Investment Management Regulatory Update

August 31, 2017

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Rules and Regulations

SEC Staff Releases FAQs on Investment Company Reporting Modernization Reforms

In July 2017, the Division of Investment Management of the SEC prepared responses to certain frequently asked questions (the "**FAQs**") relating to the investment company reporting modernization reforms adopted in October 2016. For a detailed discussion of these reforms, please see the ***October 31, 2016 Davis Polk Investment Management Regulatory Update***.

The updated FAQs provide guidance on several topics, including:

Compliance Dates and General Filing Obligations

- According to the FAQs, the following compliance dates apply to the various forms and disclosures mandated by the recent reforms:
  - Form N-PORT: June 1, 2018 for larger entities (i.e., funds that, together with other investment companies in the same group of related investment companies, have net assets of $1 billion or more as of the end of the most recent fiscal year of the fund, excluding private funds relying on section 3(c)(1) or 3(c)(7) of the Investment Company Act

of 1940 (the "**Investment Company Act**")); June 1, 2019 for smaller entities. Funds must file reports on Form N-PORT no later than 30 days after the end of each month. Compliance should be based on the reporting period end date.

- Form N-CEN: June 1, 2018 based on the reporting period end date. For example, a fund with a May 31 fiscal year-end would not need to make its first filing on Form N-CEN until the fiscal year ending May 31, 2019 because May 31, 2018 is prior to Form N-CEN's compliance date. Funds with a fiscal year-end on April 30 or May 31, 2018 may file their final reports for fiscal year 2017-2018 on either Form N-SAR (due 60 days after the reporting period end) or Form N-CEN (due 75 days after the reporting period end).
- Regulation S-X Amendments: August 1, 2017 based on reporting period end date. For example, financial statements contained in a report on Form N-CSR for the period ended June 30, 2017 need not comply with the amendments to Regulation S-X, even though that report is required to be filed by September 8, 2017 (i.e., 70 days after the period end date).
- Securities lending disclosures (Forms N-1A, N-3 and N-CSR): August 1, 2017.

- According to the FAQs, once a fund begins filing reports on Form N-PORT, it will no longer be required to file reports on Form N-Q. In addition, when a fund stops filing reports on Form N-Q, its certification on Form N-CSR must cover any change in internal control over financial reporting that occurred during the most recent fiscal half year (instead of the most recent fiscal quarter, which is currently required).
- According to the FAQs, money market funds also must continue to file Form N-Q until the form is rescinded on August 1, 2019. Thereafter, money market funds must continue to post their portfolio holdings on a web site monthly and file Form N-MFP monthly.
- According to the FAQs, test filing will be permitted following EDGAR Release 17.3 later this year. During the testing period, filers should identify their filings as "test" filings. Any filings marked as "test" filings will not be evaluated for compliance with the forms or be available to the public.

Specific Requirements of Form N-PORT

Calculation Methodologies. The FAQs provide clarifications regarding certain calculation methodologies used for reports required under Form N-PORT:

- According to the FAQs, a fund is permitted to distinguish between the basis on which it calculates portfolio holdings and the basis on which it calculates risk metrics. For example, a fund that uses T+1 accounting for calculating daily NAV and reporting portfolio holdings on Form N-PORT may nonetheless calculate and report security- and portfolio-level risk metrics on Form N-PORT on a T+0 basis, subject to certain other requirements.
- The FAQs clarify that closed-end funds that do not strike their NAV on at least a monthly basis may use their internal methodologies to report information on Form N-PORT (in a manner consistent with how they would report to current and prospective investors). Such funds may provide additional information in Part E (explanatory notes to Form N-PORT) to explain the internal methodology.
- With respect to the reporting of notional amount for derivatives investments, the FAQs note that Form N-PORT separately requires notional amount with a delta adjustment while Article 12 of Regulation S-X specifically requires notional amount without a delta adjustment.

Part F Attachments. The FAQs also provide guidance on filing requirements regarding Form N-PORT Part F attachments, which contain portfolio holdings information:

- According to the FAQs, funds must file reports on Form N-PORT up to 30 days after the end of each month, but may file Part F attachments up to 60 days after the end of the reporting period.

The FAQs notes that additional instructions pertaining to these filings will be provided in an EDGAR filing manual.

- The FAQs clarify that when filing the Part F attachment, trusts that have multiple series with the same fiscal year end may combine into one Part F attachment the portfolio schedule for all series in the trust with the same fiscal year end, as well as one set of financial statement notes that covers all of the different series.
- The FAQs state that Part F attachments for the first and third quarters of a fund's fiscal year will be made public even during the six-month non-public filing period that applies to the rest of Form N-PORT (reports filed on Form N-PORT for the months ended June 30 through November 30, 2018 will be non-public, and reports filed for the months ended December 31, 2018 and later will be made public).

