Investment Management Regulatory Update

April 27, 2017

Industry Update

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IM Information Update Provides Guidance to Advisers Using a Participating Affiliate Structure

In March 2017, the staff of the SEC's Division of Investment Management issued an IM Information Update (the "**Update**") regarding the information multinational financial firms should submit to the SEC in order to rely on the staff's position relating to the extraterritorial application of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), set forth in the Unibanco line of no-action letters (the "**Unibanco Letters**"). According to the Update, the staff stated in the Unibanco letters that it would not recommend enforcement action (i) regarding the applicability of the substantive provisions of the Advisers Act with respect to a non-U.S. adviser's relationships with its non-U.S. clients and (ii) if a non-U.S. advisory affiliate of a registered adviser (a "**Participating Affiliate**") shares personnel with, and provides certain services to U.S. clients through, the registered adviser, without such Participating Affiliate registering under the Advisers Act.

According to the Update, the staff will generally not recommend enforcement action in situations in which:

- the unregistered Participating Affiliate and the registered adviser are separately organized;
- the registered adviser is staffed with personnel (in or outside the U.S.) who are capable of providing investment advice;
- all personnel of the Participating Affiliate involved in U.S. advisory activities are deemed ''associated persons'' of the registered adviser; and
- the SEC has sufficient access to trading and other records of the Participating Affiliate and to its personnel to enable it to identify conduct that may harm U.S. clients or markets.

According to the SEC, an adviser's reliance on the Unibanco Letters is conditioned upon its making certain representations and undertakings, maintaining certain records and providing the SEC with access to the adviser's foreign personnel. Participating Affiliates seeking to share personnel with, and provide services to U.S. clients through, a registered adviser, without registering under the Advisers Act, should, according to the Update, provide documentation containing the following representations and undertakings to the SEC:

- The name of the Participating Affiliate and registered adviser, and a representation that the Participating Affiliate is an associated person of the registered adviser within the meaning of Section 202(a)(17) of the Advisers Act.
- The Participating Affiliate's appointment of an agent for service of process, including the name and contact information of such agent.
- A representation that the Participating Affiliate is under the jurisdiction of U.S. courts for actions arising, directly or indirectly, under U.S. securities laws or the securities laws of any state in connection with any of the following for U.S. clients:
    - investment advisory activities;
    - related securities activities arising out of or relating to any investment advisory services provided by the Participating Affiliate through its registered adviser; and
    - any related transactions.

  In addition, the documentation should include a representation that the Participating Affiliate has designated and appointed, without power of revocation, an agent upon whom all process, pleadings, or other papers may be served in:
    - any investigation or administrative proceeding conducted by the SEC; and
    - any civil suit or action brought against the registered adviser or the Participating Affiliate or in which the Participating Affiliate has been joined as defendant or respondent, in any appropriate court in any place subject to the jurisdiction of any state or of the U.S. or any of its territories or possessions or the District of Columbia in connection with the activities and transactions described above.
- A representation that any civil suit or action or administrative proceeding may be commenced by the service of process upon, and that service of an administrative subpoena shall be effective service upon, such agent, and that such service shall be taken and held in all courts and administrative tribunals to be valid and binding as if personal service has been made.
- A representation that the Participating Affiliate will appoint a successor agent if the Participating Affiliate or any person discharges the existing agent or the existing agent is unwilling or unable to accept service on behalf of the Participating Affiliate at any time until six years have elapsed from the date of the last investment advisory activity; an undertaking that the Participating Affiliate will advise the SEC promptly of any change to the agent's name or address during the applicable period.
- A representation that the Participating Affiliate will promptly, upon receipt of an administrative subpoena, demand, or request for voluntary cooperation made during a routine or special inspection or otherwise, provide to the SEC or the SEC's staff any and all of the books and records required to be maintained in accordance with staff guidance, and make available for testimony before, or other questioning by, the SEC or the SEC's staff the employees of the Participating Affiliate (other than clerical or ministerial personnel) involved in the investment advisory activities or related securities transactions, at such place as the SEC may designate in the U.S. or, at the SEC's option, in the country where the records are kept or such personnel reside.

- A representation that the Participating Affiliate will produce, pursuant to an administrative subpoena or a request for voluntary cooperation, any documents in accordance with staff guidance.

Documentation supporting the above representations and any other information being provided in reliance on the Unibanco Letters should be submitted by email to **IMOCC@sec.gov** with the subject line "Participating Affiliate."

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

IM Information Update Sets Out Framework for Requesting Tax Claims Letters

In March 2017, the staff of the SEC's Division of Investment Management (the "**Division**") issued an IM Information Update (the "**Update**") regarding the process for U.S.-registered funds to request letters from the Division in connection with obtaining refunds of inappropriately withheld foreign taxes.

According to the Update, the Court of Justice of the European Union and certain European Union member state courts have held that European Union member states could not impose withholding taxes on certain foreign investors if they would not impose such taxes on substantially similar domestic investors. According to the Division, U.S.-registered funds have been requesting that the Division provide letters addressed to foreign jurisdictions in order to obtain refunds of foreign taxes that should not have been withheld based on these court holdings. Since late 2015, the Division has provided over 100 funds with such letters, and the Update establishes a framework for U.S.-registered funds to make such letter requests. In particular, according to the Update, funds should provide draft letters to the Division that include:

- The name of the fund and registration statement file numbers (and series number, if any);
- The first date of the fund's first fiscal year to which the tax claims are related;
- A statement that the fund is an open-end registered investment company; and
- The date and state of organization of the fund.

According to the Update, in addition to the draft letters, the Division also requests that funds submit supporting documentation that corroborates the information above, typically in the form of a small PDF packet that includes the fund's registration statement filings.

