August 11, 2016

Ropes & Gray's Investment Management Update: June – July 2016

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

DOJ Obtains Record Fine Against ValueAct; SEC Issues New Guidance on Schedule 13G Eligibility for Investors Engaging with Company Management

On July 12, 2016, the Department of Justice ("DOJ") announced that certain ValueAct Capital Management, L.P. entities ("ValueAct") had agreed to pay a record fine of $11 million to settle DOJ allegations that ValueAct violated the reporting and waiting period requirements of the Hart-Scott-Rodino Act (the "HSR Act"). The DOJ asserted that the ValueAct adviser, a registered investment adviser that actively involves itself in the management of the companies in which it invests, improperly relied on the HSR Act's "investment only" exemption in connection with purchasing voting shares of Baker Hughes and Halliburton in advance of their proposed merger. Voting securities are acquired "solely for the purpose of investment" if the acquirer has "no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." According to the DOJ, after the two companies announced their plan to merge, ValueAct purchased over $2.5 billion of the two companies' voting shares without complying with the HSR's notification requirements (that obligated ValueAct to report to the DOJ and the Federal Trade Commission about its investment plans and observe a waiting period before making the investments) and, thereafter, attempted to influence the companies' business decisions.

Against this backdrop, on July 14, 2016, the SEC's Division of Corporation Finance updated a Compliance and Disclosure Interpretation. Question 103.11 has been added to confirm that a shareholder's failure to satisfy the HSR Act's "investment only" exemption does not automatically disqualify the shareholder from initially reporting, or continuing to report, beneficial ownership on Schedule 13G. Question 103.11 distinguishes between (1) engagement with an issuer's management on executive compensation, social or public interest issues (*e.g.*, environmental policies) and corporate governance matters (*e.g.*, removal of staggered boards, adoption of majority voting standards in director elections, and elimination of poison pill plans) and (2) engagement with an issuer's management on matters that specifically call for the sale of the issuer to another company, the sale of a significant amount of the issuer's assets, the restructuring of the issuer, or a contested election of directors. Question 103.11 confirms that the examples in the first set of actions would not cause an investor to become ineligible to rely on Schedule 13G, while the examples in the second set would cause an investor to become ineligible to rely on Schedule 13G.

OCIE Announces New Exam Initiative Targeting RIAs' Share Class Recommendations

On July 13, 2016, the SEC's Office of Compliance Inspections and Examinations (the "OCIE") issued a Risk Alert announcing a new exam initiative that will focus on the conflicts of interest that arise when advisers receive compensation or financial incentives for recommending mutual fund and 529 Plan share classes that have substantial loads or distribution fees. According to the Risk Alert, "examples of conflicts of interest related to share class recommendations include situations where the adviser is also a broker-dealer or affiliated with a broker-dealer that receives fees from sales of certain share classes, and situations where the adviser recommends that clients purchase more expensive share classes of funds for which an affiliate of the adviser receives more fees." The Risk Alert indicates that the OCIE will conduct focused, risk-based examinations on the following "high risk" areas:

- ***Fiduciary Duty and Best Execution.*** Whether advisers are acting in the clients' best interests and seeking best execution when recommending or selecting mutual fund and 529 Plan investments to clients.

- ***Disclosures.*** The accuracy, adequacy and effectiveness of advisers' disclosures regarding compensation for the sale of shares and related conflicts of interest.

- ***Compliance Program.*** The adequacy and effectiveness of advisers' written policies and procedures surrounding its selection of mutual fund and 529 Plan share class investments in clients' accounts.

The OCIE notes that, while the topics noted above are the primary areas of focus for the initiative, examiners may select additional topics based on other risks identified during the examinations.

Financial Stability Board Issues Recommendations to Address Structural Vulnerabilities from Asset Management Activities

On June 22, 2016, the Financial Stability Board (the "FSB"), an international body that monitors and makes recommendations about the global financial system, released its report, titled "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (the "FSB Recommendations"). The FSB Recommendations provide the FSB's members, consisting of financial regulatory officials of G20 countries (including the Chair of the SEC), a list of recommended steps that the FSB believes should be followed to address financial stability risks arising from asset management activities within the officials' jurisdictions.

