Investment Management Regulatory Update

October 31, 2016

SEC Rules and Regulations

SEC Adopts Sweeping Reforms to Enhance Liquidity Risk Management for Mutual Funds and ETFs

On October 13, 2016, the SEC voted to adopt reforms to certain rules under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), to enhance liquidity risk management by open-end management investment companies, including mutual funds and exchange-traded funds ("**ETFs**"). According to the SEC, the new rules are intended to promote effective liquidity risk management across the open-end fund industry and are part of the SEC's broader initiative to enhance its monitoring and regulation of the asset management industry. The rules do not, however, apply to money market funds, which are subject to separate liquidity requirements. For a detailed discussion of the rules as proposed on September 22, 2015, please see the **October 27, 2015 Investment Management Regulatory Update**.

According to the adopting release, the SEC is adopting new Rule 22e-4 under the Investment Company Act ("**Rule 22e-4**"), with a number of modifications from the rule as proposed, to enhance the effectiveness and workability of the rule's liquidity risk management requirements. According to the SEC, Rule 22e-4 requires each registered open-end management investment company, including mutual funds and open-end ETFs (but not money market funds), to adopt and implement a written liquidity risk management program reasonably designed to assess and manage the fund's liquidity risk. The new rule, according to the adopting release, requires a fund's liquidity risk management program to incorporate certain elements, including:

- *Assessment, Management and Periodic Review of Liquidity Risk*. A fund is required to assess and periodically review its liquidity risk, defined as the risk that a fund could not meet redemption requests without significant dilution of remaining investors' interests (rather than, as initially proposed, whether a fund could meet redemption requests without materially affecting the fund's net asset value per share). Such review, according to the SEC, must occur no less frequently than annually and must include consideration of the following factors, as applicable:
    - The fund's investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions;
    - The fund's short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;
    - The fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
    - For an ETF, (i) the relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, ETF shares trade and (ii) the effect of the composition of baskets on the overall liquidity of the ETF's portfolio.
- *Classification of the Liquidity of Fund Portfolio Investments*. A fund (other than an ETF that meets redemptions through in-kind transfers of securities, positions and assets (other than a *de minimis* amount of cash) and that publishes its portfolio holdings daily (an "**In-Kind ETF**")) is required to classify the liquidity of each portfolio investment based on the number of days in which it reasonably expects that the investment would be convertible to cash (meaning the ability to be sold, with the sale settled) or otherwise disposed of without such conversion or disposition significantly changing the market value of the investment. Specifically, according to the SEC, Rule 22e-4 requires a fund to classify each of its portfolio investments, including its derivatives transactions, into one of four liquidity categories (down from six categories as originally proposed) of highly liquid investments (convertible to cash in less than three business days), moderately liquid investments (more than three calendar days but within seven calendar days or less), less liquid investments (in seven calendar days or less) and illiquid investments (not within seven calendar days). According to the adopting release, a fund must review the classification of its portfolio investments at least monthly and more frequently if changes in relevant market, trading and investment-specific considerations are reasonably expected to materially affect one or more of its investments' classifications.
- *Establishment of a Highly Liquid Investment Minimum*. A fund (other than funds with portfolio assets consisting primarily of highly liquid investments and In-Kind ETFs) is required to determine a minimum percentage of its net assets required to be invested in highly liquid investments. According to the adopting release, Rule 22e-4 also requires a fund to adopt and implement policies and procedures for responding to a shortfall in its highly liquid investments below the fund's minimum, which must include reporting any shortfall to the fund's board.
- *Limitation on Illiquid Investments.* Rule 22e-4 prohibits a fund (including In-Kind ETFs) from acquiring any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments. According to the adopting release, although the limitation as proposed referred to 15% of total, not net, assets, the text of the proposed rule was intended to refer to "net assets."
- *Board Approval and Designation of Program Administrative Responsibilities*. A fund's board, including a majority of the fund's independent directors, is required to approve the fund's liquidity risk management program and the designation of the fund's adviser or officer to administer the program. In a change from the proposal, however, the board will not be required to specifically approve the fund's highly liquid investment minimum (except in the limited circumstances that a fund below its minimum seeks to change it) or to approve material changes to the program.

- *Reporting to the Board.* Rule 22e-4 requires that the administrator of the liquidity risk management program report any shortfall in the fund's highly liquid investment minimum to the board no later than its next regularly scheduled meeting with a brief explanation of the causes and extent of the shortfall and any actions taken in response; if the shortfall lasts more than seven consecutive calendar days, the program administrator must report to the board within one business day with an explanation of how the fund plans to restore its minimum within a reasonable period of time. Further, a fund's board must be informed within one business day if the fund's holdings of illiquid investments exceed 15% of its net assets. Rule 22e-4 also requires the program administrator to provide the board with a written report of the adequacy of the fund's liquidity risk management program, including the highly liquid investment minimum and the effectiveness of its implementation, at least annually.

According to the adopting release, in connection with the liquidity risk management program, the SEC is also adopting a new nonpublic reporting requirement on Form N-LIQUID, which generally requires a fund to confidentially notify the SEC within one business day when the fund's level of illiquid assets exceeds 15% of its net assets or when its highly liquid investments fall below its set minimum for more than seven consecutive calendar days.

