Investment Management Regulatory Update

November 19, 2014

SEC Rules and Regulations

SEC Issues Preliminary Denial to Exemptive Relief Applications for Operation of Non-Transparent Active ETFs

On October 21, 2014, the U.S. Securities and Exchange Commission ("**SEC**") issued two notices (the "**Notices**") of applications for exemptive relief filed by two sets of applicants seeking relief from the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), to launch non-transparent actively managed exchange-traded funds ("**ETFs**"). In both Notices, the SEC stated that the proposed ETFs do not meet the standard for exemptive relief under Section 6(c) of the Investment Company Act and that it preliminarily intends to deny the applications. One such application was filed by Spruce ETF Trust, BlackRock Fund Advisors and BlackRock Investments, LLC (collectively, "**Spruce**") and the other was filed by Precidian ETFs Trust, Precidian Funds LLC and Foreside Fund Services, LLC (collectively, "**Precidian**," and, together with Spruce, the "**Applicants**").

ETFs are only permitted to operate subject to certain SEC orders that provide exemptive relief from certain provisions of the Investment Company Act and rules thereunder. In the Notices, the SEC explained that "open-end" investment companies are required, among other things, to redeem their shares on demand at a price approximating their proportionate share of the fund's net asset value ("**NAV**") at the time of redemption. As a type of open-end fund, ETFs are subject to these requirements; however, since ETFs are typically only made available to investors through secondary market transactions on exchanges, ETFs require exemptions from certain of the requirements applicable to open-end funds in order to operate. The SEC emphasized that in granting exemptions to other ETFs, it has required that the applicants show that the ETF shares would trade at a price that is "at or close to the NAV per share of the ETF." According to the SEC, having a mechanism for regulating the trading price is "essential" since large broker-dealers (in this capacity, "**Authorized Participants**") purchase and redeem shares from the ETF in share blocks (rather than an ETF investor redeeming its shares directly from the ETF). When Authorized Participants conduct a transaction with an ETF, they deposit a basket of

securities and other assets with the ETF and receive a block of shares of the ETF in return, and then sell the ETF shares in the secondary market. The SEC explained that this process helps to keep the market price of the ETF's shares at or close to the NAV per share of the ETF by providing arbitrage opportunities and thus provides the crucial mechanism that the SEC has typically required. An integral aspect of this mechanism, according to the SEC, is the daily portfolio transparency of the ETF, which empowers market makers and participants to value the ETF portfolio on an intraday basis and, consequently, evaluate whether an arbitrage opportunity exists.

In contrast, the ETFs proposed by the Applicants are actively managed ETFs that would not disclose their portfolio holdings on a daily basis and instead would provide only the standard portfolio and disclosure required for other mutual funds (generally, reporting of portfolio holdings on a quarterly basis within 60 days of the end of the relevant quarter). The Applicants noted that the intraday indicative value ("**IIV**") of the ETF would be disclosed every 15 seconds during the trading day but acknowledged that such IIV would be calculated by a third-party calculation agent using the last available market quotation or sales price of the portfolio holdings. Furthermore, the Applicants proposed a creation of a blind trust mechanism whereby creation unit purchases would be made in cash and redemptions effected in-kind through such blind trust established for each Authorized Participant. According to the Applicants, the blind trust would shield the contents of the underlying portfolio from the Authorized Participant while managing its securities. Applicants further proposed allowing investors to redeem shares, subject to a fee of up to 2% of the value of shares redeemed, directly from the ETFs in the event of a "significant deviation" of closing market price from the NAV of the ETF. Precidian also noted in its application that this redemption option would only be available to retail investors after the ETF's shares had been persistently trading at a discount of at least 5% from NAV for 10 consecutive business days.

According to the Notices, the SEC believes that the features proposed by the Applicants fail to provide an acceptable alternative to the arbitrage activity in ETF shares that, according to the SEC, is essential in order to keep the market price of ETF shares at or close to the NAV per share of the ETF. First, disclosure of the IIV does not provide enough information to serve as a primary pricing signal for market making (and thus lead to an effective arbitrage mechanism) since, according to the SEC, such IIV data is stale, not subject to meaningful standards and would be inaccurate for certain securities and asset classes. The SEC additionally asserted that the inaccuracies in the IIV data can increase during periods of market stress or volatility and further cause an increase in ETF tracking errors.

