February 13, 2017

Ropes & Gray's Investment Management Update: December 2016 – January 2017

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

SEC Staff Interpretive Guidance – Fund of Funds May Acquire Shares of Closed-End Funds Within the Same Group of Investment Companies

On January 25, 2017, the SEC staff issued a letter (the "Letter") confirming that, for the purposes of Rule 12d1-2, the term "group of investment companies" does not include closed-end funds and, therefore, an open-end fund relying on Section 12(d)(1)(G) of the 1940 Act could invest in closed-end funds within the same group of investment companies up to the limits contained within Rule 12d1-2.

By way of background, Section 12(d)(1)(G), which was added to the 1940 Act in 1996, permits an open-end fund to acquire without limit shares of other open-end funds that are part of the same "group of investment companies." The term is defined in Section 12(d)(1)(G)(ii) as "any 2 or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services." An open-end fund relying on Section 12(d)(1)(G) (an "affiliated open-end fund-of-funds") is limited in the types of other securities it can acquire beyond shares of funds in the same group of investment companies. In 2006, the SEC adopted Rule 12d1-2, which codified relief the SEC had provided to various affiliated open-end fund-of-funds in prior exemptive orders, expanding the types of securities that an affiliated open-end fund-of-funds may acquire. Among other things, subject to certain limits, Rule 12d1-2 permits an open-end affiliated fund-of-funds to acquire securities issued by other funds, "other than securities issued by another registered investment company that is in the same group of investment companies." This left an interpretive question about whether an affiliated open-end fund-of-funds could invest in closed-end funds within the same group of investment companies.

The Letter resolved this interpretive question by confirming that, for the purposes of Rule 12d1-2, the term "group of investment companies" does not include closed-end funds and, therefore, an affiliated open-end fund-of-funds could invest in closed-end funds within the same group of investment companies up to the limits contained in Rule 12d1-2. The Letter simply stated that the staff's conclusion was based on the analysis set forth in the applicant's incoming letter, in which the applicant argued that (i) in adopting Rule 12d1-2 to expand the scope of permissible investments for an affiliated open-end fund-of-funds, there was no indication that the SEC intended to preclude investments in closed-end funds that are within the same group of investment companies, and (ii) there were no policy reasons to justify prohibiting affiliated open-end fund-of-funds from investing in closed-end funds within the same group of investment companies.

Relying on the Letter, it is now clear that an affiliated open-end fund-of-funds can rely on Rule 12d1-2 to invest in closed-end funds that are members of the same group of investment companies up to the limits contained in Rule 12d1-2 (i.e., the limits set forth in Sections 12(d)(l)(A) or 12(d)(1)(F) of the 1940 Act regarding investments in other investment companies).

SEC No-Action Letter – Fund Foreign Currency Transactions Through an Affiliated Agent

On December 16, 2016, the SEC staff issued a no-action letter (the "Letter") providing no-action assurance under Section 17(e) of the 1940 Act where a broker (the "Broker") that is an affiliated person of the Russell family of funds

(the "Funds") received compensation from the Funds for effecting their foreign currency transactions ("FX Transactions"), within the parameters of Section 17(e)(2) or the 1940 Act.

In general, Section 17(e)(2) of the 1940 Act permits any first- or second-tier affiliated person of a fund, acting as the fund's broker, to receive commissions from the fund for effecting brokerage transactions, provided that the commissions do not exceed "the usual and customary broker's commission if the sale is effected on a securities exchange." Rule 17e-1 provides that a commission will not be deemed to exceed the usual and customary broker's commission if the commission is reasonable and fair compared to the commission "received by other brokers in connection with comparable transactions involving similar securities being purchased or sold on a securities exchange during a comparable period of time."

The Russell applicants noted in their letter to the staff (the "Incoming Letter") that in the 1998 *Drinker* no-action letter,[1] the SEC staff provided no-action assurance under Section 17(e) to funds utilizing an affiliated broker to effect FX Transactions, based on representations that all such transactions would be conducted in accordance with certain procedures that would satisfy the requirements of Rule 17e-1. *Drinker* also was based on a representation that the Rule 17e-1 procedures would permit a fund to use an affiliated broker only when the price obtained for an FX Transaction, plus the affiliated broker's commission, was at least as favorable as the price contemporaneously quoted by an independent source previously selected by the fund's trustees. The Incoming Letter contended that these conditions were unworkable in the foreign exchange market where most of the participants are principals acting for their own accounts and where there is limited price and commission transparency. Accordingly, the Incoming Letter proposed variations of the Rule 17e-1 procedures approved in *Drinker*.

