Investment Management Regulatory Update

March 29, 2017

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SEC Rules and Regulations

Division of Investment Management Grants No-Action Relief to the Investment Adviser Association under Custody Rule

On February 15, 2017, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to the Investment Adviser Association ("**IAA**") clarifying that the SEC will not recommend enforcement under Section 206(4) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") and Rule 206(4)-2 thereunder (collectively, the "**Custody Rule**") if a registered investment adviser (an "**RIA**") otherwise complies with the Custody Rule but does not obtain a surprise audit where it has authority over client assets solely due to its being named in a standing letter of instruction (an "**SLOI**") to the client's custodian.

As described in the incoming letter (the "**Incoming Letter**"), an SLOI is a letter from a client to the qualified custodian that maintains the client's account (a "**Custodian**") instructing the Custodian to transfer funds from time to time to a designated third party upon the future request of the adviser. According to the IAA, many clients rely on an RIA to manage their strategy across all of their accounts, and SLOIs are a common way for clients to grant RIAs authority to move money among a client's accounts or to specific third parties designated by the client. The IAA argued that an RIA with authority over client assets due to an SLOI does not have "custody" for purposes of the Custody Rule because an

RIA's authority over the client's assets is limited and the discretion an RIA has over the funds does not allow it to "withdraw client funds" nor does it amount to "holding" the assets, as those terms are used in the Custody Rule.

According to the Letter, however, the SEC disagreed with the IAA's argument, noting that when an SLOI or similar arrangement grants an RIA authority to transfer assets to third parties, such authority is sufficient to require compliance with the Custody Rule. According to the SEC, the power to dispose of client funds or securities for any purpose other than authorized trading constitutes access to the client's assets and therefore custody.

Nonetheless, according to the Letter, the SEC stated that it would not recommend enforcement action if an RIA does not obtain a surprise audit but otherwise complies with the Custody Rule so long as:

- The client provides signed, written instructions to the Custodian including the relevant addresses and account numbers of any third parties to whom transfers may be made (each, a "**Third Party**").
- The client provides written authorization to the RIA to direct transfers to each such Third Party.
- The Custodian verifies that the instructions are valid and promptly notifies the client after each transfer.
- The client has the ability to terminate or change the SLOI.
- The RIA does not have authority to designate or change a Third Party, a Third Party's address or any other information about the Third Party contained in the SLOI.
- The RIA maintains records showing that the Third Party is not a related party of the RIA or located at the same address as the RIA.
- The Custodian sends the client a written notice confirming receipt of the instruction and an annual notice reconfirming the instruction.

The Letter also noted that, for any annual updating amendment of an RIA's Form ADV filed after October 1, 2017, an RIA should include client assets that are subject to an SLOI in its response to Item 9 of Form ADV, which concerns assets over which the RIA has custody.

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

Industry Update

SEC Division of Investment Management Issues Guidance on "Robo-Advisors"

In February 2017, the staff of the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update (the "**Update**") regarding certain unique considerations for automated advisers, often referred to as "robo-advisors," to meet their legal obligations under the Advisers Act.

According to the Update, because they may provide services directly to clients over the internet with limited or no direct human interaction, robo-advisors' business models raise concerns in the following three areas with respect to their compliance with the Advisers Act:

- The substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers;

- The obligation to obtain information from clients to support the robo-adviser's duty to provide suitable advice; and
- The adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated advice.

Substance and Presentation of Disclosures

According to the Update, a registered investment adviser's fiduciary duties require it to provide information that is not misleading to its clients and that will enable its clients to understand the adviser's business practices and conflicts of interest. As such, according to the Update, a robo-adviser should consider the most effective way to communicate to its clients the limitations, risks and operational aspects of its unique services and business model, and the Division identified certain specific items for disclosure in order to address potential gaps in a client's understanding of how the robo-advisor provides investment advice, including:

- A statement that an algorithm is used to manage individual client accounts;
- A description of the algorithmic functions used to manage client accounts (*e.g.*, that the algorithm generates recommended portfolios; that individual client accounts are invested and rebalanced by the algorithm);
- A description of the assumptions and limitations of the algorithm used to manage client accounts;
- An explanation of the particular risks inherent in the use of an algorithm to manage client accounts;
- An explanation of any circumstances that might cause the robo-adviser to override the algorithm used to manage client accounts (*e.g.*, that the robo-adviser may freeze trading or take other temporary defensive measures in stressed market conditions);
- A description of any third-party involvement in the development, management or ownership of the algorithm used to manage client accounts, including disclosure of any conflicts of interest due to such arrangement;
- A description of any advisory fees and any other costs the client may bear either directly or indirectly, such as brokerage costs;
- A description of the degree of human involvement in the oversight and management of individual client accounts;
- An explanation of how the robo-adviser uses the information gathered from a client to generate a recommended portfolio and any limitations to such method; and
- An explanation of how and when a client should update information he or she has provided to the robo-adviser.

