June 3, 2015

Ropes & Gray's Investment Management Update: April 2015 – May 2015

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

Registered Fund Adviser and Chief Compliance Officer Agree to Settle SEC Action Based on Inaccurate and Incomplete 15(c) Information

On April 21, 2015, the SEC settled an action brought against an investment adviser, Kornitzer Capital Management, Inc. ("KCM"), and Barry E. Koster ("Koster"), KCM's CFO and CCO, for allegedly furnishing inaccurate and incomplete information to the board of the Buffalo Funds in connection with the advisory contract renewal process conducted pursuant to Section 15(c) of the 1940 Act. The settlement order asserts that, in connection with the advisory contract review process, the Buffalo Funds' board requested an analysis of KCM's profitability in managing the Buffalo Funds, including an explanation of KCM's expense allocation methodology. In response to that request, Koster, acting on behalf of KCM, prepared and provided to the board the requested analysis and explanation of KCM's expense allocation methodology, which specifically represented that KCM allocated all employee compensation expenses to the Funds "based on estimated labor hours." In fact, the settlement order alleges that Koster adjusted the allocation of the compensation of KCM's CEO to the funds in a manner designed, in part, to achieve year-over-year consistency of KCM's reported profitability in managing the Buffalo Funds. Koster did not disclose this information to the board.

The SEC found that KCM's failure to disclose the allocation methodology was a violation of Section 15(c), and that Koster caused the violation by KCM. Without admitting or denying fault, KCM and Koster agreed to cease and desist from future violations of Section 15(c) and to pay to the SEC civil penalties of $50,000 and $25,000, respectively.

Regulatory Priorities Corner

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

Petition for Rehearing in Northstar v. Schwab Denied by Ninth Circuit

In *Northstar Financial Advisors Inc., v. Schwab Investments*, the United States Court of Appeals for the Ninth Circuit recently ruled that three novel state law claims were validly pled by a plaintiff seeking to represent a class of mutual fund shareholders.[1] The state law claims alleged in this case were based on theories of breach of contract against the fund, breach of fiduciary duty against the trustees and adviser, and breach of the investment advisory agreement against the adviser. The district court judge had previously dismissed the plaintiff's claims in a 2011 ruling. The Ninth Circuit's decision became final on April 28, 2015, when the defendants' motion for rehearing and for rehearing *en banc* was denied.

[1] *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 779 F.3d 1036, 2015 U.S. App. LEXIS 3670 (9th Cir. 2015), as amended by *Northstar Fin. Advisors, Inc. v. Schwab Invs.*, 2015 U.S. App. LEXIS 7027 (9th Cir. 2015). - See more at: https://www.ropesgray.com/news-and-insights/Insights/2015/June/Ropes-Grays-Investment-Management-Update-April-2015-May-2015.aspx#sthash.5iOTP11h.dpuf

Supreme Court Widens SEC's Reinterpretive Reach

As a general matter, when a federal agency, including the SEC, first issues a rule interpreting one of its regulations, it is generally not required to follow the notice-and-comment rulemaking procedures under the federal Administrative Procedure Act ("APA"). In a March 9, 2015 decision, Perez v. Mortgage Bankers Association, the Supreme Court rejected the argument that an agency must use the APA's notice-and-comment procedures when it wishes to issue a new interpretation of a regulation that deviates significantly from one the agency has previously adopted. From time to time, the SEC issues interpretive guidance with respect to the rules it has promulgated. In view of the *Mortgage Bankers* decision, the SEC now has greater latitude in changing its prior interpretive guidance.

SEC's Risk Alert Regarding Never-Before-Examined Investment Company Initiative

On April 20, 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a National Exam Program Risk Alert to provide further information concerning an initiative to conduct risk-based examinations of certain SEC-registered investment company complexes that have not previously been examined by OCIE. According to the Risk Alert, the initiative will focus on registered investment company complexes that were launched one or more years ago, with regard to two or more of the following "higher risk areas" associated with the operation of such complexes: Rule 38a-1 compliance programs, annual contract reviews, advertising and distribution, valuation and NAV calculations, and leverage and the use of derivatives.

