

October 7, 2015

Ropes & Gray's Investment Management Update: August 2015 – September 2015

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

SEC Charges Investment Adviser with Improper Use of Mutual Fund Assets to Pay Distribution Fees

On September 21, 2015, the SEC announced that it had agreed to settle enforcement proceedings brought against an investment adviser and its affiliated distributor for causing mutual funds to violate Section 12(b) of the 1940 Act and Rule 12b-1 thereunder and for the adviser's violations of Section 206(2) under the Advisers Act. According to the [SEC settlement order](#), the adviser and distributor had caused the funds to make payments to two intermediaries for distribution and marketing services outside of a Rule 12b-1 plan.

The settlement related to payments to intermediaries under two agreements. The first was a selected dealer agreement ("SDA") that expressly stated that the distributor had invited the intermediary "to distribute shares" of the funds and under which the funds paid the intermediary for services that expressly included "due diligence, legal review, training, [and] marketing." Payments under the agreement included a one-time fee and payments based on new gross sales. Notably, the same intermediary had also entered into a separate financial services agreement with the distributor under which the intermediary provided typical sub-TA services, for which the funds paid fees on a per-account basis. The second agreement, a correspondent marketing program participation agreement ("CMPPA"), called for the intermediary to provide a variety of sales-related activities. Critically, payments under the first intermediary's SDA and the second intermediary's CMPPA were made outside of the funds' Rule 12b-1 plan, and were in addition to payments made to the two intermediaries pursuant to the funds' Rule 12b-1 plan.

The complex's adviser made reports to the funds' board regarding payments for distribution and sub-TA services. In the board reports, the distribution fees to the two intermediaries were allegedly inaccurately characterized as sub-TA fees. The funds' prospectus disclosure regarding distribution expenses stated that the distributor or its affiliates would bear distribution expenses to the extent they are not covered by payments under the Rule 12b-1 plans. In fact, the funds bore the additional distribution and marketing expenses associated with the SDA and CMPPA not covered by the funds' Rule 12b-1 plans.

As part of the settlement, the adviser agreed to disgorge \$25 million and pay \$2.3 million in prejudgment interest. In addition, the adviser and the distributor agreed to jointly and severally pay a civil monetary penalty of \$12 million.

Petition for Writ of Certiorari in *Northstar v. Schwab Investments* Denied by U.S. Supreme Court

In March 2015, in [Northstar Financial Advisors Inc. v. Schwab Investments](#), the United States Court of Appeals for the Ninth Circuit ruled that three novel state law claims were validly pled by a plaintiff seeking to represent a class of mutual fund shareholders. 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 Ninth Circuit's decision became final on April 28, 2015, when the defendants' motion for rehearing and for rehearing *en banc* was denied. On July 27, 2015, Schwab Investments and the other defendants filed a petition for writ of certiorari with the U.S. Supreme Court. On October 5, 2015, the court denied the petition.

The *Northstar* opinion could subject funds, directors/trustees and advisers to shareholder class actions under state law contract and fiduciary duties theories, without protections normally provided by the derivative demand requirements under the weight of existing authority. Moreover, because it would be binding on federal district courts in the Ninth Circuit, the decision is likely to make that circuit a magnet for shareholder litigation.

Dismissal of *Jones v. Harris Associates* Affirmed on Remand

In 2010, in *Jones v. Harris Associates L.P.*, the U.S. Supreme Court adopted the Second Circuit's long-standing *Gartenberg* standard for cases brought under Section 36(b) of the 1940 Act. As part of its decision in *Jones*, the Supreme Court reversed a 2008 decision of the Seventh Circuit (which had applied a different standard), and remanded the case so that the Seventh Circuit could evaluate whether the district court had correctly decided to dismiss the case under the *Jones/Gartenberg* standard. On August 6, 2015, the Seventh Circuit issued its [decision](#), affirming the dismissal of the case on summary judgment by the district court.