In addition, according to the Update, robo-advisors should be sure not to mislead clients by implying that they are providing a comprehensive financial plan if they are not or that additional information aside from that collected from the client (typically in a questionnaire) will be considered if it will not be.

Finally, according to the Update, in addition to ensuring that the above-referenced disclosure is written in plain English and easily accessible, robo-advisors should also consider:

- Whether certain key disclosures are made available to potential clients prior to engaging the robo-advisor;
- Whether key disclosures are emphasized through specific design features, such as pop-up boxes;

- Whether certain disclosures should be accompanied by additional details to provide clients with additional information (such as through a "Frequently Asked Questions" section); and
- Whether the disclosures have been properly presented and formatted for display on a mobile platform.

Provision of Suitable Advice

According to the Update, in order to comply with its duty to act in the best interests of its clients and only provide suitable investment advice, robo-advisors should consider whether the questionnaires they rely on in order to determine a client's suitability are detailed enough to elicit sufficient information to support their suitability obligation. According to the Division, robo-advisors may wish to consider facts such as:

- Whether their questionnaires allow the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable and appropriate for that client based on his or her financial situation and investment objectives;
- Whether the questions in its questionnaire are sufficiently clear and whether the questionnaire is designed to provide additional clarification or examples to clients when necessary; and
- Whether tools are in place to address inconsistent client responses, such as including alerts when a client's response seems internally inconsistent and having a system that automatically flags apparently inconsistent information provided by a client for review by the robo-adviser.

Further, according to the Update, if the robo-adviser allows clients to select portfolios other than those it recommends, it should consider providing its reasoning as to why it believes that certain portfolios may be more appropriate for a given investment objective or risk profile, perhaps through the use of pop-up boxes or other design features.

Effective Compliance Programs

According to the Update, in order to comply with Rule 206(4)-7 of the Advisers Act, which requires a registered adviser to maintain an internal compliance program with written policies and procedures reasonably designed to prevent violations of the Adviser's Act, robo-advisers should consider addressing the unique aspects of their business model in such written policies and procedures by including policies that address:

- The development, testing and back testing of the algorithmic code and ongoing monitoring of such code;
- The questionnaire eliciting sufficient information to address suitability obligations;
- The disclosure to clients of changes to the algorithmic code that may materially affect their portfolios;
- The oversight of any third party that develops, owns or manages such algorithmic code or software used by the robo-adviser;
- Processes for the prevention and/or detection of and response to cybersecurity threats;
- The use of social and electronic media for advisory services and marketing; and
- The protection of client accounts and key systems.

► **See a copy of the IM Guidance Update**

IM Guidance Update Cautions Investment Advisers Regarding Inadvertent Custody under the Custody Rule

In February 2017, the staff of the SEC's Division of Investment Management issued an IM Guidance Update (the "**Update**") regarding when an investment adviser may inadvertently have custody of client funds or securities under Rule 206(4)-2 under the Advisers Act (the "**Custody Rule**").

According to the Update, advisers may have custody of client funds inadvertently due to certain language or provisions in the separate custodial agreements between the advisory client and the custodian, even if the adviser is not a party to such agreements. For example, according to the Update, the custodial agreement between a client and custodian may grant an adviser broader access to client funds or securities than the adviser's own agreement with the client, thereby inadvertently conferring custody on the adviser (and potentially subjecting the adviser to the surprise examination requirement under the Custody Rule as well).

According to the SEC, the definition of "custody" under the Custody Rule turns on whether the adviser is permitted to "withdraw" client funds or securities upon its instruction to the custodian. According to the Update, an adviser would be deemed to have custody where the custodial agreement enables the adviser to withdraw or transfer client funds or securities upon instruction to the custodian. Examples of such custodial agreements, according to the Update, include:

- A custodial agreement that grants the client's adviser the right to "receive money, securities and property of every kind and dispose of same";
- A custodial agreement whereby a custodian "may rely on [an adviser's] instructions without any direction from [the client]"; and
- A custodial agreement that provides authorization for the client's adviser to "instruct [the custodian] to disburse cash from [the client's] cash account for any purpose…."