According to the adopting release, unit investment trusts ("**UITs**") are excluded from Rule 22e-4's liquidity risk management program requirements, but UITs are required to undertake a limited liquidity review. Under Rule 22e-4, a UIT's principal underwriter or depositor must determine, on or prior to the initial deposit of portfolio securities into the UIT, whether the illiquid investments the UIT holds or will hold upon deposit is consistent with the redeemable nature of the securities it issues.

The compliance date for the liquidity risk management program requirement and Form N-LIQUID is December 1, 2018 for larger entities, namely, funds that, together with other investment companies in the same group of related investment companies, have net assets of $1 billion or more, and June 1, 2019 for smaller entities.

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

SEC Adopts Rules to Modernize Information Reported by Investment Companies

On October 13, 2016, the SEC announced its adoption of a final rule (the "**Final Rule**") to strengthen and modernize the reporting and disclosure of information by certain types of registered investment companies ("**RICs**"), including mutual funds, ETFs and closed-end funds. For a discussion of the rules as proposed on May 20, 2015, please see the **June 18, 2015 Davis Polk Client Memorandum, SEC Proposes Rules to Modernize and Enhance Information Reported by Investment Companies and Investment Advisers**.

Pursuant to the Final Rule, the SEC has adopted a new Form N-PORT and has rescinded Form N-Q under the Investment Company Act. Currently, according to the SEC, management investment companies, other than money market funds and small business investment companies ("**SBICs**"), are required to submit quarterly reports on Form N-Q and Form N-CSR. Under the new Form N-PORT, all registered management investment companies and UITs that operate as ETFs, except for money market funds and SBICs, must report information about their monthly portfolio holdings to the SEC in an Extensible Markup Language ("**XML**") format on a monthly basis, including data related to the pricing of portfolio securities, information regarding repurchase agreements, securities lending activities and counterparty exposures, terms of derivative contracts and discrete portfolio level and position-level risk measures. According to the SEC, information reported on Form N-PORT will help the SEC understand trends in the fund industry, carry out regulatory responsibilities and analyze and understand the various risks in a particular fund, as well as across the industry as a whole.

Pursuant to the Final Rule, within 30 days after the close of each month, subject funds must provide on Form N-PORT the following information as of the end of such month:

- *General Information about the Fund.* This includes the name of the fund, the name of the series, relevant file numbers, the fiscal year end date, the date as of which information is reported on the form and whether or not this will be the fund's final filing.
- *Assets and Liabilities.* This includes total assets, total liabilities and net assets. In addition, funds will also report the aggregate value of any miscellaneous securities (as described below), any assets invested in a controlled foreign corporation for the purpose of investing in certain types of investments and amounts of certain liabilities including: borrowings attributable to amounts payable on notes, bonds and similar debt, payables for investments purchased either on a delayed delivery or standby commitment basis and liquidation preference of outstanding preferred stock issued by the fund.
- *Certain Portfolio Level Metrics.* Funds must report quantitative measurements of certain risk metrics that will provide information beyond the more narrative disclosures found in the registration statement.
- *Information Regarding Securities Lending Counterparties.* Funds are required to report certain borrower information, including aggregate borrower exposure for all securities lending borrowers and position-level information.
- *Information Regarding Monthly Returns.* Funds must provide monthly total returns for each of the preceding three months; if the fund is a multiple class fund, it must report returns for each class and funds with multiple classes must also report their class identification numbers. According to the SEC, funds must calculate returns using the same standardized formulas required for calculation of returns as reported in the performance table contained in the risk-return summary of the fund's prospectus and in fund sales materials.
- *Flow Information.* Similar to what is currently reported on Form N-SAR, the Final Rule requires funds to report on Form N-PORT the total net asset value of (i) shares sold (including exchanges but excluding reinvestment of dividends and distributions), (ii) shares sold in connection with reinvestments of dividends and distributions, and (iii) shares redeemed or repurchased (including exchanges) for each of the preceding three months.
- *Information Regarding Each Investment in the Portfolio.* Funds must report certain information on an investment-by-investment basis about each investment held by the fund and its consolidated subsidiaries. Part C of new Form N-PORT includes questions about the investment's identification, amount, payoff profile, asset and issuer type, country of investment or issuer, fair value level and whether the investment is a restricted security, as well as (if applicable) questions regarding specific types of investments such as debt securities, repurchase and reverse repurchase agreements, derivatives and securities lending.
- *Miscellaneous Securities (if any).* Funds will have the option of identifying and reporting certain investments as "miscellaneous securities." Part D of Form N-PORT allows funds to report an aggregate amount not exceeding 5% of the total value of their portfolio investments in one amount, provided that the securities so listed are not restricted, have been held for not more than one year prior to the date of the related balance sheet and have not previously been reported by name to any shareholders or set forth in any registration statement, application or report to shareholders, or otherwise made available to the public.
- *Explanatory Notes (if any).* Funds will have the option of providing explanatory notes relating to the filing, which can be used to explain assumptions that funds have made in responding to specific items or provide context for seemingly anomalous responses.

- *Exhibits to the SEC.* Pursuant to the Final Rule, for reports filed at the end of the first and third quarters of a fund's fiscal year, the fund must also attach its complete portfolio holdings as of the close of the period covered by the report. According to the SEC, these reports do not have to be reported in XML format and can be in accordance with the schedule set forth in §§ 210.12-12 to 12-14 of Regulation S-X. Funds have up to 60 days after the end of such quarters to file these reports as exhibits to their Form N-PORTs.

