Investment Management Regulatory Update

June 26, 2017

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Rules and Regulations

SEC Adopts Technical Amendments to Form ADV and Form ADV-W to Reflect Enactment of a Wyoming State Law Regulating Investment Advisers

On May 4, 2017, the Securities and Exchange Commission (the "**SEC**") issued a release (the "**Release**") making technical amendments to Form ADV and Form ADV-W under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") to reflect the enactment of a Wyoming state law regulating investment advisers.

According to the Release, under Section 203A(a)(1) of the Advisers Act, an adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business is prohibited from registering with the SEC unless the adviser (i) has assets under management of not less than $25 million or (ii) advises an investment company registered under the Investment Company Act of 1940, as amended (a "**RIC**"). Under Section 203A(a)(2) of the Advisers Act, a mid-sized adviser (*i.e.*, an adviser with between $25 million and $100 million of assets under management) is also prohibited from registering with the SEC if that adviser is required to be registered as an investment adviser in the state in which it maintains its principal office and place of business and, if registered, would be subject to examination as an investment adviser. However, if an adviser's principal office and place of business is located in a state that has not enacted a statute regulating advisers, then such adviser—regardless of the amount of assets it manages—must register with the SEC.

The Release stated that until recently, Wyoming had not enacted such a statute regulating investment advisers, and all advisers with a principal office and place of business in Wyoming were required to register with the SEC by filing a Form ADV. According to the Release, the SEC staff has confirmed with the Wyoming Secretary of State Compliance Division that after Wyoming's statute regulating investment advisers becomes effective on July 1, 2017, mid-sized advisers with a principal office and place of business in Wyoming will be required to register with the state and will be subject to examination.

Accordingly, an adviser with a principal office and place of business in Wyoming will no longer be permitted to register with the SEC unless it has more than $100 million in assets under management, advises a RIC, or is eligible to rely on one of the exemptions from the prohibition on registration contained in Rule 203A-2 of the Advisers Act.

According to the Release, the SEC is making technical amendments to Form ADV and Form ADV-W to reflect the enactment of Wyoming's statute regulating investment advisers. The Release states that effective July 1, 2017, Form ADV will no longer include the option to select principal office and place of business in Wyoming as a basis for SEC registration, and will include a "WY" checkbox allowing advisers to add Wyoming to the list of states that can receive notice filings; in addition, Form ADV-W will be amended to add a reference to Wyoming to section (b) concerning withdrawals from state investment adviser registration.

According to the Release, approximately 35 advisers with an aggregate reported $530 million in regulatory assets under management will, as a result of Wyoming's new statute regulating investment advisers, be required to register with Wyoming and withdraw from registration with the SEC unless they have an alternative basis for SEC registration.

- **See a copy of the Release**

House Approves Revised Financial CHOICE Act

On June 8, 2017, the U.S. House of Representatives approved the Financial CHOICE Act of 2017 (the "**Act**") in a 233-186 vote on near-party lines. **As we reported in April**, 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 Act now faces an uncertain future in the Senate, where it is unlikely to be adopted in full. It is possible, however, that certain aspects of the Act will be approved by the Senate or implemented by the Trump administration, which on June 12, 2017 released a Treasury Department report outlining the administration's financial regulatory goals.

- **See a copy of the Act**

Industry Update

SEC Releases Statistics Report on Private Funds

On April 24, 2017, the SEC published a report (the "**Report**") summarizing recent private fund industry statistics and trends, which were gathered through aggregating data reported by private fund advisers on Form ADV and Form PF. The Report reflects data reported by private fund advisers from the fourth calendar quarter of 2014 through the third calendar quarter of 2016.

The Report includes statistics about private funds' gross and net assets, fund domiciles and adviser main offices, beneficial ownership, distribution of borrowings, use of derivatives and use of high-frequency

[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.

trading, as well as specific reported information on large hedge fund advisers, liquidity funds, hedge funds and private equity funds. The Report also includes an analysis of hedge fund gross notional exposure relative to net asset value and a comparison of average investor liquidity and portfolio liquidity for hedge funds.

- See a copy of the Private Funds Report

SEC Chairman Issues Public Statement Seeking Comments on DOL Fiduciary Rule

On June 1, 2017, SEC Chairman Jay Clayton released a public statement soliciting comments from members of the public regarding standards of conduct for investment advisers and broker-dealers who provide advice to retail investors.

Clayton began by acknowledging recent statements by the Department of Labor (the "**DOL**") regarding its intent to issue a Request for Information in connection with its fiduciary rule and related prohibited transaction exemptions (the "**DOL Fiduciary Rule**"). Clayton further acknowledged remarks by DOL Secretary Alexander Acosta, wherein Acosta expressed a desire for the DOL and the SEC to work together in providing standards of conduct applicable to investment advisers and broker-dealers who provide advice to retail investors.

Clayton then went on to acknowledge the SEC's history of review in this area, including the RAND study, which was commissioned in 2006, the Dodd-Frank section 913 staff study, which was conducted in 2010-2011 and a recent solicitation of data and other information regarding the duties of broker-dealers and investment advisers in 2013. Clayton noted that the extensive history of review underscored the complexity of the issues and the changing nature of the markets. Furthermore, Clayton cited a broad range of suggestions previously submitted in this area, which included maintaining the existing regulatory structure, requiring enhanced disclosure to mitigate reported investor confusion and the development of a single standard of conduct applicable to investment advisers and broker-dealers who provide advice to retail investors.

Next, Clayton cited recent market developments, including financial innovations, changes in business models and regulatory developments, as motivations for the SEC's initiative to reassess the current regulatory framework, the current state of the market for retail investment advice and market trends. In connection with such a reassessment, Clayton announced that the SEC is making available a webform and email box to members of the public in order to solicit comments on a range of topics.

