Investment Management Regulatory Update

November 28, 2017

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SEC Rules and Regulations

SEC Proposes Amendments to Investment Company Act and Advisers Act Rules to Require Hyperlinking of Certain Filings and Modernize Rules for Incorporation by Reference

On October 11, 2017, the SEC proposed amendments (the "**Proposed Amendments**") to modernize and simplify certain disclosure requirements in Regulation S-K, and, in connection therewith, proposed parallel amendments to several rules and forms applicable to investment companies and investment advisers under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") and the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"). While the Proposed Amendments also affect disclosure requirements of operating companies that make filings with the SEC, this update solely highlights key Proposed Amendments affecting investment companies and investment advisers. Such Proposed Amendments primarily relate to the use of hyperlinking and incorporation by reference in SEC filings.

Exhibit Hyperlinks and HTML Format

The SEC recently adopted rules requiring certain registration statements under the Securities Act of 1933, as amended, to include hyperlinks to most exhibits that are filed with such registration statements. To accommodate hyperlinks, a filing must be made in HTML format. The Proposed Amendments would include parallel amendments to certain forms used by investment companies to apply similar hyperlinking and HTML requirements to these registrants.

Under the Proposed Amendments, affected registrants would be required to include a hyperlink to each exhibit identified in a filing's exhibit index, unless the exhibit is filed in paper pursuant to a temporary or continuing hardship exemption. This requirement would apply to registration statements on Form S-6, Form N-1A, Form N-2, Form N-3, Form N-4, Form N-5, Form N-6 and Form N-14 and to reports on Form N-CSR. Under the Proposed Amendments, an electronic filer would also be required to correct an inaccurate or nonfunctioning link or hyperlink to an exhibit, in the case of a registration statement that is not yet effective, by filing an amendment to the registration statement or, in the case of a registration statement that has become effective, in the next post-effective amendment.

In order to ensure that the above hyperlinking requirement is feasible, the SEC is also proposing amendments to Rule 105 of Regulation S-T to require investment company registrants to file registration statements and reports referenced in the foregoing paragraph that include exhibits in HTML format. Currently, investment company registrants must submit electronic filings to the SEC using the EDGAR system in either HTML format or ASCII format, the latter of which does not support hyperlink functionality. Registrants would continue to be permitted to file in ASCII any schedules or forms that are not subject to the exhibit filing requirement, such as proxy statements or other documents included with a filing.

Incorporation by Reference

Under the Proposed Amendments, Rule 0-4 under the Investment Company Act, which provides general incorporation by reference rules for investment company registration statements, applications and reports filed with the SEC, would require hyperlinks to information that is incorporated by reference if such information is available on EDGAR. In line with the proposed requirements on hyperlinking of exhibits discussed above, a registrant would not be required to file an amendment to a document solely to correct an inaccurate hyperlink unless that hyperlink was included in a pre-effective registration statement. Unlike the requirement for exhibit hyperlinking, however, a registrant would not be required to correct inaccurate hyperlinks in an effective registration statement by including a corrected hyperlink in a subsequent post-effective amendment. The SEC explained that this difference is due to the fact that while exhibit hyperlinks can be corrected in an unobtrusive manner in the exhibit index, refiling a disclosure document solely to correct a hyperlink would create more confusion than clarity.

Other Proposed Amendments under the Investment Company Act and the Advisers Act include, among other things:

- Eliminating the requirement under Rule 8b-23 under the Investment Company Act that an investment company registrant file, along with a registration statement or report, a copy of any other registration statement, report or prospectus from which information is incorporated by reference, except if such registration statement, report or prospectus was filed electronically;
- Amending Rule 0-4 under the Investment Company Act to restrict the incorporation of financial information required to be given in comparative form for two or more fiscal years or periods unless the information incorporated by reference includes the entire period for which the comparative data is given. Amended Rule 0-4, as proposed, would also provide that financial statements may be filed as exhibits to investment company applications; and
- Streamlining the different rules for incorporation by reference contained in Rule 0-4 under the Investment Company Act and Rule 0-6 under the Advisers Act, including:
  - Eliminating the requirement that if a certificate of an independent public accountant is incorporated by reference in an investment company's filing of a registration statement, application or report or an investment adviser's filing of an application, a written consent of such accountant must be filed with the filing;
  - Eliminating the restrictions on incorporating by reference exhibits or financial statements made in certain filings that have been withdrawn or in connection with certain registration statements that have ceased to be effective, among other filings; and
  - Adding a general requirement that information may not be incorporated by reference in any instance where such information would render the disclosure incomplete, unclear or

confusing, and that, unless expressly permitted or required, a document may not be incorporated by reference if such document incorporates pertinent information by reference to another document.

