October 12, 2016

Ropes & Gray's Investment Management Update: August – September 2016

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

SEC Settles with Adviser Over Undisclosed Adviser-Subadviser Agreement

On August 25, 2016, the SEC announced that it had settled an enforcement action against Orinda Asset Management, LLC ("Orinda"), a registered investment adviser to two registered investment companies (the "Funds"). According to the settlement order, in 2011, Orinda and the Funds applied for a manager-of-managers exemptive order. The application disclosed that Orinda had entered into a side agreement with the principal sub-adviser that provided for termination payments if Orinda were to recommend that the sub-adviser should be terminated for something other than cause. The Division of Investment Management (the "Division") informed Orinda and the Funds that it would not support the application in light of the termination payment arrangement. In 2012, Orinda and the Funds amended the application and eliminated any discussion of the side agreement with the principal sub-adviser.

Based on the representations in the amended application, in 2012, the SEC granted the manager-of-managers exemptive order. However, according to the settlement order, before filing the 2012 amended application, Orinda had (i) agreed with the principal sub-adviser to waive Orinda's ability to terminate, or recommend the termination of, the sub-adviser, and (ii) informed legal counsel to the Funds and the Funds' board of trustees of Orinda's termination waiver. The settlement order states that neither Orinda nor the Funds informed the Division of the revised side agreement with the principal sub-adviser and, further, that the Funds' registration statements inaccurately disclosed that all of the Funds' sub-advisory agreements could be terminated at any time by Orinda.

Based on these facts, the SEC determined that Orinda had willfully violated Section 34(b) of the 1940 Act, which makes it unlawful for any person to make any untrue or misleading statement of a material fact in a document filed with the SEC, or to omit from such a document any fact necessary in order to prevent the statements made therein from being materially misleading. In settlement of the action, without admitting or denying the SEC's findings, Orinda agreed to be censured and to pay a civil penalty of $75,000.

On September 8, 2016, the SEC issued a rarely seen notice of intent to rescind Orinda's 2012 exemptive order. The notice stated that Orinda and the Funds requested the rescission of the exemptive order because "they are not presently relying on the [2012 exemptive order] and will not do so in the future."

OCIE to Examine Advisers that Employ Individuals with a History of Disciplinary Events

On September 12, 2016, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a National Exam Program Risk Alert (the "Risk Alert") announcing that it will be conducting examinations of registered investment advisers that employ or contract with supervised persons who have a history of disciplinary events, including individuals who have been disciplined or barred from a broker-dealer. As a basis for its concern that "such individuals may present an increased risk of future misconduct," the Risk Alert cites a 2016 study of broker-dealer representatives conducted by the National Bureau of Economic Research. This study concluded that FINRA-registered broker-dealer representatives ("financial advisors") with disciplinary histories were five times more likely to engage in misconduct than the average financial advisor and that "while approximately half of the offenders lose their job after the misconduct, 44 percent of the offenders are reemployed in the financial services industry within one year."

According to the Risk Alert, the exam initiative will focus on the following key risk areas:

- **Compliance Program**. Examiners will review advisers' hiring processes, ongoing reporting obligations, employee oversight practices, and complaint handling processes and evaluate whether the advisers foster robust compliance cultures and tone at the top.

- **Disclosures**. Examiners will likely review registered advisers' practices regarding their disclosures of regulatory, disciplinary or other actions with a focus on assessing the accuracy, adequacy and effectiveness of such disclosures.

- **Conflicts of Interest**. Examiners will assess conflicts of interest faced by a registered adviser or supervised person, with particular attention to conflicts that may exist with respect to financial arrangements (*e.g.*, unique products, services, or discounts) initiated by supervised persons with disciplinary histories.

- **Marketing**. Examiners will review a registered adviser's advertisements, including pitch-books, website postings, and public statements, to identify any conflicts of interests or risks associated with supervised persons with disciplinary histories.

