Investment Management Regulatory Update

July 28, 2017

Rules and Regulations

SEC Updates Form ADV Frequently Asked Questions

On June 12, 2017, the SEC's Division of Investment Management updated its Frequently Asked Questions relating to Form ADV and IARD (the "**FAQs**") to provide additional guidance on certain amendments to Form ADV that were adopted by the SEC in 2016 (the "**Amendments**"), which investment advisers must comply with beginning October 1, 2017. For a discussion of the Amendments, please see the October 31, 2016 Investment Management Regulatory Update.

Among other things, the FAQs contain updated guidance on two key areas: (i) the "umbrella registration" approach and (ii) disclosure of client information.

- *Umbrella Registration*. The umbrella registration approach (under which an investment adviser files a single Form ADV covering both the "filing adviser" and certain affiliated "relying advisers") originally relied on a January 18, 2012 no-action letter addressed to the American Bar Association (the "**ABA Letter**"). As umbrella registration was codified by the Amendments, the updated FAQs clarify that the SEC staff is withdrawing only the portions of its response in the ABA Letter that relate to umbrella registration. In addition, the updated FAQs clarify that umbrella registration may continue to be used for special purpose vehicles created for the purpose of acting as a private fund's general partner or managing member, but may not be used for exempt reporting advisers. Further, the FAQs provide guidance on how to change a relying adviser to an exempt reporting adviser and how to remove a relying adviser from a Form ADV.
- *Client Information*. According to the updated FAQs, a sub-adviser to an investment company, business development company or pooled investment vehicle client should treat the entity itself, rather than the entity's primary adviser, as its client for Form ADV purposes. In addition, the FAQs clarify that, for purposes of client reporting, "pooled investment vehicle" does not only include private funds, although a "fund of one" should not be categorized as a pooled investment

vehicle if its purpose is for the investment adviser to provide individualized advice directly to the investor in the fund of one.

In addition to the above guidance, the updated FAQs also include guidance on:

- *Separately Managed Accounts*. Under the Amendments, an adviser generally must categorize its regulatory assets under management attributable to separately managed accounts according to the type of assets into which the accounts invest and reject any borrowing transactions executed on behalf of the accounts. The FAQs indicate that while "borrowing transactions" cover a broad range of activities (including bank loans, margin accounts, synthetic borrowing, short selling transactions and transactions in which variation margin is owed), an adviser need not report securities lending, repurchase arrangements or leverage through derivative exposure. In addition, the FAQs state that any borrowings undertaken without the adviser's knowledge do not need to be reported.
- *Audited Financial Statements*. According to the FAQs, if audited financial statements have not yet been distributed to a private fund's investors when an adviser files its Form ADV, but will be distributed, such adviser can indicate on its Form ADV that such private fund's investors have received such statements.
- *Chief Compliance Officer*. Under the Amendments, an adviser must disclose whether its chief compliance officer is employed or compensated by a person other than the adviser. The FAQs clarify that this requirement does not apply to a situation where an adviser's chief compliance officer also provides compliance services to, and is compensated for such services by, third-party advisers.
- *Social Media*. The Amendments require an adviser to disclose its social media activity regardless of whether such activity is used to promote its advisory business. The FAQs clarify that an adviser does not need to disclose the social media accounts of its employees even if the content of these accounts is controlled by the adviser. In addition, according to the FAQs, the social media account of a parent company used to promote the advisory business of a subsidiary may need to be disclosed by the subsidiary adviser.

▸ **See a copy of the FAQs**

Interacting with Retirement Investors under the DOL Fiduciary Rule

The new Department of Labor ("**DOL**") fiduciary rule took effect on June 9, 2017. For now the DOL and Internal Revenue Service have announced that they will not take enforcement action against impacted parties in reasonable compliance. The fate of the rule over the longer term remains uncertain as the rule is under review by the new leadership of the DOL and bills have been introduced in the House and Senate to override the rule. Nevertheless, the basic thrust of the rule has taken effect.

