Investment Management Regulatory Update

May 25, 2017

Rules and Regulations

SEC Proposes Amendments to Advisers Act Rules to Reflect Changes Made by the FAST Act

On May 3, 2017, the SEC proposed amendments (the "**Proposed Amendments**") to the definition of venture capital fund under Rule 203(l)-1, as well as to the private fund adviser exemption under Rule 203(m)-1, under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), to reflect changes made by Title LXXIV, Sections 74001 and 74002, of the Fixing America's Surface Transportation Act of 2015 (the "**FAST Act**").

According to the Proposed Amendments, Title LXXIV, Section 74001, of the FAST Act amends Section 203(l) of the Advisers Act, which provides an exemption from investment adviser registration for any adviser solely to one or more "venture capital funds" by deeming "small business investment companies" to be "venture capital funds" for purposes of the exemption. Consequently, according to the Proposed Amendments, the SEC has proposed to amend the definition of "venture capital fund" to include "small business investment companies," as described in Section 203(b)(7) of the Advisers Act (other than an entity that has elected to be regulated or is regulated as a business development company pursuant to Section 54 of the Investment Company Act of 1940, as amended (the "**Investment Company Act**")).

Further, according to the Proposed Amendments, Title LXXIV, Section 74002, of the FAST Act amends Section 203(m) of the Advisers Act, which provides an exemption from investment adviser registration for any adviser solely to "private funds" with less than $150 million in assets under management by excluding the assets of "small business investment companies" when calculating the $150 million registration threshold. The SEC has thus proposed, according to the Proposed Amendments, to amend the definition of "assets under management" in the private fund adviser exemption to exclude the assets of "small business investment companies."

The SEC has requested comments regarding the Proposed Amendments by June 8, 2017. Comments may be submitted:

(i) through the SEC's internet comment form (**https://www.sec.gov/rules/proposed.shtml**);

(ii) by email to **rule-comments@sec.gov**;

(iii) via the Federal eRulemaking Portal (**http://www.regulations.gov**); or

(iv) via mail to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

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

House Financial Services Committee Approves Revised Financial CHOICE Act

On May 4, 2017, the U.S. House Financial Services Committee approved the Financial CHOICE Act (the "**Act**"), setting the stage for broader consideration on the House floor in the coming weeks. **As we reported last month**, the Act would make sweeping changes to the Dodd-Frank Wall Street Reform and Consumer Protection Act and other financial regulatory laws.[1] 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. The Committee's vote to approve the Act was divided along party lines, a reminder of the Act's uncertain future in the closely divided Senate.

Industry Update

SEC Releases Statistics Report on Money Market Funds

On April 20, 2017, the SEC staff published a report (the "**Report**") summarizing recent money market fund industry statistics and trends based on data from reporting money market funds for the period beginning March 31, 2015 to March 31, 2017. The Report includes statistics about the total number, assets, 7-day yields, weighted average life and weighted average maturity of prime funds, government and treasury funds and tax exempt funds, as well as additional information regarding prime funds (including liquidity, bank holdings and portfolio composition) and taxable funds. The Report shows a steady decreasing trend in the number of money market funds in the past two years, from 542 as of March 31, 2015 to 411 as of March 31, 2017. In addition, while the Report shows a decrease of $14.5 billion of assets in government and treasury funds since February 28, 2017, the overall trend since December 31, 2016 has been a significant increase of assets in government and treasury funds of approximately $1 trillion and a decrease of assets in prime funds of approximately $1 trillion. For further details on the SEC's prior report on money market funds, as well as its report on private fund statistics, please see the **November 22, 2016 Investment Management Regulatory Update**.

- **See a copy of the Report**

[1] For a recent summary of the major provisions of the CHOICE Act as currently proposed, see ***Financial CHOICE Act 2.0 Passes House Financial Services Committee*** on the Davis Polk Financial Regulatory Reform website.

Litigation

SEC Charges Credit Suisse and Former IA Representative with Breaches of Fiduciary Duty

On April 4, 2017, the SEC issued orders (the "**Orders**") against Credit Suisse Securities (USA) LLC ("**CS**") and a former CS investment adviser representative ("**IA Representative**") finding that both CS and the IA Representative breached their fiduciary duties when they improperly invested advisory clients in more expensive Class A shares despite such clients being eligible to invest in the less expensive institutional shares.

According to the Orders, between January 2009 and January 2014, CS and the IA Representative invested their advisory clients in a more expensive share class, due to certain marketing and distribution fees imposed on shareholders pursuant to Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder, even though such clients were eligible to hold the less expensive institutional share class. According to the Orders, such fees were passed through to CS, and in turn CS paid a portion of such amount to its investment adviser representatives, including the IA Representative. This practice, according to the Orders, resulted in CS collecting approximately $3.2 million in 12b-1 fees, $1.1 million of which was paid to the IA Representative, while the value of their advisory clients' investments decreased. In addition, according to the CS Order, CS's Form ADV, client agreements and certain other disclosures failed to adequately inform its advisory clients of the conflict of interest inherent in an investment adviser representative's ability to select for or recommend to clients mutual fund share classes that paid 12b-1 fees, despite such clients being eligible to invest in less expensive share classes. Finally, according to the Order, CS did not institute sufficient compliance procedures to require personnel to identify or evaluate available institutional share classes or to address those instances when investment advisor representatives were purchasing or holding more expensive Class A shares when less costly institutional share classes were available.

According to the Orders, CS and the IA Representative violated Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to directly or indirectly engage in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client. In addition, according to the CS Order, CS violated Section 207 of the Advisers Act, which deems it unlawful for any person to willfully make any untrue statement of a material fact in any registration application or report filed with the SEC or to willfully omit to state any material fact in such application or report, and Section 206(4) and Rule 206(4)-7 thereunder, which require a registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act or its rules.