Draft letters and supporting supplemental information packets should be sent via e-mail to **IMEuropeanTaxClaims@sec.gov**.

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

Division of Investment Management Issues Guidance on Holding Companies and the Application of Rule 3a-2 under the Investment Company Act

Last month, the staff of the SEC Division of Investment Management (the "**Division**") issued an IM Guidance Update (the "**Update**") regarding the commencement of the one-year safe harbor pursuant to Rule 3a-2 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") as it applies to holding companies engaged in various operating businesses through wholly-owned and majority-owned subsidiaries, where neither the holding companies nor their subsidiaries are regulated as investment companies.

Section 3(a)(1)(A) of the Investment Company Act defines an investment company to mean any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities. Section 3(a)(1)(C) of the Investment Company Act defines an investment company to mean any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire

investment securities having a value exceeding 40% of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. Rule 3a-2 under the Investment Company Act provides a temporary exclusion from the Investment Company Act's provisions to certain issuers that are in transition to a non-investment company business and specifically deems an issuer that meets the definition of investment company in Section 3(a)(1)(A) or 3(a)(1)(C) not to be an investment company for a period not to exceed one year, provided that certain conditions are satisfied. The one-year period begins on the earlier of: (i) the date on which an issuer owns securities and/or cash having a value exceeding 50% of the value of such issuer's total assets on a consolidated or unconsolidated basis (the "**50% Threshold**") or (ii) the date on which an issuer owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis (the "**40% Threshold**," and collectively, the "**Thresholds**").

According to the Update, many holding companies experience extraordinary events that may result in such companies owning investment securities exceeding 40% of the value of their total assets on an unconsolidated basis, such as through: (i) investing their offering proceeds in securities while arranging to acquire a new majority- or wholly-owned subsidiary, (ii) selling a large operating division and investing the proceeds in securities pending acquisition of a new majority- or wholly-owned subsidiary and (iii) making a tender offer to stockholders of a non-investment company and failing to obtain a majority of the target company's stock. According to the Division, a holding company may seek to rely on the safe harbor in Rule 3a-2 in such a situation, but a literal reading of the rule suggests that a holding company may be unable to rely on the safe harbor under certain circumstances. According to the Update, the 50% Threshold may prove problematic for holding companies because it is based on all cash and securities held by such company, including U.S. Government securities and equity securities issued by majority- and wholly-owned subsidiaries, not just its investment securities. Further, according to the Update, the 50% Threshold is measured on a consolidated and unconsolidated basis, resulting in a holding company being unable to "look through" the securities of its subsidiaries and test their assets on a consolidated basis. As a result, according to the Update, a holding company may exhaust the one-year period before ever needing to rely on Rule 3a-2.

According to the Division, the Thresholds attempt to pinpoint the time at which an issuer would have the characteristics of an investment company. With respect to holding companies, however, the Division believes that a holding company may not have the characteristics of an investment company until it fails the 40% Threshold. According to the Division, the SEC's intent was to make the safe harbor available to all companies with a bona fide intent to be engaged primarily in a non-investment company business, regardless of whether they operate directly or through a holding company structure.

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

Financial CHOICE ACT Proposes to Exempt Private Equity Fund Advisers from Registration and Reporting Requirements of Advisers Act

On April 19, 2017, the U.S. House Financial Services Committee released an updated version of the Financial CHOICE Act (the "**Act**") to be further discussed by the committee. The Act is legislation originally introduced in mid-2016 by Representative Jeb Hensarling to amend a number of financial regulations, including the Dodd-Frank Act. Among other things, section 858 of the Act would amend the Advisers Act to exempt private equity fund advisers from the registration and reporting requirements of the Advisers Act. The Act does not define the term "private equity fund," but rather requires the SEC to define the term by issuing final rules within six months of the enactment of the relevant section of the Act.

- **See a copy of the Act**

SEC Subpoena Serves as a Reminder to Fully Disclose IRR Calculations and Assumptions

As Apollo Global Management, LLC ("**Apollo**") reported in its most recent 10-K, the SEC has subpoenaed Apollo for information concerning its disclosure of IRR calculations for certain private equity funds.[1] While Apollo did not disclose the nature of the SEC's concerns, this case serves as a reminder that a private equity firm's IRR calculations can come under intense scrutiny by both regulators and investors.

IRR calculations are important to many private equity funds for several reasons. First, they form the basis of the fund's track record used for marketing and investor reporting purposes. Second, they are typically used in the carried interest "waterfall" that determines the amount of carry to which the fund manager is entitled. The industry, however, lacks a formal standard for calculating IRRs and firms vary in their approaches toward calculating such figures. Absent sufficient disclosure, therefore, there is risk that investors may not appreciate the specific methodology being used in the IRR calculations. Accordingly, in its routine examinations of private equity firms, the SEC has often included inquiries relating to IRRs, including how such figures are calculated and reported.

As such, private equity firms may wish to use the Apollo subpoena as an opportunity to review their disclosures regarding their IRR calculations and assumptions. For example, in light of the increasing prevalence of, and attention to, subscription line financing, firms that use these credit lines may wish to review the effect of subscription line financing on their IRR calculations and whether any specific disclosure is advisable.

SEC Approves Move to T+2 Standard Settlement Cycle

On March 22, 2017, the SEC approved a rule amendment to shorten the standard settlement cycle for most broker-dealer securities transactions to two business days after the trade date from the current three-business-day cycle. The compliance date for broker-dealers to implement the rule change will be September 5, 2017. For a detailed discussion of the rule amendment, please see the March 24, 2017 Davis Polk Client Memorandum, **SEC Approves Move to T+2 Standard Settlement Cycle in September 2017**.

[1] **Notes to Consolidated Financial Statements, 10-K of Apollo Global Management, LLC, dated February 13, 2017**

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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