PAUL HASTINGS

REPORT OF COUNSEL ON RECENT LEGAL DEVELOPMENTS

Third Quarter 2014

1. **SEC Staff Reminds Firms to Keep Summary Prospectuses Short and Concise**

The Securities and Exchange Commission ("SEC") staff recently issued a guidance update (the "Guidance Update") reminding firms that summary prospectuses are meant to be short, clear, and contain a uniform set of information. The Guidance Update highlights certain rule and form requirements and is intended to focus funds on providing investors with a clear and concise set of the most important disclosures. Since Form N-1A was amended and the summary prospectus rules were introduced in 2009, the SEC staff has reviewed a significant (and growing) number of summary sections which it feels contain disclosures that are highly technical, duplicative, or complex. The Guidance Update reminds filers to only include required or permitted information in the summary prospectus, avoid cross references, and use plain English.

In addition, the SEC staff stated that many summary prospectus filings are unnecessarily long. Although there are no page limits imposed on summary prospectuses, the Guidance Update provides that 3 to 4 pages for a single fund should usually be the target. The Guidance Update notes that it is not uncommon for the SEC staff to review summary prospectuses that exceed 10 or even 20 pages in length. Ultimately, the SEC staff is concerned that the usefulness of the summary prospectus as a tool for investors has declined over time.

The Guidance Update is available on the SEC website at: http://www.sec.gov/investment/im-guidance-2014-08.pdf.

2. **Stakeholders Align on Efforts to Slow or Halt SIFI Designations**

The possibility that the Financial Stability Oversight Council ("FSOC"), a multi-agency body tasked with identifying risks to the nation's financial stability, could designate certain large asset managers as systemically important financial institutions ("SIFIs") is being met with vigorous and growing resistance from industry participants, politicians, and the SEC. According to these groups, asset managers designated as SIFIs would become subject to a regulatory scheme designed primarily for banks in the wake of the subprime crisis, which would disrupt the competitive landscape of the asset management industry and result in increased costs for investors. According to research by American Action Forum, depending on the exact regulatory regime imposed on designated managers, returns in funds managed by SIFIs could be reduced by as much as 25%. The Investment Company Institute has agreed that returns would be impacted and believes that the regulatory framework could limit investors' choices in the marketplace and impede a fund's ability to serve its investors.

Along with the possible effects on SIFI-designated firms and the industry as a whole, significant controversy surrounds a September 2013 report (the "Report") by FSOC's research arm, the Office of Financial Research ("OFR"). The Report concludes that the largest asset managers introduce vulnerabilities into the financial system and can pose systemic risk, which FSOC believes forms the basis for regulation of such entities as SIFIs. The SEC solicited public comment on the Report the same day that it was issued by OFR, and many commenters have expressed negative views of the Report's facts

and analyses, as well as FSOC's possible intentions. Some of the harshest critics have been the SEC commissioners themselves. SEC Chair Mary Jo White and Commissioners Aguilar, Gallagher and Piwowar have criticized the Report for demonstrating a weak understanding of the asset management industry and have suggested that FSOC is taking steps toward intruding on the SEC's regulatory sphere. Members of Congress have also voiced concerns about FSOC's approach and process for designating an asset manager as a SIFI.

In May, FSOC held a conference designed to discuss the Report and the asset management industry's role in the greater financial markets. In her opening remarks at the conference, Treasury Under Secretary Mary Miller said that FSOC is still in the fact-finding stages and had not yet concluded that tighter regulations are warranted. She emphasized that at the end of FSOC's review, it may choose to take no action at all.

3. **SEC Begins Sweep Examinations of Retail Alternative Funds**

The SEC has begun its sweep examinations of alternative mutual funds, looking closely at areas where alternative strategies make compliance with the Investment Company Act of 1940 (the "1940 Act") difficult or awkward. Marc Wyatt, co-head of the SEC's new private funds unit, confirmed that the initiative has started and will run into 2015. In his statement, Mr. Wyatt provided that the examinations' core areas of focus are valuation, liquidity, leverage, disclosure and governance. In separate remarks, director of the SEC's Division of Investment Management ("DIM") Norm Champ stated that the examinations will also look closely at how well fund boards are carrying out their oversight duties.