The SEC has requested comments regarding the Proposed Amendments on or before January 2, 2018. Comments may be submitted (i) through the SEC's internet comment form (**https://www.sec.gov/cgi-bin/ruling-comments**), (ii) by email to **rule-comments@sec.gov**, (iii) via the Federal eRulemaking Portal (**http://www.regulations.gov**) or (iv) via mail to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

- **See a copy of the Proposed Amendments**

SEC Denies No-Action Relief Under Section 17(d) and Rule 17d-1 of the Investment Company Act in Connection with Expense Allocation Between Funds

On October 26, 2017, the staff of the Division of Investment Management of the SEC (the "**Staff**") issued a response (the "**Response**") denying no-action relief to a registered investment adviser (the "**Adviser**") that sought to allocate certain operational expenses incurred by registered funds of funds managed by the Adviser (the "**Funds of Funds**") to other registered funds also managed by the Adviser (the "**Underlying Funds**" and, together with the Funds of Funds, the "**Funds**") in which the Funds of Funds invest, without first seeking an exemptive order under Rule 17(d)-1 under the Investment Company Act.

According to the incoming letter (the "**Incoming Letter**"), the proposed expense allocation methodology would allocate non-advisory expenses of the Funds of Funds, including legal and compliance costs, printing and distribution costs and custodial fees, solely to the Underlying Funds. The Incoming Letter stated that because the Funds of Funds mainly serve as a convenient method of investing in a number of the Underlying Funds, allocating expenses away from the Funds of Funds would attract new assets and thus reduce the expense ratios of all Funds (including the Underlying Funds) by an amount that exceeds the extra expenses borne by the Underlying Funds. Further, the Incoming Letter noted that the Funds have a common board of directors, a majority of whom are independent directors (the "**Independent Directors**"), which would review and approve any such expense allocation methodology.

Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder generally prohibit first- and second-tier affiliates of a registered investment company from participating in or effecting any joint enterprise or other joint arrangement or profit sharing plan with the registered investment company on a principal basis, absent an exemptive order from the SEC. Under Section 2(a)(3)(E) of the Investment Company Act, an "affiliated person" of a registered investment company includes any person who directly or indirectly owns, controls or holds with power to vote, five percent or more of the outstanding voting securities of the registered investment company.

According to the Incoming Letter, the legislative history of Rule 17d-1 indicates that entities having common directors or investment advisers should not automatically be presumed to be affiliates under Section 2(a)(3)(E). The Incoming Letter argued that in most instances of affiliation between two funds with the same investment adviser, such affiliation arises from funds being under the common control of the investment adviser. According to the Incoming Letter, because the Funds are not controlled by the Adviser but rather by a shared board of directors, the Funds of Funds and the Underlying Funds should not be considered affiliates for purposes of Section 17(d) and Rule 17d-1. The Incoming Letter further argued that the proposed expense allocation would not represent the type of "self-dealing and profit motive" that Section 17(d) and Rule 17d-1 seek to prevent, because it does not create an incentive for the Adviser to recommend one Fund over another.

The Staff disagreed with the Incoming Letter's arguments, stating that the Funds of Funds and the Underlying Funds may be first- or second-tier affiliates by virtue of being under common control of the Adviser, having common directors or officers, or a Fund of Funds' owning, controlling or holding with power to vote five percent or more of an Underlying Fund's outstanding voting securities. According to the

Response, the proposed expense allocation would constitute a joint arrangement between the Funds of Funds and the Underlying Funds and would thus require an exemptive order before it could be implemented. In particular, the Response noted the fact that some of the expenses to be allocated to the Underlying Funds would not be incurred by the Underlying Funds but would have been solely attributable to the Funds of Funds, thus creating the potential for conflicts of interest. The Response cautioned registered funds and their investment advisers against entering into similar arrangements without first obtaining an exemptive order as required under Rule 17d-1.

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

SEC Grants No-Action Relief Permitting Credit Risk Transfer Securities to Be Treated as "Real Estate-Type Interests" Under Section 3(c)(5)(C) of the Investment Company Act

On October 16, 2017, the Staff issued a no-action letter (the "**Letter**") to Redwood Trust, Inc. ("**Redwood**"), permitting certain wholly owned subsidiaries of Redwood (the "**Redwood Subsidiaries**") to treat their investments in credit risk transfer securities as "real estate-type interests" for purposes of Section 3(c)(5)(C) of the Investment Company Act.