Reporting Requirements. The FAQs also address questions regarding the information required to be reported by specific items of Form N-PORT and the presentation of such information:

- According to the FAQs, Item B.5.a of Form N-PORT requires funds to report monthly total returns for each of the preceding three months for each class of a multiple class fund, and Item B.5.b of Form N-PORT requires funds to report class identification numbers, if any, of the class(es) for which returns are reported. According to the FAQs, if a class terminates during the reporting period, a fund should report all information for each of its classes through the reporting period in which the class existed. For example, if a fund class terminates in January, the fund should continue reporting the Items B.5.a and B.5.b information for that class through its March Form N-PORT filing, which should include monthly total returns for January and report "N/A" for the terminated class for February and March.
- According to the FAQs, Item B.6 of Form N-PORT requires funds to provide aggregate flow information for the preceding three months. The FAQs clarify that master portfolios should provide flow information at the master portfolio level for transactions between the master portfolio and its feeder funds.
- According to the FAQs, Items C.2.b and C.2.c of Form N-PORT require funds to report, for each investment, the currency in which the investment is denominated and the value in U.S. dollars (and if the investment is not denominated in U.S. dollars, the exchange rate used to calculate value). The FAQs state that for foreign currency forward contracts, funds must report value in U.S. dollars in Item C.2.c but are permitted to report "N/A" for the other reporting requirements in Items C.2.b and c because that information is separately reported in Items C.11.e.i and ii.
- According to the FAQs, in responding to Item C.4.a (asset type) of Form N-PORT for investments in the shares of other funds, the asset type should be reported as either "short-term investment vehicle" (e.g., money market fund, liquidity pool, or other cash management vehicle) or "equity-common" (other funds). In responding to Item C.4.b (issuer type) of Form N-PORT for investments in other funds, the FAQs state that the issuer should be reported as "registered fund" or "private fund," as appropriate.
- According to the FAQs, when reporting restricted securities in response to Item C.6 of Form N-PORT, funds may consider previous SEC guidance on amendments to Article 12 of Regulation S-X regarding identification of restricted securities. For example, such previous guidance indicates that a fund should indicate that a derivative that cannot be sold as of the reporting date because of a restriction applicable to the investment itself (as opposed to the markets more generally) should be identified as a restricted investment.
- According to the FAQs, Item C.9.b.i of Form N-PORT requires funds to select the category that most closely reflects the coupon type of debt securities among the following: fixed, floating,

variable, none. The FAQs clarify that funds may look to definitions in Rule 2a-7 under the Investment Company Act to make these determinations.

- According to the FAQs, in responding to Item C.10.f of Form N-PORT, which requires funds to report certain collateral information for securities subject to repurchase agreements, a fund should separately report this information for each category of investments. However, the FAQs state that a fund may aggregate the principal amount and value of collateral for each category of investments even if the collateral is not issued by the same issuer.
- According to the FAQs, Item C.11.c.iii.2 of Form N-PORT contemplates a tiered reporting structure for the reporting of derivatives where the underlying asset is an index or basket of investments. The FAQs confirm that if such index's or custom basket's components are not publicly available, funds can voluntarily report information about all of the underlying index or custom basket's components even if such disclosure is not required..
- Finally, according to the FAQs, funds may categorize "To Be Announced" or "TBAs" (a phrase commonly used to describe forward mortgage-backed securities trades where the actual mortgage-backed security delivered to fulfill a TBA trade is not designated at the time the trade is made) either as derivatives or securities in their reports on Form N-PORT, as long as the categorization is consistent with the fund's internal reports and reports to current and prospective investors.

Specific Requirements of Regulation S-X Amendments

- According to the FAQs, Rules 12-13, 12-13A, 12-13B, 12-13C, 12-13D, and 12-14 of Regulation S-X prescribe information to be presented for derivatives contracts, other investments and investments in affiliates. These rules contemplate a tabular format where each row is an individual contract or investment, and each column is a specified data element such as number of contracts, expiration date or notional amount. The FAQs clarify that (i) the order of the columns need not be the same as the order set forth in the rules and (ii) when columns contain the same information, such information may be provided in a single column with a clear, descriptive heading.
- According to the FAQs, Article 12 of Regulation S-X requires in certain circumstances that funds disclose, for derivatives where the underlying asset is an index or basket of investments, (i) the 50 largest components in the index or custom basket and (ii) for each component of the index or custom basket, a "description of the underlying investment as required by [Rules] 210.12-12, 12-13, 12-13A, 12-13B or 12-13D." The FAQs clarify that for purposes of (i), notional values of short positions should be treated in terms of absolute value, and the metric used to determine the magnitude of other components may vary based on the nature of the investment (e.g., notional amount should be used for swaps, while par value and value can be used for bonds and equities, respectively). For purposes of (ii), the FAQs state that when providing a description of the components of the index or custom basket, funds may limit their disclosures to the information required by the column in each of the tables included in Article 12 that relate to the description of the instrument, including any notes in that column.
- According to the FAQs, Rules 12-13 through 12-13D of Regulation S-X require funds to "[i]ndicate by an appropriate symbol each investment which cannot be sold because of restrictions or conditions applicable to the investment." According to the FAQs, a fund should identify a derivatives transaction as restricted if, as of the balance sheet date, the fund would not have been able to exit the transaction. The FAQs note that the ability to exit derivatives transactions may be effected by means other than a sale, such as through a negotiated agreement with the fund's counterparty, a transfer to another party, or close out of the position through execution of an offsetting transaction.

