Ropes & Gray's Investment Management Update: February 2014 - March 2014

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

IM Guidance Update Discusses Unbundling of Proxy Proposals

In February 2014, the staff of the Securities and Exchange Commission's ("SEC") Division of Investment Management published an IM Guidance Update concerning the "unbundling" of proxy proposals for amendments to investment company charters (the "Unbundling Guidance Update"). Rules 14a-4(a)(3) and 14a-4(b)(1) under the Securities Exchange Act of 1934 (the "Exchange Act") require that the form of proxy identify "each separate matter to be acted upon" and provide separate boxes for shareholders to vote on "each separate matter referred to therein as to be acted upon." The Unbundling Guidance Update states that the staff's position is that "a matter should be voted upon separately if the Investment Company Act of 1940 (the "1940 Act"), state law, or a fund's organizational documents (charter, by-laws) require a matter under consideration to be submitted to shareholders." In practice, this staff position has not been uniformly applied to registrants.

According to the Unbundling Guidance Update, a proxy proposal to amend an investment company's charter should be "unbundled" to permit a separate vote for each proposed material amendment. Although the Unbundling Guidance Update affirms that there is no bright-line test for determining whether a proposed charter amendment is "material," it provides several examples of proposed charter amendments that, in the staff's opinion, should be "unbundled" into separate votes, including proposals seeking:

1. to amend voting rights from one vote per share to one vote per dollar of net asset value;
2. to authorize a fund to involuntarily redeem small account balances;
3. to authorize a fund to invest in other investment companies;
4. to change supermajority voting requirements;
5. to authorize the board to terminate a fund or merge with another fund without a shareholder vote; and
6. to authorize the board to make future amendments to the charter without a shareholder vote.

The Unbundling Guidance Update notes that a soliciting party may condition effectiveness of any proposal on the adoption of one or more other proposals, if permitted by state law. It further acknowledges that the staff has not objected to "bundling" proxy proposals that are either ministerial in nature (such as proposals involving editorial or non-substantive changes to fund documents) or otherwise immaterial with a single material matter.

No-Action Relief Eases Restrictions on Securities Lending Agent's Ability to Negotiate Rebate Rates

In a February 13, 2014 no-action letter, the SEC staff granted relief requested by Nuveen Investment Funds, Inc., Nuveen Fund Advisors, LLC ("Nuveen Advisors"), and U.S. Bank National Association ("U.S. Bank," and collectively with Nuveen Investment Funds, Inc. and Nuveen Advisors, "Nuveen") to allow U.S. Bank, the custodian and securities lending agent for certain funds advised by Nuveen Advisors, to negotiate the interest rates charged to broker-dealers and other borrowers in connection with loans of the funds' securities (the "Rebate Rates"). Section 17(e)(1) of the 1940 Act prevents persons who are affiliated with a fund (or affiliated with such affiliated persons) from accepting compensation for the purchase or sale of any property to or for a fund. A bank that provides custody of fund assets may be deemed to be an affiliated person of that fund if it acquires ownership or control of specified amounts of the voting securities of that fund through its other investment management activities. In *Norwest Bank Minnesota, N.A.*, SEC Staff No-Action Letter (publicly available May 25, 1995) (the "Norwest Letter"), the SEC staff granted relief that permits an affiliated custodian to receive compensation for providing certain services as securities lending agent. Among other things, the Norwest Letter allows a fund's investment adviser to delegate to the securities lending agent the task of entering into loans with pre-approved borrowers on pre-approved terms.

In its application letter, Nuveen stated that it is generally not practicable for the bank, in its capacity as securities lending agent, to submit the Rebate Rates to the adviser for pre-approval as required under the Norwest Letter and that it is not industry practice to do so. Nuveen argued that pre-approval of the Rebate Rates from the adviser is not needed to protect the funds' shareholders due to the protections afforded by securities lending procedures that have been put in place to ensure that the Rebate Rates are being set by the custodian in line with prevailing market conditions. The SEC indicated that it generally agreed with Nuveen's position and granted the relief requested, subject to the conditions described in the Nuveen no-action letter. In addition, the SEC staff affirmed its view that relief from Section 17(e)(1) of the 1940 Act is "inappropriate" when the lending agent retains full discretion to negotiate loan terms.

