December 7, 2016

Ropes & Gray's Investment Management Update: October – November 2016

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

Adviser Settles SEC Proceeding Alleging Valuation Deficiencies

On October 18, 2016, the SEC published a settlement order with a mutual fund adviser in which the SEC alleged that the adviser had misvalued an issuer's bonds for which market quotations were not readily available. Eight of the adviser's funds owned the bonds for more than three years. According to the settlement order, the misvaluation of the bonds resulted in the adviser executing shareholder transactions at incorrect NAVs, providing inaccurate performance figures for the funds in annual reports to shareholders and in filings with the SEC, and collecting inflated asset-based fees. The SEC claimed that the adviser's fair value calculations relied on an approach that was principally based upon a third-party analytical tool, and failed to incorporate other indicia of the bonds' value, including the prices at which the adviser transacted in the bonds on behalf of its fund clients and the values assigned by other holders of the bonds. Moreover, according to the order, the adviser failed to back-test its fair value determinations for the bonds despite doing so for other positions held by the funds.

The settlement order noted that, after the discovery of the pricing error on October 19, 2011, the adviser contributed a total of $27 million to the affected funds, reflecting an effort to compensate shareholders and the funds for harm caused by the incorrect NAVs. Thereafter, the funds distributed nearly all of the contributed amounts to accountholders of record as of October 19, 2011, and the undistributed amounts were retained by the funds. According to the SEC, these remediation efforts did not conform to the funds' NAV error correction procedures and compensated shareholders differently based on whether they invested directly or through an intermediary. In particular, the adviser lacked data concerning underlying shareholder activity within intermediary subaccounts and did not seek to obtain data from intermediaries to support its calculations of appropriate remedial payments. According to the SEC, this process resulted in different payments to shareholders who transacted through an intermediary and shareholders who transacted directly with the funds, notwithstanding that they had otherwise engaged in identical transactions.

Without admitting or denying the SEC's findings in the order, the adviser agreed to be censured and to pay a civil money penalty of $3.9 million. In addition, the adviser agreed to undertake a detailed remediation process, including reaching out to intermediaries for underlying account information, to reimburse fund shareholders who had not been fully compensated previously.

Regulatory Priorities Corner

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

SEC Announces Results of 2016 Enforcement Program

On October 11, 2016, the SEC announced its enforcement results for its fiscal year ended September 30, 2016. According to the announcement, the SEC filed 868 enforcement actions in fiscal 2016 (compared to 807 such actions in the prior year) covering a wide range of misconduct, and obtained orders totaling "over $4 billion" in disgorgement and penalties (compared to $4.2 billion in the prior year). Fiscal 2016 also included a record high

number of enforcement cases involving investment advisers or investment companies (160), as well as a record high number of standalone cases involving investment advisers or investment companies (98).

OCIE Examination of Whistleblower Rule Compliance

On October 24, 2016, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert announcing that OCIE will be conducting examinations of registered investment advisers and registered broker-dealers concerning compliance with whistleblower regulations adopted under Exchange Act Section 21F (titled "Securities Whistleblower Incentives and Protection"). To implement Section 21F, the SEC promulgated Exchange Act Rule 21F-17, which provides that "no person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications." The Risk Alert stated that recent enforcement actions identified provisions of confidentiality or other agreements required by employers that contribute to violations of Rule 21F-17 because the provisions included language that interfered with employee communications with the SEC about potential securities law violations.

The Risk Alert noted that OCIE is examining registered investment advisers and registered broker-dealers to review compliance manuals, codes of ethics, employment agreements, and severance agreements to determine whether these documents contain provisions that have been found to violate Rule 21F-17. In particular, OCIE will assess these documents for provisions that (i) require an employee to represent that he or she has not assisted in any investigation involving the registrant, (ii) prohibit disclosure of confidential information, without any exception for voluntary communications with the SEC regarding potential securities law violations, (iii) require an employee to notify and/or obtain consent from a registrant prior to disclosing confidential information, without any exception for voluntary communications with the SEC regarding potential securities law violations and (iv) purport to permit disclosures of confidential information only as required by law, without any exception for voluntary communications with the SEC regarding potential securities law violations.

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 Adopts Optional Swing Pricing Rule
November 16, 2016
In an October 13, 2016 release, the SEC amended Rule 22c-1 under the 1940 Act to permit, but not require, an open-end fund (other than an ETF or a money market fund) to implement "swing pricing." Swing pricing allows a fund to adjust its NAV to pass on to purchasing or redeeming shareholders the costs incurred arising from their purchases or sales.