The Risk Alert notes that OCIE is using OCIE's analytical capabilities to evaluate information from a variety of sources to identify registered advisers for examinations under this initiative. These sources include SEC databases and filings as well as external sources. In addition to information in the firm's Form ADV, OCIE also will review information about other legal actions (*e.g.*, private civil actions) not required to be reported on Form ADV and information from SEC enforcement actions that barred or suspended individuals from certain financial industries.

ICI Provides FAQs Regarding Fidelity No-Action Letter and Auditor Independence

As described in our prior Alert, in June, the Division provided a temporary no-action letter (the "Letter") to the Fidelity family of funds and affiliated entities whose financial statements are audited by a public accounting firm that is not "independent" from the funds and entities because of non-compliance with Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Rule").

On September 23, 2016, the Investment Company Institute (the "ICI") published a list of FAQs that the ICI believes reflects the Division's interpretation of the Letter, based upon telephone calls with ICI members and the staff of the Division. Most notably, the list of FAQs confirms that funds are not required to test fund ownership throughout the year to determine the impact of the Loan Rule (*e.g.*, determine record or beneficial ownership and/or whether such an owner could exercise discretionary voting authority), unless a matter that could influence the objectivity and impartiality of the independent auditor is put before fund shareholders for approval. In addition, the list of FAQs confirms that, when conducting the "reasonable inquiry" prescribed by the Letter in connection with certain imminent shareholder meetings, "negative consent" letters may be used to determine whether an entity owns more than 10 percent of a fund's shares or exercises discretionary voting authority. The negative consent letter would inform the recipient that the fund will assume that the recipient will not exercise discretionary voting authority over greater than 10 percent of the fund's shares, unless the fund receives a written response indicating otherwise.

We note that, while a fund may not be *required* to test fund ownership throughout the year to determine the impact of the Loan Rule, a fund may want to consider its communications with its auditor in advance of the fund's audit regarding any 10 percent record or beneficial owners identified by the fund during the year. This may help identify potential Loan Rule issues earlier, leaving time to verify compliance with the terms of the Letter or, if necessary, to rely on a different auditor.

SEC Announces Tandy Representations No Longer Required in Filing Reviews

On October 5, 2016, the SEC staff announced (the "Announcement") that, effective immediately, it would no longer require filers to include "Tandy representations" in their filing review correspondence. The Announcement also applies to companies that have received staff comment letters but have yet to provide such representations. The Tandy representations, named after the Tandy Corporation (the first company to receive a letter containing the representations' language) were acknowledgements by a filer that the disclosure in the filed document was its responsibility and that staff comments or changes to disclosure in response to such comments did not foreclose the SEC from taking any action with respect to the filing and, finally, a statement by the filer that it would not raise the SEC review process as a defense in any legal proceeding.

Prospectively, the Announcement stated that the SEC staff will include the following statement in its comment letters: "We remind you that the company and its management are responsible for the accuracy and adequacy of their disclosures, notwithstanding any review, comments, action or absence of action by the staff."

IRS Issues Guidance and Proposes Regulations on RIC Qualification

On September 27, 2016, the Internal Revenue Service ("IRS") issued proposed regulations (the "Proposal") and a related revenue procedure concerning the good income and the asset diversification requirements for qualification of a fund as a regulated investment company ("RIC").

Pursuant to the new revenue procedure, the IRS will no longer rule on whether a specific financial instrument or position held by a RIC constitutes a "1940 Act security" for purposes of the good income or asset diversification requirements. In the Proposal, the IRS requests comments on whether it should withdraw previously issued published guidance that involved determinations of whether a financial instrument or position held by a RIC was a 1940 Act security, including, in particular, Rev. Rul. 2006-1 and Rev. Rul. 2006-31 (relating to commodity swaps and certain derivative instruments based on the value of a commodity or commodities). The IRS also has started to contact taxpayers that have received private rulings regarding whether certain commodity-linked notes constitute 1940 Act securities, to inform them that these rulings will be revoked.