According to the SEC, the information reported on a fund's Form N-PORT at quarter-end will be made publicly available 60 days after the end of the fund's fiscal quarter. However, according to the SEC, the information reported on Form N-PORT for the first and second months of a fund's fiscal quarter will not be made public.

According to the SEC, Form N-Q will be rescinded effective August 1, 2019, and there will be a tiered set of compliance dates based on a fund's asset size for the first Form N-PORT filing. RICs and UITs that operate as ETFs with net assets of $1 billion or more (together with other RICs and UITs that operate as ETFs in the same related group) must comply by June 1, 2018, and those with net assets of less than $1 billion must comply by June 1, 2019.

Pursuant to the Final Rule, the Commission has also adopted amendments to Regulation S-X, which will require standardized, enhanced disclosure about derivatives in fund financial statements. Currently, according to the SEC, Regulation S-X does not prescribe specific information for most types of derivatives, including swaps, futures and forwards. Pursuant to the Final Rule, the amendments to Regulation S-X will (i) require new, standardized disclosures regarding fund holdings in open futures contracts, open forward currency contracts and open swap contracts, as well as additional disclosures regarding fund holdings of written and purchased option contracts, (ii) update the disclosures for other investments and investments in and advances to affiliates, as well as reorganize the order in which some investments are presented, and (iii) amend the rules regarding the general form and content of financial fund statements. Additionally, pursuant to the Final Rule, a fund's disclosure regarding derivatives use must be displayed prominently in the financial statements, rather than in the notes. According to the SEC, the compliance date for the new amendments to Regulation S-X will be August 1, 2017.

Pursuant to the Final Rule, the SEC will rescind Form N-SAR and has adopted a new Form N-CEN requiring RICs, other than face-amount certificate companies, to annually report certain census-type information to the SEC in an XML format. The new Form N-CEN, according to the SEC, replaces items that are outdated or of limited usefulness in Form N-SAR, but will include many of the same data elements. According to the SEC, Form N-SAR will be rescinded, and new Form N-CEN will become effective, on June 1, 2018.

Pursuant to the Final Rule, the SEC has declined to adopt proposed Rule 30e-3, which would provide funds with an optional method to satisfy shareholder report transmission requirements by posting their reports online if they meet certain conditions. According to the SEC, additional consideration regarding the use of electronic transmission is necessary.

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

SEC Adopts Rule Amendments Permitting the Use of Swing-Pricing by Certain Open-End Funds

On October 13, 2016, the SEC adopted amendments to Rule 22c-1 under the Investment Company Act, permitting open-end funds (except money market funds and exchange-traded funds) under certain circumstances to use swing pricing, which is the process of reflecting in a fund's net asset value ("**NAV**") the costs associated with shareholder trading activity in order to pass on such transaction costs to the purchasing or redeeming shareholders, thereby mitigating shareholder dilution. The SEC also adopted

amendments to Rule 31a-2 under the Investment Company Act, requiring funds to preserve certain records related to swing pricing. For a discussion of the rules as proposed on September 22, 2015, please see the **October 27, 2015 Davis Polk Investment Management Regulatory Update**.

According to the adopting release, a fund that elects to use swing pricing must set both a "swing threshold" and a method for determining a "swing factor." The swing threshold, according to the SEC, is the level of redemptions or purchases that, once exceeded, trigger the adjustment of the fund's NAV by the amount of the swing factor in order to help offset the transaction costs arising from the volume of purchases or redemptions. Therefore, according to the adopting release, when net purchases in a fund exceed the swing threshold, the NAV would be adjusted upward by the amount of the swing factor so that purchasing shareholders would bear the costs of the fund investing in additional portfolio assets. In the same manner, when net redemptions exceed the amount of the swing threshold, the fund's NAV would be adjusted downward by the amount of the swing factor so that redeeming shareholders bear the costs of the fund's sale of portfolio assets to meet redemption requests. According to the SEC, a fund is required to consider certain factors when determining its swing threshold, including: (i) the size, frequency and volatility of historical net purchases or net redemptions of the fund's shares during normal and stressed periods; (ii) the fund's investment strategy and the liquidity of the fund's portfolio investments; (iii) the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and (iv) the costs associated with transactions in the markets in which the fund invests.

The swing factor, according to the adopting release, is a fluctuating percentage, not to exceed 2% of NAV per share and calculated pursuant to the fund's swing pricing policies, by which a fund's NAV is adjusted once its swing threshold is exceeded. According to the SEC, a fund's process for setting a swing factor must consider the expected near-term costs resulting from net purchases or redemptions that occur on the day the swing factor is used, including spread costs, transaction fees and charges, as well as borrowing-related costs arising from asset purchases or asset sales to satisfy purchases or redemptions. The designated administrator of the fund's swing pricing must also determine that the swing factor is reasonable in relation to these near-term costs.

According to the SEC, for any fund that uses swing pricing, the method for determining the swing factor, the upward limit for the swing factor and policies and procedures for swing pricing must be approved by such fund's board and reviewed no less frequently than annually. In addition, according to the adopting release, a fund's board must also designate the fund's adviser or an officer to be responsible for administering the fund's swing pricing activities and such administration activities must be reasonably segregated from the portfolio management of the fund. Such administrator, according to the SEC, must, at least annually, provide a written report to the fund's board describing its assessment of the adequacy of the swing pricing policies and procedures and their implementation, including the effectiveness of the swing pricing procedures on mitigating dilution and the swing threshold and swing factor used by the fund for swing pricing. Finally, according to the adopting release, a fund must also disclose its use of swing pricing in various places in its registration statement and financial statements.