According to the Orders, CS and the IA Representative have agreed to collectively pay disgorgement of $3,224,483, prejudgment interest of $577,678 and penalties of $4,125,000. In addition, according to the Orders, a Fair Fund financed with the money collected from the settlement will be established to compensate affected clients.

- **See a copy of the Press Release**
- **See a copy of the CS Order**
- **See a copy of the IA Representative Order**

SEC Grants Two Whistleblower Awards in a Week

On April 25, 2017, the SEC announced an award of nearly $4 million to a whistleblower who provided the SEC with information about misconduct and also assisted during the course of the SEC's investigation. One week later, on May 2, 2017, the SEC announced a separate award of more than $500,000 paid to a company employee who reported information that led to a successful enforcement action.

The whistleblower program, which arises from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, directs the SEC to pay an award to whistleblowers who voluntarily provide original information to the SEC that leads to successful enforcement actions and results in monetary sanctions of more than $1 million. The size of the award can range from ten to thirty percent of the monetary sanctions that the SEC collects and is paid from the SEC's Investor Protection Fund. Since the inception of the whistleblower program, approximately $154 million has been awarded to 44 different whistleblowers.

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

Two Advisers Settle Charges for Using Mutual Fund Assets to Pay Expenses Outside of a 12b-1 Plan

On May 1, 2017, the SEC issued an order (the "**Blair Order**") announcing that William Blair & Company, L.L.C. ("**William Blair**"), a Chicago-based investment adviser to a number of mutual funds ("**Blair Funds**"), agreed to settle charges relating to the improper use of Blair Fund assets to pay for (i) distribution and marketing of Blair Fund shares outside of a written, board-approved Rule 12b-1 plan and (ii) sub-transfer agent services ("**Sub-TA Services**") in excess of board-approved limits. The next day, the SEC issued a similar order (the "**Calvert Order**," and together with the Blair Order, the "**Orders**") against Calvert Investment Management, Inc., a Maryland-based investment adviser, and its broker-dealer affiliate, Calvert Investment Distributors, Inc. (collectively, "**Calvert**"), finding that Calvert had caused funds it advised (the "**Calvert Funds**") to pay for marketing and distribution agreements that it improperly categorized as Sub-TA Services.

According to the Blair Order, William Blair, on behalf of the Blair Funds, entered into agreements with four intermediaries for certain services that it inadvertently misclassified as Sub-TA Services, thereby causing the Blair Funds to pay for those services outside of a Rule 12b-1 plan. This misclassification occurred, according to the Blair Order, even though the agreements concerned the provision of distribution and marketing services, which must be paid as part of a 12b-1 plan. According to the Blair Order, the agreements were disclosed in the Blair Funds' prospectuses, but the prospectuses stated that William Blair, and not the Blair Funds, paid for the services under the agreements. Additionally, according to the SEC, William Blair erroneously caused the Blair Funds to pay certain expenses associated with the agreements twice, and also caused the Blair Funds to pay certain expenses that were in excess of expense caps approved by the Blair Funds' boards. Similarly, according to the Calvert Order, Calvert improperly caused the Calvert Funds to pay for marketing and distribution agreements that were wrongly categorized as Sub-TA Services agreements, and Calvert also inaccurately characterized these agreements in reports to the Calvert Funds' boards and in the Calvert Funds' prospectus disclosure.

In addition, according to the Blair Order, William Blair caused the Blair Funds to enter into shareholder administration agreements ("**SAAs**") with it and informed the Blair Funds' boards that it generally expected that the fees paid in connection with the SAAs would not be retained by William Blair and would instead be passed on to the various service providers that actually provided the services contracted for in the SAAs. However, according to the Blair Order, William Blair retained all of the revenue from the SAAs, and although the actual amount of revenue was disclosed to the Blair Funds' boards, the disclosure did not state that William Blair was retaining all such revenue.

Section 12(b) of the Investment Company Act, and Rule 12b-1 thereunder, prohibit advisers to registered funds from using a fund's assets to pay certain expenses for the costs of marketing and distributing fund shares unless pursuant to a written Rule 12b-1 plan approved by the fund's board or shareholders. As a result, if a fund's board or shareholders have not approved a Rule 12b-1 plan permitting the fund's adviser to use fund assets to pay for distribution services, then fund assets cannot be used to pay for such expenses. Because of this, according to the Orders, the SEC found that both William Blair and Calvert violated Section 12(b) of the Investment Company Act and Rule 12b-1 thereunder.

The SEC also found that William Blair and Calvert both violated Section 206(2) of the Advisers Act, which prohibits advisers from directly or indirectly engaging in any transaction which operates as a fraud or deceit upon a client, and Section 34(b) of the Investment Company Act, which makes it unlawful for any person to make an untrue statement of a material fact, or omit to state any fact that prevents a statement from being materially misleading, in any document filed pursuant to the Investment Company Act.

William Blair consented to the SEC's order without admitting or denying the SEC's findings and agreed to pay a civil money penalty of $4.5 million. According to the Blair Order, the SEC considered remedial acts undertaken by William Blair, including its bringing the payments to the attention of the boards of the Blair Funds, reimbursement of the Blair Funds with interest and changes to its oversight of payments to financial intermediaries, in determining to accept the offer of settlement.

Calvert also consented to the SEC's order without admitting or denying the SEC's findings and agreed to pay approximately $17.8 million of disgorgement, $3.8 million in prejudgment interest and a $1 million civil penalty. According to the Calvert Order, the SEC considered Calvert's self-reporting efforts, cooperation during the investigation and prompt remediation, in determining to accept the offer of settlement.

- **See a copy of the Blair Order**
- **See a copy of the Calvert Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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