Investment Management Regulatory Update

April 29, 2014

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SEC Rules and Regulations

SEC Grants No-Action Relief to Permit Fund to Implement Sub-advisory Arrangement Prior to Shareholder Approval

On March 6, 2014, the Staff of the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued a no-action letter to RS Global Natural Resources Fund (the "**Fund**"), an open-end investment company registered under the 1940 Act, SailingStone Capital Partners LLC ("**SailingStone**") and RS Investment Management Co. LLC (the "**Adviser**"). In the letter, the Staff stated that it would not recommend enforcement action under Section 15(a) of the Investment Company Act against the parties to the letter in the event that the Adviser entered into an interim sub-advisory agreement with SailingStone that had not been approved by vote of a majority of the outstanding voting securities of the Fund.

Section 15(a) of the Investment Company Act generally prohibits a person from serving as an investment adviser to a registered investment company except pursuant to a written contract that has been approved by the vote of a majority of the outstanding voting securities of the registered investment company. Rule 15a-4 under the Investment Company Act generally provides a temporary exemption from this shareholder approval requirement, and applies where the previous advisory contract was terminated (i) by either the board of directors or fund shareholders; (ii) by a failure to renew the previous advisory contract; or (iii) by an assignment of the previous advisory contract, as defined in Section 2(a)(4) of the Investment Company Act. In these cases, subject to various requirements, the exemption allows a person to act as an investment adviser to a registered investment company under an interim advisory agreement that has been approved by the company's board, but not by the company's shareholders, for a period of 150 days following the date on which the previous contract terminated.

According to the no-action letter, the Global Natural Resources Team (the "**GNR Team**") currently manages the Fund as part of the Adviser, but certain members of the GNR Team have entered into a separation agreement with the Adviser and have formed a new entity: SailingStone, an SEC-registered investment adviser. According to the no-action letter, the Adviser (also an SEC-registered investment adviser) serves the Fund pursuant to an investment advisory agreement that is compliant with Section 15 of the Investment Company Act and allows the Adviser to retain one or more sub-advisers at its own cost to provide advisory services for the Fund. Furthermore, according to the no-action letter, the Adviser wishes to enter into an interim sub-advisory agreement with SailingStone without a shareholder vote for a 150-day period following the effective date of the separation agreement to minimize the disruption of the Fund's operations while the Fund's board is in the process of considering approval of the sub-advisory agreement.

According to the no-action letter, the Division would not recommend enforcement action against the parties to the letter in the event that, even though the Adviser's contract with the Fund had not been terminated as required by Rule 15a-4, the Adviser entered into an interim sub-advisory agreement with SailingStone that had not been approved by Fund shareholders based on the facts described above and the parties' additional representations that: (i) the interim sub-advisory agreement would comply with the provisions of Rule 15a-4(b)(2), (ii) SailingStone would be compensated and supervised by the Adviser and that the fees paid by the Fund to the Adviser will remain unchanged and (iii) a shareholder meeting to approve the new sub-advisory agreement would be held during the 150-day interim period.

- See a copy of the no-action letter

Industry Update

IM Director Discusses Recent Developments and Rulemaking Initiatives

Norm Champ, the Director of the SEC's Division of Investment Management (the "**Division**"), discussed recent developments and rulemaking initiatives at the 2014 Mutual Funds and Investment Management Conference. Champ emphasized the importance of mutual funds to American investors, noting that mutual funds hold close to $15 trillion of savings of over 46 million American households, and discussed the Division's role in improving the regulatory framework in order to protect investors, ensure fair and orderly markets and promote capital formation.

Champ also discussed the Division's recent rulemaking initiatives. According to Champ, the Division takes a four factor approach: (1) a review of the risks the proposed rulemaking seeks to mitigate, (2) consideration of the urgency associated with the initiative, (3) an analysis of the initiative's potential impact on investors, registrants, capital formation, efficient markets and efficiency of the Division and (4) a review of the resources available for the initiative. Champ indicated that the Staff was in the process of analyzing reforms related to money-market mutual funds and disclosure by investment companies, variable annuity disclosure, target date retirement funds and the implementation of the Volcker Rule.