Second, according to the SEC, reporting of portfolio holdings on a quarterly basis would lose relevance shortly after being reported for purposes of valuing or hedging the ETFs given that the content of such portfolios may change on a daily basis. Third, the Applicants' proposed redemption option that, in their view, would act as a "fail-safe" mechanism in the event of a material deviation of closing market price from NAV does not, according to the SEC, provide a solution for the defects in their proposal. The SEC noted that retail investors would likely be discouraged from use of the redemption option due to the associated fees and potential additional brokerage commissions they would need to pay. With respect to Precidian's application, the SEC also noted that since such option would be available to investors only subsequent to ETF shares trading at a discount of at least 5% for 10 consecutive business days, investors would be treated differently than the ETF's Authorized Participants—who would be able to transact with the ETF on a daily basis at NAV—and investors could be harmed by being forced to remain invested in the ETF for two weeks before they are able to use this redemption option to exit.

In sum, the SEC's preliminary view is that Applicants have not provided an adequate substitute for portfolio transparency. According to the SEC, the high risk that market price and NAV of the ETF may materially differ, and therefore that Authorized Participants and retail investors may pay differing amounts for the same ETF shares, may "inflict substantial costs on investors, disrupt orderly trading and damage market confidence in the secondary trading of ETFs." Therefore, the SEC preliminarily believes that it is not in the public interest or consistent with the protection of investors to grant Applicants' requested relief from various Investment Company Act provisions and rules thereunder.

- See a copy of the application and SEC Notice for Spruce
- See a copy of the application and SEC Notice for Precidian

Industry Update

CFTC Announces Self-Executing Registration No-Action Relief for Certain Delegating CPOs

On October 15, 2014, the Division of Swap Dealer and Intermediary Oversight (the "**Division**") of the U.S. Commodity Futures Trading Commission (the "**CFTC**") issued CFTC Letter No.14-126 (the "**Letter**") providing self-executing no-action relief from the requirement to register as a commodity pool operator ("**CPO**") under Section 4m(l) of the Commodity Exchange Act (the "**CEA**") to persons who have delegated certain of their rights and obligations as a CPO of a commodity pool (a "**Delegating CPO**") to a registered CPO (the "**Designated CPO**") to serve as the CPO of such commodity pool. The Letter replaces CFTC Letter No. 14-69 ("**Letter 14-69**") issued by the Division on May 12, 2014, which provided similar relief from registration for certain delegating CPOs, but required such delegating CPOs to request no-action relief from the Division. Please see the **June 23, 2014** and **September 26, 2012** Investment Management Regulatory Updates for further discussion of Letter 14-69 and the guidance behind it. The Letter notes that the circumstances and conditions for no-action relief under the Letter are the same as those set forth in Letter 14-69, with the exception of certain clarifications to the criteria for no-action relief set forth in the Letter.

The conditions for no-action relief under the Letter are the same as those provided in Letter 14-69, except for some additional clarifications as noted in the first three points below. The criteria are:

1. The Delegating CPO has delegated all of its investment management authority to the Designated CPO pursuant to a legally binding document. The Letter clarifies that a Delegating CPO and Designated CPO may satisfy this condition where either party appoints one or more third parties to serve as investment manager(s) to the pool and each such third party is registered as a commodity trading advisor ("**CTA**") or is exempt from such registration.

2. The Delegating CPO does not participate in the solicitation of participants for the pool. The Letter clarifies that a Delegating CPO may still satisfy this condition despite participating in the solicitation of participants in a commodity pool if it does so in its capacity as a registered or exempt associated person of the Designated CPO.

3. The Delegating CPO does not manage any property of the pool. The Letter clarifies that satisfaction of this condition is not precluded where the Delegating CPO (a) is a principal or employee of the Designated CPO or of a commodity pool's CTA and (b) has management responsibilities over pool properties, so long as the Delegating CPO (i) exercises such management authority in its capacity as principal or employee of the Designated CPO or of the commodity pool's CTA and (ii) such management authority is subject to supervision as a principal or employee of the Designated CPO or of the commodity pool's CTA in accordance with CFTC regulation 166.3.