The FSB Recommendations discuss four areas of structural vulnerabilities from asset management activities: (i) liquidity transformation by investment funds; (ii) leverage within funds; (iii) operational risk challenges in transferring investment mandates in stressed conditions; and (iv) securities lending activities of asset managers and funds. For each of these four areas, the FSB Recommendations propose policies to address the related financial stability risks. Comments on the FSB Recommendations are due no later than September 21, 2016.

The four areas of structural vulnerabilities from asset management activities covered in the FSB Recommendations were discussed earlier this year by the U.S. Financial Stability Oversight Council ("FSOC") in its report, *Update on Review of Asset Management Products and Activities* (the "Review"), which we described in this IM Update. With respect to liquidity risk, FSOC's recommendations were similar to those made in the FSB Recommendations. The Review noted the SEC's May 2015 proposal to modernize and enhance data reporting by funds (described here), as well as the SEC's September 2015 proposal to enhance liquidity risk management by open-end funds (described here). The Review stated that FSOC "welcomes the SEC's policy initiatives in this area." In contrast, with respect to leverage risk, operational (resolution/transition) risk and securities lending risk, the Review cited insufficient data and incomplete analyses as the basis for FSOC's refraining from making any recommendations on these topics in the Review. For the time being, it remains unclear how the FSB Recommendations will affect recommendations from FSOC.

Regulatory Priorities Corner

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

Wrap Fee Subadviser Sanctioned for Inadequate Disclosure of Brokerage Costs

On July 14, 2016, the SEC announced that it had settled an enforcement action against RiverFront Investment Group ("RiverFront"), a registered investment adviser. The SEC alleged that RiverFront made materially misleading statements to its advisory clients with respect to the brokerage costs incurred by investors in wrap fee programs. Clients in wrap fee programs pay an annual wrap fee that is intended to cover the costs of various services, such as custody, trade execution, portfolio management and back office services that are "wrapped" together by the program's sponsor. Subadvisers to wrap fee programs typically use the brokerage firm designated by the sponsor of the wrap fee program to execute trades on behalf of clients in the program, and trades executed by the designated brokerage firm are covered by the wrap fee. However, in order to obtain best execution, a subadviser may decide to "trade away" from the designated broker-dealer by executing trades with other broker-dealers, resulting in additional charges to the wrap fee program clients.

The settlement order alleges that during the period from mid-2008 until March 2009, RiverFront executed almost all of the wrap fee program trades through broker-dealers designated by the sponsor. However, at the end of the first quarter of 2009, RiverFront significantly increased the number of trades that were "traded away" through other brokers and, by the beginning of 2010, RiverFront was trading away a majority of its trades for the wrap fee program. According to the SEC, "RiverFront did not profit by trading away, and it claims to have obtained improved execution prices by doing so." Nonetheless, the SEC found fault with RiverFront's alleged failure to adequately disclose its increased use of non-designated brokers and related additional costs to clients.

The order states that RiverFront's Form ADV disclosed to its clients that it "*might* trade away in an effort to obtain best execution," and that in such instances clients may pay transaction costs not covered by the annual wrap fee. However, the order further states that RiverFront's Form ADV also disclosed to its clients that "if a client retains RiverFront through a wrap fee arrangement, RiverFront *will generally* execute transactions for the client's account through the client's Program Sponsor, in order to enjoy the greatest cost benefits of the wrap fee program." Because the latter statement covered the period when RiverFront was trading away a majority of the trades for the wrap program accounts, the SEC found that statement to be materially misleading. As a result, the SEC determined that RiverFront willfully violated Section 204(a) of the Advisers Act and Rule 204-1(a) thereunder. In settlement of the action, without admitting or denying the SEC's findings, RiverFront agreed to be censured, to pay a civil penalty of $300,000 and to post on its website on a quarterly basis the volume of transactions traded away from sponsors and the associated transaction costs paid by clients.