According to the incoming letter (the "**Redwood Incoming Letter**"), Redwood is a residential mortgage-focused finance company structured as a real estate investment trust. The Redwood Incoming Letter explains that Redwood, through the Redwood Subsidiaries, acquires mortgages, mortgage-backed securities and other real-estate related assets, including "credit risk transfer securities"—*i.e.*, securities that effectively transfer to private investors a portion of the credit risk of mortgage pools that are owned by Fannie Mae or Freddie Mac or that back mortgage-backed securities whose payments are guaranteed by Fannie Mae or Freddie Mac.

Section 3(c)(5)(C) of the Investment Company Act provides an exclusion from the definition of "investment company" for any person that is "primarily engaged in . . . [the business of] purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." According to the Letter, the Staff has previously issued several no-action letters allowing an issuer to rely on Section 3(c)(5)(C) if it meets the following test (the "**Asset Composition Test**"): (i) at least 55% of the issuer's assets consist of "qualifying interests" (*i.e.*, assets that represent an actual interest in real estate or are loans or liens fully secured by real estate) and the remaining 45% of its assets consist primarily of "real estate-type interests," (ii) at least 80% of its total assets consist of qualifying interests and real estate-type interests, and (iii) no more than 20% of its total assets consist of assets that have no relationship to real estate.

According to the Letter, although the term "real estate-type interests" is not defined in the Investment Company Act, the Staff has indicated in previous no-action guidance that certain mortgage-related instruments, including agency partial pool certificates (*i.e.*, certificates issued by Fannie Mae or Freddie Mac that represent less than the entire ownership interest in a mortgage pool), may be treated as real estate-type interests for purposes of the Asset Composition Test. According to the Redwood Incoming Letter, the credit risk transfer securities owned by the Redwood Subsidiaries have similar characteristics and the same economic substance as agency partial pool certificates, and should thus qualify as real estate-type interests for Section 3(c)(5)(C) purposes.

The Letter granted the relief requested, allowing Redwood Subsidiaries to treat their investments in credit risk transfer securities as real estate-type interests for purposes of determining whether the Redwood Subsidiaries meet the Asset Composition Test and thus are eligible to rely on the exclusion from the definition of investment company in Section 3(c)(5)(C) of the Investment Company Act.

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

SEC Issues No-Action Guidance Regarding MiFID II Research Provisions

On October 26, 2017, the SEC issued three related no-action letters (the "**MiFID II Letters**") to address certain issues raised by cross-border implementation of the European Union's Markets in Financial Instruments Directive ("**MiFID II**"), which will take effect on January 3, 2018. For a detailed discussion of the guidance provided in the MiFID II Letters, please see the **November 6, 2017 Davis Polk Client Memorandum**.

Industry Update

SEC Enforcement Division Issues Report on Priorities and FY 2017 Results

On November 15, 2017, the Division of Enforcement of the SEC (the "**Enforcement Division**") issued a report (the "**Annual Report**") highlighting its priorities for the upcoming year and reviewing the enforcement actions it brought during the 2017 fiscal year.

According to the Annual Report, five core principles will guide the Enforcement Division's decision-making in 2018: focusing on retail investors' interests, emphasizing individual accountability for wrongdoers, keeping pace with technological changes, imposing the most effective sanctions to further enforcement goals and continuously assessing resource allocation at the Enforcement Division.

The Annual Report also summarizes the Enforcement Division's enforcement results for fiscal year 2017. According to the Annual Report, the Enforcement Division brought 754 enforcement actions during 2017, which led to more than $3.7 billion in disgorgement and penalties and $1.07 billion returned to investors. These enforcement actions also resulted in the suspension of trading in 309 companies and the barring or suspension of more than 625 individuals.

According to the Annual Report, 446 of the 754 enforcement actions were standalone actions, of which a significant number involved investment advisory issues, securities offerings and issuer reporting/accounting and auditing, with each category constituting approximately 20 percent of the total number of standalone actions. Other major categories included market manipulation, insider trading and broker-dealer issues, each of which constituted approximately 10 percent of the total number of standalone actions.

- **See a copy of the Annual Report**

Treasury Department Publishes Recommendations on Regulation of Asset Management Industry

On October 26, 2017, the U.S. Department of Treasury (the "**Treasury**") issued a report (the "**Report**") on the status of the current U.S. regulatory regime governing the asset management and insurance industries. This update solely highlights recommendations relating to the asset management industry, which fall into four framework categories: (1) Systemic Risk and Stress Testing; (2) Efficient Regulation and Government Processes; (3) International Engagement; and (4) Economic Growth and Informed Choices.