Under the rule, a party will be deemed to have provided advice and become a fiduciary to an employee benefit plan or individual retirement account ("**IRA**") if the party directs a communication toward a specific audience that includes a plan or IRA and, based on its content, context and presentation, the communication would reasonably be viewed as a recommendation that the receiving party engage in or refrain from taking a particular course of action with respect to an investment. If a fund manager were deemed to have provided fiduciary advice to a plan or IRA with respect to a plan's or IRA's investment in the manager's funds, this would not only attract fiduciary responsibility for that advice but would arguably cause any fees or allocations received by the manager or its affiliates to be viewed as a prohibited transactions under the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**") and the Internal Revenue Code of 1986, as amended (the "**Code**"). Under ERISA and the Code, fiduciaries are prohibited from providing advice where they have a potential conflict of interest and the resulting excise taxes and other penalties could be draconian.

One important exception under the rule that has received some attention in the private funds community is the so-called "sophisticated investor" exception. Under this exception, communications with a plan or IRA will not create an advisory relationship if they are made to a sophisticated independent fiduciary of a plan or IRA. Before relying on this exception for communications to a plan or IRA, a fund manager must know or reasonably believe that:

- the communications are being received on behalf of the plan or IRA by an independent fiduciary who is responsible for exercising its judgment in evaluating the communications and related transactions;
- the independent fiduciary is a bank, insurance carrier, registered investment adviser, registered broker-dealer or independent fiduciary with at least $50 million in assets under management; and
- the independent fiduciary is capable of evaluating the relevant investment risks independently.

In addition, the fund manager must not receive any fee specifically for the information or advice provided in its communications and must inform the independent fiduciary that the manager is not providing impartial investment advice and that the manager receives fees and other benefits from managing the funds.

Given the condition that fund managers must know or reasonably believe that their communications are being received by an independent fiduciary meeting the criteria above, fund managers might consider requiring any pension plan investor to confirm that it is represented by a qualified independent fiduciary in connection with its investment in the manager's funds. This can be accomplished by including appropriate representations and acknowledgements in the funds' subscription documents.

While pension plan investors are usually represented by qualified independent fiduciaries in connection with their investment in private funds, IRA investors are usually not and therefore fund managers likely would not be able to rely on the sophisticated investor exception in their communications with IRA investors. The DOL has indicated that IRA owners cannot qualify as sophisticated independent fiduciaries of their own IRAs, regardless of their wealth.

Because the sophisticated investor exception is likely unavailable with respect to IRA investors, fund managers will need to be cautious in their communications with current and potential IRA investors to avoid having these communications rise to the level of investment advice under the new rule. In general, fund managers and their employees should not recommend, suggest or advise any given course of action or inaction to IRA investors and should limit their communications with IRA investors to providing information and answering general questions. The more individually tailored a communication is, the more likely that it would be viewed as advice. As a further safeguard, all communications with IRA investors should include a disclaimer that the communication does not constitute advice and the investor should consult its own adviser regarding its investment decision. This disclaimer is often included in investor reports and similar distributions, but managers should consider making it a staple of all substantive communications and presentations.

Industry Update

Acting Director and Acting Chief Economist of DERA Gives Speech on Market Fragility and Interconnectedness in the Asset Management Industry

On June 20, 2017, Scott W. Bauguess, Acting Director and Acting Chief Economist of the SEC's Division of Economic and Risk Analysis ("**DERA**") gave a speech on market fragility and interconnectedness in the asset management industry.

Bauguess began by acknowledging the frequency with which the relationship between asset management and financial stability risks has been addressed in recent years, mostly as a result of both

the growth in the asset management industry and the focus on financial stability risks in the years after the financial crisis.

Bauguess then turned to a theory of financial stability risk that has been a major focus in the aftermath of the financial crisis: "run risk." According to Bauguess, while run risk is widely understood in the context of a traditional bank as a run on deposits, run risk in the asset management industry differs significantly. For example, Bauguess explained that investors in the asset management industry have intentionally taken on investment risk and funds generally provide greater transparency with regard to their holdings than banks, allowing investors to better assess the riskiness and quality of holdings. However, Bauguess notes that run risk at funds is still a large concern, citing a Financial Stability Board report that stated that the global asset management industry accounts for 65% of market-based financial activity that could result in financial stability risks.