According to Clayton, these topics include, among other things: (i) the reported confusion among retail investors regarding types of professionals and firms providing investment advice and the different standards of conduct applicable to different types of relationships; (ii) the identification and resolution of potential conflicts of interest related to the provision of investment advice to retail investors, and whether disclosure or other means can appropriately address such conflicts; (iii) the potential discrepancy between retail investors' perception of duties applicable to entities providing investment advice in new ways (such as robo-advisers and fintech) and the actual obligations owed by such entities; (iv) whether there is a trend towards providing retail investment advice under fee-based models rather than commission-based brokerage models and, if so, the impact of such trend on the availability, cost or quality of investment advice and other services provided to retail investors; and (v) issues relating to the implementation of the DOL Fiduciary Rule, including the different standards of conduct applicable to accounts subject to the DOL Fiduciary Rule and those that are not. Clayton concluded by encouraging commenters to provide data and other information that may be helpful to the SEC's analysis, and further noted that as submissions will be posted on the SEC's website in unedited form, commenters should submit confidential data or information in an aggregated or anonymous format.

Comments may be submitted:

(i) through the SEC's internet comment form (https://www.sec.gov/cgi-bin/ruling-comments); or

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

- **See a copy of the Public Statement**

DOL Fiduciary Rule Comes Into Effect

The DOL Fiduciary Rule went into effect on June 9, 2017. For a detailed discussion of the DOL Fiduciary Rule, please see the April 5, 2017 Davis Polk Financial Regulatory Reform Blog Post, **DOL Fiduciary Rule: Officially Delayed for Now, with More to Come**.

Litigation

SEC Charges Brokerage Firm with AML Violations

On June 5, 2017, the SEC filed a complaint (the "**Complaint**") in the Southern District of New York charging Alpine Securities Corporation ("**Alpine**"), a Salt Lake City-based broker-dealer, with violations of anti-money laundering ("**AML**") laws in connection with its alleged practice of clearing transactions in microcap stocks that were used to defraud investors.

According to the Complaint, broker-dealers are generally required by Section 17(a) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), and Rule 17a-8 thereunder, to comply with the recordkeeping, retention and reporting obligations of the Bank Secrecy Act (the "**BSA**") and its implementing regulations. The BSA and its implementing regulations generally require broker-dealers to file suspicious activity reports ("**SARs**") with the U.S. Treasury Department's Financial Crimes Enforcement Network ("**FinCEN**") to report certain suspicious transactions conducted by, at, or through their firms. The instructions to FinCEN's SAR form generally require broker-dealers to include a description of what makes the reported transactions unusual, irregular, or suspicious. Further, FinCEN's regulations require broker-dealers to implement and maintain an AML program that complies with the requirements of the applicable self-regulatory organization governing such programs.

According to the Complaint, from at least May 2011 until December 2015, Alpine routinely failed to follow its internal AML compliance program by either omitting information from SARs that it was required to file or, in certain instances, failing to file them altogether. The Complaint alleges that, despite the existence of policies and procedures, as well as formal and informal training on AML compliance, Alpine routinely and systematically failed to identify and report suspicious activity of which it was aware in its SARs. According to the Complaint, these alleged failures included: (i) the systematic omission of material "red-flag" information (such as a customer's criminal or regulatory history, evidence of stock promotion or status as a foreign financial institution) from at least 1,950 SARs; (ii) approximately 1,900 instances where Alpine filed an SAR only on the deposit of stock but not on subsequent related transactions, such as the liquidation of such stock or transfer of funds resulting from the liquidation of such stock and (iii) at least 250 instances of failure to file an SAR altogether.

The Complaint notes that Alpine had repeatedly been warned by regulators regarding its failures in implementing its AML compliance program. According to the Compliant, such warnings included a May 2012 examination by the Financial Industry Regulatory Authority ("**FINRA**"), in which every SAR that FINRA reviewed failed to meet FinCEN requirements regarding SARs, and an April 2015 examination by the SEC's Office of Compliance Inspections and Examinations, which resulted in a deficiency letter noting that the BSA compliance issues identified by FINRA had not been rectified. The Complaint alleges that, notwithstanding the results of these examinations, Alpine continued omitting material "red-flag" and other information from the SARs that it filed.

The Complaint seeks an injunction permanently restraining and enjoining Alpine from further violations of Section 17(a) of the Exchange Act and Rule 17a-8 thereunder, which require broker-dealers to comply

with the reporting, recordkeeping, and record retention requirements of the BSA and its implementing regulations. The Complaint also seeks civil money penalties.

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

Supreme Court Rules that SEC Disgorgement Actions Are Subject to Five-Year Statute of Limitations

On June 5, 2017, the Supreme Court unanimously held in *Kokesh v. SEC* that the five-year statute of limitations in 28 U.S.C. § 2462 applies to claims for disgorgement by the SEC. In *Kokesh*, the question turned on whether disgorgement, which requires a defendant to give up ill-gotten gains, constitutes a "forfeiture" or "penalty" under § 2462 and is thus within the applicable five-year statute of limitations. The *Kokesh* decision resolved a circuit split between (i) the Tenth, D.C. and First Circuit Courts of Appeals, which found that disgorgement was not a penalty under § 2462, and (ii) the Eleventh Circuit Court of Appeals, which found in a 2016 decision that disgorgement fell within the plain meaning of "forfeiture" and was therefore limited by the five-year statute of limitations.

For a detailed discussion and analysis of the *Kokesh* decision, please see the June 6, 2017 Davis Polk Client Memorandum, **Securities Enforcement Update: Supreme Court Rules that Five-Year Statute of Limitations Applies to SEC Disgorgement Actions**.

- **See a copy of the Kokesh decision**

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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