4. The Designated CPO is a registered CPO.

5. The Delegating CPO is not subject to any statutory disqualification under Sections 8(a)(2) and 8(a)(3) of the CEA.

6. There is a business purpose for the Designated CPO to be a separate entity from the Delegating CPO that is not for the purpose of avoiding registration by the Delegating CPO.

7. The Designated CPO maintains all relevant books and records of the Delegating CPO in compliance with Regulation 1.31.

8. If the Delegating CPO and the Designated CPO are both non-natural persons, then each party controls, is controlled by or is under the common control with the other party.

9. If either (a) the Delegating CPO is a non-natural person or (b) the Delegating CPO is a natural person but is affiliated with the Delegated CPO, then such Delegating CPO and Designated CPO

have executed a legally binding document whereby each agrees to be jointly and severally liable for any violation of the CEA or the CFTC's regulations by the other in connection with the operation of the pool.

10. If the Delegating CPO is a natural person and satisfies certain conditions, such as, generally, being a voting board member of the commodity pool with little or no relationship with the Designated CPO, such Delegating CPO must remain fully responsible as a board member in accordance with the laws under which the pool is established, but does not need to undertake to the jointly and severally liable with the Designated CPO for violations of the CEA or the CFTC's regulations by the Designated CPO in connection with the operation of the pool.

The Letter states that the Division will no longer consider requests for no-action relief pursuant to the streamlined approach described in Letter 14-69, including previously submitted but still pending requests. However, the Division noted that any person granted a no-action letter pursuant to Letter 14-69 may continue to rely upon it. The Division also indicated its intention to continue to evaluate requests for CPO registration no-action relief from persons whose situations fall outside the scope of the Letter.

- See a copy of the no-action letter
- See a copy of no-action letter no. 14-69

SEC Investor Advisory Committee Offers Recommendations for Accredited Investor Definition

On October 9, 2014, the Investor Advisory Committee (the "**IAC**"), which was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") to advise the SEC on various regulatory and policy issues, submitted recommendations to the SEC on the definition of "accredited investor" under Rules 506 and 501 of Regulation D under the Securities Act of 1933 (the "**Securities Act**") (respectively, "**Rule 506**" and "**Rule 501**").

The IAC made the following five recommendations:

1. The SEC should evaluate whether the current definition of "accredited investor" effectively identifies the class of individuals who do not need the protections afforded by the Securities Act, since the IAC expects that a "significant percentage" of individuals who meet such definition are not capable of looking out for their own interests. The IAC noted that the income and net worth tests were imprecise proxies for financial sophistication, and that such tests are being significantly eroded by the effects of inflation since when they were first established in 1982. The IAC also specifically expressed concern over the population of older investors who may use retirement assets to qualify for the accredited investor definition, noting that some of them may see their retirement security put at risk as a result of potential losses associated with private offerings. The IAC acknowledged that adjusting the thresholds for inflation could have a significant impact on the pool of capital available for private offerings, and urged the SEC to adopt the IAC's earlier recommendations regarding Regulation D information collection in order to have the necessary information to estimate the impact of any change in the thresholds. The IAC also recommended that the SEC consider changing the types of assets counted under the net worth test, stating that certain assets, such as retirement accounts and illiquid assets, should not be included in the calculation.

2. The SEC should revise the definition of accredited investors to enable individuals to qualify based on their financial sophistication. The IAC discussed three methods of measuring an individual's financial sophistication: professional credentials, investment experience and a test of relevant financial knowledge. The IAC noted that the series 7 securities license and the Chartered Financial Analyst designation were two commonly noted measures for qualification of financial sophistication, but also acknowledges that there may be other qualifying credentials that test knowledge relevant to the evaluation of securities offerings. The IAC also noted that the SEC

could draw on the definition of a knowledgeable employee to determine which categories of financial industry employees should be deemed to meet the standard of financial sophistication.