- According to the FAQs, with respect to the disclosures required by Rule 12-14 of Regulation S-X regarding investments in and advances to affiliates, such disclosures may, if already presented in the schedule of investments under Rules 12-12 and 12-13 through 12-13D of Regulation S-X, be provided in the notes to the financial statements.
- According to the FAQs, while Rule 6-04.6 of Regulation S-X requires a fund to state separately amounts held by others in connection with different types of investments (such as short sales, open options contacts and futures contracts), a fund's counterparty may in some cases collect margin or collateral for all open derivatives transactions between the fund and such counterparty instead of separately collecting margin or collateral for each particular type of transaction. In these circumstances, the FAQs clarify that a fund may provide the amounts held by others in connection with derivative contracts by counterparty in the notes to the financial statements, as long as the disclosure also includes the rights of setoff associated with the investments and the effect of the arrangements with counterparties on the fund's balance sheet.

Specific Requirements of Form N-CEN

- According to the FAQs, a fund without an "authorized" class (i.e. funds that have not adopted a plan pursuant to Rule 18f-3 under the Investment Company Act) should report "0" in response to Item C.2.a of Form N-CEN (number of authorized classes of shares of the fund). Such a fund must, however, report its ticker and class ID, if applicable, in response to Item C.2.d (name, class ID and ticker of each class with shares outstanding).
- According to the FAQs, for purposes of Item C.10.vii of Form N-CEN (which requests information on transfer agent arrangements), a fund does not need to identify intermediary arrangements that are administrative service type in nature (also known as "sub-accounting" and "sub-transfer agent" arrangements), since such intermediaries are engaging with the fund's primary transfer agent and are not part of the primary transfer agent's recordkeeping arrangement with the fund.
- Finally, according to the FAQs, a variable insurance product must continue to file annual reports on Form N-CEN even when it no longer files post-effective amendments (for example, because the variable insurance product is no longer being sold).

▸ **See a copy of the FAQs**

SEC's Acting Director of OCIE Says Private Equity May Be Less of a Priority Ahead

The SEC's Acting Director of Office of Compliance Inspections and Examinations ("**OCIE**"), Peter Driscoll, **recently noted** that the SEC likely will not continue to blanket most private equity firms for potential regulatory violations. Driscoll noted that, "I think we've hit that area pretty hard. Generally we are going to focus more on retail investors." Nonetheless, we believe that it is important not to overread this statement. Any shift in emphasis at the SEC may take some time to be felt, and we believe that private equity firms still should expect continued SEC attention.

SEC Confirms That Some Initial Coin Offerings Are Illegal Unregistered Securities Offerings

On July 25, 2017, the SEC issued a **Section 21(a) report** of its investigation into an offering of digital tokens by "The DAO," an unincorporated virtual organization. Though declining to take enforcement action against The DAO, the SEC used this much-anticipated opportunity to warn others engaged in similar activities that an unregistered sale of blockchain tokens can, depending on the circumstances, be an illegal public offering of securities. Simultaneously, the SEC issued a **bulletin** warning investors about such sales, often called "initial coin offerings" or ICOs. The DAO 21(a) report focused on a fact-pattern where the classic test for a "security" under federal law, announced in the Supreme Court's 1946 case *SEC v. W.J. Howey Co.*, was easily met: the tokens were sold for value and represented ownership interests in a common enterprise; the purchasers had an expectation of profit from the efforts of others; and the tokens were distributed in a manner that bore the hallmarks of a traditional securities offering. In a recent Client Memorandum, we explore further the DAO ICO, situations where ICO tokens may be considered securities and implications for the token ecosystem.

- **See a copy of the memorandum**

Industry Update

SEC Chairman Discusses Guiding Principles, Priorities in First Public Speech since Taking Office

On July 12, SEC Chairman Jay Clayton gave remarks to the Economic Club of New York, outlining his guiding principles and his priorities as the SEC's new chairman.