In the Letter, the staff repeated the Incoming Letter's description of the foreign exchange market and the apparent difficulties in satisfying the representations in *Drinker*. However, instead of approving the Incoming Letter's proposed Rule 17e-1 procedures, the staff stated:

> Although we express no view as to whether the procedures you describe satisfy the requirements of Section 17(e)(2) and Rule 17e-1, we note that any such procedures must be reasonably designed to address the concerns that Section 17(e) was intended to address, including the potential that RICs might be managed and operated in the interest of the adviser and its affiliated persons, rather than in the interest of RIC shareholders . . . We further confirm that the procedures described in *Drinker* do not represent the sole means by which [the Broker] may satisfy the requirements of Section 17(e)(2) and Rule 17e-1.

The Letter is helpful to similarly situated fund complexes in getting past the unworkable *Drinker* conditions. However, because the staff did not expressly approve of the Rule 17e-1 procedures proposed in the Incoming Letter, a fund complex may have to proceed cautiously in creating its own set of workable procedures.

FINRA Exempts Fund MDFP in Reports from Filing Requirements

On January 9, 2017, amendments to FINRA Rule 2210 (Communications with the Public) (the "Rule") became effective. Prior to that date, the Rule required the management's discussion of fund performance ("MDFP") in a fund's annual or semi-annual report to shareholders to be filed with FINRA if the report was also distributed or made available to prospective investors by member firms. FINRA's rationale for requiring the MDFP to be filed was that such use made the MDFP promotional material. FINRA now believes that the MDFP presents less risk to investors than other types of promotional communications concerning registered funds because the MDFP focuses on the fiscal period covered by the shareholder report instead of containing promotional content. Accordingly, as amended, the Rule excludes the MDFP from the Rule's filing requirements by adding of an express exclusion for annual or semi-annual reports that have been filed with the SEC in compliance with applicable requirements.

[1] Drinker Biddle & Reath LLP, SEC Staff No-Action Letter (pub. avail. Dec. 18, 1998).

Bankruptcy Court Requires Disclosure of Private Funds' 10-Percent Owners

In a December 9, 2016 ruling, in *In re Motors Liquidation Co.*,[2] the United States Bankruptcy Court for the Southern District of New York denied the motion of a group of creditor private funds and registered funds (the "Funds") seeking to redact or seal the names of parties holding 10 percent or more of the Funds' equity interests from their corporate ownership statements and required them to disclose the ownership information in a public filing without redactions.

Federal Bankruptcy Rule 7007.1 requires non-debtor corporate parties in adversary proceedings to file a corporate ownership statement that identifies any parties who directly or indirectly hold 10 percent or more of the corporate parties' equity. Under local bankruptcy rules in New York, partnerships and joint ventures, along with corporations, must file corporate ownership statements when they are parties to an adversary proceeding. The Funds argued that a public filing including the identities of their investors would reveal information about the commercial operations of their business and should be treated as confidential commercial information under section 107(b) of the Bankruptcy Code, which protects such information from disclosure.

In denying the Funds' motion, the court noted that the court must protect confidential commercial information under section 107(b) and that this requires a determination whether movants in a particular case have shown that the information they seek to protect is properly classified as confidential commercial information. Judge Glenn, citing his own opinion in an earlier case, held that for otherwise sensitive information to be considered confidential commercial information, it must be "so critical to the operations of the entity seeking the protective order that its disclosure will unfairly benefit the entity's competitors." A moving party, the court noted, must show an "extraordinary circumstance or compelling need" for the court to grant an exception to the public's right of open access and instead protect the confidentiality of the information required to be disclosed. Without ruling on whether the identities of the owners of 10 percent or more of the equity interests of a party in an adversary proceeding can ever be considered confidential commercial information, the court found that the Funds had not met their burden of proof.

The *Motors Liquidation* court stated its belief that the local bankruptcy rule applicable in the Southern District of New York that requires disclosure from partnerships and joint ventures "clarifies" Bankruptcy Rule 7007.1, which only expressly requires disclosure from corporations. However, courts in districts lacking local rules that expressly require disclosure from partnerships may not require disclosure from investment funds organized as partnerships, and bankruptcy judges may not all share Judge Glenn's very narrow view of the scope of "confidential commercial information" entitled to protection. Nevertheless, private funds commencing or responding to adversary proceedings in bankruptcy court should be prepared for the possibility that they may be required to make public disclosure of their principal investors.

