Investment Management Regulatory Update

March 26, 2015

SEC Rules and Regulations

SEC Extends Rule 482 No-Action Position to Certain Information Furnished to Participants and Beneficiaries in Certain Non-ERISA Retirement Savings Plans

On February 18, 2015, the Division of Investment Management of the Securities and Exchange Commission (the "**SEC**") issued a No-Action Letter to the American Retirement Association (the "**Letter**") regarding retirement savings plan communications.

In a No-Action Letter to the U.S. Department of Labor, dated October 26, 2011, the SEC agreed to treat certain investment-related information provided by a plan administrator (or its designee) to participants and beneficiaries in participant-directed individual account plans subject to the Employee Retirement Income Security Act of 1974 ("**ERISA**"), pursuant to the disclosure requirements set forth in Rule 404a-5(d) under ERISA (such information, "**DOL Required Investment Information**"), as if it were a communication that satisfies the requirements of Rule 482 under the Securities Act of 1933 (the "**Securities Act**"). Rule 482 under the Securities Act generally permits investment companies to advertise investment performance data, as well as other information, subject to the requirements of the rule. Rule 404a-5(d) under the Securities Act mandates that plan participants receive certain plan information, including performance data, comparative benchmarks, and fees and expenses.

In the Letter, the SEC agreed to treat DOL Required Investment Information furnished to other retirement savings plans that are not subject to ERISA and participants and beneficiaries in such plans as if it were a communication that satisfies the requirements of Rule 482 under the Securities Act. The specific plans covered by the Letter are 403(b) plans, governmental 457(b) plans, governmental 401(a) plans, 415(m) plans, church 401(a) plans, non-governmental 457(b) plans, and 409A plans or 457(f) plans of governmental or tax-exempt entities.

- **See a copy of the February 18, 2015 No-Action Letter**
- **See a copy of the October 26, 2011 No-Action Letter**

Industry Update

Interagency Volcker Rule FAQ Addresses Scope of U.S. Marketing Restrictions under SOTUS Funds Exemption

On February 27, 2015, the Federal Reserve and other implementing agencies, including the SEC, updated their responses to frequently asked questions regarding the Volcker Rule to address the marketing restriction associated with Section 13(d)(1)(I) of the Bank Holding Company Act (the "**BHCA**") and Section __.13(b) of the Volcker Rule. For a detailed discussion of previously issued FAQs, please see the June 18, 2014 Davis Polk Client Memorandum, Volcker Rule: Observations on Interagency FAQs, OCC Interim Examination Guidelines.

Section 13(d)(1)(I) of the BHCA and Section __.13(b) of the Volcker Rule generally provide an exemption for foreign banking entities from the prohibition on acquiring or retaining an ownership interest in, or sponsoring, a "covered fund" (which includes most private funds), provided certain conditions are satisfied to ensure the activities are conducted solely outside of the United States (the "**SOTUS funds exemption**"). This exemption applies if the investment is made and booked outside of the United States and, among other conditions, no ownership interest in a covered fund is offered for sale or sold to a resident of the United States (the "**marketing restriction**"). The staffs of the Agencies had received inquiries as to whether the marketing restriction applies only to the activities of a foreign banking entity that is seeking to rely on the SOTUS funds exemption or whether it applies more generally to the activities of any person offering for sale or selling ownership interests in such fund.

The FAQ clarified that the marketing restriction applies only to the activities of the foreign banking entity that is seeking to rely on the SOTUS funds exemption, and not to the activities of unaffiliated third parties. Accordingly, as long as the foreign banking entity is not itself a sponsor, investment adviser, investment manager, commodity pool operator or commodity trading advisor to a U.S. or foreign covered fund, it may invest in that fund in reliance on the SOTUS funds exemption without regard to whether the sponsor or any other unaffiliated third-parties offered or sold the fund to U.S. investors, provided the other SOTUS funds exemption conditions are satisfied. As a result, U.S. asset managers can market and sell interests in covered funds to foreign banking entities.

- **See a copy of the FAQ**

IM Guidance Update regarding Gifts and Entertainment

In February 2015, the Division of Investment Management of the SEC issued an IM Guidance Update regarding gifts and entertainment presented to advisory personnel of registered investment companies ("**RICs**").

