Ropes & Gray's Investment Management Update: December 2014 – January 2015

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

SEC 2015 Examination Priorities

The National Examination Program, which is administered by the SEC's Office of Compliance Inspections and Examinations ("OCIE"), recently published its *Examination Priorities for 2015* ("2015 Exam Priorities"). At five pages, the 2015 Exam Priorities is less than half the length of the 2013 and 2014 examination priorities.

In the 2015 Exam Priorities, OCIE listed the following priorities that are of particular interest to asset managers:

- "Alternative" Funds. OCIE will continue to assess funds investing in alternative assets and using alternative investment strategies, with a particular focus on (i) leverage, liquidity, and valuation; (ii) the adequacy of the funds' internal controls; and (iii) the manner in which the funds are marketed to investors.
- Bond Funds. With higher interest rates anticipated in the future, OCIE will review whether funds facing significant interest-rate-increase exposure have implemented compliance procedures and controls that are sufficient to ensure that their funds' disclosures are not misleading and that their investments and liquidity profiles are consistent with those disclosures.
- Cybersecurity. OCIE will continue to examine broker-dealers' and investment advisers' compliance efforts and controls in connection with cybersecurity-related risks.
- Large Firm Monitoring. Along with the Division of Trading and Markets and the Division of Investment Management, OCIE will continue to monitor the largest U.S. broker-dealers and asset managers for the purpose of assessing systemic risks.
- Proxy Services. OCIE will examine select proxy advisory service firms, including how they make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest, as well as investment advisers' compliance with their fiduciary duty in voting proxies on behalf of their clients.
- Potential Equity Order Routing Conflicts. OCIE will assess whether firms are prioritizing trading venues based on payments or credits for order flow in conflict with their best execution duties.
- Fees and Expenses in Private Equity. Noting that it has observed a high rate of deficiencies among advisers to private equity funds in connection with fees and expenses, OCIE will continue to conduct examinations in this area.
- Never-Before-Examined Investment Companies. OCIE will conduct focused, risk-based examinations of selected registered investment company complexes that have not yet been examined.

SEC Chair Highlights Core Asset Management Regulatory Initiatives

On December 11, 2014, SEC Chair Mary Jo White spoke at the *New York Times* DealBook Opportunities for Tomorrow Conference. In her remarks, Chair White focused on three core initiatives – data reporting, enhanced fund controls and transition planning – intended to help ensure that the SEC's regulatory program is addressing fully the increasingly complex portfolio composition and operations of today's asset management industry.

Chair White identified potential areas of improvement within each of these initiatives. Specifically, she stated that the reporting and disclosure of fund investments in derivatives, the liquidity and valuation of fund holdings, and funds' securities lending practices should all be significantly enhanced. She also identified liquidity and use of derivatives as two key areas of focus within funds' control environments. Chair White reported that the staff of the SEC is considering whether to implement specific requirements applicable to funds (*e.g.*, updated liquidity standards) and whether broader risk management programs should be required for mutual funds and ETFs to address risks related to their liquidity and derivatives use. With respect to transition planning, Chair White noted that the staff is developing a proposal to require investment advisers to create transition plans to prepare for major disruptions in their business, and that the staff is considering new rules for stress testing by large investment advisers and large funds, as required by Dodd-Frank. She noted that the market perspective that the SEC brings to analyzing systemic risk issues complements the Financial Stability Oversight Council's work.

Chair White concluded her speech by affirming the SEC's continued focus on assessing the activities of the asset management industry as it evolves, ensuring that the SEC is addressing the risks of modern portfolio composition and operations, and anticipating and planning for the worst. She stated that the SEC's objective is not to eliminate all risk. "Far from it. Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors." Instead, she stated, that as our regulatory program evolves, "so too must our understanding of the balance that program strikes between reducing undue risks and preserving the principle of 'reward for risk' that is at the center of our capital markets."

