Ropes & Gray's Investment Management Update: August 2014 – September 2014

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

SEC Staff Provides No-Action Relief for Advisory Fee Waivers that are Contingent on Negative Performance

On August 19, 2014, the staff (the "Staff") of the SEC's Division of Investment Management provided no-action relief under Section 205(a)(1) of the Investment Advisers Act of 1940 (the "Advisers Act") permitting a registered investment adviser to offer clients an advisory fee rebate for periods of negative performance. As described in the no-action letter, Amerivest Investment Management, LLC ("Amerivest") provides discretionary advisory services to certain clients by implementing model portfolios based on recommendations provided to Amerivest by Morningstar Associates, LLC ("Morningstar"). Under a proposed change to the fee arrangement for Amerivest's clients, Amerivest would continue to charge a quarterly asset-based advisory fee in advance, but would rebate advisory fees for eligible clients who are invested pursuant to a model portfolio that experiences two consecutive discrete calendar quarters of negative performance (before advisory fees) during a twelve-month period.

Section 205(a)(1) of the Advisers Act generally prohibits registered investment advisers from entering into, extending or renewing any investment advisory contract that provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation in a client's account or any portion thereof. Section 205(a)(1) was designed, in part, to prevent fee arrangements in which an adviser participates in profits and does not participate in the losses. Although Section 205(a)(1) does not, on its face, extend to fee waivers or rebates that are contingent on negative performance, the Staff has previously expressed the view that the concerns underlying the performance fee ban "are as apposite to advisory fees which are contingent upon an advisory account obtaining a certain level of performance as they are to fees which vary directly with capital gains or appreciation."[1] In requesting no-action relief, Amerivest had emphasized that the conflicts of interest typically associated with performance-based fees (and targeted by the Section 205(a)(1) prohibition) were not present or were substantially mitigated under Amerivest's proposed fee arrangement.

In granting no-action relief, the Staff noted a number of conditions that contributed to alleviating the concerns about performance-based fees underlying Section 205(a)(1), including, but not limited to, the following:

- Amerivest would fully and clearly disclose the terms of the proposed fee arrangement to participating clients, including advance disclosure of any changes to the fee arrangement;
- The proposed fee arrangement would not contain any "catch up" or other provision that would allow Amerivest to recapture foregone fees through future appreciation;
- Amerivest would not deviate from or seek to influence Morningstar's investment recommendations to avoid payment of any fee rebate pursuant to the fee arrangement;
- Amerivest could deviate from Morningstar's investment recommendations solely for non-investment related reasons such as tax considerations or reasonable client restrictions or to the extent required to fulfill its fiduciary duty to clients; and

[1] *Contingent Advisory Compensation Arrangements*, Investment Advisers Act Release No. 721 (May 16, 1980).

- There would be no contract or other understanding between Amerivest and Morningstar, such that Morningstar's compensation or continued engagement would be affected by the payment or non-payment of any fee rebate pursuant to the proposed fee arrangement.

SEC Issues No-Action Letter for Relief Permitting Amendment of Sub-Advisory Agreement

The Staff issued a no-action letter stating that it would not recommend enforcement action to the Commission under Section 15(a) of the Investment Company Act of 1940 (the "1940 Act") against a fund, its investment adviser or a sub-adviser if a sub-advisory agreement was amended without shareholder approval to change the method for calculating the portion of the advisory fees allocated to the sub-adviser, provided that the change did not increase the total advisory fees paid by the fund and its shareholders and did not change the nature and level of services provided to the fund. Under an advisory arrangement, RiverNorth Capital Management, LLC ("RNCM") serves as investment adviser to RiverNorth/DoubleLine Strategic Income Fund (the "Fund"), and DoubleLine Capital, LP ("DoubleLine") serves as the Fund's sub-adviser with respect to a portion of the Fund's assets. Under the existing sub-advisory agreement, DoubleLine receives a portion of the total advisory fees from RNCM based on the percentage of the Fund's net assets managed by DoubleLine. The proposed amendment to the sub-advisory agreement would instead allocate advisory fees based on DoubleLine's gross assets under management, which would result in an increase in the advisory fees paid to DoubleLine and a corresponding decrease in the advisory fees paid to RNCM. In issuing no-action relief, the Staff focused on representations that the proposed amendment would not increase the overall advisory fees paid by the Fund and its shareholders or reduce or modify the nature and level of services that DoubleLine and RNCM provide with respect to the Fund.

