Ropes & Gray's Investment Management Update: December 2013-January 2014

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

SEC's National Exam Program – Examination Priorities for 2014

On January 9, 2014, the U.S. Securities and Exchange Commission's ("SEC") National Examination Program ("NEP") of the Office of Compliance Inspections and Examinations ("OCIE") published its 2014 examination priorities for NEP-wide initiatives for each of the NEP's four program areas: (1) investment advisers and investment companies, (2) broker-dealers, (3) exchanges and self-regulatory organizations, and (4) clearing agencies and transfer agents. These priorities reflect topics that the SEC staff perceives to have heightened risk and to which the NEP expects to allocate significant resources throughout 2014.

The NEP-wide initiatives include: (i) using quantitative and qualitative tools to enhance fraud detection and prevention; (ii) meeting with senior management and boards of SEC-registered entities and their affiliates to examine corporate governance, conflicts of interest, and enterprise risk management; (iii) examining information technology systems, information security and ability to respond to sudden malfunctions and system outages; (iv) examining registrants that are both broker-dealers and investment advisers and the attendant risk of conflicts of interest that this business model presents; (v) examining issues relating to new laws and regulations, including general solicitation practices and verification of accredited investor status under newly adopted Rule 506(c) under the Securities Act of 1933 (the "1933 Act"), industry developments and compliance with new rules regarding crowdfunding offerings and entities, compliance with new rules governing municipal advisors, and issues relating to new rules regarding security-based swaps dealers and other registered entities created or impacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"); and (vi) examining practices of investment advisers and broker-dealers that target retirement-age investors and investors changing employment, including potential misrepresentations of credentials, IRA plan features, and suitability of investments.

The pro/gram area-specific initiatives are divided into core risks, new and emerging risks, and policy topics. Core risks are those risks that are common to the business models of a category of registrants and that have existed for a sustained period and are likely to continue for the foreseeable future. New and emerging risks are those arising from changes and developments in the industry. Policy topics are areas in which the SEC seeks to gain a better understanding of business practices and the application of previously-adopted rules and guidance. The Investment Adviser/Investment Company Program (the "IA-IC Program") core risk initiatives include: (i) testing compliance with Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 and confirming the existence of assets through a risk-based asset verification process; (ii) examining conflict of interest risks in compensation arrangements, allocation of investment opportunities, side-by-side management of performance-based and purely asset-based fee accounts, illiquid investments, leveraged investment strategies, and higher risk strategies targeted to retail investors; and (iii) reviewing advisers' claims about their investment objectives and performance and reviewing marketing efforts arising out of newly effective rules under the Jumpstart Our Business Startups Act of 2012. New and emerging risk initiatives for the IA-IC Program include: (i) examining never-before examined and newly registered advisers; (ii) assessing whether advisers are fulfilling their obligations in relation to wrap fee programs; (iii) examining advisers that rely substantially on quantitative trading models; (iv) reviewing the payments made by advisers and funds to distributors and intermediaries and related disclosure and board oversight to assess whether such payments are "payments for distribution in guise"; and (v) monitoring the risks associated with a changing interest rate environment and its impact on bond funds and related risk disclosures. The IA-IC

Program policy topics include: (i) money market funds, with focus on the management of potential stress events and funds that exhibit outlier behavior; (ii) funds offering "alternative" investment strategies; and (iii) securities lending arrangements to assess compliance with exemptive orders and no-action letters. The full publication can be found here.

SEC Removes Reference to NRSRO Credit Ratings in Rule 5b-3 and Forms N-1A, N-2 and N-3

On December 27, 2013, the SEC adopted amendments to eliminate references to credit ratings by nationally recognized statistical rating organizations ("NRSRO") in Rule 5b-3 under the Investment Company Act of 1940 (the "1940 Act") and Forms N-1A, N-2, and N-3 under the 1940 Act and the 1933 Act.[1] The amendments were adopted to implement Section 939A of the Dodd-Frank Act and effectuate Congressional intent to reduce reliance on NRSRO credit ratings. The amendments have an effective date of February 7, 2014 and a compliance date of July 7, 2014.