Mutual funds with alternative strategies have seen substantial growth in recent years. According to DIM director Susan Nash, such funds accounted for 2.3% of the mutual fund market as of December 2013, but received 32.4% of inflows into mutual funds in 2013. The SEC staff previously signaled that alternative mutual funds would be an examination priority for 2014 and has voiced particular concern about the lack of experience by many alternative managers with 1940 Act restrictions and the lack of experience of traditional mutual fund managers in the alternative space. Mr. Wyatt explained that as part of the examinations, the SEC will examine how firms calibrate their policies and procedures when they add a registered alternative product.

At a conference in Washington, D.C., Ms. Nash elaborated on some of the sweep's areas of emphasis. She suggested that an alternative mutual fund's nontraditional investments may cause a relatively high percentage of its portfolio to be "fair valued," and she recommended that a board overseeing an alternative fund be thorough in its consideration of the fund's policies and procedures for valuation, as well as how those policies and procedures are written. Ms. Nash also commented on disclosure issues faced by retail alternative funds, warning that the names and marketing of such funds should be consistent with their actual investment objectives and strategies.

4. **IRS Provides Transitional Relief for New FATCA Rules**

On May 2, 2014, the Internal Revenue Service ("IRS") provided some breathing room for mutual funds in their role as withholding agents for the agency. Rules imposed by the Foreign Account Tax Compliance Act ("FATCA") that require reporting to the IRS of U.S. taxpayers with foreign financial accounts and offshore assets went into effect on July 1, 2014. Failure to share the required information

with the IRS could subject funds to a 30% withholding tax on all income and proceeds from their investments in U.S. securities.

In its notice, the IRS stated that calendar years 2014 and 2015 will be treated as a transition period while funds work toward full compliance with FATCA rules and reporting requirements. During this transition period, funds (in their capacity as withholding agents) will not be subject to penalties for FATCA violations so long as they make a meaningful attempt to comply. The IRS hopes that this transition period will facilitate an orderly implementation of FATCA compliance policies and procedures, as well as allow the IRS to respond to comments regarding certain aspects of the regulation.

5. **Final Rules for Money Market Fund Reform Could be Imminent**

The SEC announced that it will hold an open meeting on July 23, 2014 to consider whether to adopt rules to reform the money market fund ("MMF") industry. Intended to mitigate a perceived vulnerability of MMFs to runs during times of financial instability, the proposed rules set forth two alternative frameworks for additional regulation of MMFs, which could be adopted separately or together. The first proposal would require institutional MMFs to operate with a floating net asset value ("NAV"), as opposed to the current stable $1 NAV. The second proposal would require all MMFs, other than governmental MMFs, to impose a liquidity fee on redemptions, or temporarily suspend all redemptions, when liquid assets fall below 15% of total assets.

The SEC announcement comes as the SEC has been under pressure from the Federal Reserve and other global regulators to finalize the MMF rules. In early July, Federal Reserve Chair Janet Yellen remarked that progress on the new rules has been frustratingly slow. In addition, the SEC commissioners are reportedly deadlocked over which of the approaches set forth in the proposed rules should be adopted, with at least one commissioner concerned that the gates-and-fees option could actually generate more risk by encouraging preemptive runs on MMF products during times of financial distress. This view was echoed by several Federal Reserve economists in their most recent research, but has been rebuffed in comments by other industry participants.

6. **Merrill Lynch Sanctioned by FINRA for Failure to Apply Sales Charge Waivers to Eligible Accounts**

The Financial Industry Regulatory Authority ("FINRA") announced in June 2014 that it has ordered Merrill Lynch to pay an $8 million fine and $24.4 million in restitution in connection with improperly applying sales charges to certain retirement accounts. These amounts are in addition to approximately $64.8 million that Merrill has already paid to reimburse affected clients.

Most mutual funds (including nearly all of the funds on Merrill's brokerage platform) offer to waive sales charges for employee retirement accounts sponsored by small businesses and charities. According to FINRA, Merrill improperly applied sales charges to over 40,000 of such accounts from 2006 through 2011, even though the accounts were eligible for waivers offered by the funds that were purchased. Merrill learned of the problem early on, in 2006, and chose to rely on the financial advisers responsible for each client to determine whether sales charges should be waived. FINRA asserted that this reliance had little effect in preventing future inappropriate sales charges because Merrill did not adequately retrain or supervise the financial advisers on which it relied. The settlement also noted that Merrill did not notify FINRA of the issue until approximately five years after the overpayments were initially discovered.

