Ropes & Gray's Investment Management Update: February 2015 – March 2015

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

SEC and FINRA Report Results of Cybersecurity Examinations

In 2014, the SEC and FINRA separately conducted sweep exams to increase their understanding of the cybersecurity threats faced by investment advisers and broker-dealers. Recently, both the SEC and FINRA reported on the results of those efforts, and the reports reveal that the two regulators took very different approaches. The SEC's Risk Alert, which was released on February 3, 2015 (the "SEC Risk Alert"), describes current cybersecurity practices and the frequency with which these practices have been adopted by broker-dealers in comparison to investment advisers. In contrast, FINRA's February 2015 Report on Cybersecurity Practices (the "FINRA Report") provides a set of principles and effective practices that FINRA expects member firms to consider as they develop or enhance their cybersecurity programs.

The SEC Risk Alert summarizes the findings of the National Exam Program staff of the Office of Compliance Inspections and Examinations as a result of its examinations of 57 registered broker-dealers and 49 registered investment advisers, conducted under the Cybersecurity Examination Initiative announced in April 2014. Based on the information provided in the SEC Risk Alert, there appear to be significant differences between the practices of broker-dealers and the practices of advisers, with broker-dealers having generally adopted more extensive cybersecurity practices. In particular, although advisers typically have significant interaction with and rely upon third-party vendors and service providers, the SEC Risk Alert indicates that fewer advisers: (1) require cybersecurity risk assessments of vendors with access to their firms' networks (32% of advisers examined versus 84% of broker-dealers examined), (2) incorporate requirements related to cybersecurity risk in their contracts with third-party vendors (24% of advisers examined versus 72% of broker-dealers examined); and (3) maintain policies and procedures related to information security training for vendors/business partners authorized to access their networks (13% of advisers examined versus 51% of broker-dealers examined).

The FINRA Report combines information gleaned from FINRA's 2010 and 2011 on-site firm reviews, as well as its 2011 and 2014 examination sweeps to present a detailed series of "Principles and Effective Practices." These Principles and Effective Practices cover a broad range of topics, including cybersecurity governance and risk management, cybersecurity risk assessment, technical controls, incident response planning, vendor management, staff training, cyber-intelligence and information sharing, and cyber-insurance. Among other topics, the FINRA Report highlights the importance of the active involvement of senior management and also states that boards of broker-dealer firms "should play a leadership role in overseeing firms' cyber-security efforts."

Acceptance of Gifts or Entertainment by Fund Advisory Personnel

The SEC staff issued a February 2015 IM Guidance Update (the "Guidance Update"), reminding investment advisers to funds and other fund industry participants that the receipt of gifts or entertainment may violate the Investment Company Act of 1940 (the "1940 Act") and, in the staff's view, should be addressed by a fund's 1940 Act Rule 38a-1 compliance policies and procedures.

In an oft-cited opinion, the court wrote that "[t]he objective of § 17(e)(1) is to prevent [a fund's] affiliated persons from having their judgment and fidelity impaired by conflicts of interest." *United States v. Deutsch*, 451 F.2d 98, 109 (2d Cir. 1971). Specifically, Section 17(e)(1) prohibits an affiliated person of a fund, or an affiliated person of such person, acting as agent, from accepting from any source any compensation (other than regular salary or wages from the fund) for the purchase or sale of any property to or for the fund. The SEC has found that gifts or entertainment meets the broad definition of "compensation" in the context of section 17(e)(1).

In the Guidance Update, the staff opined that the conflicts arising from the receipt of gifts and entertainment by fund advisory personnel should be addressed in a fund's compliance policies and procedures required by Rule 38a-1 under the 1940 Act. The staff did not mandate specific parameters for such a policy and instead suggested that the written policy might range from an outright ban on the receipt of gifts and entertainment by a fund's advisory personnel, to some type of pre-clearance system that would determine whether the proposed gift or entertainment would be for the purchase or sale of any property to or for the fund and, therefore, prohibited by Section 17(e)(1).