First, Clayton highlighted the following as guiding principles for his chairmanship:

- *The SEC's mission*. Clayton emphasized that each tenet in the SEC's three-part mission ((1) the protection of investors, (2) the maintenance of fair, orderly and efficient markets and (3) the facilitation of capital formation) was equally important and should be given equal attention.
- *Long-term interests of "Main Street" investors*. Clayton proposed that the success of the SEC in achieving its mission can be judged by how well the interests of the broader public are being served by the SEC's actions.
- *Disclosure and materiality*. Clayton brought special attention to what he saw as the "heart" of the SEC's historic approach to regulation: disclosure and materiality. Clayton noted that he had faith in the SEC's practice of arming investors with information that facilitates informed decision-making, placing heighted responsibilities on market players that actively participate in securities markets, and vigorously enforcing the regulatory regime against bad actors.
- *Lasting impact of regulatory actions*. Clayton noted that while incremental regulatory changes may not seem significant, they may have a powerful cumulative effect on the markets. As an example, Clayton discussed the public company disclosure requirements, which, though effective in providing information to the general public, have contributed to a 50% decline in the number of U.S.-listed public companies over the past two decades and led to an all-time low in readability of SEC filings. Clayton believes that this decline in the public markets has directly affected the aforementioned Main Street investors, who are unable to participate in the growth of companies that eschew public markets in favor of private capital.
- *Evolution of the SEC*. Clayton emphasized that the evolution of the markets must be mirrored by evolution at the SEC. For example, Clayton noted that the technological innovation such as artificial intelligence and machine learning should be harnessed by the SEC to detect and analyze suspicious activity.
- *Effective rulemaking beyond rule adoption*. Clayton acknowledged that the SEC has robust systems in place for obtaining public input during the proposal and adoption stages of rulemaking. However, Clayton noted that even after a rule has been adopted, the SEC should continue efforts to gather public input to understand whether the rule is functioning as intended.
- *Cost of compliance*. Clayton stated that rules should be written so that those who are regulated are fully aware of how to demonstrate compliance with those rules. Clayton also emphasized that the practical costs of compliance should be taken into account at the time a rule is adopted so

that neither subpar compliance solutions nor an overinvestment in compliance controls result from such rule.

- *Coordination with other regulators*. Clayton underscored the importance of the SEC's coordination with other regulators, both domestic and international, to craft a well-functioning regulatory environment. Clayton cited cybersecurity and over-the-counter derivatives as examples of areas in which the SEC has worked and will continue to work closely with other financial regulators.

Next, Clayton discussed his plans to apply these principles in the following practice areas:

- *Enforcement and examinations*. Clayton affirmed his intention to devote significant resources to combat fraudulent practices that target Main Street investors, focusing specifically on "pump-and-dump scammers," schemes that target retirees and the use of new technologies to commit fraud. Clayton also underscored the growing importance of cybersecurity, noting that while public companies have clear obligations to disclose material cyber risks and cyber events, there is a need to tread cautiously in punishing such companies when they become victims of cyber attacks.
- *Capital formation*. Clayton indicated that he plans to take steps to enhance the attractiveness of the public markets to allow a broader set of investors to participate in investment opportunities. As an example, Clayton pointed to the recent opening up of the SEC's nonpublic review process (which had formerly been accessible only to emerging growth companies under the JOBS Act) to larger domestic and non-U.S. companies that do not qualify as emerging growth companies. Clayton also reminded publicly traded companies that, under Rule 3-13 of Regulation S-X, they may request the SEC to grant modifications to disclosure requirements that are burdensome to generate but are not material to the information available to investors. Clayton stated that the SEC will place a high priority on responding to such requests.
- *Market structure*. Clayton indicated that the SEC expects to consider a proposal in the coming months for a pilot program to test how adjustments to the access fee cap under Rule 610 of the Securities Exchange Act of 1934 would affect equities trading. Furthermore, Clayton suggested that the SEC's focus should shift to the fixed-income markets, as they are viewed by Main Street investors as a stable place to store money but may not be as well understood as the equities markets. To that end, Clayton noted that he has asked the SEC staff to develop a plan to create a Fixed Income Market Structure Advisory Committee focused on fixed-income products.
- *Investment advice and investor disclosure*. Clayton focused on the need for the SEC to bring clarity to the Department of Labor's new fiduciary rule regarding standards of conduct for investment professionals. Clayton emphasized the importance of robust public input in helping the SEC to assess potential regulatory actions. In addition, Clayton discussed the SEC's current initiatives to improve disclosure to investors, including the preparation of rulemaking proposals based on a November 2016 report by the SEC staff, which recommended ways to modernize and simplify Regulation S-K's disclosure rules.
- *Investor education*. Clayton acknowledged that while the SEC's examination and enforcement programs are robust, it is more useful for investors to take action to protect themselves. To this end, Clayton noted that his priority is to increase the number of resources at investors' disposal so that investors are better able to research their investment professionals and spot fraud, including increasing interaction between investors and the SEC and simplifying online resources to better allow Main Street investors to conduct background checks on investment professionals.

- **See a copy of the Speech**

SEC Releases Results of Audit of OCIE's Investment Adviser Examination Completion Process

On July 21, 2017, the SEC Office of Inspector General published a report (the "**OCIE Report**") detailing the results of its audit of the OCIE's investment adviser examination completion process. According to the OCIE Report, OCIE conducts the SEC's National Exam Program ("**NEP**") and uses a risk-based, data-driven process to select entities for examination. The OCIE Report explains that OCIE examiners oversee about 26,000 market participants, of which 12,000 are investment advisers ("**IAs**"), 10,000 are mutual funds and exchange-traded funds, 4,000 are broker-dealers, 400 are transfer agents and the remaining are self-regulatory agencies. In preparing the OCIE Report, the SEC reviewed (1) all IA Corrective Action Reviews ("**CARs**") that OCIE approved between fiscal years 2015 and 2016 and closed in the Tracking and Reporting Examination National Documentation System ("**TRENDS**") as of November 22, 2016 and (2) 240 of the 2,443 IA examinations OCIE approved and closed in TRENDS during the same period.

