June 5, 2017

Ropes & Gray's Investment Management Update: April 2017 – May 2017

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

SEC Settles Two Distribution-in-Guise Enforcement Cases

In 2013, the SEC launched an initiative to identify instances in which fund complexes were using fund assets improperly to pay for distribution-related services. As we described in a previous Alert, in September 2015, the SEC announced that it had agreed to settle a distribution-in-guise enforcement proceeding brought against an investment adviser and its affiliated distributor. The SEC announced no additional distribution-in-guise settlements until this May, when it announced two settlements.

On May 1, 2017, the SEC published a settlement order with the adviser and the principal underwriter of the William Blair funds (together, "William Blair"). According to the order, William Blair negligently used fund assets to pay for (i) distribution of fund shares outside of a written Rule 12b-1 plan and (ii) sub-transfer agent ("sub-TA") services in excess of board-approved limits. The settlement order stated that William Blair had agreements with financial intermediaries to provide distribution services but, for two years, misclassified the agreements as being for sub-TA services. The settlement order also stated that William Blair, on behalf of the Funds, had agreements with intermediaries to provide for sub-TA services, and that the funds' board set a cap on the amount of fees to be paid out of fund assets to intermediaries for sub-TA services. According to the settlement order, over several years, William Blair caused the funds to pay for sub-TA services at a rate greater than the board-approved cap.

Without admitting or denying the SEC's findings in the settlement order, William Blair agreed to pay a $4.5 million civil money penalty. The settlement order states that in agreeing to the terms of the settlement, the SEC considered that remedial acts were promptly undertaken by William Blair. In particular, in June 2013, when the inspection staff notified William Blair that it planned to examine William Blair's payments to intermediaries, William Blair initiated an independent internal review of its intermediary arrangements and discovered the payments discussed above. After identifying the payment errors, William Blair promptly notified the funds' board, reimbursed the funds with interest, and enhanced its oversight practices of payments to intermediaries.

Separately, on May 2, 2017, the SEC published a settlement order with the former adviser and the former distributor (together, the "Sponsor") of another group of mutual funds. According to the order, the Sponsor caused the funds to pay distribution payments to numerous intermediaries outside of a written Rule 12b-1 plan. The order also stated that, while the Sponsor's agreements with intermediaries called for the provision of distribution and marketing services, the Sponsor had, for a seven-year period, treated the agreements as being for sub-TA services, and improperly caused the funds to pay for those services outside of a Rule 12b-1 plan. During the same period, the Sponsor improperly caused the funds to pay intermediaries for sub-TA services in excess of a limitation in effect during the period. According to the SEC, both payment streams were in addition to payments to intermediaries pursuant to the funds' written Rule 12b-1 plans and, in reports provided to the funds' boards, the Sponsor inaccurately disclosed that the fees paid for distribution services were for sub-TA services.

Without admitting or denying the SEC's findings in the settlement order, the Sponsor agreed to disgorge approximately $21.6 million to a distribution fund in escrow, to pay a civil penalty of $1 million and to be censured. The Sponsor also agreed to undertake a detailed remediation process, including contacting intermediaries for

underlying account information, to make fund shareholders whole through payments from the distribution fund. The order notes that the SEC agreed to impose a reduced civil penalty in light of the Sponsor's self-reporting of the improper fee payments, significant cooperation, and prompt remediation of the violations.

Suit Alleges Mutual Fund's Prospectus Violated the Securities Act

In April, fund shareholders filed a putative class action suit in the U.S. District Court for the Eastern District of New York against the Catalyst Hedged Futures Strategy Fund (the "Fund"), its adviser and distributor and all members of its board of trustees. In their complaint, the plaintiffs asserted claims under Sections 11 and 12 of the Securities Act, claiming that the Fund's prospectus contained untrue statements of material facts and omitted material facts (collectively, "misstatements"). The plaintiffs also asserted control-person claims against the Fund's adviser and trustees.

The plaintiffs claimed that the Fund's prospectus represented that the Fund intended to provide "consistency of returns and to mitigate the extent of losses." In fact, plaintiffs claimed, the Fund made "massive directional bets against U.S. stock market indexes through complex derivative instruments, thereby exposing investors to the heightened risk of loss." The undisclosed risks materialized during a during a two-week period in February when the Fund's directional bets turned out to be incorrect, causing the Fund's NAV to drop by more than fifteen percent and resulting in losses to the plaintiffs.

In general, plaintiffs can prevail in lawsuits under Sections 11 and 12 without showing that: (i) they relied on the misstatements in a fund's prospectus or (ii) there was fault on the part of any defendant with respect to the misstatements. However, defendants have an affirmative defense to claims under Sections 11 and 12 that depends on a showing that, even if a prospectus contained misstatements, plaintiffs' losses were not caused by the misstatements. This is a "loss causation" defense, and it has been deployed successfully by mutual funds and related defendants in other lawsuits under Sections 11 and 12.

While some federal district courts have accepted this loss causation defense as dispositive in cases against a mutual fund and related defendants, others have rejected the defense.

