Ropes & Gray's Investment Management Update: April 2014 – May 2014

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

SEC Reopens Comment Period for Investment Company Advertising: Target Date Retirement Fund Names and Marketing Release

The SEC has reopened the comment period on a rule, proposed on June 16, 2010, that would require increased disclosure to investors in advertisements for target-date retirement funds. The purpose of reopening the comment period is to seek public comment on the SEC's Investor Advisory Committee's 2013 recommendations. As we previously reported, the Committee's 2013 recommendations would require that funds develop a glide path illustration based on a standardized measure of fund risk as either a replacement for, or supplement to, existing glide path illustrations based on asset allocation, employ standard methodology for all illustrations, disclose risk assumptions in fund prospectuses, warn investors in marketing materials that funds are not guaranteed and that losses are possible, and enhance fee disclosure of costs over time. The comment deadline is June 9, 2014. For further details, please see the Proposed Rule, the Committee's proposed recommendation and the release reopening the comment period.

OCIE Risk Alert Provides Cybersecurity Exam Road Map

On April 15, 2014, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert concerning upcoming cybersecurity preparedness examinations within the securities industry. Following on the heels of the 2014 Cybersecurity Roundtable and the announcement of "Technology" as one of the significant 2014 Examination Priorities, OCIE will be conducting examinations of more than 50 registered broker-dealers and investment advisers, focusing in particular on:

- cybersecurity governance;
- identification and assessment of cybersecurity risks;
- protection of firm networks and information;
- risks associated with remote customer access and funds transfer requests;
- risks associated with vendors and other third parties;
- detection of unauthorized activity; and
- experiences with certain cybersecurity threats.

The Risk Alert includes a sample document request that OCIE may use in conducting examinations of registered entities regarding cybersecurity matters. Although OCIE reserved its right to request additional information, the sample request consists of 28 detailed questions in the above-mentioned areas. Some of the principal subjects covered by the information request include the specific elements of the firm's cybersecurity program, the security measures used in connection with providing customers with on-line account access, the cybersecurity risk assessments conducted by the firm with regard to vendors and business partners with access to the firm's networks, customer data, or other sensitive information, or due to the cybersecurity risk of the outsourced function, and a description of the firm's recent experience with any of the seven types of cybersecurity "events" described in the information request.

Adviser Settles Proceeding Alleging Improper Calculation of Breakpoint Discounts

On April 3, 2014, the SEC announced that it had entered into a settlement with a registered investment adviser and broker-dealer based on allegations that the defendant failed to give certain of its clients the benefit of applicable breakpoint discounts. Specifically, the SEC's order states that the defendant, through its investment adviser representatives ("IARs"), offered retail clients several investment programs which provided assistance with respect to allocation of their assets among various investment products and that each such program involved different management tools, research, and fees. According to the SEC, the defendant failed, despite client requests, to aggregate values of related accounts in several of its retail advisory fee programs as provided in the defendant's disclosures in its Form ADV Part 2 filings, account opening documents, and policies and procedures. The order alleges that SEC examiners first alerted the defendant about these breakpoint aggregation problems in 2010 after an examination of a branch office. Although the firm provided client refunds to customers of that branch office, in a 2012 follow-up exam the SEC found that the aggregation issues identified in the previous branch office examination existed in the defendant's nationwide operations and were ongoing.

The SEC's order states that the failures occurred because the defendant failed to adopt and implement policies and procedures reasonably designed to ensure that its IARs reduced advisory fees when clients opted to aggregate accounts in the applicable retail investment programs. Without admitting or denying the SEC's finding, the defendant, which had already reimbursed its clients for the fee overcharges, agreed to a pay a civil money penalty in the amount of $553,624 and also undertook to, among other things, retain an independent consultant to conduct a review of its policies and procedures and certain other disclosure documents.

Regulatory Priorities Corner

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

IM Guidance Update Discusses Common Mistakes in Applications on Form N-8F — Deregistration of Investment Companies

The Division of Investment Management of the SEC has issued an IM Guidance Update regarding Form N-8F, the application to deregister investment companies that fall into one of the enumerated categories covered by the form. The IM Guidance Update provides a brief description of the staff's process for reviewing Form N-8F applications and the timing for issuance of SEC deregistration notices and orders. In the IM Guidance Update, the staff notes that, while many applications for deregistration proceed based on the initial application filing, there are six common deficiencies that result in comments by the staff requesting revisions or additional information. The staff has observed that a significant number of these comments relate to a handful of items on the Form. In order to assist applicants in filling out the Form, the IM Guidance Update clarifies how the SEC staff expects applicants to answer these items.