The SEC reports three deficiencies in OCIE's IA examination process in the OCIE Report:

(1) Two IA examination completion controls regarding control sheets and post-exam fieldwork lacked adequate segregation of duties;

(2) Examiners did not always document preliminary exit interviews with examined IAs; and

(3) Examiners either did not assign final risk ratings, or may have assigned final risk ratings inconsistently.

The OCIE Report explains that these deficiencies could result in examinations that are more susceptible to error, could impede examiners' abilities to sufficiently review prior examination findings and perform comprehensive risk assessments, and could hinder OCIE's evaluation of risk for future examinations. The OCIE Report contains three recommendations for corrective action that aim to improve OCIE's internal controls over the examination completion process and enhance oversight of examination outcomes generally.

The first recommendation in the OCIE Report is that OCIE (i) design control activities related to the review and approval of examination work products to require segregation of duties and (ii) update NEP policies and procedures and the TRENDS system to reflect this requirement. The Acting Director of OCIE, Peter Driscoll, concurred with this recommendation and stated that OCIE will act to strengthen its controls and update its policies and procedures to ensure adequate segregation of duties at intermediate phases of the examination process.

The second recommendation in the OCIE Report is for OCIE to update NEP policies and procedures to more clearly define the requirements for documenting in TRENDS examination meetings and interviews, including preliminary exit interviews, and to make corresponding changes to the TRENDS system controls and guidance. Driscoll concurred with this recommendation and stated that varying practices existed among regional offices due to a lack of clearly articulated policies and procedures, and agreed that OCIE senior management should more clearly define expectations for examination staff regarding preliminary exit interviews.

The third recommendation in the OCIE Report is that OCIE develop and disseminate guidance for assigning final examination risk ratings and notify all OCIE examination staff of the requirement and importance of selecting final examination risk ratings before closing examinations. Driscoll concurred with this recommendation and stated that OCIE's Exam Process Steering Committee, along with OCIE senior management, will recommend guidance for assigning final examination risk ratings.

- **See a copy of the OCIE Report**

SEC Commissioner Publishes Comment Letter Criticizing DOL Fiduciary Rule

On July 25, SEC Commissioner Michael Piwowar published a letter he sent to the U.S. Department of Labor ("**DOL**") criticizing its new fiduciary rule (the "**Fiduciary Rule**").

Piwowar's letter begins by summarizing the Fiduciary Rule, which defines the term "fiduciary" for purposes of the Employee Retirement Income Security Act of 1974 ("**ERISA**") and the Internal Revenue Code with respect to the provision of investment advice in exchange for a fee or other compensation, particularly in connection with an ERISA plan or an individual retirement ("**IRA**") account.

Piwowar then discusses his three main concerns with the Fiduciary Rule:

- *The Fiduciary Rule is dismissive of the efficacy of conflict of interest disclosure*. According to Piwowar, the Fiduciary Rule is intended to address the concern that disclosure "has proven ineffective" to mitigate conflicts of interest that arise in the financial services industry – rendering unsophisticated consumers confused as to whether providers of financial services are obligated to act in their best interests. However, Piwowar suggests that the SEC's current disclosure-based regime is the best solution to conflict of interest issues, and comports with both standard economic theory and American traditions of "self-reliance, pioneering spirit and rugged individualism." Piwowar further emphasizes the SEC's decades of experience in enforcing multiple disclosure-based regimes and suggests greater collaboration between the DOL and the SEC in creating new regulation.
- *The Fiduciary Rule fails to properly distinguish between "selling" activities and "advice" activities*. Piwowar first points out the long-standing distinction between broker-dealers (who are traditionally associated with "selling" activities regulated by the Securities Exchange Act of 1934, as amended) and investment advisers (who are traditionally associated with "advice" activities regulated by the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"))—distinctions codified by Congress more than 70 years ago. According to Piwowar, while investment advisers are fiduciaries who have duties to serve the best interests of their clients, broker-dealers are generally not considered to be fiduciaries even if they owe their customers a duty of fair dealing (including the customer protections of "suitability" and "best execution"). Piwowar argues that the creation of a uniform fiduciary duty for investment advisers and broker-dealers (on the assumption that broker-dealers are subject to less stringent duties than investment advisers) overlooks the long-standing nuanced and tailored regulation of "selling" and "advice" activities.
- *The Fiduciary Rule will disrupt broker-client relationships generally*. Piwowar argues that the Fiduciary Rule's effects will extend beyond the ERISA plan and IRA account markets because many broker-dealers provide financial services to clients for both their ERISA and IRA retirement portfolios and other, non-retirement accounts. According to Piwowar, such a broker-dealer would be subject to separate obligations when performing the same services for a client's retirement and non-retirement securities accounts, based solely on the regulatory status of each account. In such circumstances, Piwowar believes that the broker-dealer is likely to apply the Fiduciary Rule's standards to the client's non-retirement securities accounts, and may even apply the Fiduciary Rule's standards to all of the accounts it administers for the sake of simplicity.