3. The SEC should consider alternative approaches to setting investment thresholds to protect investors without minimizing the pool of accredited investors. Specifically, the IAC recommended that the SEC consider limiting investments in private offerings to a percentage of an investor's total assets or income in order to better protect the investor from the risks of investment. The IAC believes this approach would significantly minimize the risk of unsophisticated investors suffering "unaffordable losses."

4. The SEC should encourage the development of alternative means for verifying accredited investor status that shift the burden away from the issuer. The IAC noted the current challenges that issuers face in verifying accredited investor status for potential investors, and further acknowledged that the difficulty of such verification would increase if the SEC were to add complexity to the verification tests. The IAC expressed its view that those concerns could be addressed through an independent third-party verification service that was subject to the appropriate standards with regard to accuracy, privacy, information security, and regulatory oversight and professional accountability. The IAC noted that brokers, investment advisers, accounts and attorneys "would all appear to be well situated to provide such services."

5. The SEC should strengthen the protections afforded to non-accredited investors when they rely on advice from a purchaser representative by prohibiting the purchaser representative from receiving direct or indirect compensation from the issuer or from having any personal financial stake in the recommended investment. The IAC further recommends that any purchaser representatives who are compensated by the purchaser should be required to accept a fiduciary duty to act in the best interests of the purchaser.

- See a copy of the IAC's recommendations

IM Director Discusses Risk Monitoring Efforts and Alternative Mutual Funds

On October 29, 2014, Norm Champ, the Director of the SEC's Division of Investment Management (the "**Division**"), discussed recent risk monitoring efforts and the challenges of appropriate risk disclosure for alternative mutual funds at the SIFMA Complex Products Forum in New York. Champ noted that the Division has become increasingly focused on effectively monitoring the risks of new and innovative products that meet the evolving demands of investors. He also remarked on the rapid growth of the alternative mutual fund space, stating that the inflows into such funds in 2013 represented 32.4% of the inflows of the entire mutual fund industry.

Champ discussed the various ways that the SEC gathers data and monitors risk in the asset management industry. Champ discussed the SEC's review of requests for no-action or exemptive relief and disclosure filings. He stated that the Division views the exemptive application process as a place to examine new ideas from market participants and noted the recent SEC denial of two applications for exemptive relief to launch non-transparent ETF structures. For a discussion of these denials, please see the article ***SEC Issues Preliminary Denial to Exemptive Relief Applications for Operation of Non-Transparent Active ETFs*** above. Champ also discussed the industry monitoring program as a way that the Division has enhanced its ability to protect investors. He noted the monitoring of the gross yield of funds as a marker for risk and highlighted an instance where such monitoring led to the identification of a fund whose gross yield was "consistently different" from the rest of the market and a subsequent investigation led to an enforcement action against that fund for fraud. Champ also discussed the new analytical tool MIDAS (Market Information Data Analytics System), which collects daily records from the proprietary feeds of each of the 13 national equity exchanges, and the new technologies employed by the Quantitative Analytics Unit in the SEC's National Exam Program, which allow examiners to analyze trading data at a much quicker pace than in the past. Champ stated that the risk monitoring efforts continue to influence the potential policies that the SEC is considering in the area of asset management, noting that among the initiatives that the SEC is considering is expanding risk testing of the largest asset management firms.

Champ addressed the growing alternative mutual fund space and the challenges of appropriately disclosing the heightened risk of such funds to retail investors. Champ noted that the staff believes that funds that use or intend to use alternative investment strategies should assess the accuracy and completeness of their risk disclosure in light of such strategies. He explained that the disclosure of investment strategies should be tailored both to the way the fund expects to be managed and to how that management will impact performance. He further explained that the staff believes that a small investment in derivatives does not necessarily correlate to a small impact on fund performance because of the impact of leverage. He also noted that the staff has observed that a significant exposure to derivatives may not make the fund substantially riskier. Champ specifically mentioned that an alternative mutual fund should disclose material risks related to volatility, leverage, liquidity and counterparty creditworthiness that relate to the alternative investment strategies of the fund.