Section 17(e)(1) of the Investment Company Act of 1940 (the "**Investment Company Act**") generally forbids a RIC's investment adviser and its officers, directors and employees (among others) from accepting "any compensation (other than a regular salary or wages from such registered company) for the purpose or sale of any property to or for such registered company . . . except in the course of such person's business as an underwriter or broker."

Rule 38a-1 under the Investment Company Act generally requires a RIC's board adopt or approve the written policies and procedures of the RIC and its investment adviser, principal underwriter, administrator, and transfer agent based on a finding by the board that the policies and procedures are reasonably designed to prevent a violation of the federal securities laws.

According to the Guidance Update, receipt of gifts or entertainment by a RIC's advisory personnel may violate Section 17(e)(1) of the Investment Company Act and therefore should be addressed by the RIC's compliance policies and procedures pursuant to Rule 38a-1 under the Investment Company Act. According to the SEC, the specific policies of any RIC may be tailored according to the nature of the advisory business. The SEC suggested two potential policies to mitigate the risk of violating Section 17(e)(1): (1) preclearance procedures for gifts and entertainment so that compliance personnel may assess any Section 17(e)(1) implications or (2) an outright prohibition on gifts and entertainment.

- **See a copy of the Guidance Update**

SEC Commissioner Discusses Regulation of Asset Management Industry at 2015 Mutual Funds and Investment Management Conference

On March 16, 2015, SEC Commissioner Michael S. Piwowar addressed what he views as the regulatory overreach by prudential regulators in the asset management industry at the 2015 Mutual Funds and Investment Management Conference, sponsored by the Investment Company Institute and the Federal Bar Association. In his remarks, Piwowar focused on criticisms of the capital markets by prudential regulators that are, according to him, baseless and unwarranted.

Piwowar first discussed the idea that one cause of the financial crisis was the expansion of a largely unregulated "shadow banking system." He cited a recent speech by Janet Yellen, the Chair of the Board of Governors of the Federal Reserve System (the "**Fed**"), where Yellen discussed improving oversight of large financial institutions, which would include not only banking entities, but other large and complex financial firms. According to Piwowar, the track record of prudential regulators in managing systemic risks in the banking sector "leaves much to be desired," and their recent push for more oversight in the banking sector has led to the dominant position of investment funds in providing liquidity in the fixed income market. Since capital market activities, in Piwowar's view, have left the banking sector and moved into the non-banking sector (primarily the asset management industry), prudential regulators such as the Financial Stability Oversight Council and the Financial Stability Board are seeking to expand their oversight over investment managers.

As an example, Piwowar discussed what he views as a false narrative regarding leveraged exchange-traded funds ("**ETFs**") which, according to Piwowar, are typically designed to achieve their performance objectives on a daily basis and pursue a range of investment strategies. According to Piwowar, prudential regulators continue to emphasize that these products lead to increased volatility in the financial markets because leveraged ETFs purchase assets when they go up and sell assets when they go down, leading to instability, in the eyes' of the regulators, during periods of adverse stress. This view is at odds with empirical research, according to Piwowar, who then cited a working paper by researchers at the Fed and Pennsylvania State University that observes that capital flows mitigate the potential for leveraged ETFs to augment volatility.

Piwowar then acknowledged that, in terms of systemic risk, there are three areas of the asset management regime that may merit closer examination by the SEC: fund data reporting, in-kind redemptions and temporary suspension of redemptions. With respect to fund data reporting, Piwowar discussed the long history of registered funds being subject to disclosure requirements, and suggested that the SEC make the existing quarterly fund portfolio holding information available in an "interactive data" format that can be more easily analyzed by market observers and participants. Piwowar then cited the concern that a mutual fund investor is akin to a bank depositor (since such investor can redeem its securities in the mutual fund) and therefore that a mutual fund is susceptible to a bank-like run. In response to this concern, he explained that the numerous crises in the past two decades have not triggered a panic among mutual fund investors and that there are important legal differences between a mutual fund and a bank, specifically, that a mutual fund has the ability to satisfy a redemption request in-kind. He opined that the SEC should consider eliminating the technical undertakings that mutual funds must go through in order retain the ability to redeem in-kind.

