Ropes & Gray's Investment Management Update: June 2014 – July 2014

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

SEC Staff Provides Proxy Voting Guidance

The SEC's Division of Investment Management and Division of Corporation Finance jointly issued a Staff Legal Bulletin regarding the duties of investment advisers in voting proxies on behalf of clients and duties relating to the use of proxy advisory firms (the Proxy Guidance). The Proxy Guidance, which is written in question and answer format, first discusses steps that an investment adviser could take to demonstrate that proxy votes are cast in accordance with clients' best interests and the investment adviser's proxy voting procedures. According to the Proxy Guidance, the investment adviser could demonstrate this by periodically sampling votes to review whether the votes were cast in compliance with the investment adviser's proxy voting policies and procedures, by reviewing a sample of proxy votes that relate to certain proposals that may require more analysis and by reviewing, no less frequently than annually, the adequacy of the investment adviser's policies and procedures. The Proxy Guidance also provides that an investment adviser is not required to vote every proxy and that an investment adviser and its client have flexibility in determining the scope of the investment adviser's obligation to exercise proxy voting authority.

With regard to retaining a proxy advisory firm, the Proxy Guidance notes that an investment adviser should ascertain whether the proxy advisory firm has "the capacity and competency to adequately analyze proxy issues." The SEC staff additionally specifies that an investment adviser that has retained a proxy advisory firm should adopt and implement policies and procedures reasonably designed to provide sufficient ongoing oversight of the firm to ensure that proxies are being voted in clients' best interests. In this regard, relevant factors to consider could include: the adequacy and quality of the proxy advisory firm's staffing and personnel; the adequacy of the proxy advisory firm's policies and procedures designed to ensure that proxy voting recommendations are based on current and accurate information and that the proxy advisory firm is able to identify and address any conflicts of interest; and any other considerations that the investment adviser believes would be appropriate.

The Proxy Guidance emphasizes that an investment adviser has an ongoing duty to oversee a proxy advisory firm it utilizes, especially in light of any changes to the proxy advisory firm's business or policies. The Proxy Guidance also addresses the duty of an investment adviser with regard to overseeing that the proxy advisory firm's decisions are based on materially accurate information. If an investment adviser determines that a proxy advisory firm's recommendation was based on a material factual error, the SEC staff believes that the investment adviser should take reasonable steps to investigate the error and should seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.

The Proxy Guidance also addresses the application of the proxy rules under the Securities Exchange Act of 1934, as amended (the Exchange Act), to proxy advisory firms, including the exemptions available in Rule 14a-2 under the Exchange Act. These include certain exemptions for the furnishing of proxy voting advice by any person to another person with whom a business relationship exists (subject to certain conditions), as well as solicitations by persons who do not seek the power to act as a proxy for a security holder and do not furnish or otherwise request a form of revocation, abstention, consent or authorization.

The Proxy Guidance states that the SEC staff expects investment advisers and proxy advisory firms to make any necessary changes to their current systems and processes in light of this guidance "promptly, but in any event in advance of next year's proxy season."

SEC Issues IM Guidance Update Regarding Mutual Fund Enhanced Disclosure

The SEC's Division of Investment Management has issued an IM Guidance Update (the Enhanced Disclosure Guidance Update) relating to the enhanced mutual fund disclosure amendments to Form N-1A adopted in 2009, which were aimed at providing investors with improved and more concise and user-friendly disclosure, including by permitting funds to provide investors key information in the form of a summary prospectus. The Enhanced Disclosure Guidance Update is based on comments the SEC staff has provided to a number of funds since the 2009 amendments. Specifically, the SEC staff reminds funds, when updating or drafting their prospectuses, to prepare a concise summary section of the prospectus (on the order of three or four pages). The SEC staff notes that, despite guidance to the contrary, it often receives filings with summary sections that are significantly longer than three to four pages, including those that are ten to twenty pages in length. The Enhanced Disclosure Guidance Update highlights certain other form requirements that are intended to further the SEC's goal of clear and concise disclosure and provides guidance on such requirements, including the following:

- Principal investment strategies and risks in Item 4 (the summary section) should be summarized in a way that is not duplicative of the information given in response to Item 9 of Form N-1A;
- The plain English requirements of Form N-1A should be followed, including by avoiding technical terms that are not explained in plain English, unnecessary defined terms, long, compound sentences, and long, dense paragraphs that may be difficult for investors to read;
- Only the information required or permitted by Form N-1A in the summary section (including, in particular, in the footnotes to the fee table) should be included;
- Principal and non-principal strategies and risks should be distinguished; and
- Cross-references in the summary section should be avoided.

The SEC staff encourages funds to revisit their prospectus disclosure in light of the guidance.

