Investment Management Regulatory Update

October 27, 2015

SEC Rules and Regulations

SEC Proposes Rule Reforms to Enhance Liquidity Risk Management for Mutual Funds and ETFs

On September 22 2015, the Securities and Exchange Commission (the "**SEC**") voted to propose a comprehensive package of rule reforms to promote effective liquidity risk management by open-end funds, including mutual funds and exchange-traded funds ("**ETFs**"). The reforms would require such funds to implement liquidity risk management programs and enhance their disclosure regarding fund liquidity and redemption practices.

Under proposed Rule 22e-4 ("**Rule 22e-4**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), the liquidity risk management program of mutual funds or other open-end management investment companies, including ETFs, would be required to include certain elements, including:

- **Classification of the Liquidity of Fund Portfolio Assets**. A fund would be required to classify each asset in its portfolio based on the number of days in which the position could be converted to cash at a price that does not materially affect the value of the asset immediately prior to sale. A fund would need to consider certain factors included in proposed Rule 22e-4 in determining the liquidity of a given portfolio position and review each of its portfolio assets regularly.
- **Assessment, Periodic Review and Management of a Fund's Liquidity Risk**. A fund would be required to assess and periodically review its liquidity risk, defined as the risk that a fund could not meet redemption requests anticipated under normal or stressed conditions without materially affecting the fund's net asset value per share. In addition, proposed Rule 22e-4 would codify the current 15% limit on illiquid assets per SEC guidelines.
- **Establishment of a Three-Day Liquid Asset Minimum**. A fund would be required to periodically determine a "three-day liquid asset minimum," which would be a minimum percentage of the fund's net assets required to be invested in cash and assets that are

convertible to cash within three business days at a price that would not materially affect the value of the assets immediately prior to sale. The SEC explained in the proposing release accompanying Rule 22e-4 that it proposed this requirement to increase the probability that a fund will hold sufficient liquid assets to meet redemption requests without materially affecting a fund's net asset value.

- **Board Approval and Review**. A fund's board, including a majority of the fund's independent directors, would be required to approve the fund's liquidity risk management program, including the adequacy of its three-day liquid asset minimum, as well as review annually a written report provided to it reviewing the program's adequacy.

In addition, the SEC will consider proposed amendments to Rule 22c-1 under the Investment Company Act that would permit, but not require, open-end funds (except money market funds and ETFs) to use "swing pricing," which is the process of reflecting in a fund's net asset value the costs associated with shareholder trading activity in order to pass such costs on to the purchasing and redeeming shareholders and to protect existing shareholders from dilution. The proposed amendments provide factors funds must consider in connection with their swing pricing policies, and such policies would be required to be approved by the fund's board.

Finally, the SEC will consider proposed amendments to Form N-1A and two recently proposed reporting forms: Form N-PORT and Form N-CEN. The proposed amendments to Form N-1A, the registration form used by open-end investment companies, would require funds to disclose the use swing pricing, if applicable, as well as the methods the fund uses to meet redemptions. The proposed amendments to Form N-PORT, a portfolio holdings report the SEC proposed in May 2015, would require a fund to disclose its three-day liquidity minimum, as well as report the liquidity classification of each of its assets according to the categories proposed in Rule 22e-4. Finally, the proposed amendments to Form N-CEN, the census reporting form the SEC proposed in May 2015, would require a fund to disclose information regarding committed lines of credit, swing pricing and interfund borrowing and lending. The amendments to Form N-CEN would also require ETFs to report whether they required the posting of collateral by an authorized participant in connection with the purchase or redemption of ETF shares. For further discussion of proposed Forms N-PORT and N-CEN, please see the **May 20, 2015 Davis Polk Investment Management Regulatory Update**.

- **See a copy of the Press Release**
- **See a copy of the Proposing Release**

SEC Removes References to Credit Ratings in Money Market Fund Rule and Form

On September 16, 2015, the SEC adopted amendments to remove credit rating references in Rule 2a-7 under the Investment Company Act of 1940 (the "**Investment Company Act**"), the principal rule that governs money market funds, and Form N-MFP, the form on which money market funds report monthly portfolio holdings to the SEC (the "**Final Rule**"). In the Final Rule, the SEC also adopted amendments to the issuer diversification provisions of Rule 2a-7 that would eliminate a currently available exclusion for securities subject to a guarantee issued by a non-controlled person.