Next, Bauguess stated that, in light of the fundamental market changes that have occurred since the financial crisis, both new risks and new contexts in which old risks can arise must be considered and addressed. He then focused on the following particular market participant behaviors and associated risks:

- *Increased frequency of open-end funds investing in fixed-income securities and other alternative investments*. Bauguess notes that portfolios of fixed-income securities are usually less liquid than portfolios of equity securities. As a result, because open-end funds must offer investors daily redemption rights at end-of-day net asset value (NAV), such funds may be particularly susceptible to the risk of fire sales (i.e., forced sales of assets at discounted prices). According to Bauguess, fire sales on a large scale could cause serious financial stability concerns.
- *Investor herding*. According to Bauguess, investor "herding" (i.e., the phenomenon of investors behaving in ways previous investors behaved without a separate evaluation of the circumstances that triggered the previous investors' decision) is particularly prevalent in times of financial market stress. Bauguess notes that the riskiness of investor herding is dependent on whether (i) there are countercyclical investors who take advantage of arbitrage opportunities and (ii) the capital that investors redeem out of funds is placed back into the financial markets.
- *Interconnectedness of asset management industry and liquidity management*. Bauguess also pointed to the tendency for fund managers to respond similarly to market stress, even if there is no intention to coordinate such actions, as a source of risk. Although such actions, when taken individually, may be prudent for each fund, they have the potential to further stress the market when taken simultaneously by many managers. Recognition of this risk, according to Bauguess, contributed to the SEC's recent liquidity risk management reforms.
- *Rules-based investing*. According to Bauguess, the rise in rules-based investing executed by fixed algorithms (such as robo-advising and smart beta ETFs) can also result in "mechanical herding." For example, if decision rules are derived from changes in market conditions, investment decisions could then be made that in turn affect market conditions, creating a feedback loop that exacerbates the problem. Bauguess warned that, although this sector of the asset management industry is currently small, the risks could become greater as it continues to increase in popularity.

Bauguess then acknowledged the SEC's efforts to combat risks in the asset management industry. Bauguess noted that, in addition to promulgating new rules and regulations, the SEC is continuously monitoring the market by assessing the aforementioned risks, both within DERA and across the various SEC divisions. Bauguess also described the SEC's response plan to emerging market events, which includes, among other things, a real-time assessment of the potential spillover of investor reaction to a stress event.

Bauguess concluded by reminding the audience of the important lessons of the financial crisis and predicting that leverage, and the use of derivatives that create synthetic leverage, will be the cause of or a

major contributor to the next significant market disruption. Bauguess stressed that even though current rules cannot prevent future market stress events, the SEC's collection of market information and practices will assist regulators and market participants in assessing and responding to risks that arise in the asset management industry.

- **See a copy of the Speech**

SEC Grants No-Action Relief to Nuveen Fund Advisors under Section 15(a) of the Investment Company Act to Extend Interim Sub-Advisory Agreements Past Their Expiration Dates without Shareholder Approval

On June 20, 2017, the staff of the Division of Investment Management of the SEC issued a no-action letter (the **"Letter**") to Nuveen Fund Advisors, LLC ("**Nuveen Fund Advisors**") and NWQ Investment Management Company, LLC ("**NWQ**"), clarifying that the SEC will not recommend enforcement against NWQ under Section 15(a) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**") if, under certain conditions, NWQ continued to serve as investment adviser to certain series of the Nuveen Investment Trust and Nuveen Investment Trust II (the "**Trusts**") pursuant to written investment sub-advisory agreements that were not approved by the vote of a majority of the outstanding voting securities of such series.