Systemic Risk and Stress Testing

- *Systemic Risk*. According to the Report, due to fundamental differences between asset managers and prudentially regulated institutions (*e.g.*, banks), entity-based systemic risk evaluations of the asset management industry is unlikely to be an effective regulatory approach. Instead, the Report recommends that federal regulators focus on potential systemic risks arising from asset management products and activities and implement regulations that strengthen the overall industry.

- *Stress Testing*. According to the Report, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") requires certain non-bank financial companies, including investment advisers and investment companies, to conduct annual stress tests. The Report notes that stress testing raises significant implementation challenges in the asset management industry and argues that the spirit of Dodd Frank's stress testing requirements are already satisfied by the stress testing provisions currently applicable to registered investment companies under the Investment Company Act. The Report recommends that Dodd-Frank be amended to eliminate the stress testing requirement for investment advisers and investment companies.

Efficient Regulation and Government Processes

- *Liquidity Risk Management*. With respect to liquidity risk management, the Report recommends rejecting a highly prescriptive approach in favor of a principles-based approach to rulemaking. As an example of the type of rulemaking the Report would reject, the Report cites Rule 22e-4 of the Investment Company Act, which contains detailed rules surrounding illiquid asset thresholds and liquidity risk management programs. The Report also specifically encourages further analysis by the SEC on swing pricing and its effects on investors.
- *Derivatives*. The Report notes that the SEC has proposed a new derivatives rule that generally allows mutual funds, exchange-traded funds ("**ETFs**") and closed-end funds to enter into derivatives transactions if they: (i) comply with one of two portfolio limitations to limit leverage obtained through derivatives; (ii) segregate an amount of qualifying coverage assets (*i.e.*, cash and cash equivalents) for derivatives; and (iii) establish a formalized derivatives risk management program. The Report recommends that the SEC consider eliminating the portfolio limit condition and broadening the types of assets that can be considered qualifying coverage assets.
- *Exchange-Traded Funds*. The Report recommends that the SEC propose a new rule to streamline the current ETF approval process and allow entrants access to the market without the cost and delay of obtaining exemptive relief orders.
- *Business Continuity and Transition Planning*. The Report notes that while investment advisers and investment companies are currently required under Rule 206(4)-7 of the Advisers Act and Rule 38a-1 of the Investment Company Act to maintain business continuity plans as a part of their compliance policies and procedures, the SEC recently proposed a new Rule 206(4)-4 under the Advisers Act, which would impose additional requirements on the content of business continuity plans. The Report argues that the existing rules regarding business continuity planning are sufficient and recommends that the current SEC proposal be withdrawn.
- *Dual SEC and CFTC Registration*. The Report notes that currently, many investment advisers and funds are required to dually register with the Commodity Futures Trading Commission ("**CFTC**") and the SEC, which subjects them to two distinct sets of reporting and regulatory requirements. The Report recommends amending the CFTC rules such that an investment company registered with the SEC and its adviser are exempt from dual registration and regulation by the CFTC.
- *Delivery of Registered Fund Disclosures*. The Report notes that registered investment companies are subject to an extensive set of disclosure requirements which, absent consent for electronic delivery, must be provided in paper by mail. The Report recommends that the SEC finalize proposed Rule 30e-3 under the Investment Company Act, which, among other things, would permit the use of implied consent to delivery by website in the absence of further instructions from shareholders of mutual funds. The Report further encourages the SEC to identify other areas where delivery of information through an electronic medium using implied consent is appropriate and consistent with investor protection.

- *Asset Management and Disclosure Requirements*. According to the Report, while reporting obligations are critical to ensure regulatory and public transparency into a fund's activities, duplicative reporting requirements can increase costs, which are then borne by investors. The Report recommends that regulators cooperate to combine duplicative forms and remove unnecessary data collection. Further, the Report recommends that all regulatory agencies focus on ensuring that their information security measures are meeting and/or exceeding standards set by Congress and other federal oversight bodies.
- *Volcker Rule*. The Report recommends that regulators reduce the burden of the Volcker Rule on asset managers and investors by not enforcing (i) the proprietary trading restrictions against foreign funds that are not "covered funds" under the Volcker Rule and (ii) the restriction on funds sharing a name with the bank entities that sponsor them. The Report further recommends that Congress revise the definition of "banking entity" to encompass only insured depositary institutions, their holdings companies, foreign banking organizations and affiliates and subsidiaries of such entities.