According to the adopting release, funds that use swing pricing must preserve certain records related to such practice, including creating and maintaining a record of support for each computation of adjustment to the NAV of the fund's shares based on its swing pricing policies and procedures.

Finally, the SEC also approved amendments to Form N-1A and Form N-CEN that affect reporting in connection with the use of swing pricing. According to the adopting release, the amendments to Form N-1A would require a fund to disclose its use of swing pricing, if applicable, as well as the methods such fund uses to meet redemptions and the swing factor upper limit, and the amendments to Form N-CEN would require a fund to disclose whether it engaged in swing pricing during the reporting period and the swing factor upper limit, if applicable.

A two-year extended effective date is being adopted to enable funds that desire to implement swing pricing to implement any necessary operational changes to comply with the amended rules. The effective date is October 15, 2018.

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

Proposed Treasury Regulations and Changes in Ruling Policy on RIC Qualification Requirements

The Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**IRS**") have issued proposed regulations that, if finalized, would affect regulated investment companies ("**RICs**") that hold equity interests in controlled foreign corporations ("**CFCs**") and passive foreign investment companies ("**PFICs**"). In addition, in Revenue Procedure 2016-50 (the "**Revenue Procedure**") the IRS has announced that, in the future, it will generally not issue private letter rulings addressing whether a financial instrument or position is a "security" for purposes of the rules applicable to RICs. The proposed regulations would require operational changes for certain RICs, while the Revenue Procedure (and, for certain RICs, the proposed regulations) may require changes in some RICs' investments strategies. In addition, the proposed regulations may affect certain publicly traded partnerships ("**PTPs**").

The proposed regulations would have only prospective effect: they would apply to taxable years beginning on or after the date that is 90 days after the regulations are issued in final form. The Revenue Procedure applies to all requests for private letter rulings that were submitted on or after September 27, 2016.

The proposed regulations overturn the conclusions of a large number of private letter rulings previously granted by the IRS and, if finalized, will presumably override those rulings for the RICs to which they were issued. Treasury and the IRS have requested comments on the proposed regulations by December 27, 2016. In the past, the IRS has also issued many private letter rulings addressing whether various financial instruments constitute "securities" for purposes of the RIC rules. Treasury and the IRS have requested comments as to whether this previously-issued guidance on whether financial instruments constitute "securities" should be withdrawn.

In general, the IRS rulings on RIC investments in CFCs and on the definition of "securities" have addressed structures and financial instruments through which RICs have sought exposure to commodities. In July 2011, the IRS announced that it would not issue further rulings addressing commodities-related investments by RICs (either through CFCs or through derivative financial instruments) while it reviewed the issues and considered more generally applicable guidance. While the proposed regulations and the Revenue Procedure are the outcome of that review, they are not limited in their scope to commodities-related investments, but rather will apply generally to investments by a RIC in any CFC, PFIC or financial instrument that does not clearly constitute a "security."

Proposed Regulations

Under the provisions of the Internal Revenue Code of 1986, as amended (the "**Code**")[1] relating to investments in CFCs, a "United States shareholder" (as defined for this purpose, a "**United States Shareholder**") of a CFC is required to include in income each year its share of certain types of the CFC's income, generally including the CFC's investment income, regardless of whether the CFC makes any distribution (such an income inclusion, a "**Subpart F Inclusion**"). Distributions that the CFC makes out of

[1] Unless otherwise indicated, all "Section" references herein are to the Code.

earnings and profits that have given rise to Subpart F Inclusions are not includible in income by the United States Shareholder. Under the provisions of the Code relating to investments in PFICs, a U.S. shareholder of PFIC stock can mitigate the otherwise potentially adverse consequences of the PFIC rules by making either a "qualified electing fund" election (a "**QEF Election**") or a mark-to-market election. A PFIC shareholder that makes a QEF Election is required to include in income each year its share of all of the PFIC's ordinary income and net capital gain, regardless of whether the PFIC makes any distribution (such an income inclusion, a "**QEF Inclusion**"), and distributions made by the PFIC out of any such previously taxed amounts will not be included in the U.S. shareholder's income. Although PFIC shareholders are generally permitted to make a mark-to-market election only with respect to publicly traded PFIC stock, most RICs may make a "mark-to-market" election with respect to any PFIC stock they hold. Given the administrative burdens associated with QEF Elections, RICs generally make mark-to-market elections, rather than QEF Elections, with respect to PFICs in which they hold equity interests.

To qualify as a RIC for U.S. federal income tax purposes, a corporation must satisfy certain requirements prescribed by Section 851(b) of the Code, including an annual "qualifying income" test and a quarterly asset diversification test. Under the "qualifying income" test, at least 90% of the corporation's gross income for each taxable year must consist of certain types of passive income, including dividends, gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended (the "**1940 Act**")) and "other income" derived with respect to the corporation's business of investing in such stock or securities ("**Other Income**"). Section 851(b) provides that a Subpart F Inclusion or QEF Inclusion realized by a RIC in any taxable year will be treated as a dividend for purposes of this "qualifying income" requirement to the extent that the CFC or PFIC makes a distribution out of the earnings and profits to which the Subpart F Inclusion or QEF Inclusion is attributable. The IRS has issued a large number of private letter rulings concluding that Subpart F Inclusions will be treated as Other Income under Section 851(b) in situations in which the distribution requirement for dividend treatment is not satisfied. The proposed regulations would reverse the conclusion of those rulings by providing that a Subpart F Inclusion or a QEF Inclusion will not constitute "qualifying income" for a RIC except to the extent that the CFC or PFIC makes a corresponding distribution in the same taxable year, thereby permitting the Subpart F Inclusion or QEF Inclusion to be treated as a dividend under Section 851(b).

