Investment Management Regulatory Update

September 29, 2017

Industry Update

SEC Staff Issues Information Update on Compliance with Form ADV Amendments for Other-Than-Annual Amendments

The staff of the Securities and Exchange Commission (the "**SEC**") recently issued an information update (the "**Update**") regarding the SEC's recently adopted amendments to Form ADV, which go into effect on October 1, 2017. Beginning on this date, any investment adviser filing an initial Form ADV or an amendment to an existing Form ADV will be required to provide responses to the amended form. For a discussion of the Form ADV amendments, please see the **September 28, 2016 Investment Management Regulatory Update**. For a summary of the FAQs released by the SEC in respect of the Form ADV amendments, please see the **July 28, 2017 Investment Management Regulatory Update**.

The Update addresses situations where an adviser must file an other-than-annual amendment to its Form ADV on or after October 1, 2017 but before the adviser's next annual amendment. In such circumstances, the filer would be required to complete certain items in Item 5 of Form ADV and related Schedule D sections that would otherwise need to be completed on an annual basis (e.g., new Schedule D, Section 5.K.(2), which asks for the amount of regulatory assets under management and borrowings in a filer's separately managed accounts that correspond to ranges of gross notional exposure as of the end of the filer's fiscal year). According to the Update, some Form ADV filers have inquired as to how they should respond to such questions in an other-than-annual Form ADV amendment if the requested information is not yet available, since the Investment Adviser Registration Depository (IARD) system, through which Form ADV filings are submitted, does not allow the submission of incomplete filings.

According to the Update, if, as described above, a filer does not have enough information to provide a complete response to a new or amended question in Item 5 or related Schedule D sections during the time period from October 1, 2017 to the filer's next annual Form ADV amendment, the filer may respond "0" to the relevant questions in Item 5 and include a corresponding note in the Miscellaneous section of Schedule D to identify that such a placeholder was entered.

- See a copy of the Update

SEC Grants No-Action Relief to Registered Closed-End Management Investment Companies Filing Rule 486(b) Post-Effective Amendments to Registration Statements

On July 27, 2017, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to several registered closed-end management investment companies (the "**Funds**") advised by Nuveen Fund Advisors, LLC, confirming that the SEC will not recommend enforcement against the Funds under Section 5(b) or Section 6(a) of the Securities Act of 1933, as amended (the "**Securities Act**"), if, under certain conditions, a Fund files a post-effective amendment to its shelf registration statement on Form N-2 pursuant to Rule 486(b) under the Securities Act.

According to the incoming letter (the "**Incoming Letter**"), open-end management investment companies may file post-effective amendments to their registration statements with automatic effectiveness pursuant to Rule 485 under the Securities Act. In addition, the Incoming Letter notes that closed-end management investment companies which are operated as interval funds pursuant to Rule 23c-3 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), may also file post-effective amendments or registration statements for additional shares of common stock with automatic effectiveness pursuant to Rule 486(b) under the Securities Act, subject to certain conditions. In contrast, according to the Incoming Letter, closed-end management investment companies that are not interval funds must file post-effective amendments pursuant to Section 8(c) of the Securities Act, which does not provide for automatic effectiveness, with the result that such post-effective amendments are subjected to SEC staff review and comment even if they are routine and non-material.

According to the Incoming Letter, in adopting Rule 486(b), the SEC recognized that interval funds may have a need to raise capital continuously and therefore would benefit from continuously effective registration statements and automatic effectiveness for certain filings. The Incoming Letter argued that this line of reasoning should be extended to closed-end management investment companies that are engaged in delayed or continuous offerings pursuant to Rule 415(a)(1)(x) under the Securities Act, such as the Funds, which are not interval funds but may also benefit from the ability to raise capital as the opportunity arises and the reduction in expenses currently incurred as part of the registration statement review and comment process. According to the Incoming Letter, the SEC staff had previously given no-action relief to many such closed-end fund complexes based on the representations that: (i) each fund's board of directors had approved the fund's delayed or continuous offerings, (ii) each fund's post-effective amendment would comply with the conditions of Rule 486(b) and (iii) each fund would file a post-effective amendment containing a prospectus pursuant to Section 8(c) of the Securities Act prior to any offering of its common stock at a price below net asset value. In addition to the foregoing representations, each Fund represented in the Incoming Letter that it would sell newly issued shares at a price no lower than the sum of the Fund's net asset value plus the per share commission or underwriting discount, and that it would use Rule 486(b) to file post-effective amendments only for the purpose of: (i) updating the financial statements of the Fund as required by Section 10(a)(3) of the Securities Act or Rule 3-18 of Regulation S-X; (ii) updating the information required by Item 9.1.c of Form N-2; or (3) making non-material changes.

The Letter noted that while the SEC staff generally permits third parties to rely on no-action letters issued to others, because of the fact-specific nature of the issues addressed in the Letter, only the Funds can rely on the Letter.

- See a copy of the Letter

- See a copy of the Incoming Letter

OCIE Issues Risk Alert on Common Advertising Rule Compliance Issues Identified in Investment Adviser Examinations

On September 14, 2017, the Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert (the "**Risk Alert**") detailing a list of compliance issues relating to Rule 206(4)-1 (the "**Advertising Rule**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), that were most frequently identified in deficiency letters sent to registered investment advisers.