IM Guidance Update Discusses Series Investment Companies: Affiliated Transactions

The SEC's Division of Investment Management has issued an IM Guidance Update (the Series Companies Guidance Update) regarding transactions between a registered investment company that is a "series company" and its affiliates. A series company is a typical structure for open-end mutual funds in which a single corporation or state business trust is established under one set of organizational documents and a single board of directors or trustees and offers investors several separate investment portfolios (series) or funds within the series company. The SEC staff notes that the Series Companies Guidance Update was being issued to remind mutual funds that are series companies about the importance of ensuring that their compliance policies and procedures are reasonably designed to prevent violations of the federal securities laws with respect to each fund or series viewed separately. The SEC staff notes that such funds should review their compliance policies and procedures relating to transactions with affiliated persons that may be prohibited under the Investment Company Act of 1940, as amended (the 1940 Act). As an example of the type of compliance issue that can arise with respect to different series of a series company, the SEC staff cited Section 17(a) of the 1940 Act which, in part, generally prohibits an "affiliated person" of a mutual fund or an affiliated person of such a person from selling any security or other property to the mutual fund. Under the 1940 Act, an "affiliated person" of another person includes, among others, a person who owns 5% or more of the outstanding voting securities of such other person. The Series Companies Guidance Update states that the compliance policies and procedures of a series company should provide for the identification of persons owning 5% or more of the outstanding voting securities of each fund of the series company in order to monitor compliance with Section 17(a).[1]

SEC Brings First Enforcement Action under Dodd-Frank Whistleblower Protection Provisions

In the first such action brought under its Dodd-Frank anti-retaliation enforcement power, the SEC entered into a settlement order with Paradigm Capital Management, Inc. (Paradigm), a registered investment adviser, and its majority owner Candace King Weir (Weir).[2] The order finds that Paradigm and Weir retaliated against a Paradigm employee who reported to the SEC alleged improper principal transactions between a hedge fund client of Paradigm and an affiliated broker-dealer. The enforcement action provides insight into what the SEC viewed as a flawed conflict resolution process, and underscores its commitment to creating meaningful incentives for individuals to report violations of the securities laws to federal authorities.

The settlement order indicates that, as part of a trading strategy to reduce the tax liability of the hedge fund's investors, Paradigm caused the fund to sell securities to a proprietary trading account controlled by C.L. King & Associates, Inc. (C.L. King), a broker-dealer owned by Weir. Because Weir controlled both Paradigm and C.L. King, these transactions required prior written disclosure to and the consent of the fund under Section 206(3) of the Investment Advisers Act of 1940, as amended (the Advisers Act). However, Weir also held a controlling interest in the fund's general partner and, accordingly, any written disclosure to her (as the owner of the general partner) was insufficient and, according to the SEC, she could not provide effective consent to the principal transactions.

To address the structural conflict of interest, Paradigm had established a conflicts committee to review and approve principal transactions on behalf of the fund, but one of the committee's members was also the Chief Financial Officer of C.L. King (the affiliated broker-dealer) who, in that capacity, was responsible for monitoring the transactions' impact on the broker-dealer's net capital. The SEC found that the conflicts committee was itself conflicted, and accordingly Paradigm failed to provide effective written disclosure to the fund and failed effectively to obtain the fund's consent to the principal transactions in violation of Section 206(3) of the Advisers Act. The SEC also alleged that Paradigm failed adequately to disclose the conflict in its Form ADV in violation of Advisers Act Section 207.

In March of 2012, Paradigm's head trader provided information about the principal transactions to the SEC. Several months later, the trader informed Paradigm and Weir that he had advised the SEC of potential securities law violations stemming from these transactions. The settlement order indicates that, immediately thereafter, Paradigm and Weir "engaged in a series of retaliatory actions" against the trader that included "removing him from his position as head trader," "changing his job function from head trader to full-time compliance assistant,

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[1] In a footnote in the Series Companies Guidance Update, the SEC staff notes that a mutual fund's compliance policies and procedures also should provide for the identification of entities owning 5% or more of the outstanding voting securities of the series company for purposes of monitoring transactions with affiliated persons of the series company and preventing violations of, among others, Section 17(a).
[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 amended the Exchange Act to add Section 21F, which, among other things, directs the SEC to pay awards to individuals who provide original information about violations of the securities laws that leads to successful enforcement actions.

stripping him of his supervisory responsibilities, and otherwise marginalizing him." The SEC alleged that these adverse employment actions violated Section 21F(h) of the Exchange Act, which prohibits an employer from discriminating against a whistleblower in the terms and conditions of his or her employment because of any lawful act done by the whistleblower in providing information to the SEC.

Regulatory Priorities Corner

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

SEC's Investor Advocate Office to Study Cybersecurity Threats

The SEC's Office of the Investor Advocate (OIA) has issued a Report on Objectives for Fiscal Year 2015 stating that one of its objectives in 2015 will be to study efforts by the SEC and other market participants, including FINRA, stock exchanges, and alternative trading systems, to protect investors from cybersecurity threats. OIA will initially focus on evaluating the potential impact of proposed Regulation SCI, which would require new technology standards and compliance rules for market participants, and look for other improvements that would protect investors from cybersecurity threats.

