GODFREY & KAHN S.C.

Investment Management Focus

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Legal and Regulatory Update

Recent SEC Guidance

Proxy Voting Responsibilities of Investment Advisers

The SEC's Divisions of Investment Management and Corporation Finance recently issued a Staff Legal Bulletin to provide guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. While there has been ongoing debate and concerns expressed by SEC commissioners about advisers' overreliance on the recommendations of proxy advisory firms in corporate elections, many investment advisers and other institutional investors value the assistance of proxy advisory firms in decision-making.

The SEC's latest guidance details investment advisers' responsibilities when engaging proxy advisory firms. The Bulletin indicates that as a fiduciary, an investment adviser owes each of its clients a duty of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting. Rule 206(4)-6 under the Investment Advisers Act of 1940 (the "Advisers Act") provides that an adviser must adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interests of its clients.

The Bulletin was issued in question and answer format and includes the following guidance:

- An investment adviser should periodically sample proxy votes to ensure that proxy votes are cast in accordance with the client's best interests and the adviser's procedures, and review the adequacy of its proxy voting policies annually.
- An investment adviser and its client have flexibility in determining the scope of the adviser's obligation to exercise proxy voting authority. Clients may delegate proxy voting authority completely or enter into other proxy voting arrangements in which the adviser would not assume all of the proxy voting authority.
- In retaining a proxy advisory firm, an investment adviser should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues. The Bulletin sets out criteria for this inquiry, such as the adequacy and quality of the proxy firm's staffing and personnel.
- An investment adviser that has retained a proxy advisory firm should implement measures to provide sufficient ongoing oversight of the firm to ensure that the adviser continues to vote proxies in the best interests of its clients and to address proxy advisory firms' conflicts that can arise on an ongoing basis.
- If an investment adviser determines that a proxy advisory firm's recommendation was based on a material factual error, the adviser should take reasonable steps to investigate the error and seek to determine whether the proxy advisory firm is taking reasonable steps to reduce similar errors in the future.

Source: Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, SEC Staff Legal Bulletin No. 20 (June 30, 2014), available at: http://www.sec.gov/interps/legal/cfslb20.htm.

Series Investment Companies and Affiliated Transactions

The Division of Investment Management recently issued guidance regarding series investment companies, which are organized as corporations or trusts that offer multiple mutual funds or series. Series investment companies must ensure that their compliance policies and procedures are reasonably designed to prevent violations of the federal securities laws as they apply to each series, because each series is a separate investment company for purposes of the investor protections afforded by the Investment Company Act of 1940 (the "1940 Act"). In particular, the compliance policies should appropriately identify "affiliated persons" with respect to each series of the mutual fund for purposes of transactions that may be prohibited under the 1940 Act.

For example, Section 17(a) of the 1940 Act, which prohibits an "affiliated person" of a mutual fund or an affiliated person of an affiliated person from selling any security or other property to the mutual fund, applies to transactions with each series of the mutual fund. Accordingly, to prevent violations of Section 17(a), a mutual fund's compliance policies and procedures should provide for the identification of, among others, persons owning 5% or more of the outstanding voting securities of a series.

Source: Series Investment Companies: Affiliated Transactions, SEC IM Guidance Update (June 2014), available at http://www.sec.gov/investment/im-guidance-2014-06.pdf.

Mutual Fund Disclosures

The Division of Investment Management provided guidance related to the enhanced mutual fund disclosure amendments adopted in 2009. Those amendments to the registration form used by mutual funds, Form N-1A, were intended to streamline disclosures to make them easier for investors to use and created a new summary prospectus delivery option. The SEC estimates that over 80% of mutual funds offer investors summary prospectuses. Since the adoption of these amendments, the SEC staff has noted several areas that have generated frequent comments. Among other things, the staff offered the following guidance regarding the preparation of the summary section of Form N-1A to focus funds on providing investors clear and concise disclosure:

- The staff continues to see complex, duplicative and technical disclosure in the summary section. The summary section should be concise and no longer than three or four pages, but the staff frequently reviews filings with summary sections that are longer than ten pages for a single mutual fund.
- The principal investment strategies and risks in Item 4 of Form N-1A in the summary section should be a concise summary of the information given in response to Item 9. Information included in response to Items 2 through 8 need not be repeated elsewhere. Repetition of substantially the same or identical information in both Items 4 and 9 is not acceptable.
- The summary section must be provided in plain English and the entire prospectus should be presented in a clear, concise, and understandable manner. Funds should avoid using unnecessary defined terms, long, compound sentences, and dense paragraphs.
- The summary section must only include disclosure required or permitted by Items 2 through 8, and all other information should be moved out of the summary section. In particular, the staff assesses whether information in the footnotes to the fee table is permitted or required.
- Funds are allowed to include in their prospectus (but not the summary section) information related to strategies and risks that are not principal. However, funds that include this additional information must clearly distinguish between the strategies and risks that are principal and those that are not principal.
- Funds should avoid cross-references to the SAI or shareholder reports. Cross-references within the prospectus should be used in a way that assists investors in understanding the information presented. Cross-references should be avoided in the summary section because they can add complexity.

Source: Guidance Regarding Mutual Fund Enhanced Disclosure, SEC IM Guidance Update (June 2014), available at: http://www.sec.gov/investment/im-guidance-2014-08.pdf.

OCIE Cybersecurity Initiative

The SEC's Office of Compliance Inspections and Examinations ("OCIE") published a risk alert in April detailing its initiative to examine over 50 registered broker-dealers and investment advisers to assess cybersecurity preparedness.

The Risk Alert includes a copy of a sample document request list that OCIE may use in conducting examinations regarding cybersecurity matters. OCIE stated that the sample document request list is "intended to empower compliance professionals in the industry with questions and tools they can use to assess their firms' level of preparedness, regardless of whether they are included in OCIE's examinations." OCIE indicated that it may alter this document request list for a registrant as it considers the specific circumstances presented by the registrant's particular systems or information technology environment.

OCIE is seeking information relating to a variety of cybersecurity topics including:

- identification of risks and cybersecurity governance;
- protection of firm networks and information;
- risks associated with remote customer access and fund transfer requests;
- risks associated with vendors and other third parties;
- detection of unauthorized activity; and
- a registrant's specific experiences with cybersecurity threats.

OCIE may inquire as to how broker-dealers and investment advisers are responding to cybersecurity threats and whether such threats have been reported to regulatory agencies or law enforcement. OCIE's Risk Alert was published subsequent to the SEC's Cybersecurity Roundtable held in March to inform the SEC, the industry, other government agencies and the private sector of cybersecurity risks to businesses and strategies to address those risks.

It is important for boards of directors and audit or other risk committees of both mutual funds and corporations to understand and deal with cybersecurity as a business risk, particularly in light of recent high profile breaches and the Heartbleed security bug. As Deloitte's Mary Galligan stated, audit and other risk committees should "be aware of cybersecurity trends, regulatory developments and major threats to the company, as the risks associated with intrusions can be severe and pose systemic economic and business consequences that can significantly affect shareholders" and engage "in regular dialogue with technology-focused organizational leaders" regarding risks and the company's cybersecurity plan.

Sources: For Audit Committees, a Growing Role in Cybersecurity, The Wall Street Journal, Mary Galligan (July 1, 2014), available at: http://deloitte.wsj.com/cfo/2014/07/01/for-audit-committees-a-growing-role-in-cybersecurity/; Office of Compliance Inspections and Examinations Risk Alert: OCIE Cybersecurity Initiative (April 15, 2014), available at: http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf.

Accuracy of Marked Documents in Exemptive Applications Review

In order to increase the efficiency of review of applications for exemptive relief under the 1940 Act and the Advisers Act, the SEC staff requests that applicants (or their counsel) use marked versions of documents showing changes in the applications as compared to earlier precedential applications. However, marked versions should be carefully reviewed for accuracy. When submitting marked versions, applicants should send an email to the staff reviewer with the following confirmation:

> **I confirm that the marked version of the application attached to this email is a complete and accurate comparison of the application filed on Edgar on [DATE] (file no. 812-____) to the application of [NAME] filed on Edgar on [DATE] (file no. 812-____).**

Source: Exemptive Applications Review: Comparison Documents, SEC Information Update (May 2014), available at http://www.sec.gov/investment/im-info-2014-3.pdf.

Application of the Custody Rule to Special Purpose Vehicles and Escrow Accounts

The SEC issued guidance to clarify the application of the Advisers Act custody rule, Rule 206(4)-2, when advisers to pooled investment vehicles, particularly private equity funds, use special purpose vehicles when making investments ("Investment SPVs"), and escrow accounts when selling interests in portfolio companies.