Financial Services Firm to Pay $1 Million Penalty for Cybersecurity Breaches

The SEC recently reached a $1 million settlement with a large financial services firm (the "Firm") for its alleged failure to protect customer information. The SEC asserted that an employee of the Firm, who had access to two internal web portal applications, "misappropriated data regarding approximately 730,000 customer accounts, associated with approximately 330,000 different households," between 2011 and 2014. According to the order, portions of the stolen data were posted to at least three Internet sites, together with an offer to sell a larger quantity of stolen data in exchange for "payment in speedcoins, a digital currency." After discovering the data breach in a routine Internet sweep, the Firm interviewed the employee, who acknowledged that he had downloaded confidential customer data to his own data storage device. Although the employee denied posting any of the data on the Internet, "subsequent forensic analysis of the employee's personal server revealed that a third party likely hacked into the personal server and copied the confidential customer data that the employee had downloaded from the Portals."

The SEC determined that the Firm had failed to adopt written policies and procedures reasonably designed to protect customer data, in violation of Rule 30(a) of Regulation S-P. Specifically, the settlement order states that the Firm did not have reasonably designed and operating authorization modules to restrict employee access to only the confidential customer data to which an employee had a legitimate business need; to audit and/or test the effectiveness of such authorization modules; and to monitor and analyze employee access and use of client data. In settlement of the action, without admitting or denying the SEC's findings, the Firm agreed to be censured and to pay a civil penalty of $1 million.

Federal Reserve Extends Volcker Rule Compliance Date

On July 6, 2016, the Federal Reserve Board approved an order that extends, until July 21, 2017, the conformance period for banking entities to divest ownership in certain legacy investment funds and terminate prohibited relationships with funds, as required under the Volcker Rule. The order notes that this is the final of the three one-year extensions that the Board is authorized to grant under the Volcker Rule, although the Board is also permitted to grant banking entities an additional transition period of up to five years to conform their investments in certain illiquid funds.

Revised Uniform Unclaimed Property Act Viewed as Favorable to Fund Shareholders

In July 2016, the Uniform Law Commission finalized the Revised Uniform Unclaimed Property Act (the "Revised Act"). The Revised Act, which the Investment Company Institute endorsed, contains provisions consistent with industry and shareholder advocacy groups' efforts to blunt aggressive efforts by some states to claim mutual fund shares as abandoned property. For example, the Revised Act provides that shares of a fund will escheat to the state of the fund's home office rather than to the state in which the fund is organized. This should permit shareholders to reclaim shares more effectively because they are more likely to know the state of a fund's home office.

The Revised Act, like other uniform laws, is only a model for state legislation. States that have adopted prior versions of the Revised Act are likely to adopt the Revised Act in one form or another. Various states that have been more aggressive in their escheatment practices have not adopted the prior versions and, therefore, are not expected to adopt the Revised Act.

Other Developments

Since the last issue of our Investment Management Update, we have also published the following separate Alerts of interest to the investment management industry:

SEC Streamlines Exchange Listings for Actively Managed ETFs
August 4, 2016

Call for Input on the Post-Implementation Review of the FCA's Crowdfunding Rules
July 26, 2016

Potential Implications on the Use of Passporting for Asset Management Firms in a Post-Brexit World
July 14, 2016

Amended FINRA Rule Will Require Margin for TBA Transactions
July 11, 2016

SEC Issues Guidance on Fund Business Continuity Planning
July 6, 2016

SEC Proposes Rule Requiring Investment Advisers to Adopt Business Continuity and Transition Plans
July 6, 2016

SEC Staff Addresses Funds' Auditor Independence Problem
July 5, 2016

Market Abuse Regulation
June 15, 2016

Upcoming EU Disclosure Requirements for Certain Collateral Arrangements
June 10, 2016

FinCEN Issues Customer Due Diligence Rules and Amends AML Program Rules
June 9, 2016

SEC Settles with Private Equity Fund Adviser Charged with Acting as an Unregistered Broker
June 8, 2016

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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