Further, according to the Update, an adviser may have custody of client funds inadvertently when provisions regarding the adviser's authority to withdraw or transfer client funds or securities conflict as between the custodial agreement and the adviser agreement. Moreover, according to the Update, a separate bilateral restriction between the client and the adviser would be insufficient to resolve this conflict if the custodial agreement permits the adviser to withdraw or transfer client funds upon instruction to the custodian. In addition, according to the Update, where a custodial agreement is structured narrowly to permit the deduction of advisory fees (without granting any other rights that would impute custody), an adviser may have still be deemed to have custody but will not be subject to a surprise examination, provided it otherwise complies with the exception under Rule 206(4)-2(b)(3) available to advisers with limited custody due to fee deduction.

According to the Update, one way in which an adviser may avoid inadvertent custody would be to deliver a letter to the custodian limiting the adviser's authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and having the client and custodian provide written consent to acknowledge the new arrangement.

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

OCIE Announces Five Most Frequent Compliance Topics Identified during Examinations of Investment Advisers

On February 7, 2017, the Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert (the "**Risk Alert**") announcing the following five compliance topics under the Advisers Act most frequently identified in deficiency letters sent to SEC-registered investment advisers following an OCIE examination:

Compliance Rule

According to the SEC, Rule 206(4)-7 under the Advisers Act makes it unlawful for an adviser to provide investment advice to clients unless the adviser: (i) adopts and implements written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised persons, of the Advisers Act and the rules promulgated thereunder; (ii) reviews, no less frequently than annually, the adequacy of its policies and procedures and the effectiveness of their implementation; and (iii) designates a chief compliance officer responsible for administering the compliance policies and procedures that the adviser adopts. According to the Risk Alert, the most common deficiencies relating to the Rule 206(4)-7 identified by OCIE staff include the following:

- Compliance manuals are "off-the-shelf" and not reasonably tailored to the adviser's business practices;
- Annual reviews are not performed or do not address the adequacy of the adviser's policies and procedures;
- The adviser fails to follow its compliance policies and procedures, such as by not performing certain internal reviews or not adhering to certain practices relating to marketing, expenses or employee behavior; and
- Compliance manuals are not current, such as by including strategies no longer offered by the firm or listing personnel no longer working for the firm.

Regulatory Filings

According to the SEC, advisers are obligated to accurately complete and timely file certain regulatory filings with the SEC, including: (i) pursuant to Rule 204-1 under the Advisers Act, amending their Form ADV at least annually, within 90 days of the end of their fiscal year and more frequently if required by the instructions; (ii) pursuant to Rule 204(b)-1 under the Advisers Act, filing a report on Form PF for advisers to one or more private funds with private fund assets of at least $150 million; and (iii) pursuant to Rule 503 under Regulation D of the Securities Act of 1933, as amended, filing Form Ds on behalf of their private fund clients no later than 15 calendar days after the first sale of securities in the offering of a private fund. According to the Risk Update, typical deficiencies identified by OCIE staff include:

- Advisers making inaccurate disclosures on Form ADVs;
- Advisers not promptly amending their Form ADVs when certain information became inaccurate or timely filing their annual updating amendments;
- Advisers with an obligation to file Form PF not completing the form accurately or completely; and
- Advisers not accurately completing and/or timely filing Form Ds on behalf of their private fund clients.

Custody Rule

According to the SEC, advisers with custody of client cash or securities – that is, advisers or their related persons who hold, directly or indirectly, client funds or securities or have any authority to obtain possession of them – must comply with Rule 206(4)-2 of the Advisers Act. According to the Risk Alert, an adviser also has custody if it has an arrangement under which it is authorized or permitted to withdraw client funds or securities. Typical deficiencies identified by OCIE staff include, according to the Risk Alert:

- Advisers not recognizing that they may have custody via online access to client accounts;
- Advisers with custody obtaining surprise examinations that do not meet the requirements of Rule 206(4)-2 (*e.g.*, independent public accountants were not provided with a complete list of accounts or the "surprise" examinations were conducted at the same time each year); and

- Advisers not recognizing they may have custody as a result of certain authority over client accounts (*e.g.*, powers of attorney, or related persons with powers of attorney, authorizing the adviser to withdraw client cash or securities).

Code of Ethics Rule

According to the SEC, Rule 204A-1 under the Advisers Act requires that each adviser's code of ethics (i) establish a standard of business conduct that the adviser requires of all its supervised persons, (ii) require an adviser's "access persons" to periodically report their personal securities transactions and holdings to the adviser's chief compliance officer or other designated persons and (iii) require that access persons obtain the adviser's pre-approval before investing in an initial public offering or private placement. The SEC also noted that, pursuant to Rule 204A-1, each adviser must (i) provide each supervised person with a copy of the code of ethics and any amendments thereto and require a written acknowledgment of receipt and (ii) describe its code of ethics in its Form ADV Part 2A brochure and indicate that the code of ethics is available to any client or prospective client upon request. According to the Risk Alert, typical deficiencies identified by OCIE staff include:

- Advisers not identifying all of their access persons;
- Adviser's code of ethics missing required information, such as a review of the holdings and transactions reports or specific submission time frames;
- Untimely submission of transactions and holdings; and
- Form ADVs not containing descriptions of code of ethics or not indicating that the code of ethics is available upon request.