SEC Issues First Formal Guidance on Forum Selection

In the face of criticism regarding the recent increase in the number of enforcement cases being brought as administrative proceedings, in early May 2015, the SEC's Division of Enforcement (the "Division") issued an explanation regarding its approach to forum selection in contested actions (the "Forum Selection Explanation") that describes the factors that the Division will consider in making a recommendation to the SEC regarding whether an enforcement action should be brought as an administrative or a judicial proceeding. The factors identified are the availability of the desired claims, legal theories, and forms of relief in each forum; whether any charged party is a registered entity or an individual associated with a registered entity; the cost, resource, and time effectiveness of litigation in each forum; and the fair, consistent, and effective resolution of securities law issues and matters. The Division also noted that these four factors are a non-exhaustive list, and the Division may consider other factors. The Forum Selection Explanation also states that Administrative Law Judges "develop extensive knowledge and experience concerning the federal securities laws and complex or technical securities industry practices or products." This suggests the Division believes it is beneficial to have matters that involve unsettled and complex legal issues under the federal securities laws, or an interpretation of the SEC's rules, decided by Administrative Law Judges.

EU Regulators Impose Fines for Breaches of Short Sales Regulations

A number of EU regulators have started to impose fines on firms, including U.S. firms, for breach of the EU short selling regulations, which went into effect in November 2012. As a reminder, firms that execute short sales of EU-listed securities are subject to the following requirements:

- Net short positions of 0.2% of an issuer's outstanding shares and, thereafter, each 0.1% increment must be disclosed to the relevant competent authority. Net short positions of 0.5% and above are disclosed to the relevant competent authority, which discloses the position publicly.
- The calculation of net short positions includes indirect holdings held through related financial instruments, including derivatives (including index derivatives), baskets, depository receipts, and ETFs.
- Sovereign debt – short positions of 0.1% or 0.5% (depending upon the issuer) must be reported to the relevant competent authority.
- There are prohibitions on "naked" short selling, with rules as to what amounts to an acceptable "locate" at the time of execution of the short sale.

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 Proposes More Frequent and Detailed Fund Holdings Disclosure, Website Delivery of Shareholder Reports
June 2, 2015
On May 20, 2015, the SEC proposed new and amended rules and forms (the "Proposals") that, if adopted, will significantly broaden the type and scope of information reported by registered investment companies. This alert summarizes the new disclosure forms and reporting requirements contained in the SEC's proposed rulemaking, including the new Form N-PORT, which would require registered investment companies to report detailed information about their monthly portfolio holdings and risk metrics to the SEC using a prescribed XML data format.

SEC Proposes Amendments to Form ADV and Recordkeeping Rule
June 1, 2015
In late May, the SEC proposed rules that would amend portions of Form ADV and rules promulgated under the Investment Adviser Act of 1940. The proposed amendments are intended to improve the quality of information that investors and the SEC receive, fill data gaps that the SEC has identified and facilitate the SEC's risk monitoring initiatives. The proposed amendments relate to Part 1A of Form ADV and address: 1) additional reporting requirements with respect to Separately Managed Accounts; 2) additional disclosures about investment advisers and their businesses; 3) registration on a single Form ADV of multiple fund advisers operating as a single advisory business; and 4) certain clarifying and technical changes. The SEC has also proposed amendments to the Advisers Act Books and Records Rule (Rule 204-2) to require advisers to maintain additional written materials related to the calculation and distribution of performance information.