According to the Seventh Circuit, the district court's review of the record on summary judgment focused on the lack of material dispute about four propositions: (i) the fees charged by the adviser were in line with those charged by advisers for other comparable funds, "which tells us the bargaining range"; (ii) the adviser provided accurate information to the funds' boards, whose disinterested members approved the fees; (iii) the fee schedules contained breakpoints; and (iv) the fees could not be called disproportionate in relation to the value of the adviser's work, as the funds' returns (net of fees) were the same as, if not better than, the returns of comparable funds advised by third parties. With respect to a comparison between fund fees and fees charged to institutional clients, the Seventh Circuit noted that, in *Jones*, the Supreme Court had not disagreed with the Seventh Circuit's 2008 approach. Differences in fees charged to other types of clients do not create a material issue of fact when the plaintiffs had not proffered evidence showing that (a) the adviser's services provided to other types of clients were the same as services provided by the adviser to the mutual funds in question or (b) that the adviser incurred the same costs when serving other types of clients.

Investment Adviser Sanctioned for Failing to Adopt Proper Cybersecurity Policies and Procedures

On September 22, 2015, the SEC announced that it had agreed to settle enforcement proceedings brought against an investment adviser, R.T. Jones Capital Equities Management, in connection with a cybersecurity breach that compromised the personally identifiable information ("PII") of the firm's clients. According to the SEC [settlement order](#), the adviser stored PII on its third-party hosted web server, which was attacked in July 2013 by an unknown cyber-intruder. The intruder gained access and copy rights to the data on the server, compromising the PII of more than 100,000 individuals, including thousands of the adviser's clients.

After the breach was discovered, the adviser hired cybersecurity consultants and the origin of the attack was traced to China. The adviser provided notice of the breach to every individual whose PII may have been compromised and offered free identity theft monitoring through a third-party provider. As of the date of the settlement, the firm had not received any indications that clients suffered financial harm as a result of the data security breach.

In the settlement order, the SEC noted that the adviser provided advice to retirement plan participants through a managed account option administered by a retirement plan administrator and offered by various retirement plan sponsors. The managed account program included several strategies through model portfolios maintained by the adviser. After consulting with a participant, the adviser would recommend a model portfolio. If the participant agreed with the recommendation, the adviser provided trade instructions to the retirement plan administrator, which then effected the transactions. The adviser did not control or maintain client accounts or client account information. During the relevant period, in order to verify eligibility to enroll in the managed account program, the adviser required prospective clients to log on to its website using their name, date of birth and social security number. This information was then compared against the PII of eligible plan participants that was provided by the plan sponsors, and stored, without modification or encryption, on the adviser's third party-hosted web server. According to the SEC, the plan sponsors provided the adviser with information about all of their plan participants, not just the participants

that were interested in the managed account program. Although the adviser had fewer than 8,000 plan participants as clients, its web server contained the PII of over 100,000 individuals.

Under Rule 30(a) of Regulation S-P, every investment adviser is required to adopt policies and procedures reasonably designed to: (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer. According to the settlement order, the adviser failed to adopt written policies and procedures reasonably designed to safeguard its clients' PII, as required by Rule 30(a). The SEC noted that the adviser's policies and procedures were not "reasonably designed" in that they did not include provisions for conducting periodic risk assessments, employing a firewall to protect the web server containing client PII, encrypting client PII stored on that server, or establishing procedures for responding to a cybersecurity incident.

While none of the adviser's clients were shown to have suffered any harm, the adviser agreed to pay a civil monetary penalty of \$75,000 as part of the settlement.

Recent Developments Related to the SEC's Whistleblower Program

In 2010, as part of the Dodd-Frank Act, Congress created the SEC's whistleblower program to provide monetary incentives for individuals to come forward and report possible violations of the federal securities laws to the SEC. Under the program, whistleblowers who satisfy certain objective criteria are entitled to an award of between 10 and 30 percent of the monetary sanctions collected in actions brought by the SEC and related actions brought by other regulatory and law enforcement authorities. The SEC's Office of the Whistleblower has been in operation since mid-2011. Since the program's inception, the SEC has awarded over \$50 million to whistleblowers, including \$5.5 million in 2015. In addition to several significant awards to whistleblowers, there have been certain other important developments related to the SEC's whistleblower program in recent months:

- In April (as we reported [here](#)), the SEC announced an enforcement action against a company for having overly restrictive language in confidentiality agreements that were being used for witnesses in internal investigation interviews. According to the SEC order, the confidentiality agreements contained language warning these witnesses that they may not disclose the matters discussed during the interview without prior permission from the company's legal department and that "unauthorized disclosure of information may be grounds for disciplinary action up to and including termination of employment." The SEC charged the company with violating Rule 21F-17 under the Exchange Act, which prohibits companies from taking any action that would impede potential whistleblowers from reporting violations to the SEC. Although there were no indications that the agreements actually prevented potential whistleblowers from coming forward, the SEC stated that the blanket prohibition against discussing the subject matter of the interviews "has a potential chilling effect on whistleblowers' willingness to report illegal conduct to the SEC."
- In interpretive [guidance](#) released on August 4, 2015, the SEC concluded that anti-retaliation protections cover more than just whistleblowers who report to the SEC. The protections also cover whistleblowers who report wrongdoing internally but who have not reported to the SEC. As discussed below, a September 10, 2015 decision by the Second Circuit defers to the SEC conclusion, but creates a circuit split with the Fifth Circuit.

Investment Adviser Pays \$20 Million to Settle SEC Enforcement Action Alleging Non-Disclosure and Breach of Fiduciary Duty

On August 10, 2015, the SEC settled enforcement proceedings brought against Guggenheim Partners Investment Management, LLC ("GPIM"), an investment adviser primarily to institutional clients, high net worth individuals and private funds, based on a breach of fiduciary duty and violations of the Advisers Act. The SEC [order](#) stated that the SEC determined that GPIM breached its fiduciary duty by not disclosing that a GPIM senior executive received a \$50 million loan from a client that allowed the executive to participate personally in a deal led by GPIM's corporate parent. As a result of the loan, the SEC found that GPIM had a potential conflict of interest whereby GPIM might

place the lending client's interests over the interests of other clients. The SEC noted that GPIM did not disclose the loan when GPIM placed certain of its other clients in two transactions on different terms from the client who made the loan. The allegations included a number of additional violations of provisions of the Advisers Act, including the adviser's failure to enforce its code of ethics with respect to recording the loan. In settlement of these alleged violations, GPIM agreed to pay a civil monetary penalty of \$20 million.

SEC Charges Advisory Firm with Fraud for Improperly Retaining Fees

On September 2, 2015, the SEC settled enforcement proceedings brought against Taberna Capital Management LLC ("Taberna"), an investment advisory firm, based on alleged violations that Taberna had retained certain fees (known as "exchange fees") it charged in connection with restructuring transactions undertaken between Taberna's collateralized debt obligation ("CDO") clients and the issuers of the underlying obligations in the CDOs' portfolios. According to the SEC [order](#), the exchange fees should have been paid to the CDOs, and Taberna was not permitted to retain the exchange fees as part of its compensation under the applicable CDO governing documents. In its order, the SEC determined that Taberna did not disclose to the investors in the CDOs that it was retaining the exchange fees. The SEC also found that Taberna had failed to disclose the conflicts of interest raised by its retention of the exchange fees, and falsely and misleadingly described Taberna's compensation for managing the CDOs in its Form ADV. In addition, the SEC charged Taberna's former managing director and former chief operating officer for their roles in the alleged misconduct.

As part of the settlement, Taberna agreed to pay a disgorgement of \$13 million, prejudgment interest of \$2 million and a civil penalty of \$6.5 million. Taberna also agreed that it would not serve as an investment adviser for three years. Taberna's former managing director and former chief operating officer each agreed to pay a penalty (\$100,000 and \$75,000, respectively), and to be barred from the securities industry (for at least five years and two years, respectively).

