Investment Management Regulatory Update

February 28, 2017

SEC Rules and Regulations

SEC Staff Provides Interpretative Guidance that Restrictions of Section 22(d) of the Investment Company Act Do Not Apply to a Broker for Clean Shares

On January 11, 2017, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to Capital Group Companies, Inc. ("**Capital Group**"), providing interpretative guidance regarding Section 22(d) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). In the Letter, the SEC confirmed that the restrictions of Section 22(d) do not apply to a broker when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in a class of shares of a registered investment company (a "**fund**") without any front-end load, deferred sales charge or other asset-based fee for sales or distribution ("**Clean Shares**").

According to the incoming letter (the "**Incoming Letter**"), Capital Group requested guidance on the restrictions of Section 22(d) to alleviate certain of the issues facing the mutual fund industry arising under the Department of Labor's fiduciary rule (the "**DOL Rule**"), which was designed to mitigate conflicts of interest in the provision of investment advice to retirement plan participants and sought to eliminate financial incentives that could cause a broker to recommend one investment offering over another. As such, according to the Incoming Letter, the DOL Rule demonstrates a preference for arrangements in which the financial adviser receives payment only from the investor and not from third parties.

According to the Letter, however, Section 22(d) prohibits a fund from selling its securities except at a current public offering price described in the prospectus to any person other than to or through a principal underwriter for distribution. The Incoming Letter noted that because Section 22(d) and Rule 22d-1 thereunder generally require that funds, and not broker-dealers, set the pricing on sales charges to investors, sales charge schedules are embedded in the share class structure of funds in the current brokerage model, and broker-dealer firms would appear unable to unilaterally adjust their business models to preserve a brokerage option that meets the requirements of the DOL Rule. Further, according to the Incoming Letter, although Section 22(d) does not apply to brokers, many firms are unsure whether charging their own commissions for their sales-related activities could cause them to be treated as a dealer subject to Section 22(d). Therefore, the Incoming Letter sought narrowly tailored guidance from the SEC that broker-dealers making available Clean Shares would be acting as brokers, and not dealers, and thus able to set commissions on such transactions without being subject to Section 22(d).

The SEC confirmed in its Letter that Section 22(d)'s restrictions do not apply to a broker, as that term is defined in the Investment Company Act, when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in Clean Shares. Further, according to the SEC, Section 22(d) also does not prohibit a principal underwriter of Clean Shares from entering into a selling agreement with a broker under these circumstances either. According to the Letter, the SEC's interpretative guidance rests in part on the following representations made in the Incoming Letter:

- The broker will represent in its selling agreement with the fund's underwriter that it is acting solely on an agency basis for the sale of Clean Shares;
- The Clean Shares sold by the broker will not include any form of distribution-related payment to the broker;
- The fund's prospectus will disclose that an investor transacting in Clean Shares may be required to pay a commission to a broker, and, if applicable, that shares of the fund are available in share classes that have different fees and expenses;
- The nature and amount of the commissions and the times at which they would be collected would be determined by the broker consistent with the broker's obligations under applicable law, including but not limited to applicable FINRA and Department of Labor rules; and
- Purchases and redemptions of Clean Shares will be made at the net asset value established by the fund (before imposition of a commission).

According to the Letter, the SEC's position does not depend on whether the broker sells Clean Shares to investors in retirement accounts or nonretirement accounts.

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

SEC Issues Interpretation Under Rule 12d1-2(a)(1) of the Investment Company Act

On January 25, 2017, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to Dechert LLP ("**Dechert**") concurring with Dechert's interpretation that, for purposes of Rule 12d1-2(a)(1) under the Investment Company Act, the term "group of investment companies," as defined in Section 12(d)(1)(G)(ii) of the Investment Company Act, does not include closed-end funds, and thus clarifying that an open-end fund relying on Section 12(d)(1)(G) and Rule 12d1-2 would be permitted to invest in a closed-end fund regardless of whether the two funds belong to the same group of investment companies.