Delay to the Application Date of the EU Regulation on Packaged Retail and Insurance-based Investment Products
November 9, 2016
The European Commission announced on November 9, 2016 an extension of the application date of the Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products ("PRIIPs") until December 31, 2017.

DOL Issues First Interpretative Guidance on New Fiduciary Rule
October 31, 2016
On October 27, 2016, the U.S. Department of Labor (DOL) issued the first set of FAQs about its new fiduciary rule. The FAQs include important clarifications to the final rule. The DOL also reiterated its intent to require compliance beginning on April 10, 2017. Our Alert summarizes the most notable FAQs and potential implications and action items for financial institutions, advisers and asset managers.

SEC Adopts More Frequent and Detailed Fund Holdings Reporting Requirements
October 31, 2016
In an October 13, 2016 release (the "Release"), the SEC finalized new and amended rules and forms that broaden significantly the type and scope of information required to be reported by registered investment companies. The changes effected by the Release, which are substantially the same as those proposed in the Proposing Release, fall into five categories:

- New Form N-PORT, which requires registered investment companies to report detailed information about their portfolio holdings and risk metrics on a monthly basis to the SEC using a prescribed XML data format;
- New Form N-CEN, which requires registered investment companies to report census-type information to the SEC annually, using a prescribed XML data format;
- Elimination of Forms N-Q and N-SAR, as well as amendments of certain other rules and forms;
- Amendments to Regulation S-X that require standardized, enhanced disclosure about derivatives in investment company financial statements; and
- Amendments to Forms N-1A and N-3 (and, for closed-end funds, Form N-CSR) that require disclosures about securities lending activities.

SEC Finalizes Rules Requiring Liquidity Risk Management by Open-End Funds
October 27, 2016
In an October 13, 2016 release (the "Release"), the SEC adopted Rule 22e-4 under the 1940 Act (the "Rule") and published new disclosure and data reporting requirements. Most notably:

- ***The Rule requires open-end funds (including exchange-traded funds but not money market funds) to adopt a liquidity risk management program.*** Under its program, a fund must assess and manage its liquidity risk, including classifying investments into specific liquidity categories, and, with some exceptions, maintaining a portion of its holdings in cash and assets that can be converted to cash within three business days.
- ***New public disclosure and non-public SEC data reporting requirements cover information about a fund's liquidity risk and how that liquidity risk is managed.*** These requirements are implemented through amendments to Form N-1A and through additional reporting requirements on Forms N-PORT and N-CEN and N-LIQUID.

The Release describes these changes as "reforms . . . designed to provide investors with increased protection regarding how liquidity in their open-end funds is managed, thereby reducing the risk that funds will be unable to meet redemptions timely or other legal obligations, and mitigating the risk of dilution of the interests of fund shareholders." The Release marks the advance of two components of the SEC's regulatory agenda announced by Chair White in late 2014—enhancing controls on risks related to portfolio management and enhancing data reporting.

New FINRA Capital Acquisition Broker Rules May Be of Interest to Private Fund Sponsors
October 24, 2016
The SEC recently approved a set of FINRA rules for Capital Acquisition Brokers ("CABs"), described as corporate financing firms that generally limit their businesses to advising companies on mergers and acquisitions, advising issuers on raising debt and equity capital in private placements with institutional investors, and providing advisory services on a consulting basis to companies seeking assistance analyzing their strategic and financial alternatives. Under the rules, CABs are subject to a streamlined set of conduct and compliance rules in recognition of the limited

business activities CABs can undertake. The CAB rules may be of interest to certain private fund sponsors. This is because CABs often engage in certain types of activity in which some private fund sponsors also engage, but which the SEC has indicated could require broker-dealer registration. As we have discussed in previous Alerts, recent SEC staff comments (Alert available here), as well as SEC settlements (Alerts available here and here), have raised questions about whether certain private fund sponsors should register with the SEC as broker-dealers, either because of their fund-raising activities, or because they receive transaction-based compensation in connection with acquisitions and dispositions of their portfolio companies.

SEC Approves FINRA Rules Addressing "Pay-to-Play" Practices

October 21, 2016

The SEC recently approved FINRA's proposal to adopt FINRA Rules 2030 and 4580. Those Rules set forth pay-to-play restrictions and associated recordkeeping requirements applicable to broker-dealers engaged in distribution or solicitation activities for compensation with government entities on behalf of investment advisers or their managed funds. The Rules effectively enable broker-dealers to continue to engage in solicitation and distribution activity with government entities by bringing broker-dealers into the class of persons that investment advisers are permitted under SEC rules to hire to perform those activities. The Rules are expected to become effective sometime between March and August of 2017.

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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