In particular, Champ noted that the Division would be monitoring the migration of individual investors from brokerage to advisory accounts. He noted that the Office of Compliance Inspections and Examination ("**OCIE**") had identified this issue in their national examination priorities for 2014, and that they would be examining the risk from migrations of accounts for the purpose of generating fees with little benefit to clients. Champ stated that dual registrants should consider whether such a move is in the best interests of their clients before recommending clients move from a brokerage to an advisory account. Champ also specifically identified certain challenges to funds and advisers related to cyber security risks. He stated that the Staff expects that compliance policies and procedures of investment advisers and funds focus on SEC rules, such as Regulation S-P and S-ID, which address data protection and identity thefts.

- See a copy of Champ's speech

IM Guidance Update on Testimonial Rule and Social Media

On March 28, 2014, the Division of Investment Management of the SEC issued an IM Guidance Update on the testimonial rule and social media. The guidance, in the form of questions and answers, seeks to clarify the application of the testimonial rule as it relates to third-party commentary and focuses on how registered investment advisers should apply Section 206(4) of the Investment Advisers Act and Rule 206(4)-1(a)(1) thereunder to their use of social media. For a discussion of the previously issued adviser alert from the SEC's Office of Compliance Inspections and Examinations entitled "**Investment Adviser Use of Social Media,**" please see the **February 21, 2012 Investment Management Regulatory Update**.

According to the IM Guidance Update, Section 206(4) of the Advisers Act generally prohibits an investment adviser from engaging in any act, practice or course of business that the SEC defines as fraudulent, deceptive or manipulative. Rule 206(4)-1(a)(1) under the Advisers Act states that it shall constitute a fraudulent, deceptive or manipulative act, practice or course of business for any registered investment adviser "to publish, circulate or distribute any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser." According to the IM Guidance Update, the Staff has stated that this rule forbids the use of a "testimonial"—interpreted by the Staff to include a "statement of a client's experience with, or endorsement of, an investment adviser"—by an investment adviser in advertisements.

The IM Guidance Update provided further guidance on the application of a number of social media-related topics to the testimonial rule, including:

Third-Party Commentary. The guidance explained that a situation in which an investment adviser or an investment advisory representative ("**IAR"**) publishes public commentary that is an explicit or implicit statement of a client's experience with, or endorsement of, the investment adviser or IAR on the investment adviser's or IAR's social media site would be a testimonial within the meaning of Rule 206(4)-1(a)(1), and therefore prohibited. However, if an investment adviser or IAR publishes the same public commentary from an independent social media site on its own internet or social media site, the guidance states that such publication would not implicate any of the concerns underlying Rule 206(4)-1(a)(1) if (i) the independent social media site provides content that is independent of the investment adviser or IAR, (ii) there is no material connection between the independent social media site and the investment adviser or IAR that would call into question the independence of the independent social media site or commentary and (iii) the investment adviser or IAR publishes all of the unedited comments appearing on the independent social media site regarding investment adviser or IAR.

With respect to this first condition, the IM Guidance Update clarifies that content is not "independent of an investment adviser or IAR" if the investment adviser or IAR directly or indirectly authored the commentary on the independent social media site regardless of whether it is done in their own name or that of a third party or an alias or screen name. With respect to the second condition, the Responses further clarify that a "material connection" between the investment adviser or IAR and the site or commentary that would call into question the independence of a site or commentary may exist if the investment adviser or IAR (i) compensated a social media user for creating the commentary (including through the provision of free services or offer of discounts) or (ii) prioritized, removed or edited the commentary in any way.

With respect to the third condition for the publication of commentary from an independent social media site—that the investment adviser or IAR publish all of the unedited comments appearing on such independent social media site—the Staff states that the investment adviser or IAR may publish only a totality of testimonials from an independent social media site and may not "highlight or give prominence to" a subset of testimonials that may be more favorable to the investment adviser or IAR. According to the IM Guidance Update, social media users themselves remain free to personally display the commentary or sort by any criteria, and the investment adviser and IAR sites may facilitate a user's viewing by providing a sorting mechanism. Furthermore, according to the IM Guidance Update, an investment adviser or IAR may publish testimonials from an independent social media site that include a mathematical average of the commentary only if commenters rate the investment adviser or IAR themselves based on a rating system that is not designed to elicit any pre-determined results that could favor any investment adviser or IAR.