In a footnote, the Guidance Update stated that the prohibition in Section 17(e)(1) is broader than the provisions in FINRA's rules concerning gifts and gratuities and non-cash compensation for broker-dealers (e.g., FINRA Rule 3220 prohibits broker-dealers and their associated persons from giving "anything of value, including gratuities, in excess of one hundred dollars per individual per year to any person . . . where such payment or gratuity is in relation to the business of the employer of the recipient"). Therefore, investment advisers cannot simply adopt modified versions of the FINRA rules. In another footnote, the Guidance Update stated that, because Section 17(e)(1) "prohibits the receipt of compensation in exchange 'for' the purchase or sale of property to or for a fund, courts have found some nexus must be established between the compensation received and the property bought or sold." Due the difficulty of proving the existence of this "for" nexus, the Guidance Update, quoting a leading 17(e)(1) case, stated that "once a conflict of interest is proven, the burden shifts to the party in conflict to prove that he has been faithful to his trust."

Although it covers familiar territory, the Guidance Update underscores the need for firms to have written policies and procedures, which are followed, to ensure that the concerns underlying Section 17(e)(1), and the burden-shifting that can occur under Section 17(e)(1) if a conflict of interest is proven, are adequately addressed. Advisers may want to review their policies and procedures accordingly.

SEC Proposes New Rules Concerning the Disclosure of Hedging by Employees, Officers, and Directors of Issuers, Including Certain Closed-End Investment Companies

On February 9, 2015, the SEC proposed rules to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Proposed Rules"). The Proposed Rules would require issuers of "equity securities" – defined as securities issued by the issuer, any parent or subsidiary of the issuer, and any subsidiary of the parent of an issuer, that are registered under Section 12 of the Securities Exchange Act of 1934 – to disclose whether the issuer permits any of its employees, officers or directors, or any of their designees, to purchase financial instruments or otherwise engage in transactions that hedge against any decrease in the market value of the equity securities (1) granted to the employee, officer or director as part of their compensation; or (2) held directly or indirectly by the employee, officer or director.

The Proposed Rules would not affect open-end investment companies (mutual funds) or exchange-traded funds (ETFs). However, closed-end investment companies with shares listed on a national securities exchange, as well as business development companies (BDCs), would be required to follow the new disclosure requirements discussed above (closed-end funds, but not BDCs, would be excluded if not listed on an exchange). With respect to a listed closed-end fund, in the Proposed Rules release, the SEC posited that the disclosure required by the Proposed Rules may be important to investors' voting decisions when evaluating the degree to which the interests of investors and the interests of fund directors and employees (if any) are aligned, especially with respect to seeking to decrease any discount at which the fund's shares are trading relative to the shares' NAV.

The SEC requests comments on, among other things, the application of the Proposed Rules' disclosure requirements to listed closed-end funds and to business development companies. Further, the SEC seeks input and data on the prevalence of such hedging by directors or employees (if any) for all types of registered investment companies. Comments must be received by the SEC no later than April 20, 2015.

Regulatory Priorities Corner

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

FINRA Focused on Form U4 Disclosures

In FINRA's 2015 Regulatory and Examination Priorities Letter (the "FINRA Priorities Letter"), FINRA noted that its examiners will be reviewing the completeness, accuracy, and timeliness of U4 disclosures, as well as whether firms have policies and procedures in place to ensure timely filings and to determine whether public record reviews are occurring. In addition to criminal, regulatory, and investment-related matters, Form U4 further requires registered persons of a broker-dealer to disclose personal financial matters, including compromises with creditors, bankruptcy filings and outstanding judgments or liens. Finally, the FINRA Priorities Letter stated that it expects firms to investigate representatives that fail to report appropriately.

SEC Scrutiny of Fixed-Income Markets

The SEC's fiscal 2016 budget proposal, released in February, indicated that the Division of Trading and Markets ("Trading and Markets") will seek to improve market structure for fixed-income securities, including corporate and municipal bonds. Among other things, Trading and Markets is developing best execution guidance for the corporate and municipal bond markets and developing SEC rule proposals intended to enhance pre-trade price transparency in these markets.