According to the incoming letter (the "**Incoming Letter**"), Nuveen Fund Advisors serves as investment adviser to certain series (the "**Funds**") of the Trusts and, prior to August 1, 2016, Tradewinds Global Investors, LLC ("**Tradewinds**") served as sub-adviser to the Funds. In May 2016, Nuveen Fund Advisors recommended, and the Board of Trustees of the Trusts approved, the termination of each Fund's sub-advisory agreement with Tradewinds, effective as of August 1, 2016; NWQ was also appointed as the interim sub-adviser to each Fund pursuant to an interim investment sub-advisory agreement with each Fund, which was scheduled to terminate no later than December 29, 2016, or 150 days after the effective date of the appointment (the "**Expiration Date**"). The Incoming Letter also noted that the Board of Trustees of the Trusts had determined that a reorganization of each Fund was in each Fund's best interests and, in the event that the reorganization was not approved by shareholders prior to the Expiration Date, that a new, long-term sub-advisory agreement should be entered into by each Fund with NWQ. According to the Incoming Letter, each Fund solicited shareholders (including direct mailings and the use of a proxy solicitor) to approve the reorganization and the new sub-advisory agreement; however, while a majority of the votes cast were in favor of the reorganization and the new sub-advisory agreement, as of November 29, 2016, the Funds' proxy solicitation efforts had not resulted in any Fund's reaching the quorum required for its shareholders to vote on the proposals.

Section 15(a) of the Investment Company Act generally provides that it is unlawful for any person to serve as an investment adviser of a registered investment company, except pursuant to a written contract that, among other things, has been approved by the vote of a majority of the outstanding voting securities of such registered investment company. Rule 15a-4 under the Investment Company Act provides a temporary exemption from such shareholder approval requirement where, among other circumstances, the registered investment company's board of directors has terminated the previous advisory contract. Under Rule 15a-4, a person may act as an investment adviser under an interim advisory agreement without the required shareholder approval for a period of no more than 150 days following the date on which the previous contract terminated.

Given that NWQ's appointment as interim sub-adviser to each Fund was designed to comply with Rule 15a-4 (the Expiration Date being the latest that NWQ could rely on Rule 15a-4 to serve as interim sub-adviser), Nuveen Fund Advisors requested no-action relief from the SEC for NWQ to continue to serve as the sub-adviser to each Fund for an additional period after the Expiration Date (the "**Additional Period**") not to exceed the earliest of (i) the consummation of the reorganization; (ii) shareholder approval of each Fund's new sub-advisory agreement; or (iii) 60 days after the Expiration Date.

The SEC staff granted the requested relief, noting that (i) Nuveen Fund Advisors and the Trusts believed that extending the term of the interim sub-advisory agreements was in the best interests of the Funds; (ii) the Board of Trustees of the Trusts had approved the extension and (iii) without such an extension, it may have been necessary to liquidate the Funds. The SEC staff noted that the relief granted is based on the following conditions during the Additional Period:

- Nuveen Fund Advisors and the Funds, with the assistance of their proxy solicitor, would continue their proxy solicitation efforts to seek to reach a quorum. Nuveen Fund Advisors would bear all postage, printing, tabulation and proxy solicitation costs during the Additional Period.
- Nuveen Fund Advisors would waive the portion of each Fund's investment advisory fee in an amount equal to the amount of the sub-advisory fee that would have been payable by Nuveen Fund Advisors to NWQ under the original terms of the interim sub-advisory agreement.
- Other than changes to reflect the relief granted, the terms and conditions of the interim sub-advisory agreements would remain the same.

▸ **See a copy of the Letter**

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

ILPA Issues Guidance on Use of Subscription Credit Lines

On June 27, 2017, the Institutional Limited Partners Association ("**ILPA**") issued guidance (the "**Guidance**") for limited partners and general partners regarding the use of subscription line credit facilities. **As we reported in April**, subscription line financing has been the subject of increasing attention, particularly in connection with disclosures relating to IRR calculations. In the Guidance, ILPA recommends that limited partners request (1) greater disclosures from fund managers regarding the use of subscription lines and (2) greater clarity in the partnership agreement regarding the parameters for the use of subscription lines. For example, the Guidance makes the following recommendations that, in ILPA's view, would leverage the cash flow benefits of lines of credit while also providing LPs with a greater degree of transparency and disclosure:

- LPs should require their managers to disclose quarterly information on the size of the lines, number of days outstanding, specific uses of the capital and impact of credit line facilities on reported IRRs. During due diligence, LPs should request that prospective managers provide the impact of subscription facilities on past reported performance.
- Within partnership agreements, waterfall provisions should specify that the date used to calculate the GP's preferred return hurdle is the date when the credit facility is drawn, rather than the date capital is ultimately called from the GPs.
- Partnership agreement provisions addressing the use of subscription facilities should establish reasonable thresholds for their use, such as a maximum percentage of all uncalled capital (*e.g.*, 15-25%) and maximum number of days outstanding (*e.g.*, 180 days).

While many of the suggestions have been and continue to be considered and addressed by experienced investors and managers, the Guidance will likely spur more focused discussion. Sponsors should consider reviewing such disclosures and practices with fund counsel. The Guidance, together with any subsequent revisions, will be incorporated into the revised ILPA Principles that are scheduled to be published in early 2018.

▸ **See a copy of the Guidance**

Litigation

Investment Adviser Sentenced for Fraudulent Cherry-Picking Scheme

On June 21, 2017, the U.S. District Court for the District of Massachusetts sentenced Michael J. Breton, a Massachusetts-based investment adviser, to two years in prison, two years of supervised release, and ordered him to forfeit and pay restitution in the amount of $1,326,696. Breton had previously pled guilty to securities fraud on March 3, 2017.

The SEC had initially filed fraud charges in the District Court against Breton and his advisory firm, Strategic Capital Management, LLC ("**SCM**"), on January 25, 2017. The SEC alleged in its complaint that Breton and SCM had defrauded at least 30 clients out of approximately $1.3 million by placing trades through a master brokerage account and allocating over 200 profitable trades to Breton's personal accounts while placing unprofitable trades in their client accounts.

According to the complaint, from 2010 to 2016, SCM maintained and placed trade orders through master brokerage accounts at two separate brokerage firms and subsequently allocated the purchased securities among his personal accounts as well as client accounts. The complaint alleged that SCM routinely placed orders for publicly traded securities through the master brokerage accounts on days on which the relevant public companies were scheduled to make earnings announcements, but would not designate at the time of entering the orders whether the trades would be allocated to Breton's personal accounts or the client accounts. According to the complaint, Breton typically delayed allocating the trades until the earnings announcements had been made, and frequently allocated trades that were anticipated to be profitable to his personal accounts rather than the client accounts.

In addition, the complaint alleged that Breton and SCM had made false and misleading statements in SCM's Forms ADV and had failed to disclose material facts to SCM's clients. According to the complaint, Breton and SCM had included various statements in SCM's Forms ADV, which were provided to clients each year from 2010 to 2016, relating to SCM's adherence to its fiduciary duties to clients, and specifically noting that while Breton was permitted to purchase for his own account securities that he recommended to SCM's clients, Breton would not effect any such transactions that would disadvantage SCM's clients.

According to the complaint, Breton's and SCM's actions, as described above, violated (i) Section 10(b) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), and Rule 10b-5 thereunder, which generally make it illegal for any person to make an untrue statement of material fact or omit to state a material fact necessary in order to make the statements made not misleading, or to use any measure or engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security and (ii) Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), pursuant to which an investment adviser has a general duty not to make false or misleading statements to clients, and may not omit material information necessary to make statements made not misleading.

The civil litigation surrounding Breton's and SCM's fraudulent conduct continues as the District Court considers whether to order monetary sanctions. In the complaint, the SEC had sought disgorgement plus prejudgment interest and civil penalties. In the meantime, Breton and SCM have been enjoined from future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as Sections 206(1) and 206(2) of the Advisers Act, and Breton has been barred from the securities industry by the SEC.

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

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.

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**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Sijia Cai	**212 450 3071**	**sijia.cai@davispolk.com**