FINRA Approves Use of Related Performance in Mutual Fund Marketing Materials to Institutional Investors
May 28, 2015
On May 12, 2015, the FINRA staff published an interpretive letter (the "Letter") permitting FINRA members to include related performance information (e.g., of separately managed accounts and private funds) in mutual fund marketing materials directed at institutional investors. Previously, FINRA's position was that, except in limited circumstances, related performance information in marketing materials would violate the content standards of FINRA Rule 2210(d). Therefore, the Letter is important because mutual fund marketers now may use related performance information when marketing mutual funds to institutional investors, including financial intermediaries, who may recommend these mutual funds to their customers. This is particularly important in cases where an investment adviser has been employing an investment strategy that will be used for a new mutual fund that lacks its own performance history.

The SEC's Current Views on Private Equity
May 28, 2015
As a follow-up to last year's "Spreading Sunshine in Private Equity" speech, in which then-OCIE Director Andrew Bowden stated that the SEC had found that more than half of the funds examined by OCIE had allocated expenses and collected fees inappropriately and identified "lack of transparency" as a pervasive issue in the private equity industry, Marc Wyatt delivered a speech on May 13, 2015, reflecting on progress in the past year as well as identifying likely areas of scrutiny the private equity industry will face in the future.

Supreme Court Confirms ERISA Fiduciaries' Duty to Monitor, Leaving Contours to Lower Courts
May 19, 2015
On May 18, 2015, the Supreme Court confirmed the existence of an independent duty on the part of ERISA plan fiduciaries to continuously "monitor" retirement plan investments and remove those that are imprudent. In *Tibble v. Edison International*, the Court held that ERISA's six-year statute of limitations for breaches of fiduciary duty does not extinguish claims alleging imprudent selection of investments if a continuing "duty to monitor" those investments is violated within the limitations period. The Court thus breathed life into stale claims about investment

selection by recognizing a fiduciary's continuing obligation to "monitor" investments and investment options. The opinion stopped short of defining the precise contours of the duty to monitor, leaving the development of the obligation to case-by-case evolution.

SEC Clarifies "Voting Equity Securities" for Purposes of the Bad Actor Rules
May 15, 2015
The SEC recently released additional guidance on the definition of "voting equity securities" as applied to the bad actor disqualification rules under Rule 506(d) of the Securities Act of 1933, as amended (the "Securities Act"). Private fund and hedge fund offerings to U.S. investors typically rely on Rule 506 under Regulation D as the basis for their exemption from registration under the Securities Act. Rule 506(d) disqualifies a securities offering from relying on a Rule 506 exemption if a covered person with respect to the issuer, which includes "any beneficial owner of 20% or more of the issuer's outstanding voting equity securities," has had a "disqualifying event." In the Rule 506(d) adopting release, the SEC defined the term "voting equity securities" as securities that confer to security holders the ability to "control or significantly influence the management and policies of the issuer through the exercise of a voting right." In its new guidance, the SEC states that it has reconsidered its initial views on the definition of "voting equity securities," and has now adopted a bright-line standard under which "voting equity securities" are defined as securities that, by their terms, provide the security holders with a presently exercisable right to vote for the election of directors.

Upcoming Deadline for BEA Foreign Affiliate Reporting on BE-10 (Extended to June 30)
May 8, 2015
The U.S. Department of Commerce, through the Bureau of Economic Analysis (the "BEA"), requires reporting on Form BE-10 (a "BE-10 Filing") from any U.S. person (including entities or individuals) that had a "Foreign Affiliate" at any point during the U.S. person's 2014 fiscal year. Form BE-10 is a five-year benchmark survey, with the prior survey conducted in 2009. At the time of the 2009 survey, a BE-10 Filing was required only from a U.S. person contacted by the BEA. In a rule published in the Federal Register on November 20, 2014, the BEA announced that any U.S. person that satisfies the applicable reporting threshold will be required to make a BE-10 Filing, regardless of whether the BEA has contacted such entity. A BE-10 Filing may be required as early as May 29, 2015. However, the BEA extended the submission deadline for first-time filers to June 30, 2015.