In general, the private letter rulings concluding that Subpart F Inclusions qualify as Other Income were issued to RICs with wholly owned CFCs making commodities-related investments. Following the announcement by the IRS in 2011 that it was suspending the issuance of these private letter rulings and a congressional hearing in 2012 focusing on RICs' use of CFCs to gain exposure to commodities,[2] there was some speculation as to whether Treasury and the IRS would apply anti-abuse principles to deny "qualifying income" treatment to all income derived by a RIC from such a CFC. The proposed regulations do not take that approach, but rather would permit RICs to continue to hold such CFCs, subject to the current distribution requirement.[3]

For a RIC that controls a CFC, finalization of the proposed regulations would require a new cash management approach, with annual distributions from the CFC. If a CFC recognizes any significant amount of income prior to the receipt of the corresponding cash (for example, if it holds a significant

[2] The hearing was held on January 26, 2012 by the Permanent Subcommittee on Investigations of the Senate Homeland Security and Governmental Affairs Committee.

[3] Presumably, Treasury and the IRS agreed with a memorandum prepared by the IRS Office of Chief Counsel in connection with the congressional hearing, which noted that the IRS private letter rulings reflected a number of considerations, including "section 851's express contemplation that RICs might own CFCs, the tax law principle that a taxpayer's choice of entity for conducting investment or business activity should generally be respected, and the tax law principle that, if properly organized and managed, a corporation should generally be respected as separate from its shareholders for tax purposes."

number of futures contracts that it is required to mark to market each year under Section 1256), it will need to adopt special arrangements, such as selling investments or borrowing cash, in order to make an annual distribution. RICs will also need to consult with their tax advisors about when it would be possible to make capital contributions to a CFC after a distribution without creating too great a risk that the distribution would be disregarded as a mere circular flow of cash. If, by contrast, a RIC has a Subpart F Inclusion from a CFC it does not control, it will not be in a position to require the CFC to make the distribution necessary to permit the Subpart F Inclusion to constitute "qualifying income." The proposed regulations will thus make it risky for a RIC to be a United States Shareholder of a non-controlled CFC. The application of the proposed regulations to QEF Inclusions is not likely to have any significant repercussions for RICs because RICs generally make mark-to-market elections, rather than QEF Elections, with respect to their investments in PFICs.

The proposed regulations would affect not only RICs, but also certain PTPs that invest in CFCs or PFICs. Although a PTP is generally treated as a corporation, a PTP will not be treated as a corporation if at least 90% of its gross income for each taxable year consists of certain "qualifying income" and the PTP satisfies other applicable requirements. For purposes of the PTP rules, any income that constitutes "qualifying income" for a RIC will also constitute "qualifying income" for a PTP. Relying on this cross-reference to the RIC rules, the IRS has issued private letter rulings to PTPs concluding that a Subpart F Inclusion constituted "qualifying income" without regard to whether the CFC made any current distribution. If finalized, the proposed regulations would overturn the conclusions of these rulings, requiring a current distribution by the CFC or PFIC in order to permit a Subpart F Inclusion or a QEF Inclusion to be treated as "qualifying income" for a PTP. Unlike RICs, PTPs are not permitted to make mark-to-market elections with respect to PFIC stock that is not publicly traded. As a consequence, PTPs are more likely than RICs to make QEF Elections and thus to be affected by the application of the proposed regulations to QEF Inclusions.

Revenue Procedure on the Definition of a "Security"

For purposes of both the "qualifying income" requirement and the asset diversification requirement contained in Section 851(b) of the Code, the term "securities" is defined by reference to the definition of "securities" for purposes of the 1940 Act. Despite this cross-reference to the 1940 Act definition of "securities," the IRS has issued private letter rulings addressing the question whether various types of financial instruments constitute "securities" for purposes of Section 851(b). In the Revenue Procedure, the IRS announced that, in the absence of unique and compelling reasons, it would no longer issue such a ruling. Noting that the 1940 Act grants exclusive rulemaking authority thereunder to the Securities and Exchange Commission (the "**SEC**"), Treasury and the IRS stated that any future guidance regarding whether particular financial instruments are "securities" for purposes of the 1940 Act would be within the jurisdiction of the SEC.[4] As noted above, Treasury and the IRS have requested comments on whether prior IRS rulings addressing the treatment of particular financial instruments as "securities" for purposes of Section 851(b) should be withdrawn.

In the past, the IRS has issued a large number of rulings on whether various instruments that provide RICs with exposure to commodities constitute "securities." In Revenue Ruling 2006-1, the IRS concluded that a derivative contract with respect to a commodity index was not a "security" for purposes of the RIC rules. Following expressions of concern from the mutual fund industry, the IRS issued Revenue Ruling 2006-31, in which it stated that Revenue Ruling 2006-1 was not intended to imply that certain commodities-related instruments, such as certain structured notes, did not constitute "securities." After issuing many private letter rulings in this area, the IRS suspended the issuance of these rulings in July 2011.