Books and Records Rule

According to the SEC, Rule 204-2 under the Advisers Act requires advisers to make and keep certain books and records relating to their investment advisory business, including typical accounting and other business records as required by the SEC. Typical deficiencies identified by OCIE staff include, according to the Risk Alert:

- Advisers not maintaining all required records (*e.g.*, advisory agreements and general ledgers);
- Books and records being inaccurate or not updated (*e.g.*, outdated client lists and inaccurate fee schedules); and
- Advisers maintaining contradictory information in separate sets of records.

According to the Risk Alert, in sharing these compliance topics, OCIE hopes to encourage advisers to reflect upon their own practices, policies and procedures in these areas and to promote improvements in investment adviser compliance programs.

- **See a copy of the Risk Alert**

SEC Staff Issues Responses to Frequently Asked Questions Relating to Mutual Fund Fees Guidance Update

On February 15, 2017, the Division of Investment Management of the SEC issued responses to certain frequently asked questions (the "**FAQs**") with respect to the IM Guidance Update issued in December 2016 (the "**Guidance Update**"), which addressed disclosure issues and certain procedural requirements relating to changes to fee structures of mutual funds ("**Funds**"). For a detailed discussion of the Guidance Update, please see the **January 23, 2017 Davis Polk Investment Management Regulatory Update**.

The FAQs provide guidance on several topics, including:

Variations in Sales Loads

- One of the FAQs addresses the situation in which a Fund that is implementing sales load variations has received template filing relief, which allows Funds to make substantially identical changes to additional Funds through filings under Rule 485(b) (a "**Rule 485 filing**") of the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). According to the FAQs, if a Fund has received template filing relief and has complied with the conditions thereof (including the disclosure requirements), such Fund can implement scheduled sales load variations by making a filing under Rule 497 of the Investment Company Act and then include the disclosure regarding sales load variations in its next Rule 485 filing. The FAQs state that this option is only available to Funds that (i) are implementing sales load variations, (ii) have received template filing relief and (iii) would not otherwise have needed to amend their registration statements prior to implementing sales load variations. The FAQs further clarify that Funds that are offering a new share class would not be able to rely on this option.
- With respect to a Fund that uses an appendix to disclose sales load variations, the FAQs state that the Fund would need to disclose all sales load variations for all share classes described in the Fund's prospectus in a single appendix. A Fund may not deliver to an investor only the appendix related to the investor's particular intermediary, but must rather deliver a prospectus that includes the complete appendix to that prospectus.
- According to the FAQs, a variable annuity issuer is permitted to disclose sales load variations in an appendix to the variable annuity prospectus. Such issuer will be subject to the same disclosure and procedural requirements set forth in the Guidance Update.

Template Filing Relief

According to the Guidance Update, a Fund's request for template relief filing should include the following representations:

- the disclosure changes in the template filing are substantially identical to disclosure changes that will be made in the registration statements that intend to rely on the relief (the "**Replicate Filings**");
- the Replicate Filings will incorporate changes made to the disclosure included in the template filing to resolve any staff comments thereon. (If the template filing is already effective, this representation should be replaced with "The Replicate Filings incorporate changes made to the disclosure included in the template filing to resolve any staff comments thereon."); and
- the Replicate Filings will not include any other changes that would otherwise render them ineligible for filing under Rule 485(b).

According to the FAQs, the SEC will generally not grant template filing relief for a Fund that has modified these representations, though exceptional circumstances may require additional review.

Capital Group Letter

- The FAQs clarify the filings that are required for a Fund to rely on a recent interpretive letter to the Capital Group (the "**CG Letter**"), which allows a broker to act as agent on behalf of its customers and charge its customers commissions for effecting transactions in clean shares of a Fund without being subject to the restrictions of Section 22(d) of the Investment Company Act. For a detailed discussion of the CG Letter, please see the **February 28, 2017 Davis Polk Investment Management Regulatory Update**. According to the SEC, "clean shares" are a class of shares of a registered investment company without any front-end load, deferred sales charge or other asset-based fee for sales or distribution. According to the FAQs, in order for a Fund to rely on the CG Letter, the Fund should, if it is creating new clean shares, create such new clean shares like any new share class by making a filing under Rule 485(a). A Fund that is seeking to add new

clean shares to multiple Funds within a fund complex may apply for template filing relief. For a Fund that already offers a share class that meets the requirements of the CG Letter (such as an institutional class), the FAQs explain that such Fund does not need to make a filing under Rule 485(a) for the sole purpose of adding the prospectus disclosure described in the CG Letter.

