the issuer that discusses the investment merits of the fund." A copy of the guidance can be found here.

SEC Presses Enforcement Tool Left Open by *Janus* Decision

In remarks delivered at the annual "SEC Speaks" conference, Joseph Brenner, Chief Counsel of the SEC's Enforcement Division, indicated that the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders* is not impeding the SEC from bringing enforcement actions against investment advisers. *Janus* established that fund managers cannot be held liable for prospectus misstatements in a private action under Rule 10b-5 under the 1934 Act. Although the Court's decision clarified that a fund—rather than its investment adviser—bears primary responsibility for any misstatements in its prospectus, Mr. Brenner noted that *Janus* did not foreclose an SEC enforcement action against the fund's manager as an "aider and abettor" of securities law violations.

Investment Management Division Director Highlights Priorities for New Regulations

In remarks delivered on March 8th, Norm Champ, Director, Division of Investment Management highlighted three regulatory initiatives that are short-term priorities of the Division: potential money market mutual fund reform, identity theft red flag rules and valuation guidance. He also mentioned five longer term regulatory initiatives, that the Division is "scoping" and seeking to develop: the review of rules that apply to private fund advisers, a derivatives concept release, an ETF rule, a variable annuity summary prospectus and enhancements to fund disclosures about operations and portfolio holdings. Mr. Champ's remarks are available here.

Principal of Mutual Fund Adviser Barred From Industry For Improper Options Trading

The SEC imposed sanctions against an investment adviser and its president for engaging in options trading in a mutual fund portfolio that exceeded the limited scope of what was disclosed in the fund's prospectus and statement of additional information, which stated that options could be used for hedging purposes only. According to the SEC's settlement order, the actual level of options trading, which was as high as 21% of total assets in 2009 and 75% in 2010, went "well beyond hedging and amounted to speculation." In addition, the SEC specifically references the fact that the notional values of the option contracts entered into by the fund significantly exceeded the value of the fund's assets as a clear indication that the options purchases were higher than the amount that would be required to hedge the portfolio. The SEC's Settlement Order is available here.

SEC Seeks New Trial in Reserve Fund Litigation

In the latest salvo in its long-standing litigation against the Reserve Fund money market fund managers Bruce Bent Sr. and his son, Bruce Bent II, the SEC has filed a motion for a new trial. Our November 2012 Update reported how Messrs. Bent were cleared by a federal jury of most charges in an SEC enforcement action. See our previous discussion of this case here.

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 Proposes New Technology Standards for Key Market Participants

March 19, 2013

On March 7, 2013, the SEC proposed Regulation SCI, which would replace existing voluntary standards applicable to securities exchanges, clearing agencies and certain other market participants with enforceable

rules intended to better insulate trading markets from vulnerabilities posed by technology issues. The proposed rule targets those systems, whether in production, development, or testing, that directly support trading, clearance and settlement, order routing, market data, regulation, or surveillance.

SEC Adviser Examinations Focus on Custody Rule Compliance
March 8, 2013
The SEC's Office of Compliance Inspections and Examinations ("OCIE") has issued a Risk Alert and an Investor Bulletin regarding compliance with Rule 206(4)-2 under the Investment Advisers Act of 1940 (the "Custody Rule"). The Risk Alert provides a summary of common exam deficiencies to help investment advisers comply with the Custody Rule and the Investor Bulletin is intended to inform investors of the need to be proactive ensuring the safety of their assets. While the Risk Alert provides little new guidance on the relative importance of different elements of the Custody Rule, it clearly indicates that OCIE is closely scrutinizing adviser compliance with the rule and expecting advisers to be in strict compliance with all of its technical requirements.

AIFMD Implementation – What Should Non-EU Private Fund Advisers be doing?
March 6, 2013
The Alert discusses various measures implementing the Alternative Investment Fund Managers Directive ("AIFMD"), both at European Union ("EU") and at individual EU Member State level, that have recently been finalized or are now near final, including the "Level 2" regulation supplementing the AIFMD. It also discusses the European Securities and Markets Authority has recently published various draft "regulatory technical standards" and has finalized its Guidelines on Sound Remuneration Policies.

Supreme Court Adopts Strict Interpretation of the Statute of Limitations for SEC Civil Penalty Enforcement Actions
February 28, 2013
On February 27, 2013, the United States Supreme Court unanimously adopted a strict interpretation of the five-year period in which the SEC may seek to impose a civil penalty on a registered investment adviser.

SEC Announces 2013 Examination Priorities for the Investment Management Industry
February 28, 2013
OCIE has published its list and discussion of examination priorities for the investment management industry in 2013, which includes both market-wide initiatives and those relevant to specific industry areas. This Alert focuses on elements of the announcement that are of particular relevance to investment managers, where themes of conflicts of interest, risk management, and disclosure appear to take center stage.

The Treasury Department and IRS Release Final FATCA Regulations
February 22, 2013
On January 17, 2013, the Treasury Department and Internal Revenue Service released long-awaited final regulations on the set of statutory rules commonly referred to as the Foreign Account Tax Compliance Act rules (or FATCA). FATCA establishes an information reporting regime intended to reduce evasion of U.S. taxes by identifying U.S. persons holding assets through offshore entities and accounts, and affects both U.S. and non-U.S. financial entities. The full Alert summarizes the most significant components of the final regulations, including providing an analysis of key issues under FATCA relevant to different types of U.S. and non-U.S. investment funds.

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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