SEC Issues First-ever Whistleblower Award to a Compliance and Audit Professional

The SEC recently announced its first-ever whistleblower award to a company employee who performed audit and compliance functions, and stated that it will pay more than $300,000 (representing 20% of the amount of monetary sanctions collected by the SEC) to such employee for providing the SEC with information that led to a successful enforcement action. Section 21F of the Securities Exchange Act of 1934 ("Exchange Act") requires the SEC to pay awards, subject to certain limitations and conditions, to whistleblowers that voluntarily provide original information about violations of federal securities laws that leads to both successful enforcement of an action brought by the SEC and the SEC's receipt of sanctions totaling more than $1 million. In the case of company employees whose principal duties involve compliance or internal audit responsibilities, a whistleblower generally must wait 120 days after reporting the possible violation to the company's audit committee, chief legal officer, chief compliance officer, or the whistleblower's supervisor before becoming eligible for awards. The SEC's recent whistleblower award underscores the importance of promptly addressing information about potential violations of federal securities law reported internally by personnel who perform audit, compliance and legal functions.

Second Circuit Rules that Dodd-Frank's Whistleblower Protection Provision Does Not Apply Extraterritorially

In *Liu v. Siemens*, the U.S. Court of Appeals for the Second Circuit held that the provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act that prohibits employers from retaliating against whistleblower employees who make certain disclosures (15 U.S.C. §78u-6(h)(1) (the "Anti-retaliation Provision") does not apply extraterritorially. The appeal arose out of a case brought by Liu Meng-Lin ("Liu"), a citizen and resident of Taiwan who was employed as a compliance officer by Siemens China Ltd., a Chinese corporation and wholly owned subsidiary of the defendant, Siemens AG ("Siemens"), a German corporation whose shares are traded on the New York Stock Exchange. According to Liu, Siemens employees were indirectly making improper payments to North Korean and Chinese officials in connection with the sale of medical equipment in those countries, which he believed violated company policy and U.S. anticorruption laws. Liu alleged that Siemens restricted his authority as a compliance officer, demoted him, and eventually terminated his employment as a result of his reporting of this conduct according to Siemens's internal protocols. After his termination, Liu reported the conduct to the SEC, alleging that Siemens had violated the U.S. Foreign Corrupt Practices Act ("FCPA").

Liu filed a complaint in federal district court, asserting that Siemens unlawfully retaliated against him in violation of the Anti-retaliation Provision, which prohibits retaliation against whistleblowers who: (i) provide information to the SEC in accordance with the whistleblower provisions of the statute; (ii) initiate, testify in, or assist in an investigation or judicial or administrative action of the SEC based upon or related to that information; or (iii) make disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 and any law, rule or regulation subject to the jurisdiction of the SEC. Because Liu was terminated prior to providing any information to the SEC, Liu claimed that Siemens had violated the third of these prohibitions. Liu did not assert that any of the events relating to his firing or the allegedly corrupt conduct occurred within the territorial jurisdiction of the United States.

The district court dismissed the complaint on the grounds that the Anti-retaliation Provision does not apply extraterritorially and that none of Liu's disclosures were "required or protected" by any of the statutes specifically enumerated in the Anti-retaliation Provision. The Second Circuit affirmed the district court's dismissal on the grounds that the Anti-retaliation Provision does not apply extraterritorially, without deciding the other questions that were raised at the district court level regarding whether disclosures of FCPA violations are covered by the Anti-retaliation Provision or whether internal reporting of FCPA violations would qualify someone for protection under the Anti-retaliation Provision.

SEC Denies Adviser's General Request for Confidential Treatment of Form 13F Disclosures

On September 4, 2014, the SEC denied new requests made by Brooklyn Capital Management, LLC ("Brooklyn"), for confidential treatment of information contained in its Form 13F filings. Form 13F is a quarterly report required under Section 13(f) of the Exchange Act for registered investment advisers and other "institutional investment managers" with over $100 million in qualifying assets and potentially contains information about recent investment holdings. Brooklyn, which was formerly known as Full Value Advisors LLC, initially requested confidential treatment when it passed the $100 million reporting threshold for purposes of Section 13(f), and in 2011 had its petition for a writ of certiorari on the matter denied by the U.S. Supreme Court.

In seeking confidential treatment, Brooklyn argued that Congress's intent was that the SEC should grant confidential treatment to an investment manager's Form 13F reports in every instance in which confidentiality is in the public interest or for the protection of investors. Brooklyn asserted that confidential treatment was appropriate here to protect its clients from price fluctuations that typically follow disclosure of Brooklyn's ownership of a particular security and to avoid potential harm to investors that may seek to invest based on available information about Brooklyn's holdings. Brooklyn also argued that confidential treatment was warranted because it was a value-oriented activist investor, and any revelation of its investment strategies through its Form 13F holdings reports was likely to increase Brooklyn's cost of further acquisitions and dampen the investment returns of Brooklyn's clients.