Rule 5b-3 permits a fund to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for diversification and certain broker-dealer counterparty limit purposes, provided that the obligation of the seller to repurchase the securities is "collateralized fully." Under the previous definition of "collateralized fully," securities that served as collateral for the repurchase agreement (other than cash or government securities) were required, at the time the agreement was entered into, to be rated in the highest rating category by the "requisite NRSROs" or, if unrated, to be of a comparable quality to securities rated in the highest category by the requisite NRSROs. The amendments to Rule 5b-3 have revised this definition by replacing the reference to NRSRO credit ratings with a requirement that a fund's board of directors (or its delegate) determine that the securities, at the time the agreement is entered into, are: (i) issued by an issuer that has an exceptionally strong capacity to meet its financial obligations on the securities collateralizing the repurchase agreement; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days. The amended rule does not include any specific factors to be considered in performing this credit analysis, although the SEC indicated that the analysis may incorporate third-party assessments such as ratings, reports, and opinions, including those of NRSROs. However, the determination may not be made solely in reliance on the NRSRO rating as a standard without evaluating the quality of each NRSRO's assessment. Note that the amendments to Rule 5b-3 do not affect money market fund diversification requirements under Rule 2a-7.

The SEC also amended Forms N-1A, N-2, and N-3 (the "Forms") to remove the required use of credit ratings assigned by an NRSRO in connection with the inclusion of a table, chart, or graph depicting portfolio holdings by reasonably identifiable categories (e.g., type of security, industry sector, geographic region, credit quality, or maturity). Previously, if credit quality was used to present portfolio holdings, the Forms required that securities be categorized by ratings assigned by a single NRSRO. The amended Forms eliminate this requirement and provide that if a fund chooses to depict portfolio holdings based on credit quality, it may use alternative categorizations that are not based on NRSRO credit ratings, and, if a fund continues to use credit ratings, it is no longer restricted to using the credit ratings assigned by a single NRSRO. Any fund that chooses to depict portfolio holdings based on credit quality must include a description of how the credit quality of the holdings was determined, and, if credit ratings are used, a description of how such ratings were identified and selected.

---

[1] In a separate release, the SEC also adopted amendments eliminating references to NRSRO credit ratings in certain rules and one form under the Securities Exchange Act of 1934, which relate to broker-dealer financial responsibility and confirmations of securities transactions.

Funds that invest in repurchase agreements may wish to review their compliance policies and procedures and disclosures in light of the changes to Rule 5b-3 and the Forms. The SEC's final rule release can be found here.

Investment Management Division Publishes Guidance Update Regarding Risk Management in Changing Fixed Income Market Conditions

In January 2014, the staff of the SEC's Division of Investment Management (the "IM Staff") published an IM Guidance Update concerning risk management and disclosure practices in changing fixed income market conditions (the "Guidance Update"). The Guidance Update cites to the increased volatility experienced by fixed income markets during June 2013, along with changes in bond market size and structure, as a reminder of the importance of sound risk management and disclosure practices by fixed income mutual funds and exchange-traded funds. According to the Guidance Update, while the net assets of fixed income funds are at near-historic highs, the fixed income markets have experienced a significant reduction in dealer market-making capacity. The IM Staff expressed concerns that this reduction in dealer capacity may result in decreased liquidity and increased volatility in the fixed income markets.

