February 3, 2016

Ropes & Gray's Investment Management Update: December 2015 – January 2016

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

SEC Extends Custody No-Action Relief to Derivatives Clearing Organizations

On December 29, 2015, the SEC staff issued three no-action letters1[1] that extend previously issued no-action assurance for any registered 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, 2017, 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's 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 each FCM, which (i) prohibits commingling fund customer assets with 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 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.

CFTC Applies its New Anti-Fraud Rule

On December 2, 2015, the CFTC announced a settlement order with Arya Motazedi, a gasoline and energy futures trader. According to the CFTC's order, Motazedi committed fraud by misappropriating non-public and material information from his employer, and using that information both to trade ahead of his employer and to place advantageous trades between his personal accounts and his employer's accounts. The CFTC found that Motazedi had violated Section 6(c)(1) of the Commodity Exchange Act ("CEA") and Regulation 180.1, promulgated in 2011 under

[1] LCH.Clearnet Limited and LCH.Clearnet LLC, SEC No-Action Letter (Dec. 29, 2015); ICE Clear Credit LLC, SEC No-Action Letter (Dec. 29, 2015); and Chicago Mercantile Exchange, SEC No-Action Letter (Dec. 29, 2015).

Section 6(c)(1). Without admitting or denying any of the CFTC's findings or conclusions, Motazedi agreed to pay a $100,000 civil monetary penalty and a further $217,000 as restitution to his former employer and to accept a permanent prohibition from employment in the industry, trading on any CFTC-regulated facility and transacting in any instrument within the CFTC's jurisdiction.

Section 6(c)(1) was added to the CEA by the Dodd-Frank Act and is virtually identical to Section 10(b) of the Exchange Act. Regulation 180.1 was modeled on SEC Rule 10b-5. However, the CEA, in Section 4(b), already had a provision prohibiting fraud and deception, which the Dodd-Frank Act did not affect. Accordingly, the settlement order may be noteworthy for two reasons. First, it suggests that the CFTC intends to make broad use of its new anti-fraud authority under Section 6(c)(1) and Regulation 180.1. Second, in the order, the CFTC employs Rule 10b-5's misappropriation theory set forth in *U.S. v. O'Hagan*, 521 U.S. 642 (1997). Thus, Motazedi was found to have violated Rule 180.1 and committed fraud through his "misappropriation and misuse of his employer's material nonpublic trading information to trade in personal trading accounts [in breach of] his duty to his employer." More broadly, the settlement order quotes from the CFTC's 2011 release adopting Regulation 180.1: "[B]ecause of 'the differences between the securities markets and the derivatives markets, the Commission will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule l0b-5.'"

Regulatory Priorities Corner

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

SEC 2016 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 2016 (the "2016 Exam Priorities"). In the 2016 Exam Priorities, OCIE listed the following priorities that are worthy of note:

- **ReTIRE.** OCIE will continue its "Retirement-Targeted Industry Reviews and Examinations Initiative," launched in June 2015, which focuses on the services offered by investment advisers and broker-dealers to retirement account investors.
- **Cybersecurity.** OCIE will continue to examine broker-dealers' and investment advisers' cybersecurity compliance and controls in 2016.
- **Liquidity Controls.** Reflecting the SEC's concerns related to the changes in fixed-income markets over the past several years, OCIE will examine advisers to mutual funds, ETFs, and private funds that have exposure to potentially illiquid fixed-income securities.
- **Variable Annuities.** As part of its focus on retirement products and services, OCIE will review the suitability of sales of variable annuities to investors, as well as the adequacy of disclosure and the supervision of such sales.
- **Using Data Analytics to Identify Signals of Potential Illegal Activity.** OCIE noted that it will be leveraging its capabilities in the area of data analytics in connection with several initiatives, including the detection of the promotion of new, complex, and high risk products and related sales practice issues to identify potential suitability issues and potential breaches of fiduciary obligations.

FINRA 2016 Examinations Priorities Letter

On January 5, 2016, FINRA issued its 2016 Regulatory and Examination Priorities Letter (the "FINRA 2016 Priorities"). The FINRA 2016 Priorities cover many topics and themes, including:

- **Culture, Conflicts of Interest and Ethics.** FINRA will formalize its assessment of firm culture by focusing on certain indicators of a firm's culture, including the value placed on control functions within the firm, the firm's tolerance of policy or control breaches and the firm's efforts to identify risk and compliance events proactively.
- **Supervision, Risk Management and Controls.** FINRA will focus on four areas where it has observed repeated concerns that affect a firm's business conduct and the integrity of the markets: management of conflicts of interest, technology (including cybersecurity, technology management, and data quality and governance), outsourcing (including a review of a firm's due diligence and risk assessment of service providers) and anti-money laundering controls.

Other topics discussed in the FINRA 2016 Priorities include liquidity, sales practices (including sales discounts and waivers), financial and operational controls, and market integrity.