Section 12(d)(1)(A) of the Investment Company Act generally prohibits a registered investment company (a "**RIC**") from (i) acquiring more than 3% of another RIC's shares; (ii) investing more than 5% of its assets in a single RIC; or (iii) investing more than 10% of its assets in other RICs. Section 12(d)(1)(G) provides an exemption to these percentage limits for fund of funds arrangements, permitting open-end funds to invest in (i) other open-end funds that are part of the same group of investment companies, (ii) government securities and (iii) short-term paper, under certain conditions. Section 12(d)(1)(G) defines "group of investment companies" as any two or more RICs that hold themselves out to investors as related companies for purposes of investment and investor services." Rule 12d1-2 under the Investment Company Act expands Section 12(d)(1)(G) by allowing open-end funds to invest in a range of other investments, including securities issued by other RICs, subject to certain limits. Specifically, Rule 12d1-2(a)(1) provides that an open-end fund relying on Section 12(d)(1)(G) is permitted to invest in securities issued by a RIC other than securities issued by another RIC that is in the same group of investment companies, subject to the requirements under Section 12(d)(1)(A) or 12(d)(1)(F) of the Investment Company Act. According to the Incoming Letter, this exclusion can be interpreted to include closed-end funds that are part of the investing open-end fund's group of investment companies. The Incoming Letter states that as a result, it is possible to read Rule 12d1-2(a)(1) in a way that prohibits investments by open-end funds in affiliated closed-end funds.

According to the Incoming Letter, the administrative history of Rule 12d1-2 indicates that it was intended to expand the scope of Section 12(d)(1)(G) for legitimate fund of funds arrangements. In addition, the Incoming Letter argues that there is no policy reason to justify prohibiting investments in closed-end funds that are part of the investing fund's group of investment companies. Thus, according to the Incoming Letter, the exclusion in Rule 12d1-2(a)(1) for securities issued by another RIC that is in the same group of investment companies should be interpreted to refer only to funds in which an investing fund could already invest in reliance on Section 12(d)(1)(G); *i.e.*, affiliated open-end funds. The Incoming Letter states that this would be consistent with the legislative history of Section 12(d)(1)(G) in allowing an open-end fund to invest in closed-end funds that are part of the same group of investment companies, provided such investment complies with the requirements of Rule 12d1-2.

According to the Letter, the SEC concurred with the Incoming Letter's analysis that for purposes of Rule 12d1-2(a)(1), the term "group of investment companies" does not include closed-end funds. As a result, as set forth in the Letter, a registered open-end fund or unit investment trust can, in reliance on Rule 12d1-2(a)(1), invest in a closed-end fund regardless of whether the two funds are part of the same group of investment companies, subject to the requirements of Section 12(d)(1)(A) or 12(d)(1)(F).

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

Industry Update

SEC Staff Updates Form PF Frequently Asked Questions

In January 2017, the Division of Investment Management of the SEC updated certain of the Form PF frequently asked questions (the "**FAQs**") and added new FAQs to provide further guidance on general filing requirements and specific questions regarding the form, including updates pursuant to the money market reforms adopted in July 2014. For a detailed discussion of such reforms, please see the August 5, 2014 Davis Polk Client Memorandum, ***SEC Adopts Money Market Fund Reforms***.

The updated FAQs provide guidance on several topics, including:

General Filing Information

- According to the updated FAQs, for purposes of Form PF and General Instruction 1, and in line with the treatment of similarly situated private funds, if a firm's principal office and place of business is outside the United States, such firm may disregard any parallel managed accounts that, during the firm's last fiscal year, were parallel to private funds that are disregarded in reliance on General Instruction 1 and were not managed for any United States persons.
- With respect to Instruction 16 of Form PF and the guidance that a filer is not required to update information that it believes in good faith to properly respond to Form PF on the date of filing, according to the Updated FAQs, if a fund's auditor has not yet completed its audit of the fund's financial statements for the fiscal year for which the fund is reporting on Form PF, such fund should use the estimated values for the fiscal year for which it is reporting for purposes of Form

PF, and the fund may, but is not required to, amend the form once the audit is complete. According to the updated FAQ, a fund may provide an explanation that the information is an estimate in Question 4.