Removal of References to Credit Ratings in Rule 2a-7 and Form N-MFP

Before the adoption of the Final Rule, a money market fund was limited to acquiring "eligible securities," the acquisition of which presented "minimal credit risks" to the fund. "Eligible securities" were defined primarily by reference to credit ratings by nationally recognized statistical rating organizations ("**NRSROs**"), and "minimal credit risks" were undefined. Under the Final Rule, the definition of "eligible security" under Rule 2a-7 no longer references NRSRO credit ratings but instead requires a single uniform finding that the security "presents minimal credits risks to the fund". Although "minimal credit risks" remain undefined, the Final Rule codifies earlier SEC staff guidance on the credit quality factors

that a fund may consider in analyzing the risk presented by a security. As such, the Final Rule requires a fund's board or its delegate to consider the following factors in determining the capacity of the security's issuer, guarantor or provider of a demand feature to meet its financial obligations: (i) the issuer's or guarantor's financial condition; (ii) the issuer's or guarantor's sources of liquidity; (iii) the issuer's or guarantor's ability to react to future market-wide and issuer- or guarantor-specific events (such as the ability to repay debt in highly adverse situations); and (iv) the issuer's or guarantor's competitive position within its industry, and the strength of the issuer's or guarantor's industry both within the economy and relative to broader economic trends. The SEC also suggested, but did not require, that a fund's board or its delegate consider whether the price and/or yield of the security is similar to that of other securities in the fund's portfolio, as well as analyze the counterparty relationships to the extent such information is available and would be helpful for purposes of the minimal credit risk determination. More broadly, the SEC clarified that the codified factors and suggested additional factors are not exhaustive, and that other factors may be relevant depending on the specific asset class of a security. The SEC also clarified that the "minimal credit risks" standard will apply to conditional demand features and underlying securities or guarantees. The SEC further noted that the Final Rule is not intended to change the current risk profile of money market funds or fund boards' evaluation of minimal credit risk.

Before the Final Rule, money market funds were required to disclose, in their monthly Form N-MFP filings, the name of each designated NRSRO for each portfolio security (and any guarantee, demand feature or other enhancement associated with the portfolio security) and the rating assigned to such security. The SEC noted that although the SEC staff issued a no-action letter in 2010 stating that it would not take action if a fund did not designate NRSROs in its Form N-MFP filings (and did not make related disclosures in its statement of additional information), many funds continued to report such information on Form N-MFP. With the adoption of the Final Rule, money market funds will be required to disclose only those NRSRO ratings that the fund's board (or its delegate) considered in making its minimal credit risks determination for a given security, along with the name of the agency that provided the rating.

Exclusion from Issuer Diversification Requirement

Before the adoption of the Final Rule, a money market fund's portfolio generally had to be diversified with respect to both (i) the issuers of the securities the fund holds and (ii) the providers of guarantees and demand features related to those securities. Under the issuer diversification requirement, money market funds generally had to limit their acquisitions of the securities of any one issuer to no more than 5 percent of the fund's total assets. Under the guarantor diversification requirement, money market funds generally had to limit their acquisitions in securities subject to a guarantee from any single guarantor to no more than 10 percent of the fund's total assets. Before the adoption of the Final Rule, the 5 percent issuer diversification requirement contained an exclusion for "securities subject to a guarantee issued by a non-controlled person." The Final Rule eliminates this exclusion to the issuer diversification requirements so that a money market fund acquiring securities subject to a guarantee must now comply with both the 5 percent issuer diversification requirement and the 10 percent guarantor diversification requirement.

The effective date of the Final Rule is October 26, 2015 and the compliance date is October 14, 2016. The SEC noted that this compliance date is the same as the final compliance date for previously adopted changes to Rule 2a-7 related to floating net asset value, liquidity fees, and redemption gate provisions. For additional information on these money market fund reforms, please see the August 5, 2014 Davis Polk Client Memorandum, **SEC Adopts Money Market Fund Reforms**.

- **See a copy of the Press Release**
- **See a copy of the Final Rule**

SEC Proposes Changes to Administrative Proceedings

On September 24, 2015, the SEC voted to propose amendments to its Rules of Practice (the "**Rules**") that govern its administrative proceedings. According to the releases accompanying the proposed

amendments (the "**Releases**"), the proposed amendments would modernize the sharing of documents and materials during the proceedings and provide added flexibility in timing and discovery for the parties.

The proposed amendments would require parties to administrative proceedings to submit all documents and other materials electronically. Documents that are required to be filed under Rules 151 and 152 would have to be filed through a secured system on the SEC's website. Parties would also be required to serve documents on each other electronically in accordance with SEC-prescribed guidance. The proposed rules would further require files to redact or omit certain personal information from the filings. According to the Releases, requiring electronic filings and service will make the proceedings' materials more readily available to the public and generally enhance the public's access to the proceedings.