The Guidance Update describes several steps that fund advisers may want to consider in terms of risk management and disclosure, including:

- *Assessing and Stress Testing Liquidity* – assessing fund liquidity needs during both normal and stressed environments, including assessing sources of liquidity (such as cash holdings and other assets that would not require selling into declining or dislocating markets);
- *Conducting More General Stress Tests/Scenario Analyses* – assessing the impact (beyond solely liquidity) of various stress tests, such as stress tests involving interest rate hikes, widening spreads, price shocks to fixed income products, or increased volatility;
- *Conducting a Risk Management Evaluation* – using the outcomes of any assessments, analyses and conversations to evaluate what risk management strategies and actions are most appropriate in response to changing fixed income market conditions at a fund and/or complex level;
- *Communicating with Fund Boards* – considering what information should be provided to fund directors to inform them of the risk exposures and liquidity position of the fund, and the fund's ability to adapt to changing interest rate and market conditions; and
- *Communicating with Shareholders* – assessing the adequacy of fund disclosures in light of any additional risks due to recent events in the fixed income markets and the potential impact of tapering of quantitative easing and/or rising interest rates, including the potential for periods of volatility and increased redemptions.

The Guidance Update can be found here.

OCIE Staff Issues Risk Alert on Investment Advisers' Due Diligence Processes for Selecting Alternative Investments

On January 28, 2014,OCIE staff issued a risk alert (the "Risk Alert") summarizing the results of more than ten examinations of SEC-registered investment advisers relating to the due diligence processes used by these advisers when recommending alternative investments such as hedge funds, private equity, venture capital, real estate and funds of private funds.

The Risk Alert discussed OCIE's observations of current industry trends regarding advisers' due diligence processes, including advisers' efforts to obtain more information directly from managers of alternative investments through requests for position-level transparency and the use of separately managed accounts, use of third party service providers to supplement analyses and confirm information regarding alternative investments, performance of additional quantitative analyses and risk measures on alternative investments and their managers, and expansion of due diligence processes to include onsite visit requirements and review of operations, legal documents, liquidity issues and audited financial statements. According to the Risk Alert, these due diligence methods helped advisers identify risk indicators, which led advisers to perform additional due diligence or request changes to or reject an alternative investment.

The Risk Alert also highlighted deficiencies and weaknesses in some of the advisers examined, including omitting from their annual review a review of their due diligence policies and procedures for alternative investments, providing disclosures that were not consistent with their actual practices and failing to review disclosures for consistency with fiduciary principles owed to clients, providing potentially misleading or unsubstantiated claims in marketing materials, and not conducting periodic reviews of third party service providers.

In addition, the Risk Alert discussed advisers' obligations with respect to codes of ethics, noting that where an adviser's "access persons" are permitted to invest in a limited offering with preferential terms, there is an inherent conflict of interest that may influence the adviser's due diligence process to the detriment of clients. The Risk Alert can be found here.

Regulatory Priorities Corner

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

SEC Announces Enforcement Results for Fiscal Year 2013

The SEC recently announced a record $3.4 billion in monetary sanctions in 2013, which included enforcement actions relating to fair market access, trustees and directors failing to uphold their responsibilities under the securities laws, insider trading, the financial crisis and securities violations by municipalities. The press release also highlighted the SEC's new policy of requiring admissions of misconduct in certain cases where heightened accountability and acceptance of responsibility by a defendant are appropriate and in the public interest. According to the release, the SEC's new forward-looking initiatives include launching a new Microcap Task Force to address fraud in the microcap markets and target gatekeepers, continuing to focus on violators of Rule 105 of Regulation M with respect to short selling, and improving the Enforcement Division's technological and analytical capabilities. The full press release and related materials can be found here.

CFTC Defers Certain Oral Recordkeeping Requirements

On December 21, 2013, the U.S. Commodity Futures Trading Commission (the "CFTC") issued no-action relief deferring through May 1, 2014 the effectiveness of certain CFTC oral recordkeeping requirements. Prior to the relief, recent amendments to Regulation 1.35(a), which imposes recordkeeping rules on a variety of CFTC registrants, would have required fund managers who are both registered as commodity trading advisors and members of swap execution facilities to preserve oral communications, including telephone calls, that lead to the execution of commodity interest transactions (which include futures and swaps) and related cash or forward transactions. Note that revised Regulation 1.35(a) includes a separate exclusion from the oral recordkeeping requirements for commodity pool operators.