SEC Releases New Guidance Related to Investment Funds and Cybersecurity Risks
May 7, 2015
On April 28, 2015, the SEC's Division of Investment Management released a Guidance Update titled Cybersecurity Guidance (the "Guidance"). The Guidance represents the latest evidence of the SEC's continued focus on cybersecurity issues as they relate to financial services firms, particularly investment funds and advisers. Due to this heightened focus, it is becoming increasingly important for such firms to adopt more advanced and up-to-date cybersecurity protections. Funds and advisers would be well-advised to review their cybersecurity programs and to consider how they might implement some of the recommendations offered by the Guidance.

SEC Announces a Maximum Whistleblower Award to an Employee Who Faced Employment Retaliation as a Consequence of Reporting Dodd-Frank Act Violations to the Commission
May 1, 2015
In June of last year, Paradigm Capital Management agreed to pay the SEC nearly $2 million to settle allegations that it violated the Dodd-Frank Act's conflict-of-interest rules and unlawfully retaliated against the whistleblower that brought the conflict-of-interest issue to the SEC's attention. On April 28, 2015, the SEC announced that the Paradigm Capital whistleblower would receive, on a percentage basis, the maximum allowable whistleblower reward – 30 percent of the amount that Paradigm Capital paid to the SEC to settle the allegations. In announcing the maximum reward, the SEC's press release cited the fact that the whistleblower "suffered unique hardships, including retaliation, as a result of reporting [the conflict-of-interest issue] to the Commission."

SEC Staff Responds to Frequently Asked Questions on 2014 Money Market Reform Release, Including Valuation Guidance

April 28, 2015

On April 22, 2015, the SEC staff released guidance, titled "2014 Money Market Fund Reform Frequently Asked Questions," that discusses various interpretive issues arising from the SEC's 2014 Money Market Fund Reform release (the "2014 Reform Release"). On April 23, 2015, the SEC staff released additional guidance, titled "Valuation Guidance Frequently Asked Questions," that discusses the valuation guidance applicable to all mutual funds that was included within the 2014 Reform Release. Both the April 22 release and the April 23 release were in a question-and-answer format and represent the views of the SEC's Division of Investment Management's staff.

SEC Announces Dodd-Frank Whistleblower Award for Compliance Professional

April 23, 2015

On April 22, 2015 the SEC announced that it had awarded approximately $1.5 million to a whistleblower who had served as a compliance officer of a company. According to the SEC's press release, the whistleblower "had a reasonable basis to believe that disclosure to the SEC was necessary to prevent imminent misconduct from causing substantial financial harm to the company or investors." The SEC's press release also stated that the whistleblower reported the company's misconduct to the SEC only "after responsible management at the entity became aware of potentially impending harm to investors and failed to take steps to prevent it."

2015 ICI Mutual Funds and Investment Management Conference

April 7, 2015

Ropes & Gray authored a memorandum summarizing the 2015 ICI Mutual Funds and Investment Management Conference held in March in Palm Desert, California.

SEC Imposes Fine on KBR for Violating Dodd-Frank Whistleblower Protection Rule

April 2, 2015

On April 1, 2015, the SEC announced the resolution of its first enforcement action against a company for violations of the whistleblower protection provisions of the Dodd-Frank Act regulations. Under a "no admissions" resolution, KBR, Inc. agreed to pay a $130,000 penalty to resolve charges that the language it used in its confidentiality agreements during internal investigations violated SEC Rule 21F-17. As a voluntary "remedial action," KBR also amended its internal investigation confidentiality agreements to state expressly that employees are not prohibited from reporting, without prior company consent, violations of federal law to the Department of Justice, SEC, or other relevant federal agencies.

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.