The proposed amendments also concern the timing and procedures of the administrative proceedings. Among other changes, the proposed amendments would amend the Rules to adjust the scheduling of the hearing and the deadline for filing an initial decision and establish a procedure for extending the initial decision deadline. The proposed amendments also would modify the requirements to seek SEC review of the initial decision.

Further, the proposed amendments would allow the parties to file notices to take depositions. The current rules only permit depositions by oral examination if the witness will be unable to attend or testify at the hearing. According to the Releases, allowing greater use of depositions would allow the parties to narrow the facts to be reviewed at the hearing. The proposed amendments would also modify the rules for the use of expert testimony, the methods of serving process on a person in a foreign country, the procedures for asserting affirmative defenses and the rules for admitting hearsay, among other clarifying amendments.

The SEC has requested comments regarding the proposed rules on or before December 4, 2015.

- **See a copy of the Press Release**
- **See a copy of the first Release and the second Release**

Industry Update

SEC Staff Clarifies Venture Capital Fund Rule in No-Action Letter

On September 21, 2015, the SEC Staff issued a no-action letter (the "**Letter**") clarifying the application of Section 203(l) of the Investment Advisers Act of 1940 (the "**Advisers Act**") and Rule 203(l)-1 promulgated thereunder, which exempt certain advisers to venture capital funds from registration as an investment adviser (together, the "**Venture Capital Exemption**"). The Letter was issued in response to a letter seeking no-action relief (the "**Incoming Letter**") that listed several examples of situations where the literal application of Section 203(l) and Rule 203(l)-1 could be seen as inconsistent with Congress's and the SEC's intent in adopting such section and rule, respectively.

Section 203(l) of the Advisers Act and Rule 203(l)-1 thereunder generally exempt a person or entity meeting the Advisers Act's definition of "investment adviser" from being required to register as an investment adviser if such person or entity acts as an investment adviser solely to one or more "venture capital funds." A "venture capital fund" is defined as, among other things, a "private fund" that represents to investors and potential investors that it pursued a venture capital strategy and that, immediately after the acquisition of any assets other than "qualifying investments" or short-term holdings, holds no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled capital commitments in assets (other than short-term holdings) that are not "qualifying investments," valued at cost or fair value, consistently applied by the fund. A "qualifying investment" is defined as, among other things, an equity security issued by a "qualifying portfolio company" that has been directly acquired by the private fund from the qualifying portfolio company. A "qualifying portfolio company" is defined as, among other things, any company that, at the time of any investment by the private fund, is not a public reporting

company or foreign-traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is a public reporting company or foreign-traded. Although Rule 203(l)-1 does not define "control," "control" is defined in the Advisers Act as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." According to the Incoming Letter, the SEC and its staff have previously indicated that the investment adviser to a fund can, at least under some circumstances, be deemed to control the fund for purposes of the Advisers Act.

The Incoming Letter provides two examples of what it deems the unintended consequences of a literal reading of Section 203(l) and Rule 203(l)-1. The first, "Example 1," describes a private fund ("**Relying Fund 1**") whose manager ("**Relying Manager 1**") is seeking to rely on the Venture Capital Exemption making an investment in a portfolio company that is a qualifying portfolio company by virtue of its not being a public reporting or foreign-traded company within the meaning of Rule 203(l)-1 ("**Portfolio Company 1**"). If this investment or a follow-on investment causes Relying Fund 1 to have control over Portfolio Company 1 within the meaning of Rule 203(l)-1, Relying Manager 1 could be deemed to have indirect control of Portfolio Company 1 since Relying Manager 1 can be considered to control Relying Fund 1. If Portfolio Company 1 becomes a public reporting or foreign-traded company (such as by conducting a public offering domestically or abroad), Portfolio Company 1 would continue to be a qualifying portfolio company, since it was a non-reporting company at the time of the fund's investment. However, if Relying Fund 1 makes an investment in another portfolio company that is a qualifying portfolio company ("**Portfolio Company 2**"), Portfolio Company 1 and Portfolio Company 2 could be considered to be under common control by Relying Fund 1. As a result, since Portfolio Company 1 is now a public reporting or foreign-traded company, any follow-on investment Relying Fund 1 makes in Portfolio Company 2 would not be a qualifying investment. The Incoming Letter noted that even if Relying Fund 1 had not invested in Portfolio Company 2, but a separate venture capital fund managed by Relying Manager 1 had made a controlling investment in Portfolio Company 2, such investment would also not be a qualifying investment because Portfolio Company 1 and Portfolio Company 2 could still be considered to be under the indirect common control of Relying Manager 1 by virtue of its control over Relying Fund 1 and the separate venture capital fund also managed by Relying Manager 1.