Federal Reserve May Initiate Rulemaking Affecting Fund Secured Transactions

In a recent speech, Daniel Tarullo, a member of the Federal Reserve Board, said that the Federal Reserve is likely to issue a notice of proposed rulemaking to implement minimum collateral requirements for securities financing transactions (including reverse repurchase agreements and securities lending) involving bank extensions of credit to certain non-bank institutions. The margin rules are likely to be based on the collateral requirements recommended in October 2014 by the Financial Stability Board, which 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:

SEC Requests Comment on NYSE Proposed Rule Changes that Would Allow Most Actively Managed ETFs to Forego the 19b-4 Application Process
March 12, 2015
On March 10, 2015, the SEC published a notice in the Federal Register requesting public comment on a proposed rule change from NYSE Arca, Inc. ("NYSE Arca") that, if approved, would make it easier for actively managed ETFs to list and trade their shares. Under current rules, actively managed ETFs are required to have a sponsoring exchange file a Rule 19b-4 application with the SEC and obtain SEC approval prior to listing and trading their shares. This process often takes several months and may take longer in some

cases. In contrast, most index-tracking ETFs are not subject to the Rule 19b-4 application process due to an exception contained in NYSE Arca Equities Rule 5.2(j)(3). The proposed rules would apply a similar exception to actively managed ETFs through amendments to NYSE Arca Equities Rule 8.600. If the proposed rules are approved, the time required for, and costs associated with, launching an actively managed ETF would be reduced.

Federal Agencies Release New Volcker Rule Guidance for Non-U.S. Banking Entities and Fund Sponsors Seeking to Rely on the "SOTUS" Covered Fund Exemption, Clarifying that the U.S. Marketing Restriction Does Not Apply to Third Parties
March 3, 2015
On February 27, 2015, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the SEC and the Commodity Futures Trading Commission (the "Agencies") issued an addition to their list of Frequently Asked Questions ("FAQs") pertaining to section 13 of the Bank Holding Company Act of 1956 (the "Volcker Rule").

Subject to certain exceptions, the Volcker Rule generally prohibits a "banking entity" from, as principal, "sponsoring," acquiring or retaining an "ownership interest" in, or making certain transactions with, "covered funds," which include most hedge funds and private equity funds. The Volcker Rule provides an exemption for certain covered fund activities conducted solely outside of the United States by non-U.S. banking entities holding an ownership interest in, or acting as sponsor to, a covered fund, provided that certain requirements are met (the "SOTUS Exemption"). One such condition for the SOTUS Exemption is that no ownership interest in the covered fund is offered for sale or sold to a resident of the United States (the "U.S. Marketing Restriction").

In the new FAQs, the staffs of the Agencies clarify that the U.S. Marketing Restriction only constrains the activities of non-U.S. banking entities seeking to rely on the SOTUS Exemption and does not apply more generally to the activities of unaffiliated third parties. The FAQs reaffirm, however, that a non-U.S. banking entity (including its affiliates) that seeks to rely on the SOTUS Exemption still must comply with all of the conditions of the SOTUS Exemption, including the U.S. Marketing Restriction.

Mutual Fund Adviser Sanctioned for Deficiencies in Custody of Funds' Derivatives Collateral and Directed Brokerage Compliance
February 19, 2015
On February 12, 2015, the SEC announced that Water Island Capital LLC ("Water Island") agreed to settle enforcement proceedings arising from alleged violations of the 1940 Act found during an SEC exam of Water Island and the mutual funds it advises (the "Funds"). The alleged violations related to custody of cash collateral posted as security for derivatives transactions and the requirements of Rule 12b-1(h) under the 1940 Act (which governs the direction of fund portfolio transactions to brokers that sell fund shares), as well as weaknesses in the design of the Funds' compliance program. The settlement imposed only a modest monetary penalty, and the underlying facts are not recited in great detail in the SEC's order, but the enforcement action nevertheless illustrates an SEC focus on technical compliance with the 1940 Act rules, especially in the context of mutual funds implementing "alternative" investment strategies.

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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