SEC Extends Custody No-Action Relief to Derivatives Clearing Organizations

On December 19, 2014, the SEC staff issued three no-action letters[1] that extend previously issued no-action assurance for any registered fund ("Fund") that maintains assets in the custody of certain derivatives clearing organizations ("DCOs"), or certain DCO-member futures commission merchants ("FCMs"), registered with the Commodities Futures Trading Commission ("CFTC"). In the three letters, the staff extended until December 31, 2015, its assurance that it would not recommend enforcement under Section 17(f) of the 1940 Act if a Fund deposits Fund assets as margin with a DCO or FCM for purposes of meeting the DCO or FCM's margin requirements in certain interest rate swap, credit default swap, cash-settled commodity index swap and foreign currency swap contracts. In general, Section 17(f) of the 1940 Act requires a Fund to maintain custody of its assets only with certain types of entities (usually, banks). Rule 17f-6 permits a Fund to maintain assets with a futures commission merchant when necessary to effect transactions in exchange-traded futures contracts and option contracts on futures, provided various conditions of the rule are satisfied, including the requirement that the futures commission merchant maintains Fund assets pursuant to a written contract. By its terms, Rule 17f-6 does not provide relief for other types of derivatives, such as swaps.

The SEC staff relied on the DCOs' representations that each of the requirements of Rule 17f-6 would be addressed. Specifically, each DCO represented that each Fund's assets would be governed by a written contract between the Fund and the FCM, which (i) prohibits commingling Fund customer assets and FCM/DCO assets and requires compliance with CFTC swap collateral segregation rules; (ii) for each Fund transaction, requires the FCM to place and maintain the Fund's assets with the relevant DCO only in accordance with the Commodity Exchange Act and the CFTC's rules thereunder; (iii) upon the SEC's request, requires each FCM to provide records concerning a Fund's transactions to the SEC; (iv) specifies that any transaction gains by a Fund can be maintained with the DCO only until the next business day

[1] LCH.Clearnet Limited and LCH.Clearnet LLC, SEC No-Action Letter (Dec. 19, 2014); ICE Clear Credit LLC, SEC No-Action Letter (Dec. 19, 2014); and Chicago Mercantile Exchange, SEC No-Action Letter, (Dec. 19, 2014)

following the receipt of the gains; and (v) provides that a Fund may withdraw assets as soon as practicable, if the custodial requirements of 17f-6 are no longer satisfied.

SEC Staff Clarifies Restrictions Applicable to Business Development Company Co-investments with Affiliated Private Funds

The SEC staff issued a December 2014 IM Guidance Update (the "BDC Guidance Update") clarifying the restrictions that apply to co-investment transactions made by Business Development Companies ("BDCs") with certain second-tier affiliates, specifically, limited partners of a limited partnership that is an affiliated person of the BDC. The staff noted that the 1940 Act distinguishes between prohibited BDC transactions involving "close affiliates" (persons that fall within section 57(b) of the 1940 Act) and BDC transactions involving "remote affiliates" (persons that fall within section 57(e) of the 1940 Act). Transactions with remote affiliates may be permitted under Section 57(f) and, among other things, can be effected with the approval of a majority of the BDC's disinterested directors. Transactions with close affiliates, on the other hand, generally require SEC exemptive relief unless some other exception applies.

The BDC Guidance Update focuses on the question of whether a limited partner of a BDC-affiliated private fund organized as a limited partnership, which owns more than 5% but less than 25% of the private fund, would be a close affiliate of the BDC. Because a limited partner is a "partner" of the private fund, it is deemed to be a close affiliate of the BDC. However, under the same facts, if the BDC-affiliated private fund were organized as a corporation, the limited partner would be a "shareholder" of the private fund and, as such, would be deemed a "remote" affiliate of the BDC. Presumably, this interpretation also would extend to a limited partner that owns less than 5% of the private fund.

The BDC Guidance Update clarifies the SEC staff's view that, where a limited partner is a close affiliate of the BDC solely because the private fund seeking to co-invest with the BDC is organized as a limited partnership rather than a corporation, the limited partner may be treated as if it were a shareholder of the private fund for purposes of determining whether it is a close affiliate or a remote affiliate of the BDC.

The BDC Guidance update is analogous to the SEC staff's position taken with respect to limited partnership interests and registered investment companies that are not BDCs. In *First Financial Fund*, SEC No-Action Letter (June 5, 1997), the SEC staff stated that it would not recommend enforcement action if certain registered investment companies did not treat a named director of each of the investment companies as an "interested person" under section 2(a)(19) of the 1940 Act, despite the fact that the director owned limited partnership interests in private funds of which the general partner was an affiliated person of the investment companies' investment adviser. In *First Financial Fund*, the staff noted the director's role as a passive investor in the limited partnerships was, and should be treated as, comparable to that of a shareholder owning less than 5% of the outstanding voting securities of a corporation or trust.