Inclusion of Investment Adviser Advertisements on Independent Social Media Site. The IM Guidance Update clarified that the existence of an investment adviser's or IAR's advertisement on an independent site that also contains public commentary generally does not run afoul of the testimonial rule. According to the IM Guidance Update, an advertisement would not cause the investment adviser's or IAR's publication of an independent social media site's commentary to violate Rule 206(4)-1 where (i) it would be clear to a reader that the investment adviser's or IAR's advertisement is distinguishable from the public commentary featured on the independent social media site and (ii) the receipt or non-receipt of advertising revenue did not impact which public commentary is included or excluded from the independent social media site.

Reference to Independent Social Media Site Commentary in Non-Social Media Advertisements. The IM Guidance Update explained that an investment adviser or IAR may reference the fact that public commentary regarding the investment adviser or IAR may be found on an independent social media site and may include the logo of the independent social media site on its non-social media advertisements.

Client Lists. The IM Guidance Update clarified that it would not be in violation of the testimonial rules to include a list or photographs of "contacts" or "friends" on an investment adviser or IAR's social media site that can be viewed by the general public so long as the contacts or friends are not grouped in such a way as to be identified as current or past clients. The guidance warned, however, that if an adviser or IAR attempts to create the impression that the listed contacts or friends experienced favorable results from the adviser's or IAR's services, the advertisement could be in violation of Section 206(4) and Rule 206(4)-1.

Fan/Community Pages. The IM Guidance Update explained that a third party's creation and operation of unconnected community or fan pages would generally not violate Rule 206(4)-1. According to the IM Guidance Update, however, the Staff would "strongly caution" investment advisers and supervised persons when publishing content from or driving user traffic to such third-party sites, particularly if the site does not meet the material connection and independence conditions described above.

- See a copy of the IM Guidance Update

Litigation

Supreme Court Extends Whistleblower Protection to Mutual Fund Service Providers

On March 4, 2014, in *Lawson et al. v. FMR LLC*, No. 12-3, the U.S. Supreme Court held that whistleblower protections of Section 806 of the Sarbanes-Oxley Act ("**SOX**") apply not only to employees of publicly traded companies, but also to subcontractors employed by privately owned companies that perform services on behalf of publicly traded companies. The Supreme Court's ruling reversed a holding by the U.S. Court of Appeals for the First Circuit that the protections of Section 806 of SOX apply only to employees of publicly traded companies. The plaintiffs who originally brought the suit were two former employees of FMR LLC, the parent company of Fidelity Investments ("**Fidelity**"), who claimed that they were fired for reporting fraud related to the mutual funds that Fidelity manages.

Section 806 of SOX provides that: "No [public company] . . . or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee . . . to provide information . . . regarding any conduct which the employee reasonably believes constitutes [mail fraud, fraud by wire, bank fraud, or securities fraud], [a violation of] any rule or regulation of the Securities and Exchange Commission, or [a violation of] any provision of Federal law relating to fraud against shareholders, when the information . . . is provided to . . . a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct . . . . ." The Supreme Court was considering the issue of whether the "employee" protected from discrimination in Section 806 includes those employed by contractors, subcontractors or agents of the public company, or whether the class of protected employees is limited to those persons employed by the public company itself.

In response to the plaintiffs' claims that they were retaliated against after speaking up about improper company practices, Fidelity argued that their claims were not allowed under SOX, since the plaintiffs were not employed by the mutual funds. The majority opinion struck down Fidelity's argument. "Mutual funds themselves are public companies that have no employees," Supreme Court Justice Ruther Bader Ginsburg wrote, speaking for the court majority. "Hence, if the whistle is to be blown on fraud detrimental to mutual fund investors, the whistle-blowing employee must be on another company's payroll, most likely the payroll of the mutual fund's investment adviser or manager."