[4] Treasury and the IRS made this statement in the preamble to the proposed regulations.

The announcement that the IRS will no longer issue rulings addressing whether a financial instrument constitutes a "security" for purposes of the RIC rules will apply to any financial instrument, and not solely to instruments that provide exposure to commodities. With respect to any investment in an instrument that is not clearly a "security," as defined in the 1940 Act, a RIC will need to seek guidance either from the SEC or from a securities lawyer with knowledge of the 1940 Act. If the SEC is unwilling to address the issue with respect to certain financial instruments, and the treatment of the instruments as "securities" under the 1940 Act is otherwise unclear, RICs will generally find it prudent not to invest in such instruments.

Industry Update

NFA Proposes Amendment and Interpretive Notice on Collection of CPO and CTA Financial Information

On September 6, 2016, the National Futures Association (the "**NFA**") submitted to the Commodity Futures Trading Commission a proposed amendment to NFA Compliance Rule 2-46 and a corresponding interpretive notice (the "**Notice**") regarding the collection of certain financial information from commodity pool operators ("**CPOs**") and commodity trading advisors ("**CTAs**").

NFA Compliance Rule 2-46 requires member CPOs and CTAs to file NFA Forms PQR and PR on a quarterly basis. According to the NFA, these forms collect certain general identifying information about the CPO or CTA, which the NFA uses as part of its compliance oversight program. According to the Notice, however, the NFA does not currently collect any financial information on the financial condition of CPO or CTA members.

According to the Notice, the proposed amendment will require CPOs and CTAs to report two financial ratios on Forms PQR and PR, which will be used to monitor the CPO's or CTA's financial health and identify firms that may be facing financial difficulties:

- **Current Assets/Current Liabilities Ratio.** This ratio will provide a measure of a firm's liquidity by dividing the total of a firm's assets that can be readily converted to cash within one year by a firm's obligations that are reasonably expected to be paid within one year.
- **Total Revenue/Total Expenses Ratio.** This ratio will provide a measure of a firm's operating margin. According to the Notice, total revenue is the gross income earned by a firm before any expenses are deducted, which, in the case of a CPO or CTA, is typically generated through management and/or incentive fees. Total expenses, according to the Notice, are those costs incurred by a firm's effort to generate such revenue.

According to the NFA, the components of both ratios should be based on generally accepted accounting principles, and the ratios must be reported using the accrual method of accounting. If a CPO or CTA has a fiscal year-end that does not align with the Form PQR or PR reporting quarters, then, according to the NFA, the firm may use its most recently ended fiscal quarter for reporting purposes. According to the Notice, CPOs and CTAs that are part of a holding company or subsidiary structure may choose to report the ratios at the parent level, but a firm must be sure to indicate such election to the NFA. Finally, according to the Notice, reporting CPOs and CTAs must maintain financial records supporting their calculations of the ratios pursuant to the recordkeeping requirements in NFA Compliance Rule 2-10.

- **See a copy of the Amendment and Notice**

SEC Announces Intent to Examine the Supervision Practices of Registered Investment Advisers

On September 12, 2016, the Office of Compliance Inspections and Examinations (the "**OCIE**") issued a risk alert announcing its intent to conduct examinations of registered investment advisers who employ or contract with, or have employed or contracted with in the past, individuals who have a history of disciplinary events in the financial services sector (the "**Supervision Initiative**"). According to the risk alert, through the Supervision Initiative, the OCIE intends to review the effectiveness of the supervision practices, compliance programs and disclosures of registered investment advisers with respect to the specific risks presented by employees with a disciplinary history. The Supervision Initiative was one of the areas the OCIE identified in its 2016 Examination Priorities, a more general discussion of which can be found in the **January 27, 2016 Investment Management Regulatory Update**.

According to the risk alert, the OCIE will use SEC databases and filings, as well as external sources, such as information from private civil actions and SEC enforcement actions, to determine which advisers it will examine under the Supervision Initiative. According to the OCIE, examinations under the Supervision Initiative will focus on whether advisers have implemented policies and procedures tailored to the risks presented by individuals who have a disciplinary history and will specifically review an adviser's compliance culture and tone at the top.

According to the risk alert, the Supervision Initiative will focus on the following key risk areas:

- **Compliance Program.** The OCIE examiners will assess an adviser's hiring processes, ongoing reporting obligations, employee oversight practices and complaint-handling processes, with a view to evaluating whether an adviser fosters a robust compliance culture.
- **Disclosures.** OCIE examiners will evaluate an adviser's practices in disclosing regulatory, disciplinary or other actions in its Form ADV and corresponding brochure, focusing on whether such disclosures are accurate, adequate and effective.
- **Conflicts of Interest.** OCIE examiners will assess an adviser's conflicts of interest, and those of its supervised persons, particularly focusing on conflicts that exist with respect to financial arrangements, such as unique products, services or discounts, that are initiated by supervised persons with a disciplinary history.
- **Marketing.** OCIE examiners will review an adviser's advertisements and marketing materials, including pitch-books, website postings and public statements, to detect any conflicts of interest or risks associated with supervised persons with a history of disciplinary events.