No relief was granted with respect to the written recordkeeping requirements under Regulation 1.35(a), under which all members of swap execution facilities are required to maintain full, complete, and systematic records of all transactions relating to their business of dealing in commodity interests and related cash or forward transactions (including any written communications provided or received that lead to the execution of such transactions). Under CFTC regulations, any entity with trading privileges on a swap execution facility is a "member" of that swap execution facility and is therefore subject to these requirements.

The time-limited no-action relief with respect to the oral recordkeeping requirements can be found here.

Another Excessive-Fee Lawsuit Based on Adviser/Sub-adviser Fee Split is Filed

Two shareholders of five SEI funds brought a derivative action against the funds' investment adviser, SEI Investments Management Corporation ("SIMC"), in the United States District Court for the Eastern District of Pennsylvania alleging that the adviser breached its fiduciary duty under Section 36(b) of the 1940 Act by delegating most of its investment management duties to sub-advisers while retaining a substantial amount of the investment management fees it received from the funds. Plaintiffs also allege that SIMC failed to pass along to the funds savings arising from economies of scale. Similar claims alleging violations of Section 36(b), focusing on the differential between the advisory fees paid to the adviser and the sub-advisory fees paid by the adviser to sub-advisers, have been raised in several recent cases, including those brought against The Hartford, AXA, The Principal, Russell, and ING.

FINRA Releases 2014 Regulatory and Examination Priorities

On January 2, 2014, the Financial Industry Regulatory Authority ("FINRA") published its annual letter (the "Letter") outlining FINRA's 2014 regulatory and examination priorities. The Letter is intended to provide information to industry participants about FINRA's current areas of focus in order to allow broker-dealer firms to review and enhance, if necessary, their supervisory, compliance and risk management efforts in these areas.

The regulatory and examination priorities discussed in the Letter can be classified into four broad categories: business conduct, fraud, financial and operational, and market regulation. New priorities listed for 2014 include, among others, a focus on recidivist brokers, conflicts of interest, qualified plan rollovers, the initial public offering market, crowdfunding portals, and risk control documentation and assessment. The Letter also covers many of the same topics addressed in prior years, including suitability, cybersecurity, private placements, anti-money laundering, microcap fraud, insider trading, and high frequency and algorithmic trading. A copy of the Letter is available here.

SEC Issues Compliance and Disclosure Interpretations Regarding Rule 14a-4(a)(3)

On January 24, 2014, the SEC's Division of Corporate Finance issued new Compliance and Disclosure Interpretations ("C&DIs") regarding Rule 14a-4(a)(3) of the Securities Exchange Act of 1934 concerning the "unbundling" of separate matters that are submitted to a shareholder vote by a company or any other person soliciting proxy authority. The C&DIs clarify that multiple matters that are so "inextricably intertwined" as to effectively constitute a single matter need not be unbundled. In addition, according to the guidance, the staff would not ordinarily object to the bundling of multiple immaterial matters with a single material matter and, in determining materiality in this context, registrants should consider whether a matter substantively affects shareholder rights. The C&DIs can be found here.

Other Developments

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

[NYSE Files Proposed Rules for Listing of "Managed Portfolio Shares"]

January 28, 2014

On January 23, 2014, NYSE Arca Equities filed a proposal with the SEC to permit the listing of "Managed Portfolio Shares," which are shares of actively managed exchange-traded funds ("ETFs") for which portfolio holdings are disclosed only quarterly. Actively managed ETFs have become increasingly popular recently, and NYSE Arca's proposed rule 8.900 would remove what is widely seen as a major drawback for certain actively managed strategies – the requirement for daily disclosure of portfolio holdings.

[Update Regarding Trade Execution Mandate for Certain Interest Rate Swaps]

January 17, 2014

The CFTC Division of Market Oversight announced that Javelin SEF, LLC's self-certification of available-to-trade determinations for certain benchmark interest rate swap contracts is deemed certified. Under CFTC regulations, any benchmark interest rate swaps that are the subject of such determinations will be required to be executed through a designated contract market or a swap execution facility beginning February 15, 2014. Note that subsequent to the publication of this Alert, the self-certifications of available-to-trade determinations by three additional swap execution facilities – trueEx, LLC, TW SEF LLC (Tradeweb) and MarketAxess – have been deemed certified, subjecting additional benchmark interest rate swap contracts and certain credit default index swap contracts to this execution requirement. The updated list of contracts that will be required to be executed through a designated contract market or a swap execution facility is available [here].