7. **SEC Settles with Adviser Accused of Misleading Fund Board Regarding Trading Capabilities**

In early July 2014, the SEC reached a settlement with an investment adviser, who allegedly made false claims regarding the adviser's currency trading practices. As part of the settlement, the individual agreed to a one year suspension and to pay a penalty of $50,000.

Acting on behalf of the adviser during the initial 15(c) process for a proposed new fund, the individual made a presentation to the board describing the adviser's planned use of algorithmic currency trading that would automatically take advantage of currency arbitrage opportunities. He also presented the board with a proposed prospectus for the fund that described the algorithmic trading strategy. According to the SEC, the adviser may have been in discussions with third-party providers of algorithmic trading platforms, but the adviser had no assurances that any such platform would be available for its use and had no license or agreement to secure such services. The fund launched without any algorithmic currency trading capabilities and this fact was not disclosed to the fund's board. Instead, according to the settlement, the adviser employed a human trader who based currency trades on technical analysis and intuition. The trader was terminated after a few months for poor performance and was replaced with a third party provider that used a computer algorithm to trade currencies.

Many industry professionals have followed the case given the focus by SEC examiners on materials related to the 15(c) process.

8. **Asset Managers Urge Caution Regarding SEC's Disclosure and Marketing Reform Proposals for Target-Date Funds**

The SEC's comment period related to its past efforts to improve disclosure practices by target-date funds closed on June 9, 2014. By and large, asset managers weighed in against the proposals, which were originally issued in 2010 and were subsequently dropped to prioritize other rulemaking responsibilities. The proposed rules would require target-date funds to provide certain information and disclosures regarding asset allocations over the life of the fund in their marketing materials. One of the requirements would be a glide-path illustration showing the anticipated asset allocation over time. In connection with reopening the comment period, the SEC's Investment Advisory Committee provided new recommendations, including the requirement of an additional glide-path illustration showing a quantitative measure of the anticipated risk of the fund's portfolio over time.

Industry groups and asset management firms who commented on the proposals warned that the proposals and new recommendations would confuse investors by requiring firms to provide too much information, some of which is unlikely to be understood by retail investors (e.g., quantitative risk measurements). They also took particular issue with the possibility of having to include two glide-path illustrations, suggesting that the additional illustration would be difficult to understand and less effective at communicating a fund's risks to investors than ordinary disclosures.

9. **Director Events and Programs**

The following events sponsored by the Investment Company Institute (**ICI**), the Mutual Fund Directors Forum (**MFDF**), and the ICI Independent Directors Council (**IDC**) may be of interest to fund directors:

2014 Events

September 28 - October 1	Tax and Accounting Conference – Phoenix, AZ (**ICI**)
October 7	Conference of Fund Leaders Roundtable – New York, NY (**MFDF**)
October 16	Capital Markets Conference – New York, NY (**ICI**)
November 3-5	Fund Directors Conference – Chicago, IL (**IDC**)
November 4	Closed-End Fund Conference – New York, NY (**ICI**)
December 10	Securities Law Developments Conference – Washington, D.C. (**ICI**)

2015 Events

January 20-22	Directors' Institute – Palm Beach, FL (**MFDF**)
March 15-18	Mutual Funds and Investment Management Conference – Palm Desert, CA (**ICI**)
May 6-8	General Membership Meeting – Washington, D.C. (**ICI**)
May 7	Fund Directors Workshop – Washington, D.C. (**IDC**)
October 26-28	Fund Directors Conference – Chicago, IL (**IDC**)

If you wish to register for any of these events, please contact the associations at the following information:

- Investment Company Institute (**ICI**): 202 326 5968 (Conference Dept.) or www.ici.org.
- Independent Directors Council (**IDC**): 202 326 8300 or www.idc.org.
- Mutual Fund Directors Forum (**MFDF**): 202 728 0500 or www.mfdf.org.

If you wish to participate in IDC Chapter events, you should contact the IDC at www.idc.org. Below are some of the already scheduled IDC Chapter events:

2014 Events

September 3	Chicago Chapter Meeting

If you wish to participate in MFDF Director Discussion Series events, you should contact the MFDF at www.mfdf.org. Below are some of the already scheduled MFDF Director Discussion Series events:

2014 Events

July 22	New York, NY
September 9	Minneapolis, MN
October 14	San Francisco, CA