Failure to Retain Manually Signed Signature Pages Cited in Enforcement Action

On September 8, 2015, the SEC settled enforcement proceedings brought against MusclePharm Corporation ("MSLP"), a sports nutrition company. According to the SEC [order](#), among other things, MSLP had violated Rule 302 of Regulation S-T of the Exchange Act, which requires that a signatory to an electronic filing must manually sign the signature page before or at the time the electronic filing is made, and the filer must retain the original executed document for five years. MSLP allegedly failed to receive or maintain certain manually signed signature pages over a period of several years. In settlement of the alleged violations, which included other violations in addition to the Rule 302 violations, MSLP agreed to pay a civil monetary penalty of \$700,000 and retain an independent consultant for one year to enhance its internal controls. With respect to their registration statement filings, registered funds are subject to Rule 302's signature and recordkeeping requirements.

Regulatory Priorities Corner

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

DOL Fiduciary Rule Update

In August, the Department of Labor ("DOL") held four days of hearings debating its proposed fiduciary rule, which would expand the scope of service providers subject to the fiduciary requirements under Section 3(21) of ERISA and Section 4975(e) of the Internal Revenue Code. The DOL asserts the new rule will curb incentives for brokers to place clients into high-fee products. However, opponents contend that the net effect of the proposed rule will be to limit the ability of investors to receive personalized investment guidance for retirement accounts. SEC Commissioner Gallagher expressed serious concern over the proposed rule in a July comment letter addressed to DOL Secretary Perez, stating that the proposed rule is "grounded in the misguided notion that charging fees based on the amount of assets under management is superior in every respect and for every investor to charging commission based fees." The DOL had reopened the comment period on its proposed fiduciary rule through September 24th. A final rule is expected to be issued in early 2016.

Media Attention to Adequacy of Risk Disclosures for Bank Loan Funds

A recent New York Times article entitled [Vague Disclosures by Highflying Mutual Funds May Put Investors in Peril](#) drew mainstream media attention to the question of whether funds that invest in bank loans have adequately disclosed to investors the risks associated with such investments. The article questioned references to bank loans as “junk securities,” and whether bank loan funds should have disclosure that the loans may not be protected against fraud under federal securities laws. The article further reported that many mutual funds buying bank loans fail to disclose whether they receive confidential information from the companies issuing the obligations and, if so, how they deal with this information.

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 Rules to Require Liquidity Risk Management Programs for Funds and to Permit Swing Pricing of Fund Shares](#)

October 5, 2015

In a September 22, 2015 Release, the SEC published the following proposals:

- **Proposed Rule 22e-4, which would require open-end funds (including ETFs but not money market funds) to adopt liquidity risk management programs.** These programs would require review and management of a fund’s liquidity risks, including classifying each asset into a specific liquidity category, and maintaining a portion of the fund’s holdings in assets that a fund believes could be converted to cash within three business days.
- **Revised Rule 22c-1, which would permit, but not require, an open-end fund (other than an ETF or a money market fund) to implement “swing pricing.”** Swing pricing would allow a fund to adjust its NAV to pass on to purchasing or redeeming shareholders the costs arising from their trade activity.
- **New disclosure and data reporting requirements, which would disclose information about a fund’s liquidity risk and how that liquidity risk is managed.** These requirements would be implemented through amendments to Form N-1A and through additional reporting requirements on proposed Forms N-PORT and N-CEN.

[SEC Removes Credit-Rating References and Amends Issuer Diversification Requirements in Money Fund Rules](#)

September 25, 2015

In a September 16, 2015 Release (the “Release”), the SEC completed its obligations under Section 939A of the Dodd-Frank Act by removing references to credit ratings from Rule 2a-7. Most notably, the Release removes credit ratings from Rule 2a-7’s definition of “eligible security.” In the process, the Release creates a uniform credit quality standard – “presents minimal credit risks to the fund” – for each security acquired by a money market fund. The Release also requires money market funds to adopt written procedures requiring a fund’s adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.

[SEC’s OCIE Risk Alert Announces New Cybersecurity Exam Initiative – Focus Includes Conducting Tests of Efficacy of Firm’s Procedures and Controls](#)

September 18, 2015

Following up on last year’s cybersecurity sweep exam, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) issued a new Risk Alert on September 15, 2015, announcing a second round of cybersecurity exams. In addition to gathering information about industry practices, OCIE announced that it intends to test individual firms’ implementation of cybersecurity procedures and controls.