SEC Staff Clarifies the Status of Key Employee Trusts Under the Family Office Rule

The SEC staff issued a December 2014 IM Guidance Update (the "Family Office Guidance Update") concerning whether certain key employee trusts qualify as family clients under Rule 202(a)(11)(G)-1 (the "Family Office Rule") under the Investment Advisers Act (the "Advisers Act"). The Family Office Rule provides an exception from the Advisers Act definition of investment adviser for families that manage their own wealth. Among other things, the exception requires that the investment advice provided must be provided only to "family clients". In recognition of the fact that family offices need to attract and retain talented investment professionals as employees, the Family Office Rule permits family offices to include as family clients certain non-family members, including "[a]ny trust of which each trustee or other person

authorized to make decisions with respect to the trust is a key employee; and each settlor or other person who has contributed assets to the trust is a key employee or the key employee's current and/or former spouse or spousal equivalent . . ."

The SEC staff had been asked (i) whether certain trust decision-making powers can be split between a key employee and a non-key employee; and (ii) whether the key employee who contributed assets to the trust must also be the key employee authorized to make decisions with respect to that trust. According to Family Office Guidance Update, a trust would qualify as a "family client" if a non-key employee makes non-investment decisions for the trust, provided investment decisions are made by a key employee. In addition, the Family Office Guidance Update states that the SEC staff believes it is within the intent of the Family Office Rule for one key employee to make investment decisions on behalf of another key employee's trust.

Regulatory Priorities Corner

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

Federal Reserve Extends Volcker Rule Deadline for Legacy Funds

The Federal Reserve Board ("FRB") recently approved an order under section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (commonly known as the Volcker Rule) that extends the deadline for banking entities to conform investments in, and relationships with, covered funds and foreign funds that were in place before December 31, 2013 ("legacy covered funds") from July 21, 2015, to until July 21, 2016. In general, Section 619 prohibits insured depository banks and their affiliates from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund.

The order also stated that FRB intends to act next year to approve an additional extension of the compliance deadline to July 21, 2017. This extension grants banking entities additional time to divest or conform their legacy covered fund investments with the limitations imposed by the Volcker Rule. The extensions do not apply to investments in, and relationships with, covered funds put in place after December 31, 2013, or proprietary trading activities.

Financial Stability Oversight Council Seeks Comment on Asset Management Risks

The Financial Stability Oversight Council ("FSOC") recently issued a notice inviting public comment on whether certain asset management products and activities could pose potential risks to the U.S. financial system (the "Notice"). The Notice states that as part of its ongoing evaluation of industry-wide products and activities associated with the asset management industry, the FSOC is seeking comments on risks posed to U.S. financial stability in the following areas: (i) liquidity and redemptions; (ii) leverage; (iii) operational functions; and (iv) resolutions (failures of an asset manager, investment vehicle or affiliate). Within these areas, the FSOC is interested in comments addressing risk management practices, metrics for assessing risk, methods to mitigate risks to financial stability, as well as the impact of interconnections between asset managers and other financial market participants that, in times of financial stress, could transmit risks. Comments must be submitted by February 23, 2015.

FINRA 2015 Examinations Priorities Letter

The Financial Industry Regulatory Authority ("FINRA") recently issued its *2015 Regulatory and Examinations Priorities Letter* ("FINRA Letter"). In the FINRA Letter, FINRA highlighted that some of the products offered to investors are complex and may be subject to substantial market, credit, liquidity or operational risks. In some cases, products previously available only to sophisticated investors have been modified and are

now offered to retail investors. Accordingly, FINRA's 2015 surveillance and examination activities will include product-related risk reviews and will routinely focus on due diligence, suitability, disclosure, supervision and training. These products include alternative mutual funds; products that are highly sensitive to interest rate increases; exchange-traded products that track alternatively weighted indices; structured retail products (including structured notes with complex payout structures and using proprietary indices as reference assets, complex features, long maturities, and linkages to less traditional or less well-understood reference assets); and floating-rate bank loan funds.