CFTC Approves Final Rules Imposing Minimum Margin Requirements on Uncleared Swaps

On December 16, 2015, the CFTC approved final rules that will impose mandatory minimum margin requirements on uncleared swaps entered into by registered swap dealers or major swap participants that are not subject to regulation by U.S. banking regulators (the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration or the Federal Housing Finance Agency (collectively, the "Prudential Regulators"). The rules are substantially similar to the rules adopted by the Prudential Regulators in October 2015, which apply to uncleared swaps and security-based swaps entered into by registered swap dealers, security-based swap dealers, security-based swap participants and major security-based swap participants that are subject to regulation by the Prudential Regulators, and are described in our earlier Alert. While neither the CFTC rules nor the Prudential Regulator rules will apply directly to buy-side entities, both sets of rules are expected to have a material impact on buy-side entities due to their impact on registered swap dealers and security-based swap dealers, which are typically the counterparties to buy-side entities' derivatives transactions. Both sets of rules will impose minimum margin requirements on derivatives transactions and may increase the amount of margin buy-side entities are required to provide. Both sets of rules also will likely require margin to be delivered by buy-side entities more quickly than is current market practice, and will also effectively require changes to typical derivatives documentation, including the ISDA Credit Support Annex. We understand that ISDA is developing a market-side protocol that parties can use to make those changes.

The compliance dates for the CFTC rules are identical to the compliance dates for the Prudential Regulator rules. While the compliance dates phase in beginning on September 1, 2016, we expect that the rules will affect transactions of most buy-side entities beginning on March 1, 2017 (for variation margin requirements) and September 1, 2020 (for initial margin requirements). For more information, please see our earlier Alert.

Broker-Dealer to Pay $13.75 Million for Mutual Fund Sales Deficiencies

On December 29, 2015, FINRA ordered Barclays Capital, Inc. ("BCI") to pay approximately $13.75 million for alleged deficiencies in its supervisory systems and procedures that resulted in thousands of unsuitable mutual fund transactions for its retail brokerage customers. A "mutual fund switch" involves one or more mutual fund redemption transactions coupled with one or more related mutual fund purchase transactions. According to the settlement order, BCI's compliance procedures incorrectly defined a mutual fund switch. As a result, BCI failed to review thousands of mutual fund switches for suitability and failed to ensure that the required disclosures of the costs associated with these switches were sent to customers. Separately, according to FINRA, BCI also "failed to have a supervisory system reasonably designed to ensure that mutual fund purchases were properly aggregated or householded so that customers were provided with available [breakpoint] discounts." Without admitting or denying FINRA's findings, BCI agreed to pay $13.75 million to settle the enforcement action which was comprised of over $10 million in restitution (including interest) to affected clients and a $3.75 million fine. This enforcement proceeding is one of several recent FINRA cases that have resulted in large settlement payments by broker-dealers for failure to ensure that clients receive available mutual fund breakpoint discounts.

PCAOB Adopts New Rules Regarding Disclosure of Audit Participants

In December 2015, the Public Company Accounting Oversight Board ("PCAOB") adopted new rules that, subject to approval by the SEC, will require accounting firms to file a new PCAOB Form AP disclosing information about the persons who participated in an audit, including the name of the engagement partner for the audit and the names of other firms participating in the audit. For audits of mutual funds, Form AP permits one Form AP to be filed in cases where multiple audit opinions are included in the same auditor's report. If multiple audit opinions included on the same auditor's report involved different engagement partners, a separate Form AP would need to be filed for each engagement partner, covering the audit opinions for the funds for which he or she served as engagement partner. The PCAOB believes that, by requiring disclosure of information about the engagement partner and the other accounting firms that participated in the audit in Form AP, and allowing firms to voluntarily report this information in the auditor's report, the new rules will promote the objectives of enhancing transparency and accountability for the audit.

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 Seeks Comments on Changes to Rules Governing Mutual Fund Transfer Agents
February 2, 2016
On December 22, 2015, the SEC published an Advance Notice of Proposed Rulemaking, Concept Release, and Request for Comment on Transfer Agent Regulations (the "Release") seeking public comment regarding the SEC's transfer agent rules. The SEC notes that the "first transfer agent rules were adopted in 1977 and remain essentially unchanged [while] transfer agents now operate in a market structure that bears little resemblance to the structure in 1977."

Ropes & Gray Private Investment Fund Update: January 2016
January 14, 2016
This Update summarizes recent legal developments of note affecting the private investment fund industry, including the following topics:

- SEC Lays Out Road Map for CCO Skill Set
- SEC Keynote Address: "Five Years On: Regulation of Private Fund Advisers After Dodd-Frank"
- OCIE Reports Observations from Outsourced COO Initiative
- SEC Considering Mandatory Third-Party Compliance Reviews
- Investment Adviser Sanctioned for Failing to Adopt Proper Cybersecurity Policies and Procedures.