The second example, "Example 2," describes a manager seeking to rely on the Venture Capital Exemption ("**Relying Manager 2**") causing a private fund that it advises ("**Relying Fund 2**") to invest in a portfolio company ("**Portfolio Company 3**") that was, at the time of the investment, a company under common control with a public reporting or foreign-traded company, with controlling interests in both companies held by a separate fund advised by a manager that is not affiliated with Relying Manager 2 (the "**Unaffiliated Manager**"). Since Portfolio Company 3 was under direct common control with a public reporting or foreign-traded company, Relying Fund 2's investment in Portfolio Company 3 would be deemed to not be a qualifying investment. In addition, any other private fund's investment in Portfolio Company 3 would also be deemed to not be a qualifying investment. The Incoming Letter also noted that the same result would occur if Portfolio Company 3 and a public reporting or foreign-traded company were under the direct control of separate funds both advised by the Unaffiliated Manager, since Portfolio Company 3 and the public reporting or foreign-traded company would be deemed to be under the indirect common control of the Unaffiliated Manager.

The Incoming Letter asserted that the purpose of the Venture Capital Exemption is to distinguish venture capital funds from other types of private funds because venture capital funds are less connected to the public markets and therefore involve less potential for systemic risk. The Incoming Letter argued that it would be inconsistent with the SEC's intent if a venture capital fund is allowed to treat a qualifying portfolio company that subsequently becomes a public reporting company (like Portfolio Company 1) as a qualifying portfolio company, but is not allowed to treat a company that meets all of the requirements for a qualifying portfolio company (like Portfolio Company 2) to be a qualifying portfolio company solely as a result of the fund's direct controlling interest, or its manager's indirect controlling interest, in Portfolio Company 1. According to the Incoming Letter, Portfolio Company 2 would not be any more connected

with the public markets than it was before Portfolio Company 1 became a public reporting company. As such, the Incoming Letter argues that allowing a follow-on investment in Portfolio Company 2 would be consistent with the operations of a traditional venture capital fund, while not allowing such a follow-on investment could significantly constrain the venture capital fund adviser's management of the fund. In addition, the Incoming Letter argued that the situation presented by Example 2, where a portfolio company (like Portfolio Company 3) loses its qualifying status because it is under the common control of an unaffiliated manager with a public reporting company, would be also be inconsistent with the SEC's purpose in adopting Rule 203(l)-1. Applying the rule on its face, according to the Incoming Letter, would unduly constrain the operations of venture capital funds by forcing their advisers to take into account investments made by funds managed by unaffiliated fund advisers.

The Letter acknowledged that the application of Rule 203(l)-1 in the examples discussed in the Incoming Letter would have unintended consequences. The Letter stated that the SEC would not recommend enforcement action if a venture capital fund adviser meets all of the requirements under Section 203(l) and Rule 203(l)-1, except that a portfolio company fails to meet the definition of a "qualifying portfolio company" under the circumstances set forth in Examples 1 or 2.

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

Litigation

Investment Adviser Charged with Failure to Adopt Proper Cybersecurity Policies and Procedures

On September 22, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against R.T. Jones Capital Equities Management, Inc. ("**R.T. Jones**") pursuant to Sections 203(e) and 203(k) of the Advisers Act for failing to establish cybersecurity policies and procedures in violation of Rule 30(a) of Regulation S-P (the "**Safeguards Rule**"). The SEC charged R.T. Jones following an attack on its web server that compromised the personally identifiable information ("**PII**") of more than 100,000 individuals, including R.T. Jones' clients.

According to the Order, R.T. Jones, a registered investment adviser, held its clients' PII on a third-party's web server, without encryption, from September 2009 to July 2013. In July 2013, according to the Order, an unauthorized, unknown intruder gained access to the server and consequently the ability to copy the data stored on it. Once R.T. Jones discovered the breach, the SEC asserted, it retained multiple consulting firms to trace the source of the intrusion and determine the scope of the attack and provided notice of the incident to each person whose PII was vulnerable to theft and offered identity theft monitoring services to them. According to the Order, R.T. Jones has not received any notice of a client experiencing financial harm as a result of the attack.

The Safeguards Rule requires registered investment advisers to adopt policies and procedures in writing reasonably designed to: (1) ensure the security and confidentiality of customer records and information, (2) protect against any anticipated threats or hazards to the security or integrity of such records and (3) protect against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer.