- With respect to Instruction 10 of Form PF, which requires that a private fund's identifying numbers be obtained only by filing Form ADV, the updated FAQs clarify that if a private fund launched and liquidated within the course of the firm's most recent fiscal year, the firm must report such fund on Form ADV first in order to obtain a private fund identifying number for Form PF.

Question Specific FAQs

- According to the updated FAQs, when providing a breakdown of a firm's regulatory assets under management and net assets under management for Question 3, a firm should include all of its regulatory assets under management in response to such question, including assets of a registered investment company. If certain regulatory assets under management are not attributable to the entities enumerated in Question 3(a)-(g), then, according to the updated FAQs, such assets should be reported in Question 3(h).
- According to the SEC, Question 20 requires that a firm disclose the investment strategy that best describes a reporting fund's strategies, and for each strategy, such firm must provide a good faith estimate of the percentage of the reporting fund's net asset value ("**NAV**") represented by such strategy. With respect to Question 20, Instruction 15 provides that the numerator used to determine the percentage of NAV must be measured on the same basis as gross asset value. According to the updated FAQs, if a reporting fund's gross assets exceed its net assets, the response for such fund's percentage of NAV should total more than 100%, and this instruction also applies to Questions 21, 25, 28, and 35.
- According to the SEC, Question 32 inquires as to the liquidity of a reporting fund's portfolio, and the corresponding instructions provide that a fund should exclude cash and cash equivalents. According to the updated FAQs, if a reporting fund only holds cash and cash equivalents for purposes of responding to Question 32, such fund should report that 100% of its portfolio is capable of being liquidated within one day or less, and the reporting firm should also explain in Question 4 that its reporting fund only holds cash and cash equivalents. In addition, according to the SEC, cash and cash equivalents should be excluded from both the numerator and denominator when calculating the percentages required in Question 32. Finally, according to the Updated FAQs, "value" for purposes of responding to Question 32 requires a firm to report the percentage of a portfolio's NAV that is capable of being liquidated in the time periods set out in the question.
- According to the updated FAQs, for purposes of reporting open positions in Questions 34 and 35, a reporting firm should exclude cash and cash equivalents, and that the value of unencumbered cash should be reported in Question 33.
- When responding to Question 47 when the creditor responsive to the question is an affiliate of a group listed in the drop-down menu, but is not itself an identical legal entity to the group listed, a reporting firm should, according to the updated FAQs, select the affiliated creditor group from the drop-down menu and identify the specific creditor in Question 4, but not in the "other" space for Question 47.
- According to the updated FAQs, when responding to Questions 49(c), 49(e), 61(b) and 61(d), which require the percentage of a reporting fund's NAV that may be subjected to, or is subject to, material restrictions on investor withdrawals/redemptions, a reporting firm should only account for discretionary restrictions that the adviser or fund governing body may impose on the reporting fund beyond the baseline liquidity restrictions an investor may be subject to in the ordinary course. For example, according to the SEC, if a fund generally imposes a one-year initial lock-up

period before an investor may make withdrawals/redemptions or only allows for annual withdrawals/redemptions upon 60 days' notice, the firm should not take any of these restrictions into account when responding to Question 49 and Question 61 because these restrictions will be accounted for in response to Question 50. Further, according to the updated FAQs, a firm should not report assets subject to a side-pocket arrangement for purposes of Questions 49(c), 49(e), 61(b) and 61(d), but rather must report this information in Question 48(a).

- According to the updated FAQs, when responding to Questions 50 and 62, which request a breakdown of the percentage of a reporting fund's NAV that is locked in for different periods of time, the reporting firm should evaluate the specific liquidity terms applicable to each investment as of the data reporting date and then calculate the percentage of NAV associated with each time period identified in the questions.
- With respect to Question 63(f), which requires a reporting firm to identify the category of investment that best describes each security held in a reporting fund, a fund holding derivatives should, according to the updated FAQs, report such securities as "other" for purposes of the question.