- **See a copy of the Letter**

DOL Takes Steps to Delay Certain Aspects of Fiduciary Rule, but Key Rules for Funds Remain

According to recent court filings and actions by the Office of Management and Budget ("**OMB**"), the DOL has taken new steps to delay the full applicability date of its Fiduciary Rule and related exemptions. If the DOL's intended delay comes to fruition, which is not certain, requirements that are currently delayed until

January 1, 2018 will be further delayed 18 months until July 1, 2019. The expanded definition of “fiduciary investment advice” that went into effect on June 9 is still applicable and the potential delay relates only to certain onerous requirements under the Best Interest Contract (“**BIC**”) Exemption and other exemptions proposed under the new rule to help certain retail financial service providers operate under their expanded fiduciary role. The proposed delay does not impact the aspects of the rule that apply to private funds’ communications with benefit plan investors and retail IRAs.

On August 9, 2017, in a case challenging the Fiduciary Rule, the DOL filed a notice of administrative action, notifying the court that the DOL had filed with the OMB a proposed amendment that would delay the applicability date of currently delayed requirements of the BIC Exemption and two other exemptions by 18 months. For a detailed discussion of the requirements that are currently applicable and those that are currently delayed until January 1, 2018 (and potentially delayed until July 1, 2019), please see the April 5, 2017 Davis Polk Financial Regulatory Reform Blog Post, **DOL Fiduciary Rule: Officially Delayed for Now, with More to Come**.

On August 29, 2017, the OMB accepted the DOL’s proposed delay. The next step is for the DOL to publish the text of its delay in the *Federal Register*. If and when the DOL’s administrative action is published, we will have a better understanding of the future of the Fiduciary Rule. While it is not certain at this point, it seems likely that there will be some form of delay.

ILPA’s Letter to Treasury on Private Equity Regulation

On July 28, the Institutional Limited Partners Association (“**ILPA**”) submitted a letter to the U.S. Department of the Treasury regarding the President’s February 2017 Executive Order on Core Principles for Regulating the U.S. Financial System (the “**Executive Order**”). ILPA’s letter contends that the current regulatory environment for private equity advisers is appropriately tailored both to achieve the Executive Order’s objectives and also to satisfy the Executive Order’s requirements that regulations be “efficient, effective, and appropriately tailored.” In other words, in ILPA’s view, there should be no moves to reduce the regulatory burdens currently imposed on private equity investment advisers. In making its case, ILPA asserts that increased regulation has strengthened capital formation in the private equity industry. The American Investment Council (“**AIC**”) filed its own comment letter on this topic in June, in which it made the case for reducing the regulatory burdens faced by private equity investment advisers.

- **See a copy of ILPA’s letter**
- **See a copy of AIC’s letter**
- **See a copy of the Executive Order**

Litigation

SEC Charges Adviser with Failing to Register as Investment Adviser and Inflating Asset Valuations, among Other Violations

On July 25, 2017, the SEC issued an order (the “**Order**”) instituting and settling administrative and cease-and-desist proceedings against Brian Kimball Case (the “**Owner**”), Bradway Financial, LLC (“**Bradway Financial**”) and Bradway Capital Management, LLC (“**Bradway Capital**” and, together with Bradway Financial and the Owner, the “**Bradway Parties**”) because, according to the Order, (i) Bradway Capital was not entitled to rely on the private fund adviser exemption from registration in Rule 203(m)-1 under the Advisers Act; (ii) Bradway Capital inflated the values of investments held in two private funds it advised; (iii) Bradway Capital and Bradway Financial failed to comply with the Advisers Act’s custody and compliance rules; (iv) the Bradway Parties improperly used fund assets to pay legal fees that it incurred in connection with the SEC's investigation and (v) Bradway Financial contracted to earn a performance fee for managing a fund, without determining whether the fund's investors were qualified clients.

According to the Order, Bradway Financial is an investment adviser registered with the SEC and advised Bradway Capital Insight Fund LLC (the "**Insight Fund**") from 2006 until 2013. According to the Order, the Owner formed Bradway Capital because he understood that Bradway Financial would not have to comply with certain rules under the Advisers Act, including Rule 206(4)-2 (the "**Custody Rule**"), if the Insight Fund was advised by an exempt reporting adviser (Bradway Capital) instead of an SEC-registered adviser (Bradway Financial). According to the Order, from 2013 to 2016, Bradway Capital claimed to be an investment adviser solely to private funds with regulatory assets under management of less than $150 million, and therefore exempt from registration as an investment adviser pursuant to Section 203(m) of and Rule 203(m)-1 under the Advisers Act, because it advised two private funds with combined gross asset values of approximately $11 million. However, according to the Order, because Bradway Capital shared its principal office and place of business with Bradway Financial and were both owned by the Owner, Bradway Capital was required under Rule 203A-2 to be registered with the SEC since the two entities were under common control and operationally integrated.