Advisers to pooled investment vehicles occasionally use Investment SPVs to facilitate investments in certain securities by pooled investment vehicles. These Investment SPVs typically are controlled by the adviser or a related person. If the adviser treats the

Investment SPV as a separate client, the adviser will have custody of the Investment SPV's assets. Alternatively, the adviser can treat the Investment SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly.

Generally, if the adviser is relying on the audit provision and the Investment SPV is treated as a separate client, the custody rule requires the adviser to distribute the audited financial statements of the Investment SPV to the beneficial owners of the pooled investment vehicles that own the Investment SPV. On the other hand, if the adviser treats the Investment SPV's assets as assets of the pooled investment vehicles of which it has custody indirectly, such assets must be considered within the scope of the pooled investment vehicles' financial statement audit.

The SEC's guidance details multiple scenarios to illustrate the application of the custody rule to single purpose vehicles, multi-fund single purpose vehicles, multi-purpose vehicles and vehicles used in connection with investment funds, as well as the application of the custody rule to escrow accounts that are used for a limited period of time in connection with the sale of a portfolio company owned by one or more pooled investment vehicles.

Source: Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows, SEC IM Guidance Update (June 2014), available at http://www.sec.gov/investment/im-guidance-2014-07.pdf.

SEC Releases

Additional Public Comments on Target Date Retirement Fund Marketing Proposal

On April 3, 2014, the SEC reopened the period for public comment on rule amendments it proposed in 2010 regarding target date retirement fund names and marketing. The comment period closed on June 9, 2014. The amendments proposed in 2010 were intended to provide enhanced information to investors concerning target date funds and to reduce the potential for investors to be confused or misled, and included a requirement for certain marketing materials to include a table, chart, or graph depicting the fund's asset allocation over time, which is referred to as the "asset allocation glide path."

The public comment period was reopened as a result of recommendations made last year by the SEC's Investor Advisory Committee that the SEC develop a glide path illustration for target date funds that is based on a standardized measure of fund risk to either replace or supplement the proposed asset allocation glide path illustration, and adopt a standard methodology to be used in the risk-based glide path illustration. The Committee made this proposal based on its belief that asset allocation may not reveal significant differences in the risk levels of funds with similar asset allocation glide paths. The Committee recommended that the SEC focus on factors that are directly relevant to the primary concerns of those approaching retirement, such as volatility of returns or maximum exposure to loss.

The SEC requested comment on the recommendation that the SEC develop a glide path illustration for target date funds based on a standardized measure of risk as either a replacement for, or supplement to, the proposed asset allocation glide path. Among other things, the SEC also requested comment on (a) the degree to which managers of target date funds use measures of risk as part of their investment strategy, (b) whether there are quantitative measures of risk that would be useful to investors as the basis for a target date fund risk-based glide path illustration, and (c) the potential impact of disclosure of risk measures and risk-based glide paths on investors and portfolio management.

Source: Investment Company Advertising: Target Date Retirement Fund Names and Marketing, SEC Proposed Rule, Release Nos. 33-9570; 34-71861; IC-31004; File No. S7-12-10 (April 3, 2014), available at http://www.sec.gov/rules/proposed/2014/33-9570.pdf.

IRS Regulations

FATCA Update

On July 1, 2014, the first phase of the Foreign Account Tax Compliance Act ("FATCA") went into effect with the goal of reducing tax evasion by United States persons holding assets in offshore entities and accounts.

FATCA requires mutual funds and other U.S. payors to withhold 30% from certain types of payments to foreign entities, unless the foreign entity provides the U.S. payor with appropriate documentation that exempts the payment from withholding. This documentation requirement will often be satisfied by a Form W-8BEN-E given by the foreign entity to the U.S. payor. FATCA's 30% withholding applies regardless of any other statutory or treaty exemptions or reductions of withholding under non-FATCA tax provisions. This means that U.S. investment funds will need to carefully review the status of any non-U.S. entity investors, to determine what information or withholding is required from those investors.

Payments subject to potential FATCA withholding include U.S.-source interest, dividends, rents, royalties, gross proceeds from the sale of property that produces interest or dividends, investment advisory fees, custodial fees and bank or brokerage fees.