The case has been remanded to the First Circuit for further proceedings.

- See a copy of the Opinion

Notes from Europe: European Regulatory Developments

New Pan-European Market Abuse Legislation

On April 14, 2014, the Council of the European Union announced its formal adoption of the Market Abuse Regulation ("**MAR**") and the related Criminal Sanctions for Market Abuse Directive ("**CSMAD**"), which together will replace the current Market Abuse Directive ("**MAD**") adopted in 2003. In common with other key European financial services legislation in recent years, the new legislation takes the form of a regulation to avoid potentially diverging national requirements as a result of the transposition of a directive.

The general scope of the current market abuse regime under MAD will be significantly extended under MAR. In particular, it is worth noting that:

- the scope of the market abuse framework has been extended to apply to financial instruments traded on a multilateral trading facility ("**MTF**") or organized trading facility ("**OTF**") in addition to regulated markets (please refer to the article below entitled "European Parliament Passes the Second Markets in Financial Instruments Directive" for further information on MTFs and OTFs);
- the definition of inside information has been expanded in several respects, including by providing that information relating to an intermediate step in a protracted process may constitute inside information;
- the offense of market abuse has been expanded to both the commodity and related derivative markets;
- a pan-European safe harbor to the offense of market abuse has been introduced in relation to disclosures made in the course of "market soundings" (this effectively codifies on a pan-European basis the UK's long established practice of "wall crossing" whereby a company can legitimately provide inside information to third parties); and

- the offense of market manipulation has been expanded to include abusive strategies enacted through high frequency trading and the manipulation of benchmarks.

CSMAD will complement MAR by requiring Member States to impose criminal sanctions for market abuse offenses. Market abuse is already subject to criminal sanctions in the UK and, based on the UK opt-in arrangement in respect of the area of freedom, security and justice, the UK government has previously announced its decision not to opt in to CSMAD at the present time.

It is expected that MAR and CSMAD will be published in the Official Journal of the EU in June 2014, after which there will be a 24-month period for the adoption of implementing measures by the European Commission concerning MAR and for Member States to implement CSMAD into national law. In practice therefore, MAR/CSMAD should be in force throughout the EU by summer 2016.

- See a copy of MAR
- See a copy of CSMAD
- See a copy of MAD

UCITS V Approved by European Parliament

On April 15, 2014 the European Parliament approved the fifth directive on Undertakings for collective investments in transferable securities ("**UCITS V**"). According to the European Commission, UCITS funds currently manage around 85% of the European investment fund sector's assets. UCITS V introduces a number of key changes to the UCITS regime that seek to clarify who is liable for mismanagement of funds and tailor fund managers' remuneration rules to encourage them to take reasonable risks and a long-run view. For a discussion of the political agreement reached on UCITS V, please see the **March 24, 2014 Davis Polk Investment Management Regulatory Update**. Once the new rules have been officially endorsed by the European Council, EU Member States will have 18 months to put them into effect.

- See a copy of the April 9, 2014 proposed UCITS V text

European Parliament Passes the Second Markets in Financial Instruments Directive

On April 15, 2014 the European Parliament adopted updated rules for markets in financial instruments ("**MiFID**"). The new legislation represents a significant overhaul of the pan-European system of financial regulation. Continuing the recent legislative trend in the EU, the MiFID overhaul takes the form of a directive ("**MiFID II**") and a regulation ("**MiFIR**"). The new legislation introduces eight key reforms.

Market structure framework. Firms will be required to trade on organized venues including regulated markets, such as the London Stock Exchange, multilateral trading facilities ("**MTFs**") controlled by approved market operators or larger investment firms or organized trading facilities ("**OTFs**"). OTFs are a new category of multilateral trading venue introduced by MiFID II for non-equity instruments to trade on organized multilateral trading platforms. Derivatives which are eligible for clearing under the European Markets Infrastructure Regulation (Regulation (EU) No. 648/2012) and are sufficiently liquid will have to be traded on one of these three platforms.