According to the Order, Bradway Capital also inflated the valuations of certain investments held by the Insight Fund on investor statements, which were often assigned by the Owner based on his own estimates (despite not having any valuation experience or training), and including (1) stating that the fair market value of the Insight Fund's investment in a private equity fund was more than $2 million when financial statements provided by such private equity fund as of the same date showed a capital balance of $724,103; (2) showing the value of an investment at cost on an investor statement when the Insight Fund's annual tax reporting statement for the prior year reflected that the investment was written off as bad debt and (3) using stale information to perform fair market value estimates without documenting additional valuation analysis.

Further, the Order alleged that the Forms ADV filed by Bradway Capital and Bradway Financial contained inflated valuations of certain Insight Fund investments as described above. The Order also stated that Bradway Capital listed its place of business on several of its Forms ADV as the Owner's home address and claimed that it did not share the same physical location with Bradway Financial, even though it shared employees, physical location of operations and technology systems with Bradway Financial.

According to the Order, Bradway Capital also had custody of the assets of its two fund clients but did not subject the funds to an annual audit or obtain a surprise examination. The Order further stated that, even though Bradway Financial contracted to earn a performance fee for managing the Insight Fund, the Owner failed to determine whether each prospective investor in the Insight Fund was a qualified client as defined by Rule 205-3(d) under the Advisers Act.

The Order noted that, as investment advisers registered or required to be registered with the SEC, Bradway Financial and Bradway Capital were required to adopt and implement procedures reasonably designed to prevent violations of the Advisers Act and its rules. According to the Order, Bradway Capital failed to adopt or implement any such policies and procedures and, although Bradway Financial worked with a compliance consultant, it adopted an off-the-shelf compliance manual that was not tailored to the type of business it conducted, did not address registration or exemption from registration as an investment adviser, and failed to conduct annual reviews of the adequacy and effectiveness of all of its compliance policies and procedures.

Finally, the Order stated that the Owner negligently relied on an indemnification provision within the operating agreements for the Insight Fund to pay the legal fees incurred by the Bradway Parties related to the SEC enforcement staff's investigation, even though the operating agreement only provided that the Insight Fund would pay such costs "directly relating to the ongoing activities" of the fund, and thus did not cover legal services provided to the adviser of the fund (but not to the fund itself).

As a result of the conduct described above, the SEC found that (1) by not registering with the SEC under the Advisers Act or relying on Bradway Financial's registration, Bradway Capital willfully violated Section 203(a) of the Advisers Act and Bradway Financial and the Owner willfully aided and abetted and caused those violations; (2) Bradway Capital, Bradway Financial and the Owner willfully violated Section 206(2) of the Advisers Act, which generally prohibits investment advisers from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client"; (3) Bradway Capital, Bradway Financial and the Owner willfully violated Section 207 of the Advisers Act, which generally makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission"; (4) Bradway Capital willfully violated, and the Owner willfully aided and abetted and caused such violations of, the antifraud provisions in Section 206(4) of and Rule 206(4)-8 under the Advisers Act; (5) Bradway Capital, Bradway Financial and the Owner willfully violated and/or aided and abetted and caused violations of the Custody Rule; (6) Bradway Financial willfully violated, and the Owner willfully aided and abetted and caused the violations of, Section 205(a)(1) of the Advisers Act, which generally prohibits investment advisers from entering into, extending or renewing any investment advisory contract if such contract provides for incentive compensation and (7) Bradway Financial and Bradway Capital willfully violated, and the Owner willfully aided and abetted and caused the violations of, Section 206(4) of and Rule 206(4)-7 under the Advisers Act, which require investment advisers to, among other things, adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules, and to review at least annually the adequacy of the policies and procedures and the effectiveness of their implementation.

The Bradway Parties consented to the Order without admitting or denying the findings and agreed to pay a civil money penalty of $135,000 in installments. According to the Order, the Bradway Parties also agreed to the following undertakings: (1) Bradway Capital and the Owner will not charge or accept performance fees related to the Insight Fund; (2) the Owner will complete 30 hours of Advisers Act compliance training; (3) the Bradway Parties will notify their clients of this Order within 30 days; (4) the Bradway Parties will retain an independent compliance consultant not unacceptable to the SEC, which will be required to submit an initial report (including recommendations) to the Bradway Parties and to the SEC within six months; (5) the Bradway Parties will advise the independent consultant and the SEC in writing of the recommendations to be adopted within nine months and require the independent consultant to complete and submit its final report within one year; (6) the Bradway Parties will take all necessary and appropriate steps to adopt and implement all recommendations contained in the independent consultant's final report and (7) the Bradway Parties will certify, in writing, compliance with such undertakings above, including providing written evidence of compliance in the form of a narrative and sufficient supporting exhibits.