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:

EMIR – European Commission Responds to Draft RTS on IRS Clearing
January 13, 2015
The European Commission ("Commission") has publicized its decision to endorse draft regulatory technical standards ("RTS") submitted to it by the European Securities and Markets Authority ("ESMA") on the clearing of interest rate OTC derivatives under the European Market Infrastructure Regulation ("EMIR"), with certain amendments. ESMA has until January 29, 2015 (six weeks from the date of the communication from the Commission) to re-submit the draft RTS to the Commission with amendments consistent with those proposed by the Commission or to make a different proposal. The European Parliament and the Council of Europe will have at least three months from the time when final RTS are adopted by the Commission to raise any objections to them.

Recent Changes to the BEA Foreign Direct Investment Reporting
January 6, 2015
The U.S. Department of Commerce, through the Bureau of Economic Analysis (the "BEA"), requires certain U.S. entities (such as investment funds or their portfolio companies) to file annual reports of foreign direct investments with the BEA (the "BE-13" filing). Previously, a BE-13 filing was required of entities specifically contacted by the BEA. In a recent, largely unpublicized notice published on the BEA website on November 26, 2014, the BEA announced that any entity that is party to a transaction that crosses certain reporting thresholds (a "reportable transaction") will be required to file, regardless of whether the BEA has contacted such entity. In addition to requiring prospective filing after a "reportable transaction", the BEA is requiring retroactive reporting by January 12, 2015, by any entity that crossed a reporting threshold between January 1, 2014, and November 26, 2014.

Precidian Re-Files Application for Exemptive Relief to Permit Nontransparent Actively Managed Exchange-Traded Funds
December 24, 2014
On December 22, 2014, Precidian ETFs Trust, Precidian Funds LLC and Foreside Fund Services, LLC filed an exemptive application under the 1940 Act requesting permission to operate actively managed exchange-traded funds that would not be required to disclose their portfolio holdings on a daily basis. The application was filed approximately two months after the SEC's notice of its intention to deny a prior proposal from the same applicants that requested similar relief. The application contains several changes to the proposed ETF structure.

ESMA Releases Level 2 Regulations Under MiFID II
December 19, 2014
The European Securities and Markets Authority ("ESMA") published an important new set of rules under

the revised Markets in Financial Instruments Directive ("MiFID II"). MiFID II came into force on July 2, 2014, but will not have effect until January 3, 2017, reflecting the period granted to European Union member states to make MiFID II's provisions into national law and for production of the associated "Level 2" rules.

New York Establishes New Cyber Security Examination Process for Financial Institutions

December 16, 2014

New York's Department of Financial Services released a letter on December 10, 2014, announcing the details of its plan to focus more attention on cyber security matters in conducting examinations. Directed at New York-chartered or -licensed banking institutions, the letter notes that the Department will be incorporating a number of new security-oriented questions and topics into its pre-examination "First Day Letters." Those questions and topics, outlined below, are similar to those in a more comprehensive cyber security questionnaire attached to a United States Security and Exchange Commission's Office of Compliance Inspections and Examinations' ("OCIE") Risk Alert that was issued on April 15, 2014. The OCIE used its questionnaire earlier this year in conducting a limited set of cyber security examinations of registered investment advisors and broker-dealers. Together, both underscore the need for financial institutions to adopt and implement strong governance principles and controls to protect valuable information.

Second Circuit Raises the Bar for Proving Tippee Liability

December 12, 2014

The U.S. Court of Appeals for the Second Circuit vacated the criminal insider trading convictions of two former hedge fund managers, and in doing so, clarified the elements required to prove an insider trading charge against a "tippee." The Court held that the government must prove that an individual *knew* that a company insider had disclosed confidential information in exchange for a personal benefit, and also heightened the standard for proving a personal benefit. Although this decision is being characterized as a "sweeping" blow to the government's ability to combat insider trading, the U.S. Attorney's office has petitioned the original three-judge panel to reconsider the decision or, as an alternative, the petition requests a hearing en banc before the entire Second Circuit Court of Appeals.

EU Short Selling – Sovereign Debt

December 11, 2014

The Council of the European Union, on December 1, 2014, has published a provisional version of a press release announcing its decision not to object to the adoption by the European Commission of a regulation on the notification of significant net short positions in sovereign debt. Following the press release, the regulation, a delegated regulation supplementing the EU Short Selling Regulation, can be published in the Official Journal of the European Union and entered into force, unless the European Parliament objects.

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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