No-Action Letter Eliminates Registration Fees for Closed-End Feeder Fund

On April 19, 2017, the SEC's Division of Investment Management published a no-action letter to a closed-end feeder fund (the "Fund"), relieving the Fund of the obligation to pay registration fees on shares sold to the public or tender offer registration fees on shares it repurchases from the public. All shares sold by the Fund or repurchased from the public by the Fund correspond to shares sold to or repurchased from the Fund by the master fund. The SEC staff based its no-action assurance on the Fund's representations that, because the master fund pays (i) registration fees on all of its shares sold, including shares sold to the Fund, and (ii) tender offer registration fees on all of its shares it offers to repurchase, including shares repurchased from the Fund, requiring the Fund to pay registration fees on shares sold to the public and tender offer registration fees on shares it offers to repurchase from the public would amount to "double counting" of registration fees and tender offer registration fees for shareholders of the Fund. The staff noted prior no-action letters to open-end funds under Section 24(f) of the 1940 Act providing similar relief, and that Section 24(f) does not apply to closed-end funds. Thus, prior to this no-action letter, closed-end funds that operate in a master-feeder structure were unable to take advantage of the existing open-end no-action relief.

Regulatory Priorities Corner

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

SEC Issues Risk Alert Following Global Ransomware Attack

Following a worldwide ransomware attack, on May 17, 2017, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert, *Cybersecurity: Ransomware Alert* (the "Alert"). The Alert urged broker-dealers and investment management firms to review the alert by the U.S. Department of Homeland Security's Computer Emergency Readiness Team (U.S. CERT Alert TA17-132A) and to determine whether applicable

software security patches had been installed. The Alert categorized three types of compliance cybersecurity deficiencies observed by OCIE in examinations of smaller broker-dealers, advisers and funds and recommended the following practices:

- Cyber-Risk Assessment – Periodic risk assessments of critical systems should be conducted to identify cybersecurity threats, vulnerabilities, and potential business consequences.
- Penetration Tests – Penetration tests and vulnerability scans should be conducted on systems believed to be critical.
- System Maintenance – Regular system maintenance, including updating critical and high-risk security patches, should be employed to address security vulnerabilities.

FINRA Publishes Social Media and Digital Communications Guidance

FINRA recently released Regulatory Notice 17-18 (the "Notice") to provide additional guidance to broker-dealers regarding the application of FINRA rules to social media and digital communications. In the Notice, FINRA reminds member firms of its past guidance provided in Regulatory Notice 10-06 (January 2010) and Regulatory Notice 11-39 (August 2011). FINRA adopted amendments to Rule 2210, effective February 2013, to codify guidance provided in the two prior notices regarding the supervision of interactive social media posts by member firms. The additional guidance provided in the Notice is in the form of twelve questions and answers ("Q&As"). Among other topics, the Q&As cover (i) record-keeping requirements applicable to registered representatives text messaging with investors, (ii) member firms' use of hyperlinks and sharing of hyperlinks with investors, and (iii) member firms' online advertisements.

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:

New Criminal and SEC Charges Signal Aggressive Enforcement of Insider Trading Liability for Disclosure of Political Intelligence
May 26, 2017
On May 24, 2017, the U.S. Attorney's Office for the Southern District of New York ("SDNY") and the SEC announced insider trading charges relating to a scheme in which a federal government employee is alleged to have provided confidential information involving Medicare and Medicaid reimbursement rate decisions to a political intelligence consultant, who in turn relayed the information to a hedge fund that allegedly reaped $3.9 million in gains from trades made on the basis of the illicit information. The case, *U.S. v. David Blaszczak, et al.* (SDNY), is significant as it signals a return to a broader view of the personal benefit requirement in insider trading cases in the wake of the Supreme Court's decision in *U.S. v. Salman*, which rejected the more limited view announced in *U.S. v. Newman*. Moreover, the case potentially suggests an even more aggressive enforcement posture in the area of political intelligence, as prosecutors and regulators begin to take full advantage of the authority granted to them under the STOCK Act.

Department of Labor Provides Guidance on Fiduciary Rule Transition Period
May 23, 2017
On May 22, 2017, the U.S. Department of Labor (the "DOL") released a new set of FAQs confirming that the compliance date for the fiduciary rule will remain June 9, 2017 (with compliance required as of 11:59 PM on that date) and providing guidance on the transition period from June 9, 2017 until January 1, 2018 (the January 1 date for full compliance may change). The FAQs confirm certain guidance that was previously included in the DOL's Notice delaying the applicability date of the rule from April 10 to June 9, and provide answers to some common compliance

questions. The FAQs also make it clear that the DOL's review of the rule is ongoing, and that the DOL intends to request additional comments from the public on certain aspects of the rule in the near future.

CFTC Permits Registered CTAs to Use Third-Party Recordkeepers; Action May Be Required
May 4, 2017
On April 20, 2017, the Commodity Futures Trading Commission's ("CFTC") Division of Swap Dealer and Intermediary Oversight (the "Division") issued Exemptive Letter No. 17-24 ("Letter 17-24"), which provides exemptive relief to registered commodity trading advisors ("CTAs") from the requirement of CFTC Rules 4.33 and 4.7(c)(2) that required books and records be kept at the CTA's main business office (the "Relief"). Additional action must be taken before a CTA is permitted to rely on the Relief.

Federal Court Upholds Attorney-Client Privilege for Mutual Fund Independent Trustees
May 2, 2017
In a decision affirming the importance of the attorney-client privilege in the mutual fund board setting, an Illinois federal court ruled on April 25, 2017 that fund shareholders were not entitled to access privileged communications between independent trustees and their counsel. The plaintiffs in *Chill v. Calamos Advisors LLC*, an "excessive fee" litigation under Section 36(b) of the 1940 Act, moved for an order compelling the independent trustees of the Calamos family of funds to produce in discovery documents protected by the attorney-client privilege. The court rejected the plaintiffs' argument that the "fiduciary exception" applied to overcome the privilege, ruling that shareholders must establish they have "good cause" for piercing the privilege and had failed to do so. In upholding the privilege, the court declined to follow last year's decision of another federal court that had granted a plaintiff's similar request under the fiduciary exception.

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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