Champ also noted that the staff has raised concerns that there could be a disconnect between the strategies and risks an alternative mutual fund discloses in its prospectus and the strategies that such fund actually employs, and that Division staff is reviewing data to compare these sets of information. He stated that a fund should generally review its use of alternative investment strategies when it updates its registration statement annually and further reassess the accuracy and completeness of its disclosure concerning those strategies and the associated risks as they relate to the fund's investment objectives and performance.

- See a copy of Champ's speech

IM Guidance Update Clarifies Mutual Fund Obligations for Mixed and Shared Funding Orders

In October 2014, the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update stating that a mutual fund is not required to obtain a "mixed and shared funding" order prior to offering its shares as an investment option under a variable life and/or variable annuity contract. Furthermore, according to the IM Guidance Update, a mutual fund that has previously obtained a mixed and shared funding order is not required to comply with the terms and conditions of such order if the exemptions granted by the order are not being relied upon by any person (such as insurance companies offering contracts under which the mutual fund shares are offered as an investment option).

According to the IM Guidance Update, "mixed funding" refers to the sale of the shares of a mutual fund to a variety of offerees, including when a fund is used as an investment option in both variable annuity contracts and variable life insurance contracts. The Division further explained that "shared funding" refers to the sale of the shares of a mutual fund as an investment option in variable insurance contracts issued by multiple unaffiliated insurance companies. According to the SEC, Rules 6e-2 and 6e-3(T) promulgated under the Investment Company Act provide limited exemptions from certain sections of the Investment Company Act to certain insurance company separate accounts organized as unit investment trusts that are conditioned on such insurance companies' compliance with, among other things, restrictions on mixed and shared funding. These exemptions permit, among other things, (i) an insurance company that has an officer, director or employee who is ineligible under Section 9(a) of the Investment Company Act to serve as an investment adviser, depositor or principal underwriter to an underlying fund and (ii) an insurance company to disregard, in certain limited circumstances, instructions of contract owners in voting the underlying fund shares with respect to both the appointment of an adviser or principal underwriter and matters that could result in changes in the fund's investment objectives or its sub-classification.

Mixed and shared funding exemptive orders permit insurance companies to continue to rely on such exemptions even if the underlying fund engages in mixed and/or shared funding. However, in its review of applications for mixed and shared funding orders over a period of 30 years, the SEC noted that such exemptions are relied upon by insurance companies very infrequently, if ever. As such, the SEC decided to issue the Guidance Update to clarify that a mutual fund is permitted to engage in both mixed and shared funding without obtaining an SEC order. If a mutual fund engages in mixed funding or shared funding without obtaining an order, however, an insurer (and its affiliates) who issues the contracts under

which that mutual fund is an investment option will not be able to benefit from the exemptions typically granted by a mixed and/or shared funding order.

- See a copy of the IM Guidance Update

IM Guidance Update Advises Certain Investment Companies on the Presentation of Their Consolidated Financial Statements

In October 2014, the Chief Accountant's Office (the "**Office**") of the Division of Investment Management of the SEC issued an IM Guidance Update to provide (i) certain investment companies registered under the Investment Company Act ("**RICs**") and (ii) business development companies that have elected to be treated as business development companies under the Investment Company Act ("**BDCs**") and that have wholly owned subsidiaries with its views regarding the presentation of such companies' consolidated financial statements.

According to the Office, financial statements filed pursuant to the Investment Company Act and the Securities Act of 1933 (the "**Securities Act**") are governed by, among other statutes and regulations, Regulation S-X, which provides that a registrant must consider which "financial presentation is most meaningful" under the circumstances when deciding upon its consolidation policy for its financial statements. While there is a presumption that consolidated statements are more meaningful when one entity holds, directly or indirectly, a controlling interest in another entity, according to the Office, special rules apply for RICs and BDCs. Regulation S-X provides that, for RICs and BDCs, "statements of the registrant may be consolidated only with the statements of subsidiaries which are investment companies."