If a U.S. payor fails to withhold appropriately under FATCA, the payor will itself be liable to the IRS for the 30% FATCA withholding plus interest and penalties. Given that non-compliance with FATCA may generate significant tax liabilities, U.S. payors, including investment funds, should pre-determine whether any payments they make to foreign entities are within FATCA's purview.

Acknowledging the difficulty of complying with FATCA's complex set of requirements, the IRS announced in Notice 2014-33 that calendar years 2014 and 2015 would be treated as a transition period. Accordingly, for IRS enforcement purposes during the transition period, the IRS will take into account a payor's good faith efforts to comply with FATCA. In determining "good faith efforts," the IRS likely will consider whether a payor has modified its account opening practices and procedures to document a foreign entity's FATCA status and whether the payor has written practices and procedures in place with regard to FATCA. However, U.S. payors that made no efforts at FATCA compliance prior to July 1, 2014 will not be given any leeway with regard to IRS enforcement during the transition period.

Sources: Funds Given Breathing Space on Incoming IRS Rules, Ignites, Peter Ortiz (May 20, 2014); FATCA – Current Alerts and Other News, available at http://www.irs.gov/Businesses/Corporations/FATCA-Current-Alerts-and-Other-News.

SEC Enforcement Actions and Litigation

"Pay-To-Play" Rule Enforcement Action

Rule 206(4)-5 under the Advisers Act, the "pay-to-play" rule, prohibits investment advisers from receiving compensation for providing investment advisory services to a U.S. state or local government entity within two years of a contribution by the investment adviser or its covered associate to certain elected officials or candidates.

In the first case to be brought under the pay-to-play rule, the SEC charged a Philadelphia-area venture capital firm with continuing to receive advisory fees from two public pension funds following campaign contributions totaling $4,500 made by an associate of the firm to a Philadelphia mayoral candidate and the governor of Pennsylvania. The pension funds had invested in the venture capital fund more than a decade prior to the campaign contributions. The SEC indicated that both the mayor and governor could influence the hiring of investment advisers for the public pension fund. However, as noted in the SEC's order, the pay-to-play rule "does not require a showing of quid pro quo or actual intent to influence an elected official or candidate."

The venture fund manager agreed to settle the charges by paying disgorgement and interest of approximately $260,000.

The enforcement action confirms the SEC's intention to hold advisers strictly liable for pay-to-play violations. In light of this enforcement action, advisers are reminded to carefully comply with pay-to-play policies to avoid violations.

Sources: In the Matter of TL Ventures Inc.*, Administrative Proceeding File No. 3-15940 (June 20, 2014); SEC Charges Private Equity Firm With Pay-to-Play Violations Involving Political Campaign Contributions in Pennsylvania, SEC Press Release 2014-120 (June 20, 2014).*

Excessive Fee Suits Target Subadvised Funds

Recent excessive fee suits under the 1940 Act continue to focus on subadvised funds. BlackRock Advisors, LLC has been the target of four excessive fee suits in recent months. These suits assert breaches of fiduciary duties by investment advisers allegedly charging excessive advisory fees. In a shareholder derivative suit filed in March, plaintiffs allege that BlackRock Advisors, LLC delegates "almost all" of its investment management duties to its affiliated sub-adviser but retains a substantial portion of the fees that it charges, "despite doing little, if any, work." The plaintiffs also assert that the fee schedule does not reflect savings achieved through economies of scale for the fund and its shareholders.

In a suit filed in June against Davis Selected Advisers, L.P., the plaintiffs allege that the adviser provides the same or substantially the same investment advisory services to subadvised funds for lower fees, and that the fund's effective investment advisory fee rate of 50 basis points is as much as 96% higher than the effective fee rate the fund would pay at the rate charged to subadvised funds.

In a similar lawsuit against J.P. Morgan Investment Management, Inc. in May, the plaintiffs claim that the firm's advisory fees are excessive compared to substantially lower fees that the firm receives as a subadviser.

Other firms that have faced similar suits involving advisory and subadvisory fees in recent years include Axa, Harbor Capital Advisors, Hartford, Principal and Russell. These cases highlight the need for mutual fund boards of directors and investment advisers to review the reasonableness of the portion of the advisory fee retained by the adviser after payment of the subadvisory fee in light of the oversight and other services provided by the adviser.