Thirdly, Piwowar discussed Section 22(e) of the Investment Company Act, which generally prohibits mutual funds from suspending redemptions and postponing the payment of redemption proceeds for more than seven days. However, Section 22(e) also permits a fund to suspend redemptions with approval by the SEC, including for any period during which an emergency exists. In 2008, the SEC adopted a temporary rule under Section 22(e) (which later became permanent) permitting money market funds to suspend redemptions during liquidation. Since then, Piwowar notes that commenters have addressed the question of whether such relief should be broadened to include all mutual funds and not solely money market funds. He concluded by stating that if the SEC concluded that redemption requirements under Section 22(e) could lead to market instability or other concerns, it would be more appropriate for the SEC to construct a regulatory solution to address such concern, rather than relying on prudential regulators to designate certain funds or advisers in the asset management industry as systemically risky.

- **See a copy of Piwowar's speech**

Co-Chief of Asset Management Unit Discusses Enforcement Priorities, Conflicts of Interest at IA Compliance Conference

On February 26, 2015, Julie M. Riewe, the Co-Chief of the Asset Management Unit of the Division of Enforcement (the "**AMU**") of the SEC addressed the IA Watch's 17th Annual IA Compliance Conference. Riewe covered several topics in her speech, including the enforcement priorities of the AMU, noting conflicts of interest as a particular point of focus. Her speech also touched on how the AMU works with the Office of Compliance Inspections and Examinations ("**OCIE**") and the Division of Investment Management (the "**Division**") to monitor asset managers and identify practices that are viewed as problematic for potential investigation.

Riewe first discussed AMU's 2015 priorities for registered investment companies, which include valuation, performance and advertising of performance; deviation from investment guidelines or the pursuit of undisclosed investment strategies; fund governance (in particular, the evaluation of advisory and other fee arrangements); and fund distribution, including compliance with Rule 12b-1 under the Investment Company Act. According to Riewe, fund distribution is "of particular concern" given the inherent conflicts of interest it presents for the adviser, who must determine whether to use its own assets or fund assets to distribute shares. Riewe then cited recent enforcement actions relating to the fund governance area, including the *F-Squared* case in December 2014, in which the SEC charged an investment adviser with advertising a materially inflated performance track record. For a discussion of the *F-Squared* case, please see the **February 18, 2015 Investment Management Regulatory Update**. In the private fund space, Riewe mentioned conflicts of interest, valuation and compliance and controls as being the main focus of the AMU in 2015. Riewe previewed that, on the hedge fund side, the AMU anticipates cases involving undisclosed fees, undisclosed conflicts and valuation issues. Finally, for other client accounts, the AMU, according to Riewe, would be focusing on conflicts of interest, fee arrangements and compliance.

Riewe then emphasized advisers' obligation as fiduciaries to identify conflicts of interest, and then either (1) eliminate them or (2) mitigate and disclose them. Riewe outlined a number of cases brought by the AMU in 2014 relating to conflicts of interest, including *Manarin Investment Counsel* (in which an adviser was charged with failing to obtain best execution for its fund clients), *Paradigm Capital Management* (in which a hedge fund adviser engaged in principal transactions without the required written disclosure and consent) and *Shelton Financial Group* (in which an investment adviser was charged with failing to properly disclose compensation it received from a broker-dealer for investing client assets in certain funds). For further discussion of the *Paradigm Capital Management* and *Shelton Financial Group* cases, please see the **July 24, 2014 Investment Management Regulatory Update** and the **February 18, 2015 Investment Management Regulatory Update**, respectively. According to Riewe, the AMU expects to recommend conflicts cases for enforcement action in the future, including matters involving best execution failures, undisclosed outside business activities, related-party transactions, fee and expense misallocation issues and undisclosed bias toward proprietary products and investments.