MSRB Finalizes 529 Plan Reporting Rule G-45 and Pursues Other Regulatory Initiatives

On February 21, 2014, the SEC granted accelerated approval to an amendment to a new Rule G-45 and new Form G-45, originally proposed on June 10, 2013, from the Municipal Securities Rulemaking Board ("MSRB"). Rule G-45 generally requires that each underwriter of a primary offering of municipal fund securities report to the MSRB certain information related to the offering within 60 days of the semi-annual reporting periods ending on June 30 and December 31 each year. Additionally, performance data must be submitted annually within 60 days of December 31. The new rule will impose an extensive data collection and reporting regime on underwriters of 529 municipal fund securities. Such underwriters will be required to report plan descriptive information, asset allocation information, contributions, withdrawals, fee and cost structure, performance data, and certain other information.

The MSRB has stated that it expects that the primary distributor of a 529 plan's securities will be the underwriter that submits information to the MSRB, but there may be other underwriters that would be obligated to submit information. The MSRB noted that a complete data set for each 529 plan is required by the MSRB, whether submitted by one or more underwriters, but if all the required information is submitted by the primary distributor, the submission obligation may be satisfied on behalf of all underwriters. Performance, fee, and expense information is to be submitted in a format consistent with the Disclosure Principles Statement No. 5 from the College Savings Plan Network, which is generally considered the industry standard for reporting such information for 529 plans. In response to industry confidentiality concerns regarding the proprietary nature of the reported information, the MSRB stated that the information submitted under Rule G-45 is not intended for public distribution, and any proposal to release the reported information would be done through a separate rulemaking proceeding.

The effective date for the rule change is February 24, 2015. The first submission of Form G-45 is due by August 30, 2015. The full text of Rule G-45 and information related to Form G-45 can be found here.
The MSRB has also recently requested comment on draft Rule G-18 (establishing best execution obligations for transactions in municipal securities), draft amendments to Rule G-3 (establishing professional qualification requirements for municipal advisers and their associated persons), and Rule G-44 (establishing supervisory and compliance obligations of municipal advisers when engaging in municipal advisory activities).

Shareholder Approval Requirements for Multi-Manager Fund Advisory Fee Rate Addressed in IM Guidance Update

The SEC staff issued an IM Guidance Update in February 2014 (the "Multi-Manager Update") to express its views regarding the circumstances in which changes to the aggregate advisory fee rate permitted to be charged by the adviser and subadvisers of a fund operating under a multi-manager exemptive order must be approved by shareholders. Section 15(a) of the 1940 Act makes it "unlawful for any person to serve or act as an investment adviser of a registered investment company, except pursuant to a written contract, which . . . has been approved by the vote of a majority of the outstanding voting securities of such registered company." However, the SEC often grants multi-manager exemptive orders that permit a fund or an adviser to enter into subadvisory contracts without requiring the contracts to be approved by fund's shareholders. There are two basic types of multi-manager structure: (i) the "traditional" multi-manager model in which the fund enters into a contract with, and pays compensation for advisory services to, only the primary adviser (which is responsible for entering into contracts with, and paying compensation out of its own advisory fee to, each subadviser); and (ii) the "direct-pay" multi-manager model in which the fund enters into a contract with, and pays compensation to, each subadviser, in addition to entering into a contract with, and paying compensation to, the primary adviser. Direct-pay multi-manager orders have typically included an "aggregate fee condition" that limits the relief from the shareholder approval requirement only to subadvisory contracts that will not result in an increase in the aggregate advisory rate paid to the adviser and subadvisers.
The Multi-Manager Update provides that all new applications for a multi-manager exemptive order should explicitly include the aggregate fee condition, regardless of the multi-manager model contemplated. The Multi-Manager Update includes the following examples to clarify the staff's position on certain issues that the SEC commonly encounters in in the context of the "direct-pay" multi-manager model:

- The hiring of a fund's first subadviser generally would require shareholder approval under the aggregate fee condition, unless the rate paid under the primary advisory contract is reduced by at least the amount that will be paid to the subadviser.
- Shareholder approval under the aggregate fee condition generally would not be required when a fund with one or more existing subadvisers hires an additional subadviser whose rate is no higher than: (i) in the case of the new subadviser replacing an existing subadviser, the rate of the subadviser being replaced; or (ii) the rate of another existing subadviser to which the adviser could have allocated the fund's assets that are being allocated to the new subadviser (e.g., assets in the same asset class).
- Shareholder approval under the aggregate fee condition also generally would not be required if any increase in the rate payable by a fund to an existing subadviser is accompanied by a corresponding decrease in the primary advisory contract of the rate payable by the fund to the primary adviser.

Non-Bank Custodian Permitted for Gold and Other Precious Metals

The SEC staff issued no-action relief on February 11, 2014 to The Brink's Company ("Brink's"), permitting registered investment companies ("Funds") to use Brink's as a custodian of precious metals even though Brink's is not a bank, a member of a national security exchange, or any other entity permitted to serve as a custodian under Section 17(f) of the 1940 Act. In granting the relief, the staff noted that: (i) Brink's shareholder equity and surplus exceeds $500 million (which is greater than that required under Section 17(f)(1) or Section 26(a)(1) of the 1940 Act); (ii) Brink's maintains $1 billion in insurance coverage against any precious metals losses sustained by Brink's customers; (iii) Brink's vault facilities are indistinguishable from the same type of vault facilities used by banks and provide substantially the same protection against misappropriation; (iv) Brink's U.S. facilities are NYMEX/COMEX-approved depositories, which are subject to oversight by NYMEX/COMEX pursuant to regulations enforced by the U.S. Commodity Futures

Trading Commission; and (v) Brink's London facilities are subject to the guidance of the London Bullion Market Association.

The relief is also subject to the condition that a majority of a fund's board of directors, including a majority of the independent directors, must determine that using Brink's custody services for precious metals is in the best interest of the fund and its shareholders. The no-action letter notes that in making this determination, a fund's board of directors should consider whether the services provided by Brink's will be equal in nature and quality to services provided by bank custodians in the same market and whether reasonable care will be exercised with regard to the Fund's precious metals.

Supreme Court Rules Employees of Contractors or Subcontractors of a Public Company Are Covered by Sarbanes-Oxley Act's Whistleblower Protections

In a 5-4 ruling on March 4, 2014, the Supreme Court in *Lawson v. FMR, LLC* decided that the whistleblower protection provisions of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") apply not just to employees of public companies, but also to employees of private contractors or subcontractors for a public company. The majority opinion, written by Justice Ginsburg, concludes that the term "employee" in the statutory language that prohibits a contractor from discharging an employee for whistleblowing ("No [public] company . . ., or any . . . contractor . . . of such company, may discharge . . . an employee . . . because of [whistleblowing activity]") includes a contractor's own employee. According to the Court, the provision as a whole supports this conclusion, as the prohibited retaliatory actions and remedies within Section 806(a) of Sarbanes-Oxley involve actions only an employer might take against its own employees. The Court also noted that the legislative history of Sarbanes-Oxley shows Congress's concern with protecting from retaliation outside professionals reporting fraud by the public companies with whom they contract. The opinion highlights that its conclusion is particularly appropriate in the context of mutual funds, which have no employees of their own, and that its interpretation "avoids insulating the entire mutual fund industry" from whistleblower protection. The full text of the decision can be found here.