In denying Brooklyn's request, the SEC stated that Brooklyn had failed to sufficiently detail the alleged harms of disclosure and had repeated earlier allegations without offering any new arguments for relief. The SEC noted that, in enacting disclosure requirements under the Exchange Act, Congress had determined that public disclosure under Section 13(f) would contribute to the transparency and integrity of the U.S. equity markets, and thus to investor protection, and stated that Brooklyn had provided no basis to question Congress's determination.

SEC Launches Broad Examination of Alternative Mutual Funds

During the summer, the SEC launched its previously announced sweep examination focused on so-called "alternative mutual funds" that employ hedge-fund-like strategies, including funds that invest in non-traditional asset classes (such as currencies), employ non-traditional investment strategies (such as long/short equity positions), or invest in illiquid assets (such as private debt).

The SEC appears to be using these sweep exams to gather a variety of information about alternative mutual funds, including information about board oversight of these funds, their use of derivatives and leverage, and their risk management and compliance testing policies and practices. Specifically, "sweep letters" from the SEC have requested information from these funds' investment advisers such as the following:

- A description of the additional or heightened risks relating to alternative investments and the controls in place to mitigate these risks;
- Internal reports on portfolio holdings' liquidity, including assessments of the adviser, and details of access to lending facilities in the event of unexpected redemptions;
- Valuation and risk management policies, documentation of forensic testing used to determine the appropriateness of prior valuations and pricing service valuations overridden by the adviser, sub-adviser(s) or the board;
- Results of stress tests and scenario analyses on the funds; and
- The funds' use of derivatives and leverage, such as internal reports on borrowing and leverage exposure for different categories of instruments by fund, an asset segregation report that demonstrates compliance with Section 18 of the 1940 Act, and a description of any limits on the amount of economic leverage to which alternative mutual funds may be exposed.

SEC Brings More Rule 105 Actions

On September 16, 2014, the SEC announced that it had sanctioned 19 firms and one individual for violating Rule 105 of Regulation M of the Exchange Act by short selling particular securities shortly before purchasing shares of the same securities in a follow-on public offering. Rule 105 generally prohibits firms or individuals from short selling a security that is the subject of an offering if they have purchased the same security from an underwriter, broker or dealer within a restricted period, generally a period of five business days preceding the pricing of the offering. All defendants agreed to settle their respective matters for a combined amount of over $9 million in disgorgement, interest, and penalties.

The SEC's actions are part of an ongoing enforcement initiative, which included similar enforcement actions in September 2013 that resulted in sanctions for over 20 firms and over $14.4 million in disgorgement, interest, and penalties. In its press release, the SEC announced that its Enforcement Division is able to quickly identify potential violations through close coordination with the Financial Industry Regulatory Authority (FINRA) and the SEC's National Exam Program.

FinCEN Issues Proposed Rule on AML Customer Due Diligence

On August 4, 2014, the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the Department of Treasury, issued a Notice of Proposed Rulemaking ("NPRM") proposing new rules intended to clarify and strengthen customer due diligence requirements for certain covered financial institutions, including mutual funds, banks, and broker-dealers. The NPRM focuses on four key elements of customer due diligence that FinCEN views as fundamental to an effective AML program: (i) identifying and verifying the identity of customers; (ii) identifying and verifying the identity of beneficial owners of legal entity customers; (iii) understanding the nature and purpose of customer relationships; and (iv) conducting ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions.

The first proposed rule change generally would require covered financial institutions to "look through" legal entities to identify and verify the underlying natural person beneficial owners. "Beneficial owner" is defined to include both any individual who owns 25% or more of the equity interests in a legal entity and any individual with significant responsibility to control, manage, or direct the legal entity. The look-through requirement applies for any "legal entity customer," which is broadly defined to include most U.S. or foreign corporations, limited liability companies, partnerships or similar business entities, although it exempts several entities, including certain federally registered financial institutions. In the NPRM, FinCEN clarifies that it does not expect covered financial institutions or their customers to undergo a complex or exhaustive analysis to determine beneficial ownership and expects them to be able to rely generally on representations regarding the status of individuals made at the time a new account is opened. However, the NPRM requires covered financial institutions to implement procedures to verify the identity of each beneficial owner and to respond to circumstances in which it cannot form a reasonable basis that it knows the true identity of a beneficial owner, which FinCEN expects institutions to accomplish by leveraging their existing customer identification policies. The NPRM also incorporates proposed rules that would codify requirements for covered financial institutions to identify and report suspicious activity based on development of a customer risk profile.

FinCEN has proposed an effective date for the new rules of one year from the date of the final rule. This delay is intended to allow sufficient time for covered financial institutions to modify existing customer onboarding processes to incorporate the new beneficial ownership requirement in a cost-effective manner. Comments on the NPRM must be submitted on or before October 3, 2014.