[BEA Releases New BE-180 Form and Related Guidance in Advance of Upcoming Deadline](#)

September 17, 2015

The U.S. Department of Commerce, through the Bureau of Economic Analysis (the “BEA”), requires U.S. financial services providers (including investment advisers, funds and their general partners) that had certain financial services transactions with foreign persons in excess of \$3 million during their 2014 fiscal year to file a report on Form BE-180 (a “BE-180 Filing”). In late August, the BEA released the new BE-180 form and instructions for the 2014 survey, which is due as early as November 1, 2015 (subject to certain extensions). BE-180 is a 5-year benchmark survey. At the time of the prior survey for 2009, a BE-180 Filing was required only upon request by the BEA. Similar to recent changes impacting other BEA surveys, including the BE-10 and BE-13 surveys, the BEA announced in a rule published in the Federal Register earlier this year that, in addition to those contacted by the BEA, any U.S. person that satisfies the reporting threshold will be required to make a BE-180 Filing, regardless of whether the BEA has contacted such person. Accordingly, investment advisers and the funds they advise will now be required to make a BE-180 Filing if they meet the reporting threshold.

[Second Circuit Court of Appeals Creates Circuit Split on Controversial Dodd-Frank Act Whistleblower Anti-Retaliation Provision](#)

September 11, 2015

On September 10, 2015, the United States Court of Appeals for the Second Circuit issued its highly anticipated decision in *Berman v. Neo@Ogilvy LLC*. The plaintiff-appellant, Daniel Berman, had been the finance director of Neo@Ogilvy. Mr. Berman’s lawsuit alleged that Neo@Ogilvy had unlawfully terminated him because he had reported internally, to senior company officers, supposed violations of GAAP and other accounting irregularities. The question of law presented was whether the Dodd-Frank Act’s whistleblower anti-retaliation provision offers protection to an employee who, like Mr. Berman, is fired after he reports possible financial misconduct internally but before he makes a report to the SEC.

[FTC Cautions Against Improper Reliance on “Investment-Only” Exemption](#)

August 26, 2015

Investment manager Third Point LLC and three of its affiliated funds have entered into a proposed settlement agreement with the federal antitrust authorities for violations of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, arising from improper reliance on the “investment-only” exemption. According to the Federal Trade Commission, Third Point failed to obtain HSR clearance in 2011 prior to acquiring voting securities of Yahoo! Inc. in excess of the then-applicable \$66 million threshold of the act, relying on the investment-only exemption despite taking action deemed to be inconsistent with passive investment intent. This enforcement action and related FTC guidance reminds investors that the investment-only exemption continues to be narrowly construed, and that enforcing compliance with the HSR Act remains a top priority of the federal antitrust authorities even where a transaction involves a minority stake and does not pose competition issues.

[FinCEN Rule Proposes AML Regulations for Registered Investment Advisers](#)

August 27, 2015

On August 25, the Financial Crimes Enforcement Network (“FinCEN”) proposed an anti-money laundering rule applicable to investment advisers registered with the SEC.

[Commenters React to DOL’s Proposed Expansion of Fiduciary-Duty Rules](#)

August 17, 2015

Four months after proposing a significantly expanded definition specifying when “investment advice” to employee plans and IRAs would give rise to fiduciary status under the Employee Retirement Income Security Act of 1974, the Department of Labor has its hands full grappling with comments on the multi-faceted proposal. The DOL received over 2,600 comment letters on the proposal and heard testimony from over 70 witnesses during public hearings from August 10 to August 13 in Washington D.C. This Alert describes some of the leading themes in the comment letters and the public hearings, focusing on the concerns of the regulated community.

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 Chegwiddden

New York, NY
+1 212 497 3636

bryan.chegwiddden@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

John D. Donovan

Boston, MA
+1 617 951 7566

john.donovan@ropesgray.com

Paul H. Dykstra

Chicago, IL
+1 312 845 1300

paul.dykstra@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

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

Robert A. Skinner

Boston, MA
+1 617 951 7560
robert.skinner@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