SEC Publishes Guidance on Mutual Fund Distribution and Sub-Accounting Fees
January 13, 2016
On January 6, 2016, the SEC's Division of Investment Management issued a Guidance Update titled, "Mutual Fund Distribution and Sub-Accounting Fees" (the "Guidance"). The Guidance arises from a multi-year SEC staff review of mutual fund payments for shareholder, sub-transfer agency and recordkeeping services paid to intermediaries that distribute fund shares ("sub-accounting fees"). The staff's goal has been to determine whether a portion of sub-

accounting fees were, in fact, "payments for distribution in guise" and, therefore, required to be paid pursuant to a Rule 12b-1 plan or by the adviser out of its "legitimate profits."

SEC Proposes New Rule Concerning Registered Funds' Use of Derivatives
January 7, 2016
On December 11, 2015, the SEC issued its long-anticipated release (the "Release") proposing Rule 18f-4 ("the "Proposed Rule") under the 1940 Act regarding the use of derivatives and certain related instruments by registered investment companies (collectively, "funds"). The stated objective of the Release is to "address the investor protection purposes and concerns underlying section 18 [of the 1940 Act] and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives" in light of the increased participation by funds in today's large and complex derivatives markets.

Proposed Rule 18f-4 would supplant a significant volume of SEC no-action and other guidance on derivatives use by funds, and would introduce a range of specific, technical restrictions, including:

- The Proposed Rule defines and distinguishes between derivatives transactions and a newly defined category of "financial commitment transactions."
- Each fund that utilizes any derivatives transactions would have to comply with one of two alternative portfolio limitations.
- Each fund would have to maintain a specified value of "qualifying coverage assets," and qualifying coverage assets is defined more narrowly for derivatives transactions than for financial commitment transactions.
- Depending on the extent and complexity of its derivatives usage, a fund may be required to adopt and implement a board-approved written derivatives risk management program.

CFTC Provides Relief from Certain Recordkeeping Requirements Applicable to CPOs and CTAs
January 5, 2016
Effective December 24, 2015, the CFTC revised its Rule 1.35(a) to provide relief from certain recordkeeping requirements for commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"), whether registered with the CFTC or not, that are members of a designated contract market or have trading privileges on a swap execution facility. Under the revised Rule, CPOs and CTAs still are required to keep records of all transactions in commodity interests and related cash or forward transactions. However, CPOs and CTAs not registered with the CFTC need not keep transaction records that are in the form of text messages (defined as short message service ("SMS") or multimedia messaging service ("MMS") telephone transmissions). In addition, CPOs and CTAs not registered with the CFTC need not keep records of written pre-trade communications. Moreover, CPOs or CTAs, whether registered or not, are not required to keep records of oral communications. Finally, there is no prescribed form or manner in which the required records must be kept, and no prescribed methodology by which records must be searched or retrieved. Instead, CPOs and CTAs must keep records so as to permit prompt, accurate and reliable location, access and retrieval of any particular information and to allow for identification of a particular transaction.

Common Reporting Standards Come Into Effect for Many Offshore Funds on January 1, 2016
December 28, 2015
On January 1, 2016, the new standard for automatic exchange of information between tax authorities developed by the OECD (the "Common Reporting Standard") becomes effective in the Cayman Islands, Bermuda, the British Virgin Islands, Guernsey, Jersey and a number of other jurisdictions that are part of the "Early Adopters Group."

Starting on this date, all persons opening new accounts with financial institutions located in one of such jurisdictions are required to provide certain "self-certifications" that allow such financial institutions to perform due diligence and determine the investors' tax residency. Due diligence procedures for identifying existing individual accounts with balances of at least $1 million will have to be completed by December 31, 2016, while due diligence with respect to all other investors must be completed by December 31, 2017. The first exchange of information with respect to certain accounts is expected to take place in 2017.

Omnibus Bill Includes Significant Changes to Tax Law Regarding FIRPTA, REITs, and RICs
December 24, 2015
On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "Act"). The Act includes significant changes to tax laws relevant to private equity, real estate, and mutual fund investors and managers, including important modifications to the Foreign Investment in Real Property Tax Act of 1980. In addition, the changes make permanent certain "extenders," and thus provide valuable clarity in several important areas. Overall, the changes are taxpayer-friendly. In particular, they reduce impediments for non-U.S. investors investing in U.S. real estate.

Gramm-Leach-Bliley Act Amendment Eliminates Annual Privacy Notice Requirement for Many Advisers
December 14, 2015
On December 4, 2015, President Obama signed into law the nearly 500-page Fixing America's Surface Transportation Act, which included an amendment of the consumer privacy provisions within the Gramm-Leach-Bliley Act (the "Amendment"). The Amendment, which went into effect immediately, significantly reduces the need for financial institutions to provide an annual privacy disclosure to consumers that describes the financial institution's privacy policies and practices. If a financial institution satisfies certain conditions, it need not provide an annual privacy disclosure.

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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