United States

Mark I. Bane
New York, NY
+1 212 841 8808
mark.bane@ropesgray.com

Jason E. Brown
Boston, MA
+1 617 951 7942
jebrown@ropesgray.com

Bryan Chegwidden
New York, NY
+1 212 497 3636
bryan.chegwidden@ropesgray.com

Sarah Davidoff
New York, NY
+1 212 596 9017
sarah.davidoff@ropesgray.com

Gregory C. Davis
San Francisco, CA
+1 415 315 6327
gregory.davis@ropesgray.com

Timothy W. Diggins
Boston, MA
+1 617 951 7389
timothy.diggins@ropesgray.com

Isabel R. Dische
New York, NY
+1 212 841 0628
isabel.dische@ropesgray.com

Michael G. Doherty
New York, NY
+1 212 497 3612
michael.doherty@ropesgray.com

Paul H. Dykstra
Chicago, IL
+1 312 845 1300
paul.dykstra@ropesgray.com

John D. Donovan
Boston, MA
+1 617 951 7566
john.donovan@ropesgray.com

John C. Ertman
New York, NY
+1 212 841 0669
john.ertman@ropesgray.com

Laurel FitzPatrick
New York, NY
+1 212 497 3610
laurel.fitzpatrick@ropesgray.com

Leigh R. Fraser
Boston, MA
+1 617 951 7485
leigh.fraser@ropesgray.com

Mark Gurevich
New York, NY
+1 212 841 0657
mark.gurevich@ropesgray.com

Thomas R. Hiller
Boston, MA
+1 617 951 7439
thomas.hiller@ropesgray.com

William D. Jewett
Boston, MA
+1 617 951 7070
william.jewett@ropesgray.com

Susan A. Johnston
Boston, MA
+1 617 951 7301
susan.johnston@ropesgray.com

Jeffrey R. Katz
Boston, MA
+1 617 951 7072
jeffrey.katz@ropesgray.com

Christopher A. Klem
Boston, MA
+1 617 951 7410
christopher.klem@ropesgray.com

John M. Loder
Boston, MA
+1 617 951 7405
john.loder@ropesgray.com

Richard D. Marshall
New York, NY
+1 212 596 9006
richard.marshall@ropesgray.com

Brian D. McCabe
Boston, MA
+1 617 951 7801
brian.mccabe@ropesgray.com

Stephen C. Moeller-Sally
Boston, MA
+1 617 951 7012
ssally@ropesgray.com

Deborah A. Monson
Chicago, IL
+1 312 845 1225
deborah.monson@ropesgray.com

Mark V. Nuccio
Boston, MA
+1 617 951 7368
mark.nuccio@ropesgray.com

Jessica Taylor O'Mary
New York, NY
+1 212 596 9032
jessica.omary@ropesgray.com

Paulita A. Pike
Chicago, IL
+1 312 845 1212
paulita.pike@ropesgray.com

Dwight W. Quayle
Boston, MA
+1 617 951 7406
dwight.quayle@ropesgray.com

George B. Raine
Boston, MA
+1 617 951 7556
george.raine@ropesgray.com

Elizabeth J. Reza
Boston, MA
+1 617 951 7919
elizabeth.reza@ropesgray.com

Adam Schlichtmann
Boston, MA
+1 617 951 7114
adam.schlichtmann@ropesgray.com

Gregory D. Sheehan
Boston, MA
+1 617 951 7621
gregory.sheehan@ropesgray.com

Jeremy C. Smith
New York, NY
+1 212 596 9858
jeremy.smith@ropesgray.com

David C. Sullivan
Boston, MA
+1 617 951 7362
david.sullivan@ropesgray.com

James E. Thomas
Boston, MA
+1 617 951 7367
james.thomas@ropesgray.com

Joel A. Wattenbarger
New York, NY
+1 212 841 0678
joel.wattenbarger@ropesgray.com

London

Anand Damodaran
London
+44 20 3122 1146
anand.damodaran@ropesgray.com

Monica Gogna
London
+44 20 3122 1110
Monica.Gogna@ropesgray.com

Matthew Judd
London
+44 20 3122 1252
matthew.judd@ropesgray.com

Michelle J. Moran
London
+44 20 3122 1148
michelle.moran@ropesgray.com

Asia

Daniel M. Anderson
Hong Kong
+852 3664 6463
daniel.anderson@ropesgray.com