REGULATORY PRIORITIES CORNER

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

SEC Chair Includes Decision on Uniform Fiduciary Standard in List of Critical Initiatives

SEC Chair Mary Jo White indicated in her remarks at the SEC Speaks conference on February 21, 2014 that she is urging the SEC to decide whether to implement a uniform fiduciary standard for investment advice. The Dodd-Frank Wall Street Reform and Consumer Protection Act authorized the SEC to impose a fiduciary duty standard of care for brokers providing retail investment advice. Currently, brokers are subject to a suitability standard when selling investment products. If enacted, such a measure would hold brokers to the same standard that presently governs investment advisers.

OCIE Launches Never-Before Examined Adviser Initiative

The SEC's Office of Compliance Inspections and Examinations ("OCIE") announced on February 20, 2014 that it plans to engage a significant percentage of advisers that have not been examined since registering with the SEC. The focus is on those advisers that have been registered with the SEC for three or more years. The letter sent by OCIE to advisers informing them of the initiative indicates that advisers to private funds, which are being examined pursuant to the "Presence Exam" initiative launched in October 2012, are excluded from the new exam initiative. The exams to be conducted under this initiative include two distinct approaches:

- The risk-assessment approach is designed to allow OCIE to gain a better understanding of an adviser's overall business activities with a particular focus on the adviser's compliance program and representations made in disclosure documents.
- The focused review approach involves comprehensive risk-based examinations of one or more targeted areas that OCIE deems to be high-risk, such as the adviser's compliance program, filings and disclosures, marketing materials, portfolio management conflicts of interest, or the safety of client assets.

For more information about the initiative, please see here.

SEC Re-Opens Comment Period for Asset-Backed Securities Releases to Address Data Privacy Concerns

The SEC has re-opened the comment period on two releases, *Asset-Backed Securities*, Securities Act Release 33-9117 (proposed on April 7, 2010) and *Re-Proposal of Shelf Eligibility Conditions for Asset-Backed Securities*, Securities Act Release 33-9244 (proposed on July 26, 2011), in order to permit interested persons to comment on an approach for the dissemination of potentially sensitive asset-level data. In its earlier releases, the SEC proposed that issuers of most classes of asset-backed securities publicly file information about each asset in the pool in a standardized tagged data format. This raised concerns among industry participants regarding the privacy of data pertaining to the relevant underlying obligors. The SEC tried to address these concerns by, among other things, not requiring disclosure of certain identifying information, but commenters to the proposed rule still expressed privacy concerns. The SEC is now considering an approach that will require issuers to make asset-level information available to investors and potential investors through the issuer's website. For further details, please see here for the Proposed Rule and here for the memorandum explaining the SEC staff's approach to disclosure of asset-level data that is included in the public comment file. The SEC has extended the comment deadline from March 28, 2014 to April 28, 2014, as discussed here.

Mutual Fund Monthly Portfolio Holdings Disclosure Rule May Be Proposed

According to published reports, the SEC staff is preparing to propose a rule that would require mutual funds to provide monthly disclosure of their portfolio holdings for the agency to use in its risk monitoring, compliance, and enforcement programs. The proposal is modeled on the monthly portfolio disclosure requirement for money market funds on Form N-MFP that was instituted in the wake of the financial crisis. The goals of the proposed requirement are to improve the quality of data available to the agency and to use the data to aid in compliance, enforcement, and risk monitoring functions. The SEC staff has acknowledged that the enhanced disclosure requirement will need to address industry concerns regarding possible disclosure of sensitive information to the public.