Sources: Verified Shareholder Derivative Compliant, Foote v. Blackrock Advisors, LLC*, No. 14-1991 (D.N.J. Mar. 28, 2014), 2014 WL 1355056; Complaint,* Hebda v. Davis Selected Advisers, L.P.*, No. 14-4318 (S.D.N.Y. June. 16, 2014), 2014 WL 2709446; Complaint,* Goodman v. J.P. Morgan Investment Management, Inc. *No. 14-414 (S.D. Ohio May 5, 2014), 2014 WL 1909406; BlackRock Faces Fourth Fee Suit; J.P. Morgan Also Targeted, Ignites, Beagan Wilcox Volz (May 8, 2014); $20B Davis Fund Targeted in Latest Fee Suit, Ignites, Beagan Wilcox Volz (June 20, 2014).*

Hedge Fund Settles SEC Case over Whistleblower Retaliation

The SEC recently charged hedge fund advisory firm Paradigm Capital Management, Inc. for retaliation, alleging that the firm improperly demoted its head trader after he reported concerns about certain conflicted principal trades. The firm and its owner agreed to pay $2.2 million to settle the charges. The case is significant because it is the first case the SEC has filed under its new authority to bring anti-retaliation enforcement actions.

According to the SEC's order, the firm conducted principal transactions and failed to provide effective written disclosure that it was participating on both sides of the trade because the conflicts committee was itself conflicted. When the firm learned that its head trader had reported the alleged misconduct to the SEC, the firm allegedly took actions in retaliation, such as removing him as head trader and changing his job function to full-time compliance assistant.

Under the anti-retaliation rule, which was adopted in 2011 pursuant to the Dodd-Frank Act, the SEC is authorized to bring enforcement actions based on retaliation against whistleblowers who report potential securities law violations to the SEC.

Sources: SEC Charges Hedge Fund Adviser with Conducting Conflicted Transactions and Retaliating Against Whistleblower, SEC Press Release 2014-118 (June 16, 2014); In the Matter of Paradigm Capital Management, Inc. and Candace King Weir*, Administrative Proceeding File No. 3-15930 (June 16, 2014).*

Chief Compliance Officer Sanctioned for Supervisory Failures in Insider Trading Case

The SEC recently imposed sanctions on the president and chief compliance officer, Thomas E. Meade, of a Denver-based investment adviser for his failure to prevent, detect and stop insider trading by an employee of the firm. The employee, his father and a hedge fund manager were convicted of insider trading after pleading guilty in 2011. The SEC's cease-and-desist order indicates that Meade was found to have had a personal relationship with the employee's father who served on the board of a public company. The SEC alleged that Meade had actual knowledge of the risks of the employee misusing material, non-public information, yet he did not design the firm's policies and procedures in light of these unique risks. In addition, Meade allegedly failed to adequately collect and review records of employees' personal trading, did not maintain restricted or watch lists of stocks, and did not investigate the trading misconduct or document the Code of Ethics violations.

Meade was fined $100,000, ordered to cease and desist from further violations, and barred from serving in a compliance or supervisory capacity at a broker-dealer or investment adviser.

Source: In the Matter of Thomas E. Meade*, Administrative Proceeding File No. 3-15927 (June 11, 2014).*

State Law Developments

The Wisconsin Trigger for Abandoned Property Escheatment Is Returned Mail, Not "No Contact"

Under Wisconsin law, as a general rule property is deemed to be "abandoned" when the owner of the property does not make contact with the holder for a period of time. However, unlike other types of property, securities and other intangible interests in a business are not deemed to be abandoned if the holder has sent a statement or other written communication to the owner and the statement is not returned to the holder as "undeliverable." Recently in Wisconsin, mutual funds have been receiving incorrect information from abandoned property vendors urging them to contact shareholders to avoid escheatment. Since Wisconsin follows a "returned mail" standard for deeming securities and other intangible interests in a business to be abandoned, rather than a "no contact" standard, it is not necessary for funds to contact shareholders directly as long as written statements are being sent and are not being returned as undeliverable.

Sources: Wisconsin Department of Revenue Terms, available at http://www.revenue.wi.gov/faqs/ucp/terms.html; Memorandum: ICI Confirms that the Wisconsin Trigger for Abandoned Property Escheatment is Returned Mail, Not "No Contact," Investment Company Institute (June 18, 2014), available at http://www.ici.org/my_ici/memorandum/memo28194.