International Engagement

The Report highlights the importance of a multilateral approach to addressing structural vulnerabilities from asset management activities that could potentially present financial stability risks. According to the Report, liquidity mismatch and leverage are the key vulnerabilities that merit increased regulatory attention. The Report further recommends that the U.S play a leading role on international standard-setting bodies such as the Financial Stability Board and the International Organization of Securities Commissions, and that U.S. agencies with seats on such international bodies coordinate their representation on behalf of the U.S.

Economic Growth and Informed Choices

According to the Report, the Treasury supports current efforts at the Department of Labor to delay full implementation of its fiduciary rule (the "**Fiduciary Rule**") in order to re-examine the full scope of its implications on the market. The Report encourages adopting regulations that address conflicts of interest faced by fiduciaries while preserving access to a wide range of asset classes, investment products, business models, distribution channels and other relevant features of financial services. For a detailed discussion of the DOL Fiduciary Rule, please see the April 5, 2017 Davis Polk Financial Regulatory Reform Blog Post, **DOL Fiduciary Rule: Officially Delayed for Now, with More to Come**.

- **See a copy of the Report**

Litigation

SEC Charges Former Partner at Investment Adviser with Fraudulently Charging Personal Expenses to Fund Clients

On October 25, 2017, the SEC filed a complaint (the "**Complaint**") in the U.S. District Court for the Southern District of New York against a former senior partner (the "**Defendant**") at a well-known investment adviser (the "**Firm**"), for intentionally misappropriating approximately $290,000 from certain private equity fund clients (the "**Relevant Funds**") by charging such funds for personal, non-business related expenses.

According to the Complaint, from 2010 to 2013, the Defendant charged the Relevant Funds thousands of dollars in expenses and falsified receipts related to several personal vacations, consumer electronics, personal meals at restaurants, the cost of personal visits to a hair salon and reimbursement for clothing purchases for himself and his family members by claiming that such charges were legitimate business expenses related to travel, meals and gifts with or for clients. According to the Complaint, during this time, the Defendant was an active investment adviser who sourced, evaluated and recommended investment opportunities to his clients at the Firm, including the Relevant Funds, and received millions of dollars per year related to his advisory services.

The Complaint alleged that during this time, the Relevant Funds' governing documents only permitted expenses related to the Relevant Funds' investments and operations to be charged to such funds. In addition, the Complaint stated that the Firm's travel and expense reimbursement policies and procedures provided that employees could only charge clients for reasonable business and travel expenses incurred in the performance of their duties, and listed specific examples of the types of expenses that were not reimbursable (many of which were the types of expenses the Defendant submitted for reimbursement under another classification). According to the Complaint, the Defendant signed annual certifications that he had completed the Firm's compliance trainings, which included such expense reimbursement policies; the Defendant also signed the Firm's code of ethics, which prohibited the falsification of documents and specifically prohibited any false personal expense statement or claim.

According to the Complaint, the Defendant's actions first came to light in 2010, when the chief financial officer (CFO) of the Firm was made aware of questionable expense reports and conducted a six-month review of the Defendant's expense entries. As a result of this review, the Defendant agreed to pay back approximately $8,000 he had received as reimbursement for personal expenses and was warned by the CFO not to repeat the conduct. However, according to the Complaint, a second review of the Defendant's expenses took place in 2012 after it was reported that the Defendant had once again submitted suspicious expenses. The Complaint alleged that the Defendant was again required to reimburse the Firm for improperly charged personal expenses and told that such charges were prohibited; however, the Defendant was not placed on leave until a third review in 2013 in which the Firm identified additional improper charges and the Defendant admitted that over $220,000 in business expenses that he had charged to his fund clients were personal expenses (in addition to the amount he paid back in 2010). As a result of this 2013 review, the Firm again credited the Relevant Funds for all such charges billed to them and the Defendant reimbursed the Firm.

According to the Complaint, the Defendant's actions, as described above, violated, or aided and abetted the Firm's violation of, Sections 206(1) and 206(2) of the Advisers Act, pursuant to which an investment adviser has a duty not to employ any device, scheme or artifice to defraud any client or prospective client and may not engage in transactions, practices or courses of business which operate as a fraud or deceit upon any client or prospective client. The Complaint seeks a permanent injunction preventing the Defendant from further violations of Sections 206(1) and 206(2) of the Advisers Act, along with civil money penalties.

- **See a copy of the Complaint**

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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