[SEC Clarifies Definition of Municipal Advisor for Registered Investment Advisers]

January 10, 2014

The SEC published FAQ guidance clarifying that SEC-registered investment advisers that provide advice on municipal derivatives in an investment portfolio for clients that are municipal entities are not, merely as a result of providing such advice, "municipal advisors" for purposes of the final rule adopted by the SEC to establish a permanent registration regime for municipal advisors.

[Upcoming TIC Form B Filing Deadline]

January 10, 2014

The Federal Reserve Bank of New York provided guidance with respect to the applicability of Treasury International Capital Form B to private funds, including investment adviser filing requirements and consolidation rules.

[Upcoming Municipal Advisor Temporary Registration Deadline]

January 8, 2014

The SEC recently adopted a final rule to establish a permanent registration regime for municipal advisors that requires municipal advisors to make a temporary registration filing by January 13, 2014, to be followed by a permanent registration filing later this year. This Alert discusses which investment advisers may be required to register as a municipal advisor and the registration process for becoming a municipal advisor.

[Volcker Rule Final Regulations: The Effect on Private Fund Sponsors and Investors]

December 16, 2013

The long-awaited Volcker Rule final regulations arrived on Tuesday, December 10, 2013. Many of the comments of domestic mutual funds, foreign public funds, insurance companies and foreign banking organizations about the overreaching aspects of the proposed regulations were addressed, at least in part. The final rules clean up the proposed regulations in important and obvious ways that will simplify life for those organizations. For organizations in the crosshairs of the Volcker Rule from the outset, the final regulations are as insistent as the Dodd-Frank Act's statutory language intended. There are also compliance burdens imposed for fund investment and sponsorship that are significant. It would be no surprise to see the final regulations subjected to judicial challenge, but the waiting is officially over and it's time to get to work.

Two Months to Comply With European Reporting Rules for Derivatives – What Buy-Side Entities Need To Know
December 11, 2013
Funds and advisers organized in the EU, managed by an EU-regulated entity, providing investment advice to any EU-based fund or client, participating in OTC derivatives transactions with a counterparty organized in the EU, or entering into exchange-traded derivatives in the EU may be affected by the EMIR reporting requirements, which will become effective on February 12, 2014.

SEC Issues Guidance on Bad Actor Rules
December 9, 2013
On December 4, 2013, the SEC's Division of Corporation Finance issued new C&DIs concerning the recently adopted "bad actor" rules. The new guidance will be of interest to any issuer, including private funds, offering interests in reliance on the safe harbors provided by Rule 506 of Regulation D (these issuers will include most hedge funds, private equity funds, and other private funds offered to U.S. investors). Note that in January 2014, the SEC issued additional new C&DIs relating to the "bad actor" rules, which can be found here.

CFTC Reproposes Rules on Position Limits for Futures and Swaps
November 26, 2013
On November 5, 2013, the CFTC approved the issuance of a proposal to expand its rules concerning speculative position limits (the "Proposed Rules"). The Proposed Rules would establish CFTC-mandated limits for speculative positions in futures and options contracts on 28 agricultural, energy and metals commodities as well as economically equivalent futures contracts, options contracts, and swaps. In connection with establishing these limits, the Proposed Rules would add and amend certain definitions, revise the exemptions from speculative limits, including for "bona fide hedging," and add reporting requirements for persons claiming exemptions from the limits.

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.