Norm Champ Discusses Alternative Mutual Funds in Recent Speech

In a recent speech given at the Practicing Law Institute, Private Equity Forum, Division of Investment Management Director Norm Champ noted the increased growth in alternative mutual funds in recent years. He noted that an alternative mutual fund is generally understood to be a mutual fund whose primary investment strategy is characterized by: (1) investing in non-traditional asset classes (*e.g.*, currencies), (2) employing non-traditional strategies (*e.g.*, long/short equity positions) and/or (3) investing in illiquid assets (*e.g.*, private debt). Mr. Champ reviewed a range of recent SEC guidance, inspection and examination initiatives relating to these funds. He offered his observations on how to approach regulatory issues associated with valuation, liquidity, leverage and disclosure. He also discussed the role of the boards of directors or trustees of alternative mutual funds and advised that it is essential that an investment adviser to an alternative mutual fund provide the board with sufficient and appropriate information to allow the board to perform its statutory and fiduciary obligations. He emphasized the importance of the fund board knowing its 1940 Act obligations with regard to the fund's policies and procedures, specifically in the areas of valuation, liquidity, leverage and disclosure. Mr. Champ also highlighted the need for the board to monitor conflicts of interest often associated with alternative mutual funds, including regarding side-by-side management of an alternative mutual fund and a private fund that charges performance fees with the same investment adviser and similar investment objectives. He also noted that fund boards should take care that the names given to alternative mutual funds are not misleading.

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:

Implications of the Argentina Debt Litigation for Foreign Sovereign Immunity
July 30, 2014
Foreign sovereigns have long assumed that the Foreign Sovereign Immunities Act (FSIA) provides them with substantial protection against litigants in United States courts. Although the immunity afforded by the FSIA has

never been absolute, two recent developments in the Supreme Court of the United States – both involving the Republic of Argentina – have expanded plaintiffs' ability to locate sovereign assets and force satisfaction of a judgment, notwithstanding the seemingly broad protections of the FSIA.

Ropes & Gray Private Investment Fund Update: July 2014
July 21, 2014
This Update summarizes recent legal developments of note affecting the private investment fund industry, including the following topics:

- European Commission Decision Implicated the Parental Liability of Private Equity Funds
- SEC Initiative Announced to Target Registered Investment Advisers Who Have Never Undergone Review
- SEC Issues New Guidance to Clarify the Term "Beneficial Owner" in Bad Actor Rules
- SEC Provides Guidance on the Definition of "Knowledgeable Employees"
- SEC Charges Manhattan-Based Private Equity Manager with Stealing $9 Million in Investor Funds
- SEC Announces Charges Against Arizona-Based Fund Manager in Expense Misallocation Scheme

New Credit Default Swap Terms to Be Implemented in September 2014
July 21, 2014
Earlier this year, the International Swaps and Derivatives Association Inc. (ISDA) published the 2014 Credit Derivatives Definitions (the 2014 Definitions). The 2014 Definitions introduce a new government bail-in Credit Event trigger for credit default swap (CDS) contracts on financial Reference Entities in non-U.S. jurisdictions and also modify the typical terms of sovereign CDS contracts in light of the debt crisis in Greece, by allowing a buyer of protection to deliver upon settlement the assets into which the Reference Obligation has been converted even if such assets are not otherwise deliverable. Further, they create a concept of a Standard Reference Obligation, which means that most CDS contracts on a given Reference Entity would have the same Reference Obligation, thereby increasing the fungibility of such CDS contracts. This alert discusses in more detail some of the material changes implemented with the 2014 Definitions.

Ongoing Obligations Under AIFMD for Non-EEA Private Fund Managers – Regulatory Reporting, Annual Investor Report and Investor Disclosures
July 15, 2014
The Alternative Investment Fund Managers Directive (the AIFMD) introduces new requirements for alternative investment fund managers (AIFMs) established in the European Economic Area (EEA) and non-EEA AIFMs that market their fund in an EEA state. This Alert focuses on the regulatory reporting, annual investor report and ongoing investor disclosures required under AIFMD. For a non-EEA AIFM, registering an intention to market in an EEA state triggers these requirements.

EMIR Reporting – Further Reporting Obligations Apply in August 2014
June 9, 2014
Beginning August 11, 2014, additional reporting requirements will apply under the European Regulation on Derivative Transactions, Central Counterparties and Trade Repositories (known as the European Market Infrastructure Regulation (EMIR)). Currently, all EU-established counterparties to over-the-counter and exchange-traded derivatives are required to report certain terms of their derivatives transactions to a trade repository. Starting August 11, 2014, all EU-established entities that are financial counterparties or non-financial counterparties that exceed the EMIR clearing threshold (NFC+s) will also be required to report certain additional information to a trade repository.