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 2017 (the "2017 Exam Priorities"). In the 2017 Exam Priorities, OCIE listed the following priorities that are worthy of note:

- OCIE will continue to examine exchange-traded funds ("ETFs") for compliance with the conditions of SEC exemptive relief from various provisions of the federal securities laws and other regulatory requirements. The examinations also will focus on ETFs' sales strategies, trading practices and disclosures, and the suitability of broker-dealers' recommendations to purchase ETFs with niche strategies.

[2] *In re Motors Liquidation Co.*, 561 B.R. 36 (Bankr. S.D.N.Y. 2016).

- OCIE will continue its examinations of broker-dealers' and investment advisers' cybersecurity programs, include testing and assessing how well firms have implemented cybersecurity procedures and controls.
- Beginning in October 2016, money market funds have been required to comply with certain 2014 amendments to Rule 2a-7 that are intended to address redemption or "run" risks. OCIE will examine money market funds for compliance with the amended rules. The examinations are likely to include evaluations of board oversight of fund compliance with the amended rules and reviews of policies and procedures concerning money market fund stress-testing and periodic reporting of information to the SEC.
- OCIE will examine advisers and broker-dealers that offer investment advice through automated or digital platforms, including "robo-advisers." These examinations will focus on compliance programs, marketing, formulation of investment recommendations, data protection and disclosures relating to conflicts of interest.

Valuation of Pre-IPO Issuers

According to press reports, the SEC has recently contacted several mutual fund managers to request information regarding how the funds value non-publicly traded securities issued by private technology companies such as Uber Technologies Inc. and Airbnb Inc. Although the SEC declined to comment on the matter, the SEC reportedly is concerned that there are no uniform methods for valuing such securities and that methodologies that utilize values of public companies as benchmarks are inappropriate in this context.

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:

President Signs Memorandum Requiring Further Review of DOL Fiduciary Rule
February 6, 2017
On February 3, 2017, President Trump signed a presidential memorandum directing the U.S. Department of Labor (the "DOL") to examine its new fiduciary rule. (For details on the fiduciary rule, see our prior Alert, and, for details on the related DOL-issued FAQs, see our prior Alert on the First FAQ and Alert on the Second FAQ.) Contrary to initial reports based on a leaked draft memorandum, the final memorandum does not delay the applicability date of the rule (April 10, 2017). However, following the signing of the memorandum, the acting U.S. Secretary of Labor issued a statement that the DOL will consider its legal options for delay.

ESMA issues common principles for UCITS share classes
February 1, 2017
The European Securities and Markets Authority ("ESMA") published on January 30, 2017 an opinion on the use by EU UCITS funds of share classes, outlining four key principles that all UCITS funds must follow when setting up different share classes, and considering whether certain existing share class hedging techniques comply with such principles. The opinion particularly impacts share classes that use a derivative to hedge against a particular risk.

The opinion is addressed to national regulators. It is does not bind funds or national regulators, but it is expected that the FCA and other regulators will follow it, to the extent their existing practice diverges.

UK FCA to Extend AIFMD Annex IV Reporting to Master Funds
January 31, 2017
Non-EU Alternative Investment Fund Managers (AIFMs) that currently complete "Annex IV" regulatory reporting with the FCA in respect of feeder funds are not required to complete the Annex IV report in respect of the master fund, on the condition that the master fund is a non-EEA fund and is not marketed in the EEA. As a result, non-EEA managers of master-feeder structures often do not need to satisfy Annex IV reporting in respect of the master fund.

The FCA announced on January 25, 2017 a change to this position. With effect from June 29, 2017, the FCA will require non-EEA AIFMs also to complete Annex IV in respect of the master fund, regardless of whether or not the

master fund was marketed in the EEA. This change only applies to an AIFM that currently reports information to the FCA on a quarterly basis – so it does not apply to an AIFM that reports either on a half-yearly basis or to most private equity fund AIFMs that report on a yearly basis.