- According to the FAQs, a Fund that is offering clean shares should, pursuant to the representations in the CG Letter, include disclosure stating that investors transacting in clean shares may be required to pay brokerage commissions to a broker. Such disclosure for Funds should be included in the fee table narrative.

- **See a copy of the FAQs**

Department of Labor Proposes 60-Day Delay of Fiduciary Rule Applicability

On March 2, 2017, the Department of Labor ("**DOL**") published a proposal seeking to delay the applicability date of the fiduciary rule for 60 days and soliciting comments on the rule's impact on the financial services industry. In effect, from March 2, 2017, the DOL will be running two parallel rulemaking processes: one expedited process to finalize the short-term delay of the rule and a second process to complete a broader examination of the rule. The broader examination is a result of President Trump's executive memorandum directing the DOL to examine the impact of the rule and to rescind or revise the rule if the DOL reaches certain conclusions. The DOL noted that without the 60-day delay, if the examination prompts the DOL to propose rescinding or revising the rule, stakeholders would face two major shifts in the regulation rather than one. For further discussion of the DOL's proposal, please see the March 2, 2017 Davis Polk Financial Regulatory Reform blog post, **DOL Proposes 60-Day Delay of Fiduciary Rule Applicability**. For a detailed discussion of the DOL's fiduciary rule, please see the April 18, 2016 Davis Polk Client Memorandum, **Department of Labor's Final Rule Defining Fiduciary Investment Advice and Conflicts of Interest**.

Litigation

Large Financial Institution Settles Charges Related to Failure to Implement Policies Surrounding Inverse ETFs

On February 14, 2017, the SEC issued an order (the "**Order**") instituting and settling administrative cease-and-desist proceedings against a large financial institution (the "**Financial Institution**") for violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to adequately implement its policies and procedures to ensure that advisory clients understood the risks involved with purchasing inverse exchange-traded funds ("**Inverse ETFs**").

According to the Order, the Financial Institution had initially adopted a policy in August 2009 prohibiting its financial advisors from recommending that their clients purchase nontraditional ETFs, including Inverse ETFs. However, in March 2010, according to the Order, the Financial Institution amended this policy to allow its financial advisors to recommend certain Inverse ETFs if two key requirements were met: (i) each client needed to sign a client disclosure notice, which set out certain risks associated with investing in Inverse ETFs, including that they are typically unsuitable for investors who plan to hold them for longer than one trading session, and (ii) a manager of the Financial Institution needed to conduct a risk review to evaluate the suitability of an investment in Inverse ETFs for the particular client, including whether the client had signed the required client disclosure notice. According to the Order, the Financial Institution also had other compliance policies and procedures in place relating to Inverse ETFs, including that the

purchase of such ETFs function as a hedge, that positions be monitored on an ongoing basis and that financial advisors complete training on such ETFs.

According to the Order, between early 2010 and mid-2015, financial advisors at the Financial Institution solicited investments in Inverse ETFs for approximately 1,400 nondiscretionary advisory accounts. However, the Order stated that the Financial Institution did not have signed client disclosure notices on file for about 44% of such accounts. The Order further stated that a substantial number of the accounts for which the Financial Institution did not have a client disclosure notice on file experienced losses associated with the Inverse ETF investments, and a large number of client accounts had held such ETFs for months or years. In addition, the Order alleged that the Financial Institution failed to adequately implement its policies regarding using Inverse ETFs solely as a hedge.

According to the Order, in 2010, the OCIE conducted an exam that identified deficiencies in the Financial Institution's documentation of risk reviews and monitoring of the hedge requirement; however, according to the Order, the Financial Institution failed to take corrective measures at that time. The Order also stated that several internal reviews at the Financial Institution during 2012 and 2014 also revealed significant compliance deficiencies relating to Inverse ETFs, but the Financial Institution only took limited steps to improve the implementation of its policies regarding nontraditional ETFs.

The SEC found that the Financial Institution willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which generally require an adviser to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act, by failing to adequately implement its policies and procedures regarding Inverse ETFs and failing to take firm-wide corrective measures after being put on notice (through its internal reviews and the OCIE examination) that deficiencies in such policies and procedures existed.

The SEC ordered the Financial Institution to pay an $8 million civil penalty and to cease and desist from further violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

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