Finally, the SEC withdrew the FAQs related to Questions 56 and 57.

- ▸ **See a copy of the Responses**

Financial Stability Board Releases Final Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

On January 12, 2017, the Financial Stability Board ("**FSB**") published Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (the "**Recommendations**"). The Recommendations consist of 14 final policy recommendations to address structural vulnerabilities from:

- liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units;
- leverage within investment funds;
- operational risk and challenges of asset managers in stressed conditions; and
- securities-lending activities of asset managers and funds.

The Recommendations were initially proposed in June 2016 (the "**Proposal**"), and, according to the FSB, it received more than 50 responses, each of which it considered when formulating the Recommendations. The Recommendations reflect a number of changes since the Proposal, including revising the recommendations on liquidity, distinguishing between the information that is useful to authorities and investors and emphasizing the still experimental nature of system-wide stress-testing. For a more in-depth discussion of the Proposal, please see the **July 26, 2016 Investment Management Regulatory Update**.

As in the Proposal, nine of the 14 Recommendations concern the potential liquidity mismatch between open-ended funds' redemption terms and the conditions of funds' underlying assets. Three recommendations concern leverage within funds, one on operational risk for fund managers, especially in stressed conditions, and one on funds' securities lending activities.

Only three of the 14 Recommendations materially changed since they were initially discussed in the Proposal:

- *Recommendation 8.* In the Proposal, the FSB stated that authorities should provide guidance and direction regarding open-ended funds' liquidity risk management tools. The Recommendations make clear that, in the FSB's view, asset managers have the primary responsibility for liquidity risk management, but authorities should provide guidance on how to use those tools in times of market stress and, during extraordinary circumstances, should direct funds' use of their liquidity risk management tools.

- *Recommendation 10.* The Recommendations clarify that any measures of fund leverage developed by the International Organization of Securities Commissions ("**IOSCO**") should be developed with an eye toward their use for monitoring funds' leverage for financial stability purposes. The Recommendations retain the suggestion that IOSCO consider netting and hedging as part of any leverage metrics.
- *Recommendation 13.* The Proposal suggested that authorities provide guidance for addressing operational risk for large or complex asset managers, but the Recommendations expand this to all asset managers. The Recommendations do, however, clarify that any risk management framework should be commensurate with the risks posed by an asset manager's activities.
- ► **See the Policy Recommendations**

Litigation

BlackRock Settles Charges Related to Separation Agreements Waiving Whistleblower Awards

On January 17, 2017, the SEC issued an order (the "**Order**") instituting and settling administrative cease-and-desist proceedings against BlackRock, Inc. ("**BlackRock**") for its use of separation agreements in which departing employees were required to waive their ability to obtain whistleblower awards.

According to the Order, between October 2011 and March 2016, BlackRock inserted a provision into separation agreements with 1,067 departing employees in which the employee waived any financial incentives for the reporting of misconduct, including under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the Sarbanes-Oxley Act of 2002.

According to the Order, the SEC is not aware of any instances in which a former employee of BlackRock did not communicate with the SEC about potential violations in light of the offending provision or where BlackRock took action to enforce the provision, but nonetheless, the SEC found that such a provision undermines the purpose of the whistleblower provisions of the Dodd-Frank Act and violates Rule 21F-17(a) thereunder by impeding individuals from communicating directly with the SEC.

The SEC fined BlackRock $340,000 for its conduct and ordered BlackRock to cease and desist from further violations of Rule 21F-17. In accepting BlackRock's offer of settlement, the SEC considered BlackRock's voluntary decision to discontinue use of the offending provision prior to being contacted by the SEC, as well as its mandatory annual trainings for all employees that includes discussion of the employees' rights under the SEC's Whistleblower Program and its updated Code of Business Conduct and Ethics, among other agreements and policies, to ensure that employees understand that there are no restrictions on their rights under Rule 21F-17.