The Proposal provides that so-called subpart F income inclusions (including generally in respect of passive income), triggered by a RIC's investment in a controlled foreign corporation, constitute good income only to the extent such income is currently and timely repatriated to the RIC. In the Proposal, the IRS explained that a contrary position is without support in Section 851(b) of the Internal Revenue Code of 1986, as amended. The proposed regulations are contrary to the conclusion reached by the IRS in a number of private letter rulings, issued from 2006 to 2011, that subpart F income inclusions constituted good income even in the absence of current repatriation.

The new revenue procedure concerning rulings on whether an instrument or position constitutes a 1940 Act security is effective immediately. The proposed regulations on subpart F income inclusions, if finalized as proposed, will be effective for taxable years that begin on or after the date that is 90 days after the date final regulations are published in the Federal Register. The Proposal does not specifically address whether a RIC that received a private letter ruling between 2006 and 2011 may continue to rely on such ruling in light of the Proposal. An IRS official indicated informally that such a RIC can rely on its ruling until the effective date of the final regulations.

REGULATORY PRIORITIES CORNER

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

Court Affirms SEC Views on Hypothetical or Back-Tested Performance

On August 9, 2016, a federal appeals court upheld the SEC's 2015 decision in In the Matter of Raymond J. Lucia Companies, Inc., in which an adviser and its owner (collectively, "Lucia") were found to have violated anti-fraud provisions of the Advisers Act, as well as Rule 206(4)-1 under the Advisers Act (the "Advertising Rule"), in advertisements that presented hypothetical ("back-tested") performance information.

The Advertising Rule prohibits any "advertisement," as defined under the Rule, that contains any "untrue statement of a material fact" or that "is otherwise false or misleading." Advertising using back-tested performance information – theoretical performance resulting from applying a specific investment strategy, such as a quantitative or formula-based strategy, to historical financial data – is not *per se* fraudulent. However, there are a number of requirements that an adviser must satisfy when advertising back-tested performance to avoid violating the anti-fraud provisions of the Advisers Act and the Advertising Rule.

In its decision, the SEC found that Lucia, in advertisements at seminars conducted to sell prospective clients on its investment strategy, made fraudulent misstatements of material fact and omissions of material fact necessary to make statements made not misleading. These misstatements included misrepresentations regarding the back-tests it had performed to prove that Lucia's investment strategy would have resulted in advantageous investment outcomes during difficult market periods. The SEC found that the back-tests were misleading because, among other reasons, Lucia did not sufficiently disclose to prospective clients that the back-tests used an assumed rate of inflation and an assumed rate of return on a class of investments that were not the actual historical rates. In addition, the SEC found that the back-tests did not actually follow the strategy being promoted by Lucia. Thus, the advertised performance did not, as claimed, show what would have happened if an investor had employed Lucia's investment strategy during the back-test periods. Instead, the advertised performance was materially overstated.

The SEC found that Lucia violated anti-fraud provisions of the Advisers Act and the Advertising Rule. The SEC ordered the Lucia adviser to pay a civil penalty of $250,000, and Lucia's owner to pay a civil penalty of $50,000. In addition, Lucia's owner was barred from the industry.

Thirteen Advisers Sanctioned for Negligent Use of False Performance Information

On August 25, 2016, the SEC announced that an enforcement sweep resulted in penalties for thirteen registered investment advisers that were alleged to have spread the false claims made by F-Squared Investments, Inc. ("F-Squared"), a registered investment adviser. In December 2014, F-Squared settled an enforcement action in which the SEC alleged that F-Squared materially inflated the performance track record of its proprietary "AlphaSector" investment strategy for the period from April 2001 to September 2008.