United States

Mark I. Bane
New York, NY
+1 212 841 8808
mark.bane@ropesgray.com

Jason E. Brown
Boston, MA
+1 617 951 7942
jebrown@ropesgray.com

Rajib Chanda
Washington, DC
+1 202 508 4671
rajib.chanda@ropesgray.com

Bryan Chegwidden
New York, NY
+1 212 497 3636
bryan.chegwidden@ropesgray.com

Sarah Davidoff
New York, NY
+1 212 596 9017
sarah.davidoff@ropesgray.com

Gregory C. Davis
San Francisco, CA
+1 415 315 6327
gregory.davis@ropesgray.com

Timothy W. Diggins
Boston, MA
+1 617 951 7389
timothy.diggins@ropesgray.com

Michael G. Doherty
New York, NY
+1 212 497 3612
michael.doherty@ropesgray.com

John D. Donovan
Boston, MA
+1 617 951 7566
john.donovan@ropesgray.com

John C. Ertman
New York, NY
+1 212 841 0669
john.ertman@ropesgray.com

Laurel FitzPatrick
New York, NY
+1 212 497 3610
laurel.fitzpatrick@ropesgray.com

Leigh R. Fraser
Boston, MA
+1 617 951 7485
leigh.fraser@ropesgray.com

John W. Gerstmayr
Boston, MA
+1 617 951 7393
john.gerstmayr@ropesgray.com

Thomas R. Hiller
Boston, MA
+1 617 951 7439
thomas.hiller@ropesgray.com

William D. Jewett
Boston, MA
+1 617 951 7070
william.jewett@ropesgray.com

Susan A. Johnston
Boston, MA
+1 617 951 7301
susan.johnston@ropesgray.com

Jeffrey R. Katz
Boston, MA
+1 617 951 7072
jeffrey.katz@ropesgray.com

Christopher A. Klem
Boston, MA
+1 617 951 7410
christopher.klem@ropesgray.com

John M. Loder
Boston, MA
+1 617 951 7405
john.loder@ropesgray.com

Richard D. Marshall
New York, NY
+1 212 596 9006
richard.marshall@ropesgray.com

R. Hardin Matthews
Boston, MA
+1 617 951 7259
hardin.matthews@ropesgray.com

Brian D. McCabe
Boston, MA
+1 617 951 7801
brian.mccabe@ropesgray.com

Stephen C. Moeller-Sally
Boston, MA
+1 617 951 7012
ssally@ropesgray.com

Deborah A. Monson
Chicago, IL
+1 312 845 1225
deborah.monson@ropesgray.com

Mark V. Nuccio
Boston, MA
+1 617 951 7368
mark.nuccio@ropesgray.com

Jessica Taylor O'Mary
New York, NY
+1 212 596 9032
jessica.omary@ropesgray.com

Dwight W. Quayle
Boston, MA
+1 617 951 7406
dwight.quayle@ropesgray.com

George B. Raine
Boston, MA
+1 617 951 7556
george.raine@ropesgray.com

Elizabeth J. Reza
Boston, MA
+1 617 951 7919
elizabeth.reza@ropesgray.com

Gregory D. Sheehan
Boston, MA
+1 617 951 7621
gregory.sheehan@ropesgray.com

Robert A. Skinner
Boston, MA
+1 617 951 7560
robert.skinner@ropesgray.com

Jeremy C. Smith
New York, NY
+1 212 596 9858
jeremy.smith@ropesgray.com

Amy B. Snyder
Boston, MA
+1 617 951 7073
amy.snyder@ropesgray.com

David C. Sullivan
Boston, MA
+1 617 951 7362
david.sullivan@ropesgray.com

James E. Thomas
Boston, MA
+1 617 951 7367
james.thomas@ropesgray.com

Joel A. Wattenbarger
New York, NY
+1 212 841 0678
joel.wattenbarger@ropesgray.com

London

Anand Damodaran
London
+44 20 3122 1146
anand.damodaran@ropesgray.com

Andrew Henderson
London
+44 20 3122 1277
andrew.henderson@ropesgray.com

Matthew Judd
London
+44 20 3122 1252
matthew.judd@ropesgray.com

Asia

Daniel M. Anderson
Hong Kong
+852 3664 6463
daniel.anderson@ropesgray.com