The Office provided the below guidance based on questions it has received concerning consolidation in the following situations:

- ***RICs that are Feeder Funds or Funds of Funds:***
  - *Feeder Funds*: An RIC that is a feeder fund in a master-feeder fund structure may have a controlling interest in another entity for purposes of Regulation S-X because the securities issued by the master fund are the only securities held by the RIC feeder fund. As a result, the RIC feeder may have a controlling financial interest in the master fund. For RIC feeder funds, according to the IM Guidance Update, the staff has generally determined that an unconsolidated presentation of such fund's financial statements is typically the most meaningful and transparent, provided that, among other things:
    - The master fund's financial statements are attached to those of the feeder fund; and
    - If the master fund is organized as a partnership, the feeder fund (i) separately discloses on its statement of operations the net investment income, net realized gain/loss and net change in unrealized gain/loss allocated from the master fund and (ii) includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights.
  - *Funds of Funds*: A RIC that is a fund of funds in the same group of investment companies may hold a controlling interest in one or more of the underlying funds in that same group of investment companies. As a result, a RIC fund of funds may have a controlling interest in another entity for purposes of Regulation S-X. According to the IM Guidance Update, for RIC funds of funds, the staff has generally determined that an unconsolidated presentation of such fund of fund's financial statements is the most meaningful. Since a RIC fund of funds may hold both controlling and non-controlling financial interests in some of the underlying funds, and such interests may fluctuate, the staff has taken the view that an unconsolidated presentation of a fund of fund's financial statements is less confusing and more transparent than a consolidated presentation. Nonetheless, the staff notes that a

RIC fund of funds should also consider whether a presentation of its financial statements in a manner similar to a master-feeder fund would be the most meaningful if its interest in a single fund is especially significant.

- ***BDCs with Wholly Owned Subsidiaries***. The staff has generally taken the view, according to the IM Guidance Update, that a consolidated presentation of the financial statements of a BDC with subsidiaries is the most meaningful. Through its review of registration statements and financial statements, the staff has observed that a number of BDCs have wholly owned subsidiaries to facilitate investments in portfolio companies. Since these subsidiaries are designed to function as an extension of the BDC's investment operations, the staff has determined that consolidating the subsidiaries financial statements with those of the BDC provides investors with the most meaningful presentation of the BDC's financial position.

In addition to the IM Guidance Update, the staff invited registrants, their counsel and independent auditors to contact the staff if they have further questions about the application of these requirements to their particular situations.

- See a copy of IM Guidance Update

Litigation

SEC Announces Charges Against Investment Manager and Senior Officials for Violations of Custody Rule

On October 29, 2014, the SEC issued an order (the "**Order**") instituting administrative and cease-and-desist proceedings against an investment advisory firm and three of its senior officials for violations of Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-2 thereunder (the "**Custody Rule**") for failing to distribute audited financial statements to investors in the funds managed by the investment advisory firm within 120 days after the end of the fiscal year. According to the Order, for the fiscal years 2010, 2011 and 2012, Sands Brothers Asset Management LLC ("**Sands**"), failed to timely distribute audited financials to the fund investors, despite a previous order issued by the SEC in October 2010 for similar Custody Rule violations, and Sands' co-founders and chief operating and compliance officer failed to implement any procedures or safeguards to ensure compliance with the Custody Rule after the previous SEC order was issued.

According to the SEC, the Custody Rule provides a critical investor protection safeguard in providing investors with regular independent verification of their assets. The Custody Rule generally requires, according to the Order, an adviser who has custody to, among other things, "(i) ensure that a qualified custodian maintains the client assets; (ii) have a reasonable basis for believing that the qualified custodian sends quarterly account statements to clients; and (iii) ensure that client funds and securities are verified by actual examination each year by an independent public accountant." The Order further states that the Custody Rule provides that an adviser to a pooled investment vehicle shall be deemed to have complied with the independent verification requirement and account statements delivery requirement if the adviser subjects the fund to an annual audit by an independent public accountant registered with the Public Company Accounting Oversight Board and distributes the audited financial statements to investors within 120 days after the fund's fiscal year-end.

According to the Order, Sands was at least 40 days late in distributing financial statements to certain fund investors in 2010, between six months and eight months late in 2011 and approximately three months late in 2012. Based on these alleged violations of the Custody Rule, as further described in the Order, the SEC scheduled a public hearing for the purpose of taking evidence on the allegations and determining the appropriate remedial action, if any.

- See a copy of the press release
- See a copy of the Order

- See a copy of the 2010 order

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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