► **See a copy of the Risk Alert**

SEC Chair White Addresses Legal Practice Division Luncheon at 2016 International Bar Association Annual Conference

On September 21, 2016, SEC Chair White delivered remarks to the 2016 International Bar Association Annual Conference. White discussed the SEC's global role as an international regulator and its communication and interconnectivity with other international regulators, focusing on three key topics – the SEC's current efforts to modernize the regulation of the asset management industry, the SEC's need for access to data regarding non-U.S.-based SEC registrants and the SEC's Foreign Corrupt Practices Act ("**FCPA**") enforcement program.

White began by highlighting the global role all securities regulators play, including the SEC, in today's interconnected capital markets, such as implementing global standards for over-the-counter derivatives, protecting against systemic risks to global financial systems, assisting in local enforcement actions and regulatory examinations and combatting corrupt corporate payments through the FCPA and similar global

regimes. According to White, all regulators must communicate, cooperate and coordinate with each other to effectively protect investors globally.

Next, White addressed the SEC's focus on modernizing and enhancing the regulatory regime of the asset management industry, which, according to White, is also a focus of other international regulators, such as the Financial Stability Board and the International Organization of Securities Commissions. According to White, there has been dramatic growth in the volume of assets under management by SEC-registered investment advisers over the last 15 years, and the asset management industry has become increasingly global, with an increase in registered investment advisers having principal offices outside of the United States. To address the challenges associated with these changes, the SEC, according to White, has proposed several important rulemakings, including improving effective liquidity risk management by mutual funds and exchange-traded funds, reducing the amount of leverage funds may access through derivatives, enhancing funds' disclosure and reporting of information and requiring investment advisers to implement business continuity and transition planning.

White next discussed the challenges the SEC faces in accessing information regarding non-U.S.-based registrants in light of certain foreign privacy, secrecy and data protection laws. According to White, such laws frequently complicate and impede a regulator's ability to perform its supervisory responsibilities by, for example, restricting a non-U.S. SEC registrant from providing certain information about its clients and employees, preventing direct communication between the non-U.S. SEC registrant and the SEC without authorization from the applicable foreign government and prohibiting SEC examinations of non-U.S. SEC registrants. According to White, it is imperative that regulators have access to an investment adviser's records in order to assess its compliance with regulations and understand a firm's risk profile. White noted that the SEC supports cooperation among regulators and that regulators should not operate in isolation, highlighting that an important lesson of the financial crisis was the need for regulators to have an accurate and complete understanding of the financial firms they regulate, regardless of their locations.

Finally, White discussed the FCPA and the importance of global regulators' efforts to combat the use of illicit payments. According to White, the SEC depends on the cooperation of other regulators in enforcing FCPA actions, noting one global settlement between a Dutch company charged with making illicit payments to an Uzbek government official that involved cooperation from fourteen other countries. According to White, foreign bribery must be a global regulatory priority, and the first step in combatting illicit payments and corruption on a global basis requires countries to pass comprehensive laws against bribery. White closed by noting that the SEC will continue to help combat illicit payments and corruption through the SEC's FCPA program and by cooperating with international regulators working to combat the problem locally.

- **See a copy of the Speech**

Litigation

First Reserve Settles Charges for Improper Allocation of Adviser Expenses, Insurance Premiums and Service Discounts

On September 14, 2016, the SEC issued an order (the "**Order**") instituting and settling cease-and-desist proceedings against First Reserve Management, L.P. ("**First Reserve**"), a registered investment adviser, relating to First Reserve's improper allocation of certain expenses and insurance premiums and its failure to properly disclose certain discounts for legal services it received.

According to the Order, at various times between approximately 2010 and 2015, First Reserve allocated to investors certain fees and expenses relating to the formation of two adviser entities (the "**Advisers**") for two of its fund clients. According to the SEC, the Advisers were formed as subsidiaries of a pooled investment vehicle (the "**Portfolio Company**"), in which the two funds collectively held approximately

75% of the interests, to provide investment management services solely to such Portfolio Company. In addition, certain of First Reserve's employees served on the board of the general partner of the Portfolio Company and as members of the investment advisory committee of one of the Advisers, thereby causing First Reserve, according to the Order, to essentially exert control over the members and employees of the Advisers. According to the Order, the Portfolio Company was permitted under its limited partnership agreement to call capital from the two funds for their approximately 75% *pro rata* share of one of the Adviser's organizational and startup expenses, amounting to more than $7 million of the two funds' approximately $40 million combined capital contribution to the Portfolio Company. According to the SEC, First Reserve's decision to structure the two funds' investment in the Portfolio Company in this way enabled First Reserve to avoid incurring certain administrative and other expenses in connection with providing advisory services to the two funds, thereby creating a conflict of interest which First Reserve failed to disclose.

In addition, according to the SEC, beginning in at least 2008, First Reserve caused certain of its funds to pay 100% of the premiums for a liability insurance policy covering First Reserve, some but not all of which arose out of First Reserve's management activities for such funds, even though the funds' operating agreements only provided for payment of out-of-pocket costs of any insurance expenses "relating to the affairs of" the funds.

Further, according to the Order, between at least 2010 and 2014, First Reserve negotiated certain fee discounts with a law firm, but First Reserve did not negotiate the same or a similar discount for its funds, even though the law firm performed a substantially greater volume of work for such funds than for First Reserve. Beginning in early 2013, according to the SEC, after capital was already committed to the affected funds, First Reserve disclosed in its Form ADV the possibility that it could receive service provider discounts that might be more favorable than those received by certain of its funds, but not that First Reserve in fact received a discount on certain services from the law firm while the funds did not receive a discount on the same services.