In the present actions, the SEC alleged that each of the thirteen advisers made material misstatements to their respective clients by negligently relying on F-Squared's inflated performance record for the AlphaSector strategy. Without admitting or denying the SEC's findings, the thirteen investment advisers each consented to the entry of an order finding that it had violated record-keeping and anti-fraud provisions of the Advisers Act and related rules under the Advisers Act. Each of the advisers also agreed to pay a civil penalty ranging from $100,000 to $500,000. In the SEC's announcement, Andrew Ceresney, Director of the Enforcement Division, stated: "When an investment adviser echoes another firm's performance claims in its own advertisements, it must verify the information first rather than merely accept it as fact."

Audit Firm Not Independent Due to Partners' Relationships with Audit Client Employees

On September 19, 2016, the SEC announced that it had settled two enforcement actions against Ernst & Young LLP ("EY") based upon the behavior of two EY partners. In the first enforcement action, the SEC asserted that an EY partner developed and maintained a close personal relationship with the CFO of a New York-based public company and members of the CFO's family, including spending extensive leisure time and frequent overnight trips with the CFO and his family. In the second enforcement action, the SEC asserted that an EY partner serving on the engagement team for another public company was romantically involved with the company's chief accounting officer. In both cases, according to the SEC, senior EY personnel should have identified or acted upon certain red flags.

The SEC concluded that the relationships of the two partners caused EY to violate Rule 2-02(b)(1) of Regulation S-X by causing EY's to certify falsely that the two issuers' respective audits were conducted by an independent auditor, and the partners and EY caused the audit client to violate Section 13(a) of the Exchange Act and Rule 13a-1 thereunder. Section 13(a) and Rule 13a-1 require public issuers to file annual reports with the SEC that have been audited by an independent accountant. In settlement of both enforcement actions, without admitting or denying the SEC's findings, EY agreed to disgorge audit fees and pay civil penalties totaling $9.3 million. According to Andrew Ceresney, Director of the SEC's Division of Enforcement, "these are the first SEC enforcement actions for auditor independence failures due to close personal relationships between auditors and client personnel."

Separately, one of the two issuers dismissed EY and withdrew its EY-audited financial statements for two prior fiscal years. The financial statements were reissued after they were examined and certified by another auditor.

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:

Court Rejects Excessive Fee Claims Following Trial on Mutual Fund "Manager of Managers" Theory

August 31, 2016

On August 25, 2016, a federal court in the District of New Jersey issued a much-anticipated decision, finding after a lengthy trial that shareholder plaintiffs failed to prove claims that AXA entities had charged excessive mutual fund management fees in violation of Section 36(b) of the 1940 Act. In the first case to proceed to trial since the U.S. Supreme Court established the legal standard for these claims in its landmark 2010 decision in *Jones v. Harris Associates L.P.*, the New Jersey trial court held in the defendants' favor on all claims relating to twelve mutual funds operating in a "manager of managers" structure. The plaintiffs' central theory of liability – mirrored in several other pending cases across the industry – is that AXA improperly retained a significant portion of the management fees despite delegating virtually all of the management responsibilities to external sub-advisers. Based on review of extensive documents and testimony, the district court judge rejected the premise of this theory, finding that there was ample evidence that AXA retained responsibility for a range of management services and bore significant risks in its role as fund sponsor and adviser.

SEC Whistleblower Enforcement Actions Related to Severance Agreements

September 8, 2016

On August 30, 2016, the SEC reaffirmed its commitment to its whistleblower program by issuing the second largest award in its five-year history. While admittedly less dramatic than this $22 million payment, the SEC's recent enforcement activity is similarly compelling evidence of the value that the agency places on its whistleblower program. Specifically, on August 10 and August 16, 2016, the SEC announced settlements with two companies based on language in employee severance agreements that discouraged employees from reporting possible securities law violations to the SEC, including by restricting the employees' ability to seek a monetary award from the SEC. These settlements reflect the SEC's broad interpretation of the whistleblower protection provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act and its continuing focus on internal confidentiality and severance agreements as an enforcement priority.

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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