The SEC alleged that R.T. Jones lacked any written policies and procedures reasonably designed to safeguard its clients' PII. The SEC identified several deficiencies in R.T. Jones' policies and procedures, including a lack of periodic risk assessments, a failure to establish a firewall around the relevant server or to encrypt the client PII on the server and an absence of procedures for responding to a cybersecurity threat.

R.T. Jones agreed to settle the charges without admitting or denying the SEC's findings. R.T. Jones also has undertaken several remedial measures since the cyber attack, including appointing a dedicated information security manager and retaining a cybersecurity form. The SEC censured R.T. Jones and ordered it to pay a civil money penalty of $75,000 and to cease and desist from committing or causing any violations and any future violations of the Safeguards Rule.

- See a copy of the Press Release
- See a copy of the SEC Order

SEC Brings First Case Under Distribution-in-Guise Initiative, Charging Investment Adviser with Improperly Using Mutual Fund Assets to Pay Distribution Fees

On September 21, 2015, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against First Eagle Investment Management, LLC ("**First Eagle**") and FEF Distributors, LLC ("**FEF**," and together with First Eagle, the "**Respondents**") for alleged violations of Section 206(2) of the Advisers Act, Section 12(b) the Investment Company Act and Rule 12b-1 thereunder in connection with the Respondents' allegedly improper use of approximately $25 million in mutual fund assets to pay for the distribution and marketing of fund shares outside of a written, approved Rule 12b-1 plan. The Respondents were also charged with violating Section 34(b) of the Investment Company Act for including allegedly inaccurate statements regarding such payments in the mutual funds' prospectus. This is the first case arising from a recent SEC initiative known as the Distribution-In-Guise Initiative, which aims to protect mutual fund shareholders from bearing the costs of a firm's improper use of fund assets to pay for distribution-related services masked as sub-transfer agency payments.

According to the Order, from approximately January 2008 to March 2014, First Eagle, a registered investment adviser, and its wholly-owned broker-dealer subsidiary, FEF, caused the First Eagle Funds, a Delaware statutory trust registered with the SEC as an open-end diversified investment company (the "**Funds**"), to make payments to two financial intermediaries for distribution-related services. According to the Order, financial intermediaries will often provide both distribution services and shareholder services that would otherwise be provided by the fund's transfer agent (known as "**Sub-TA Services**") to mutual funds, but distribution services are only payable out of the assets of a fund if an approved Rule 12b-1 plan is in place; Sub-TA Services, on the other hand, are typically payable by the fund. According to the SEC, FEF entered into agreements with two financial intermediaries for distribution and marketing services (the "**Agreements**"), and not Sub-TA Services, but Respondents paid for such services out of the assets of the Funds, despite the absence of a written and approved Rule 12b-1 plan.

Under Section 206(2) of the Advisers Act, it is unlawful for an investment adviser to engage, directly or indirectly, in any transaction, practice or business which operates as a fraud or deceit upon any client or prospective client. According to the Order, First Eagle willfully violated this provision by causing the Funds to make payments under the Agreements absent a written and approved Rule 12b-1 plan. Further, under Section 12(b) of the Investment Company Act, and Rule 12b-1 thereunder, it is unlawful to use fund assets to directly or indirectly finance any activity which is primarily intended to result in the sale of fund shares, absent a written and approved Rule 12b-1 plan. The SEC found that the Respondents caused the Funds to violate these provisions by treating the distribution services provided under the Agreements as Sub-TA Services and causing the Funds to pay for such services outside of a written and approved Rule 12b-1 plan.

According to the Order, the Respondents also inaccurately reported to the Funds' board of trustees regarding the payments under the Agreements, classifying such payments as Sub-TA Services fees rather than distribution and marketing fees. As a result, according to the Order, the Funds' prospectus included inaccurate disclosures concerning such payments.

Under Section 34(b) of the Investment Company Act, it is unlawful to make an untrue statement of a material fact in any registration statement or to omit any fact necessary in order to prevent the statements

in any registration statement from being materially misleading. The SEC found that First Eagle willfully violated this provision due to its inaccurate disclosure concerning the Funds' payments under the Agreements.

Respondents agreed to settle the charges without admitting or denying the SEC's findings. The SEC censured First Eagle and ordered it to pay disgorgement of $24.9 million and $2.3 million of prejudgment interest. Further, the SEC ordered Respondents to pay a civil money penalty of $12.5 million, and FEF agreed to engage an independent compliance consultant.

- See a copy of the Press Release
- See a copy of the SEC 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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