According to the Order, the SEC concluded that, based on the conduct described above, First Reserve violated (i) Section 206(2) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud upon any client or prospective client; (ii) Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which make it unlawful for an investment adviser to make any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to any investor or prospective investor; and (iii) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require an investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules.

According to the Order, in 2015, following an examination by the SEC's OCIE, First Reserve voluntarily reimbursed approximately $7.4 million to the two affected funds, representing their combined investment in the Portfolio Company that paid the expenses of the Advisers and disclosed to investors that, going forward, First Reserve or its general partner affiliates will bear the costs of the Advisers attributable to the funds. In addition, following the OCIE examination, First Reserve voluntarily paid a total of $179,466 to the affected funds for their *pro rata* share of the legal fees discount First Reserve received during the relevant period, and First Reserve disclosed to investors that it planned to pass on any future discounts to any active fund clients on a *pro rata* basis. Finally, with respect to the allocation of insurance premiums, First Reserve, according to the SEC, revised its allocation practices following a recommendation from a third-party compliance review and retroactively reimbursed $733,012 to the affected funds for prior coverage periods.

According to the SEC, First Reserve consented to the Order without admitting or denying the SEC's findings. The SEC ordered First Reserve, according to the Order, to pay a civil penalty of $3.5 million,

noting that such sanctions take into consideration the remedial efforts undertaken by First Reserve as noted above and its cooperation with the SEC during its investigation and examination.

- See a copy of the Order

Investment Advisers Charged with Compliance Failures Regarding Wrap Fee Programs

On September 8, 2016, the SEC issued orders (the "**RJA Order**" and the "**Baird Order**") instituting cease-and-desist proceedings against two registered investment advisers – Raymond James & Associates ("**RJA**") and Robert W. Baird & Co. ("**Baird**") – for violating Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to maintain adequate policies and procedures related to certain trade away practices and fees.

According to the RJA Order, RJA, through its Raymond James Consulting Services program, offered its advisory clients the ability to select a participating sub-adviser to develop a model portfolio in the client's separately managed account for a negotiated "wrap fee," a single fee for advisory services, trade execution, custody and other standard brokerage services. According to the SEC, advisory clients also paid commissions on equity transactions executed by brokers not affiliated with RJA (a "trade away" transaction). While RJA's Form ADV Part 2A brochure disclosed the possibility of such trade away transactions and the associated fees, according to the RJA Order, RJA failed to obtain information regarding the specific amounts of commissions charged for such transactions or whether any such amounts were material. Further, according to the SEC, since client account statements similarly included only the net price charged per equity trade, RJA's advisory clients were unware of the commissions charged for trade away transactions.

According to the Baird Order, Baird offered its advisory clients the opportunity to invest in separately managed wrap fee programs in which such clients paid an annual fee for access to certain sub-advisers, trading strategies, financial advisory advice and trade execution services. According to the SEC, a sub-adviser had the option to trade away from Baird, which resulted in additional fees for the advisory clients. Baird, according to the SEC, failed to track or monitor which sub-advisers traded away from Baird and the specific costs associated with such transactions, and when Baird began collecting such information in 2013, it failed to adopt or implement policies and procedures designed to provide information to Baird's clients about such additional costs.

According to the SEC, both RJA and Baird violated Section 206(4) of the Advisers Act, which prohibits investment advisers from engaging in any act, practice or course of business which is fraudulent, deceptive or manipulative, and Rule 206(f)-7 thereunder, which requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

According to the Orders, RJA and Baird both agreed to settle the charges without admitting or denying the SEC's findings and agreed to pay fines of $600,000 and $250,000, respectively. In addition, RJA agreed to:

- create a publicly available website disclosing its sub-advisers' trade away practices, with details regarding the impact such practices have on the sub-advisers' performance;
- identify any trade away transactions on client statements, disclosing any commission paid in connection therewith;
- provide adequate information and training to financial advisers regarding trade away practices and consider such information when evaluating a particular sub-adviser;
- create a report, to be included with client statements on at least an annual basis, detailing the aggregate amount of commissions arising from trade away transactions;
- certify compliance with the above undertakings; and

- periodically, and at least annually, review the policies and procedures implementing the above undertakings.

Baird agreed to:

- add a footnote to applicable wrap fee client statements indicating that certain trade away transactions executed in the last year included a commission embedded in the price of the transaction;
- report, at least annually, the commissions arising from trade away transactions;
- review and, as necessary, update its policies and procedures in connection with the above two undertakings, and review information from sub-advisers regarding their trade away procedures; and
- develop and conduct training for financial advisers regarding trade away practices and consider such information when evaluating a particular sub-adviser.

- See a copy of the Press Release
- See a copy of the Baird Order
- See a copy of the Raymond James 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.

Mary Conway	**212 450 4959**	mary.conway@davispolk.com
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
Rachel D. Kleinberg	**650 752 2054**	rachel.kleinberg@davispolk.com
Leor Landa	**212 450 6160**	leor.landa@davispolk.com
Gregory S. Rowland	**212 450 4930**	gregory.rowland@davispolk.com
Colleen Blanco	**212 450 4473**	colleen.blanco@davispolk.com