DOL Fiduciary Rule Compliance—SEC Says Brokers Can Impose Their Own Commissions on Sales of "Clean" Fund Shares

January 30, 2017

On January 11, 2017, the SEC staff issued a no-action letter to Capital Research and Management Company in which the staff confirmed that the restrictions of Section 22(d) of the 1940 Act do not apply to a broker-dealer when, as agent on behalf of its customers, the broker-dealer charges its customers commissions for effecting transactions in "Clean Shares" of a fund. Clean Shares are a class of shares of a fund that are offered without any front-end loads, deferred sales charge or other asset-based fees for sales or distribution. The offering of Clean Shares is one strategy that fund families have been exploring to simplify intermediaries' compliance with the Department of Labor's "conflict of interest" or "fiduciary" rule.

Upcoming Deadline for Form SHC - Holdings of Foreign Securities

January 19, 2017

Recently, the Department of the Treasury released the final instructions for the reporting requirements of the Treasury International Capital Benchmark Form SHC for the 2016 calendar year. Form SHC is filed every five years with the Federal Reserve Bank of New York. Data as of December 31, 2016 must be submitted no later than March 3, 2017.

CFTC Adopts Amended Position Limit Aggregation Rules – Action by Asset Managers May Be Required

January 13, 2017

The U.S. Commodity Futures Trading Commission (the "CFTC") has issued amended aggregation rules for determining compliance with speculative position limits established by the CFTC in futures contracts and options thereon. The amended rules largely continue the CFTC's existing aggregation policy, which generally requires that a person aggregate all positions in accounts or funds for which a person directly or indirectly either controls trading or holds a 10% or greater ownership interest, as well as the positions of any other person with whom the person trades pursuant to an express or implied agreement. The amended rules retain modified versions of existing exemptions from aggregation, create several additional exemptions, newly require aggregation for substantially identical trading strategies, and impose a filing requirement to rely on certain exemptions. These rules apply to all market participants, regardless of their registration status. Accordingly, asset managers, including managers of private funds, registered investment companies, hedge funds and multi-manager complexes, should assess their compliance with the amended rules. *Asset managers that intend to rely on an exemption from the federal aggregation requirements may need to file a notice with the CFTC by February 14, 2017.*

SEC Issues Guidance on Fund Changes Intended to Simplify Compliance with the Department of Labor's "Conflict of Interest" Rule

December 28, 2016

On December 15, 2016, the SEC's Division of Investment Management issued a Guidance Update titled, Mutual Fund Fee Structures (the "Guidance," available here). The Guidance focuses on disclosure issues and procedural requirements arising from (i) funds offering intermediary-specific variations (including waivers) of their sales loads, and (ii) funds offering a new share class. Both of these strategies are being contemplated by fund families to simplify intermediaries' compliance with the Department of Labor's "conflict of interest" or "fiduciary" rule (described in Ropes & Gray's Alert available here). The Guidance also discusses certain administrative procedures that can be used to expedite the SEC staff's review of fund disclosure filings required by both strategies.

Volcker Rule: FRB Issues Policy Statement on Extensions for Non-Conforming Legacy Illiquid Funds; Applications Due by Jan. 20, 2017

December 20, 2016

On December 9, 2016, the Federal Reserve Board (the "Board") issued a Statement of Policy (the "Policy Statement") regarding extension of the conformance period for investments in legacy illiquid covered funds under the final regulations implementing the Volcker Rule. The Board had previously given banking entities until July 21, 2017 to conform covered fund investments with the requirements of the Volcker Rule. Applications for the five-year extension must be filed on or before January 20, 2017 (i.e., 180 days before the end of the current conformance period). If an extension request is granted, final, complete conformity with the Volcker Rule may be extended until July 21, 2022.

Supreme Court Confirms Broad Reach of Insider Trading Liability

December 6, 2016

The Supreme Court issued its decision in *Salman v. United States*, clarifying the personal benefit standard of insider trading under the federal securities laws. In resolving what it called a "narrow" issue, the Court reaffirmed the long-standing "guiding principle" of *Dirks v. SEC* that disclosing nonpublic material information to a "trading relative or friend," even without any showing of pecuniary or tangible gain to the tipper, can give rise to criminal insider trading liability. In such situations, the Court concluded, the "tip and trade resemble trading by the insider followed by a gift of the profits to the recipient." *Salman* thus underscores that market participants should continue to exercise vigilance when disseminating or receiving any material nonpublic information.

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 Chegwidden
New York, NY
+1 212 497 3636
bryan.chegwidden@ropesgray.com

Sarah Clinton
Boston, MA
+1 617 951 7375
sarah.clinton@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

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

Pamela Glazier
Boston, MA
+1 617 951 7420
pamela.glazier@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

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