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

Investment Advisers Charged with Pay-to-Play Rule Violations

On January 17, 2017, the SEC issued orders (the "**Orders**") instituting cease-and-desist proceedings against ten investment advisory firms (the "**Firms**") for violating Rule 206(4)-5 (the "**Pay-to-Play Rule**") of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") by receiving compensation for investment advisory services from public pension funds within two years after certain of the firms' executives or employees ("**covered associates**") made certain campaign contributions.

Among other things, the Pay-to-Play Rule prohibits a registered investment adviser, an exempt reporting adviser or a foreign private adviser from directly or indirectly providing investment advice for compensation to a state or local government client (or an investment vehicle in which a government entity invests) for two years after such adviser or its covered associates make a campaign contribution to officials of such government who are directly or indirectly responsible for hiring investment advisers. The Pay-to-Play Rule contains three exceptions: (i) a *de minimis* contribution exception for natural person covered associates who contribute $350 per election to an official for whom they are entitled to vote and up to $150 per election for any other official; (ii) an exception for new associates that made a contribution six months prior to becoming a covered associate of the adviser, unless the covered associate engages in solicitation activities in connection with the government entity on behalf of the adviser; and (iii) an exemption for returned contributions when the contribution is discovered by the adviser within four months of the making of such contribution and the adviser obtains a refund within 60 days of discovery, subject to certain additional conditions.

According to the Orders, the Firms violated the two-year timeout period under the Pay-to-Play Rule since they accepted advisory fees from city or state pension funds after certain of their covered associates made campaign contributions, ranging from $400 to $10,000, to candidates or elected officials.

According to the Orders, the Firms were censured and sanctioned, and each Firm was required to pay civil penalties ranging from $35,000 to $100,000.

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

Large Financial Institution Settles with SEC for Client Billing, Custody Rule and Records Violations

On January 17, 2017, the SEC issued an order (the "**Order**") settling charges against a large financial institution (the "**Financial Institution**") for errors in its advisory client fee billing, custody examination violations and books and records violations under the Advisers Act.

According to the Order, between approximately 2002 and 2016, the Financial Institution and its predecessor inadvertently charged fees in excess of what had been disclosed to, and agreed by, its clients across more than 149,000 advisory client accounts, totaling over $16,000,000 in undue fees received by the Financial Institution. According to the SEC, the fee billing errors were largely due to coding and other billing system errors, and the Financial Institution has since reimbursed the affected clients with interest. In addition, according to the Order, the Financial Institution failed for two consecutive years to comply with the custody rule requirement for annual surprise examinations by an independent public accountant despite maintaining custody of certain client funds. Further, according to the SEC, the Financial Institution failed to maintain certain executed client contracts in an easily accessible place as required by the Advisers Act and the rules thereunder and the Financial Institution's own books and records retention policies. Finally, according to the Order, the SEC determined that the Financial Institution failed to adopt and implement written policies and procedures reasonably designed to prevent the Advisers Act violations noted above.

As a result of the above conduct, the SEC found that the Financial Institution willfully violated (i) Section 206(2) of the Advisers Act, which prohibits advisers from directly or indirectly engaging in any transaction, practice or course of business which operates as a fraud or deceit upon a client or prospective client, (ii) Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder, which states that it is a fraudulent, deceptive or manipulative action, practice or course of business for a registered investment adviser to maintain custody of client funds or securities unless such funds or securities are verified by an at least annual surprise examination by an independent public accountant, subject to certain exceptions, (iii) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder for failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder and (iv) Section 204(a) of the Advisers Act and Rules 204-2(a)(10) and 204-2(e)(1) thereunder for failing to maintain and preserve client contracts in an easily accessible place for at least five years.

The Financial Institution agreed to be censured and consented to the Order without admitting or denying the SEC's findings, and the SEC ordered the Financial Institution to pay a civil penalty of $13,000,000. In addition, the Financial Institution agreed to undertakings relating to its fee billing and books and records practices.

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

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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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