- **See a copy of the Order**

SEC Sanctions Adviser and Two Principals for Improper Asset Valuations of Private Funds

On July 19, 2017, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Enviso Capital, LLC ("**Enviso**") and two of its principals, Ryan Bowers and Jeffrey LaBerge (the "**Enviso Principals**" and, together with Enviso, the "**Enviso Parties**"), finding that the Enviso Parties materially overstated the value of two private funds advised by Enviso (the "**Enviso Funds**") in financial statements distributed to fund investors.

According to the Order, a significant portion of each Enviso Fund consisted of interests in a private company, Bluefin Renewable Energy, LLC ("**Bluefin**"). Both Enviso Principals served on the board of Bluefin and took an active role in its business. Between 2011 and 2014, Bluefin's sole asset was a renewable energy project under development in Mexico (the "**Project**"). Enviso, as the investment adviser to the Enviso Funds, determined Bluefin's valuation for purposes of the Enviso Funds' financial statements and its investment advisory fee (which was calculated based on net assets under management). The Order alleged that the Enviso Parties represented to fund investors in financial statements for fiscal years 2011 through 2013 that Bluefin was worth over $10 million despite the fact that it had never obtained financing or potential customers for the Project. By December 31, 2014, the Bluefin investment had been written down to zero. According to the Order, Enviso had stated in the financial statements that it had applied a discounted cash flow method to value Bluefin. However, the Order alleged that the assumptions on which the discounted cash flow method used by Enviso was based were unreasonable given that Bluefin had not commenced construction on the Project, had no contracts with potential customers and had not obtained any financing. As a result, according to the Order, the financial statements distributed by Enviso to its fund investors were not prepared in accordance with GAAP.

In addition to financial statements, the Order alleged that Enviso also misrepresented Bluefin's financial condition in Management Discussion and Analyses ("**MD&As**") sent to fund investors from 2012 to 2014. Specifically, the MD&As misrepresented Bluefin's relationship with a Mexican company that had legal title to the land on which the Project was based, and stated that Bluefin had secured a letter of intent from a large development bank to provide financing for the Project, which was untrue.

According to the Order, as a result of the conduct described above, the Enviso Parties willfully violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. In addition, the Order found that Enviso violated the surprise examination requirement of the Custody Rule, because while Enviso intended to rely on an exception from the surprise examination requirement for pooled investment vehicles, which, among other things, distribute annual audited financial statements prepared in accordance with GAAP to their investors, the financial statements sent to the Enviso Funds' investors were not prepared in accordance with GAAP and thus the Enviso Funds were not eligible to rely on this exception. As a result, because Enviso stated in its Forms ADV filed with the SEC from 2010 to 2013 that it did not have custody of client funds or securities, the Order alleged that Enviso willfully violated Section 207 of the Advisers Act. Finally, the Order stated that Enviso's failure to perform annual reviews of its compliance programs from 2011 to 2013 violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

The Enviso Parties consented to the entry of the cease-and-desist order and agreed to pay civil penalties of $50,000 without admitting or denying the findings in the Order. Each of the Enviso Principals also agreed to be barred from the securities industry, with the right to reapply for reentry after two years.

- **See a copy of the Order**

Delaware Supreme Court's Ruling in *DFC Global* Provides Important Clarity on the Role of Deal Price and the Sale Process in Appraisal Proceedings

The Delaware Supreme Court, in an opinion by Chief Justice Strine, recently reversed and remanded the Chancery Court's ruling in *DFC Global Corporation v. Muirfield Value Partners, L.P.*, an appraisal proceeding to determine the fair value of DFC Global following its acquisition by the private equity firm Lone Star Funds. In recent appraisal decisions, including *DFC Global* and *In re Appraisal of Dell, Inc.*, the Chancery Court declined to rely on the deal price as the best evidence of fair value, notwithstanding a robust sale process. This was due, in part, to flaws that the Chancery Court determined to exist in the ability of the market to establish a fair price. These decisions resulted in appraisal values meaningfully in excess of the deal price, creating significant uncertainty for buyers and sellers in the M&A market. *DFC Global*, a highly anticipated opinion by the Delaware Supreme Court, provides important clarity over the role of the deal price and the sale process in Delaware appraisal proceedings. The Delaware Supreme Court will also have an opportunity to provide further clarity on the role of deal price and the sale process in appraisal proceedings in its upcoming review of the Chancery Court's decision in *Dell*. The *Dell* proceedings will therefore continue to be worth monitoring.

In a recent Client Memorandum, we outline the key elements of the Delaware Supreme Court's decision in *DFC Global*, and its implications for buyers and sellers in future M&A transactions.

- **See a copy of the opinion**

- **See a copy of the memorandum**

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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