FINRA Sanctions Custodian and AML Compliance Officer for Penny Stock Anti-Money Laundering Compliance Failures

On February 5, 2014, FINRA announced that Brown Brothers Harriman & Co. ("BBH") and its Global Anti-Money Laundering ("AML") Compliance Officer (the "respondents") had entered into a Letter of Acceptance, Waiver and Consent (the "Consent Letter") to settle a FINRA enforcement proceeding that alleged, among other violations, that BBH failed to have an adequate AML program in place to monitor and detect suspicious penny stock transactions. The Consent Letter states that from January 1, 2009 to June 30, 2013, BBH executed transactions or delivered securities involving at least six billion shares of penny stocks, many on behalf of undisclosed customers of foreign banks in known bank secrecy havens. During this period, BBH provided custody and brokerage services to omnibus accounts through which the foreign banks were trading penny stocks for their underlying customers whose identities were not disclosed to BBH. According to the Consent Letter, despite numerous red flags and the high risk nature of penny stock transactions, BBH failed to implement adequate policies and procedures regarding AML procedures to detect, investigate, report, and/or prevent these transactions. In settling the proceeding, BBH agreed to pay a fine of $8 million. FINRA also suspended the BBH's Global AML Compliance Officer from association with any FINRA member for one month and fined him $25,000. The respondents neither admitted nor denied the charges, but consented to the entry of FINRA's findings. A copy of the Consent Letter can be found here.

SEC Launches National Exam Analytics Tool

In a speech to the 41st Annual Securities Regulation Institute on January 27, 2014, SEC Chair Mary Jo White stated that the SEC will be implementing a new analytical tool called "NEAT," which stands for "National Exam Analytics Tool." The new tool will allow SEC examiners to analyze large quantities of trading data in a shorter period of time. The SEC plans to use NEAT to analyze insider trading, front running, window dressing, improper allocations of investment opportunities, and other kinds of misconduct. The implementation of NEAT comes after the implementation of another system by the SEC last year used to collect and analyze trading data across markets, called "MIDAS" – the "Market Information Data Analytics System." In her comments, Chair White praised the SEC's technology initiatives, noting that "in this rapidly changing environment, we must stay on top of advances in technology. NEAT and MIDAS are important tools that will help us keep pace with evolving technology."

FINRA and BATS Impose $1.1 Million Fine on Citigroup for IPO Short Sales

On March 18, 2014, FINRA and BATS Exchange, Inc. ("BATS") announced that they had jointly concluded an enforcement action under which Citigroup Global Markets Inc. ("Citigroup") agreed to pay approximately $1.1 million for short sales made in advance of five IPOs in violation of Rule 105 of Regulation M under the Exchange Act, which generally prohibits purchasing securities in public offerings when the purchaser has sold the securities short within a certain amount of time prior to the pricing of the offering. In concluding this settlement, Citigroup neither admitted nor denied the charges, but consented to the entry of FINRA and BATS' findings. This enforcement action follows earlier actions taken by the SEC, which announced on September 16, 2013 that it had charged over 20 firms with violations of Rule 105. For a discussion of these cases, please see our September 30, 2013 Alert.

SEC Provides Guidance on the Definition of "Knowledgeable Employee"

In a no-action letter issued to the Managed Funds Association on February 6, 2014, the SEC staff provided guidance on the definition of "knowledgeable employee" under the 1940 Act. Generally, Rule 3c-5 under the 1940 Act (the "Rule") permits a knowledgeable employee of a private fund, or a knowledgeable employee of an affiliated person that manages the investment activities of the private fund, to invest in the fund without being counted for purposes of the 100-person limit applicable to a fund claiming exemption from registration under Section 3(c)(1) of the 1940 Act. The Rule also permits a knowledgeable employee to invest in a fund claiming exemption from registration under Section 3(c)(7) of the 1940 Act regardless of whether the knowledgeable employee would be a "qualified purchaser" for purposes of that exemption. The no-action letter generally expands the pool of possible knowledgeable employees who are eligible to invest in private funds. This no-action letter will be discussed in further detail in our upcoming Ropes & Gray Private Investment Fund Update.

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:

SEC Compliance Outreach Program National Seminar – Summary of Panel Discussions

February 11, 2014

On January 30, 2014, the SEC hosted a Compliance Outreach Program National Seminar for investment advisers and investment company senior officers. The seminar included panel discussions covering a range of compliance issues facing private funds and registered investment companies. This Alert summarizes remarks from the conference that may be of interest to investment advisers and investment company personnel.

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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