MSRB Adopts Rule Establishing Fees for Municipal Advisor Professionals

On April 17, 2014, the Municipal Securities Rulemaking Board ("MSRB") announced it was implementing new MSRB Rule A-11, which will impose an annual fee of $300 per individual registered as a municipal advisor pursuant to the new SEC Form MA-I. The new rule is effective immediately. The initial fee will be assessed on each municipal advisor registered either temporarily or permanently with the SEC on or before

September 30, 2014, and will be due ten business days after the acceptance of its permanent registration by the SEC. The recurring annual fee is assessed for each individual person who is registered as a municipal advisor pursuant to SEC Form MA-I as of January 31 in the relevant year, and the annual fee is due by April 30 of each year. The proceeds of this fee will be used to defray the costs and expenses of operating and administering the MSRB, particularly the costs associated with the regulation of municipal advisors.

SEC to Test Alternative Mutual Funds' Leverage, Liquidity

According to reports, the SEC plans to test approximately 25 funds over the next several months to review whether alternative mutual funds that mimic hedge-fund strategies are complying with leverage and liquidity rules for registered funds. Bloomberg reports that Jane Jarcho, an associate director in the SEC's examination program, explained that the exams will shed light on how mutual funds are trying to generate yield, how much risk they are taking and whether boards are engaged in appropriate oversight. The SEC will look at four types of alternative mutual funds: non-traditional bond funds; long-short equity funds; multi-alternative funds; and market-neutral funds. Further details 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:

California Attorney General Issues Guidance on Do Not Track
May 27, 2014
On May 21, 2014, California's Attorney General issued new guidance on how web site privacy policies should handle "Do Not Track" ("DNT") signals from browsers. In 2013, the California Legislature passed a tracking transparency bill, AB 370, which amended the California Online Privacy Protection Act ("CalOPPA"). AB 370 requires commercial website operators to inform users of how they respond to DNT browser signals. Many websites ignore those signals, though, and there is no common understanding as to what "Do Not Track" even means. This has led to a fair amount of confusion as to what regulators' expectations were regarding compliance, which the guidance addresses.

AIFMD – What Actions Should Non-EEA Private Fund Managers Be Taking Now?
May 16, 2014
The Alternative Investment Fund Managers Directive ("AIFMD"), which governs alternative investment fund managers ("AIFMs"), required EU Member States ("Member States") to implement the AIFMD into national law as of July 22, 2013. AIFMD was duly implemented by the majority of European Economic Area ("EEA") Member States as of that date, with others implementing later or planning to implement at varying points this year. Following implementation, the transitional provision in the AIFMD has exempted many non-EEA private fund managers from compliance with the AIFMD until the transitional period ends on July 22, 2014.

CFTC Staff Updates Requirements for the Delegation of CPO Functions
May 14, 2014
On May 12, 2014, the Commodity Futures Trading Commission ("CFTC") staff issued Letter 14-69 (the "Letter"), which requires that specific no-action relief be obtained when a commodity pool operator

("CPO") of a private fund delegates its rights and obligations as a CPO to another entity that will serve as the registered CPO of the fund. The Letter institutes a streamlined approach to facilitate requests for no-action relief and supersedes the Staff's prior guidance issued in August 2012.

Ropes & Gray LLP Joins Firms in Volcker Rule Interpretation on Parallel Fund Structure
May 6, 2014
This Alert discusses the consensus interpretation memorandum (prepared under the auspices of the Private Equity Growth Capital Council) which provides that the Volcker Rule should not require the integration of private funds offered and sold by non-bank sponsors to non-U.S. banking entities with parallel funds offered to U.S. investors.

Reminder Regarding Upcoming FATCA Deadline and Implications for Trading Agreements
April 30, 2014
This Alert discusses the July 1, 2014 effective date under the Foreign Account Tax Compliance Act ("FATCA") for withholding agents to begin withholding on certain U.S. source payments made to foreign financial institutions ("FFIs") and non-financial foreign entities ("NFFEs"). We note that the IRS has indicated in a recent notice that it will consider the extent to which an entity has made good-faith efforts to comply with FATCA's requirements during the calendar years 2014 and 2015.

SEC Staff Provides Guidance to Investment Advisers on the Use of Social Media
April 16, 2014
On March 28, 2014, the SEC's Division of Investment Management published an IM Guidance Update to address concerns arising from the rating of investment advisers on social media websites featuring consumer reviews, such as Yelp and Angie's List. This Alert discusses the IM Guidance Update and how the SEC staff interprets the testimonial rule in the context of the use of such social media by registered investment advisers.

2014 Mutual Funds and Investment Management Conference
April 9, 2014
This memorandum summarizes the 2014 Mutual Funds and Investment Management Conference sponsored by the ICI.

Segregation of Initial Margin Posted in Connection with Uncleared Swaps: Considerations for the Buy Side
April 7, 2014
This Alert discusses the form of notification and frequently asked questions recently published by The International Swaps and Derivatives Association ("ISDA") regarding the segregation with a third-party custodian of any initial margin (also known as "independent amounts") posted to the swap dealer in connection with uncleared swaps.

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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