Regulatory Priorities Corner

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

SEC Investigation of Distribution Payments Leads to Enforcement Action

On September 2, 2014, the SEC filed an order instituting administrative proceedings against The Robare Group ("Robare"), a Houston-based investment advisory firm, on the basis of allegations that Robare violated Sections 206(1) and 206(2) under the Advisers Act by recommending investments in particular mutual funds to clients without disclosing a material conflict of interest with respect to those funds. According to the order, Robare entered into an agreement with a brokerage firm that paid Robare a percentage of all assets invested by Robare's clients in certain unaffiliated mutual funds offered on the broker's platform (the "Funds"). The order alleges that Robare failed to disclose its compensation arrangement with respect to the Funds in its Form ADV for the period from 2005 until 2011. The order further alleges that, although Robare began disclosing the existence of the agreement in its Form ADV beginning in December 2011, and continued to make revisions to its disclosures in subsequent years, the disclosures falsely stated that Robare did not receive any economic benefit from a non-client as a result of its investment advice. In its press release, the SEC stated that this action is part of a recent enforcement initiative by its Asset Management Unit focused on undisclosed compensation arrangements between brokers and investment advisers.

Money Market Fund Reform Compliance Dates

As discussed in our previous Alert, on July 23, 2014, the SEC adopted significant new reforms for money market funds (the "Final Rule"). The Final Rule was published in the Federal Register on August 14, 2014, with an effective date of October 14, 2014. The publication of the Final Rule triggers the following compliance dates: July 14, 2015, for new Form N–CSR; April 14, 2016, for the diversification, stress testing, disclosure, Form PF, Form N–MFP, and clarifying amendments; and October 14, 2016, for amendments related to floating NAV and liquidity fees and gates.

SEC Proposes Extension of Temporary Rule Regarding Principal Trades with Certain Advisory Clients

The SEC has issued a proposed rule that would extend the sunset date for temporary rule 206(3)-3T under the Advisers Act from December 31, 2014, to December 31, 2016. Rule 206(3)-3T permits investment advisers that are dually registered as broker-dealers to engage in principal transactions with certain of their advisory clients, provided that various conditions set forth in the Rule are met. Rule 206(3)-3T became necessary to continue to permit broker-dealers to sell certain securities held in the proprietary accounts of the broker-dealer firms to their advisory clients following Financial Planning Association v. SEC, a 2007 decision of the United States Court of Appeals for the D.C. Circuit that vacated Rule 202(a)(11)-1 under the Advisers Act. Under Rule 202(a)(11)-1, fee-based brokerage accounts were not considered to be advisory accounts and thus were not subject to Advisers Act rules, including Section 206(3) restrictions on principal trading.

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 Brings First Action Against a Private Equity Fund Adviser for Misallocation of Portfolio Company Expenses
September 23, 2014
On September 22, 2014, the SEC charged private equity fund adviser Lincolnshire Management, Inc. ("Lincolnshire") with breaching its fiduciary duty to two of its private equity funds by improperly benefiting one fund over the other by misallocating expenses. The case against Lincolnshire is the SEC's first enforcement action against a private equity firm for its alleged misallocation of expenses among commonly managed funds. Lincolnshire agreed to pay approximately $2.3 million to settle the SEC's charges, including a $450,000 penalty.

CFTC Provides Exemptive Relief for Commodity Pool Operators Relying on the JOBS Act's General Solicitation Amendments and Clarifies Certain Recordkeeping and Reporting Requirements Applicable to Certain Registered CPOs
September 12, 2014
The CFTC's Division of Swap Dealer and Intermediary Oversight (the "Division") issued a series of exemptive and no-action letters applicable to commodity pool operators ("CPOs"). These letters facilitate the use of the JOBS Act general solicitation provisions by private fund managers that are relying on exemptive relief under CFTC Rules 4.7(b) or 4.13(a)(3), permit greater use of third-party recordkeepers by registered CPOs, and clarify reporting requirements for certain registered CPOs.

SEC Adopts Reforms for Money Market Funds
August 5, 2014
On July 23, 2014, the SEC voted three-to-two to adopt significant new reforms for money market funds ("MMFs"). The reforms are intended to reduce the susceptibility of MMFs to heavy redemptions during times of economic stress, mitigate potential contagion to the financial system stemming from such redemptions, increase the transparency of the risks of MMFs, and according to the SEC, preserve, "as much as possible," the benefits currently afforded by MMFs. The Final Rule makes extensive changes to the rules governing MMFs, including the elimination of the long-standing ability of certain types of MMFs to maintain a stable $1.00 share price, and the addition of complex provisions regarding discretionary and mandatory imposition of liquidity fees and redemption gates.

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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