Market transparency. The new legislation increases equity market transparency and establishes a principle of transparency for non-equity instruments such as bonds and derivatives. Trading venues will be required to make pre- and post-trade data available on a reasonable commercial basis.

Strengthened supervisory powers. Both the European Securities Markets Authority ("**ESMA**") and EU Member States' regulators will have enhanced supervisory powers including product intervention powers (as further noted below). A harmonized position-limits regime has been introduced for commodity derivatives to improve transparency, support orderly pricing and prevent market abuse. Under this system, competent authorities will be able to impose limits on positions in accordance with a methodology for calculation set by ESMA.

Trading and clearing of financial instruments. A harmonized EU regime has been established for non-discriminatory access to trading venues and central counterparties.

Controls for algorithmic trading activities. Safeguards have been introduced in relation to algorithmic trading activities, including the requirement that all algorithmic traders be properly regulated and provide liquidity when pursuing a market-making strategy. In addition, investment firms which provide direct electronic access to a trading venue will be required to have systems in place and risk controls to prevent trading that may contribute to a disorderly market or involve market abuse.

Stronger investor protection. Investor protection has been strengthened through the introduction of better organizational requirements, such as client asset protection or product governance. The new regime also provides for strengthened conduct rules such as an extended scope for the appropriateness tests and reinforced information to clients. Independent advice is clearly distinguished from non-independent advice and limitations are imposed on the receipt of commissions (inducements) (this has already been adopted in the UK through the Retail Distribution Review). ESMA has been granted powers to prohibit or restrict the marketing and distribution of certain financial instruments in well defined circumstances and similar powers have been granted to the European Banking Authority in relation to structured deposits.

Access to EU markets for firms from third countries. A new harmonized regime for granting access to EU markets based on an equivalence assessment of third-country jurisdictions by the European Commission has been introduced. The regime applies only to the cross-border provision of investment services and activities provided to professional and eligible counterparties. For a transitional period of three years, and pending equivalence decisions by the European Commission, national third-country regimes will continue to apply.

Sanctions. Administrative and criminal sanctions have been strengthened.

MiFID II and MiFIR must be formally adopted by the European Council before becoming law. The publication of the new rules in the Official Journal of the European Union is expected in the second quarter of 2014 with entry into application 30 months later.

- See a provisional copy of MiFID II
- See a provisional copy of MiFIR

UK: AIFMD Reporting Obligations

On April 15, 2014, the UK Financial Conduct Authority ("**FCA**") updated its Alternative Investment Fund Managers Directive (Directive 2011/61/EU) ("**AIFMD**") webpage with a set of Frequently Asked Questions relating to the reporting obligation contained in Article 24 of the AIFMD. Under Article 24, managers of alternative investment funds ("**AIFMs**") are required to submit periodic reports to their competent authorities. This obligation is extended by Article 42(1)(a) of the AIFMD to non-EEA managers where they are marketing alternative investment funds ("**AIFs**") in Europe. Article 110 of the AIFMD Delegated Regulation (Regulation (EU) No 231/2013) sets out the frequency at which such reports should be made to the relevant competent authority and the content of such reports.

The FCA has noted that in the UK:

- reporting is based on when the firm becomes an authorized AIFM or from the date of notification when making a notification under the National Private Placement Regime ("**NPPR**") with the first reports due for the first full quarter following authorization or such notification; on that basis, an AIFM that is subject to quarterly reporting and is authorized or has notified the FCA of its intention to market a fund under the NPPR in, for example, July 2014, will be required to report at the end of Q4 2014;
- reports should be submitted electronically to the FCA on the template provided by ESMA;

- reports should be submitted in the base currency of the fund;
- non-EEA AIFMs will be required to submit reports to the FCA for all AIFs that they market in the UK; and
- where a non-EEA AIFM is marketing a feeder fund in the UK, it will need to submit a report at the feeder fund level only but it will be required to identify the master fund for each feeder fund it submits a report on.

- See a copy of the AIFMD
- See a copy of the AIFMD delegated regulation
- See the FCA frequently asked questions
- See a copy of the ESMA reporting template

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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