Riewe concluded her speech by going through relevant questions and considerations that advisers may want to keep in mind when identifying, addressing and disclosing conflicts of interest. With respect to identifying conflicts of interest, Riewe noted that investment advisers should identify sources of conflicts of interest, including, but not limited to, dual registration as an investment adviser and broker-dealer, having an affiliated broker-dealer, managing funds or clients side-by-side, inter-fund lending or investing, compensation from third parties for recommending investments or using certain service providers or engaging in proprietary trading or investing. Riewe then urged advisers to consider whether such identified conflicts could be eliminated and, if not, how they could be mitigated and disclosed and which individuals or groups of individuals are responsible for evaluating and deciding how to address conflicts. Further, according to Riewe, advisers should ensure that they create and maintain objective and consistent firm processes to evaluate conflicts and that such processes are properly implemented. Finally, Riewe discussed the importance of written disclosure, including the review of relevant disclosure documents (e.g., Forms ADV, private placement memoranda, limited partnership agreements, client agreements and prospectuses) to ensure that all such conflicts are disclosed in such a way to allow clients and investors to understand the conflicts and what risks they may present, along with regular review of such documents to ensure timely disclosure of new or emerging conflicts and keeping relevant parties (e.g., chief compliance officers and boards of directors) informed about conflicts of interest.

- **See a copy of Riewe's speech**

SEC Commissioner Opposes Use of Bad Actor Disqualifications as Enforcement Tool

On February 13, 2015, SEC Commissioner Daniel M. Gallagher addressed the issue of waivers from "bad actor" disqualifications under the federal securities laws at the 37th Annual Conference on Securities Regulation and Business Law. In his remarks, Gallagher discussed the problem within the SEC of conflating disqualifications and enforcement sanctions and noted that Congress may need to legislate in order to provide a clear path forward.

Gallagher first discussed the nature and purpose of disqualifications and the role that waivers play within this framework. Gallagher noted that individuals and entities that commit certain "bad acts" may be subject to various disqualifications, which may prohibit them from engaging in certain business activities or from relying on certain exemptions from the federal securities laws. Gallagher explained that certain disqualifications are automatically triggered, such as upon the entry of a court-ordered injunction or an order in an administrative proceeding in some cases, while others are discretionary and require affirmative SEC action to impose. Nonetheless, according to Gallagher, all disqualifications share a common goal of removing "bad actors" from the industry in order to prevent fraud. According to Gallagher, the SEC may waive a certain disqualification after reviewing the facts and circumstances of the specific situation and considering several different factors, including the type of entity or individual who was disqualified, whether the conduct was "willful" or resulted in a violation of an anti-fraud provision of the securities laws, the length of the misconduct and remedial steps taken, if any.

Gallagher explained that the SEC has historically considered disqualifications and waivers against the policy backdrop of reducing recidivism, which, according to him, allowed the SEC to determine whether a waiver applicant presented a risk of future harm to the securities markets or other market participants. However, according to Gallagher, there has recently been a movement within the SEC to treat disqualifications as "sanction enhancements," which are, in Gallagher's view, remedial and punitive in nature. Gallagher argued that the SEC treating the waiver consideration process in this way is not consistent with congressional intent, citing Congress's decision to not include automatic disqualifications in the Securities Law Enforcement Remedies Act of 1940, the statute most relevant to the SEC's sanctioning authority (according to Gallagher). The absence of automatic disqualifications in the statute that greatly expanded the range of enforcement tools available to the SEC means, according to Gallagher, that Congress intended automatic disqualifications to serve a purpose distinct from

enforcement sanctions, and they were never meant to serve as an additional sanctions tool for SEC enforcement.

Gallagher highlighted the SEC's recent practice of not allowing SEC respondents to condition their settlements on whether the SEC will grant a disqualification waiver. If the SEC wants to treat disqualifications as sanctions, and if sanctions are a central part of any settlement negotiation, then, according to Gallagher, waivers must be negotiated during settlement talks. In addition, Gallagher repeated his public stance of conditioning his vote on enforcement recommendations on the disposition of requested waivers until the SEC officially decides how it will treat disqualifications going forward. Ideally, according to Gallagher, the SEC would revert to the historical practice of reviewing disqualifications separately from the attendant enforcement case. However, if the SEC cannot agree on a path forward, Gallagher recommended that Congress step in and clearly delineate between disqualifications and enforcement sanctions in the federal securities laws.

- **See a copy of Gallagher's speech**

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.

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Yukako Kawata	**212 450 4896**	**yukako.kawata@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Beth M. Bates	**212 450 4062**	**beth.bates@davispolk.com**