The Advertising Rule generally prohibits a registered investment adviser from directly or indirectly publishing, circulating or distributing any advertisement that (1) refers, directly or indirectly, to any testimonial concerning the adviser or any advice, analysis, report or service rendered by the adviser; (2) subject to certain exceptions, refers, directly or indirectly, to past specific recommendations of the adviser that were or would have been profitable to any person; (3) represents, directly or indirectly, that any graph, chart, formula or device can by itself determine whether to buy or sell a security; (4) contains a statement that offers purportedly free reports, analyses or services; or (5) contains any untrue statement of material fact, or which is otherwise false or misleading.

According to the Risk Alert, the six deficiencies most frequently observed by OCIE staff are:

- *Misleading Performance Results*. According to the Risk Alert, OCIE examiners found instances of advisers presenting performance results without deducting advisory fees, or comparing results to a benchmark but not including disclosures about the limitations inherent in such comparisons (including, for example, material differences between the advertised strategy and the composition of the benchmark used).
- *Misleading One-on-One Presentations*. According to the Risk Alert, OCIE examiners also found instances where advisers advertised performance results in one-on-one presentations but did not include potentially relevant disclosures, or did not reflect the deduction of advisory fees by which client returns would be reduced.
- *Misleading Claim of Compliance with Voluntary Performance Standards*. According to the Risk Alert, OCIE examiners found instances of advisers claiming that their advertised performance results complied with certain voluntary compliance standards when it was unclear to examiners whether this was true.
- *Cherry-Picked Profitable Stock Selections*. According to the Risk Alert, OCIE examiners found instances of advisers only including profitable stock selections or recommendations in presentations, client newsletters or websites, without meeting the conditions set forth in Rule 206(4)-1(a)(2).
- *Misleading Selection of Recommendations*. According to the Risk Alert, OCIE examiners found instances of advisers disclosing specific past investment recommendations to illustrate a particular investment strategy without complying with the conditions of Rule 206(4)-1(a)(2) or representations on which certain prior no-action relief was based. For example, OCIE examiners observed advertisements that included an investment strategy's best-performing holdings but not an equal number of the worst-performing holdings, and advertisements that did not disclose that the specific recommendations listed did not represent all securities transacted for clients during the relevant period.
- *Compliance Policies and Procedures*. According to the Risk Alert, OCIE examiners found instances where advisers did not appear to have compliance policies and procedures that were reasonably designed to prevent deficient advertising practices, including policies and procedures relating to: (i) reviewing and approving advertising materials prior to publication or dissemination; (ii) determining the parameters for which accounts to include or exclude from performance

calculations; and (iii) confirming the accuracy of performance results to ensure that they were compliant with the Advertising Rule.

Furthermore, according to the Risk Alert, as part of the OCIE's Touting Initiative (which examines the adequacy of advisers' disclosures in marketing materials when reporting on awards, ranking lists and/or professional designations), OCIE examiners observed the following main deficiencies:

- *Misleading Use of Third-Party Rankings or Awards*. According to the Risk Alert, OCIE examiners found instances of advisers referring to third-party awards and rankings without disclosing material facts relating thereto, such as relevant selection criteria, how "current" the awards or rankings were, or even that the awards had been obtained through the submission of false or misleading information.
- *Misleading Use of Professional Designations*. According to the Risk Alert, OCIE examiners found instances where advisers' Form ADV Part 2B Brochure Supplements contained potentially false or misleading statements surrounding employee professional designations, such as references to professional designations that had already lapsed or failure to disclose the qualifications needed to obtain such designations.
- *Use of Prohibited Testimonials*. According to the Risk Alert, OCIE examiners found instances of advisers publishing client statements endorsing their services that may constitute prohibited testimonials under the Advertising Rule, such as client endorsements published on firm websites, social media, pitch books or reprints of third-party articles.

▸ **See a copy of the Risk Alert**

So You Want to Buy a Stake in a Private Equity Manager?

Two weeks ago, the ***Wall Street Journal*** reported on the intense interest in purchases of stakes in private equity managers. Presumably, this interest has been prompted, in part, by the consistent successes of private equity as an asset class over a sustained period of time, and the opportunity for market players to buy in to private equity firms at a time of relatively low market returns elsewhere. Further, with the inevitable likelihood of generational change in top management at many sponsors on the horizon, there are many reasons to believe that M&A activity involving private equity firms will continue at notable levels for the foreseeable future.

In a **recent memo**, we address the key deal points that are likely to arise in deals involving the sale of control of a sponsor through full acquisition (e.g., Fortress/Softbank) or the taking of a larger (typically minority) stake in a secondary sale, as these transactions can raise significant and complex conflict issues between the new owner/investor, on the one hand, and the fund sponsors, on the other, that must be mediated in order for these transactions to be successful.

Litigation

Eighth Circuit Affirms Judgment Finding that Fund-of-Funds Shareholder Lacks Standing to Challenge Fees Paid by Underlying Funds

On July 24, 2017, the U.S. Court of Appeals for the Eighth Circuit (the "**Appeals Court**") issued an opinion (the "**Opinion**") affirming the decision of the U.S. District Court for the Southern District of Iowa (the "**District Court**") to grant summary judgment in favor of Principal Management Corporation ("**PMC**") in *American Chemicals & Equipment Inc. 401(K) Retirement Plan v. Principal Management Corporation*.

According to the Opinion, the plaintiff, American Chemicals & Equipment 401(K) Retirement Plan ("**ACE**"), invested in six target-date funds (the "**Lifetime Funds**") structured as funds-of-funds that invested in a portfolio of other mutual funds (the "**Underlying Funds**"). PMC served as the investment adviser of both

the Lifetime Funds and the Underlying Funds. Each Lifetime Fund paid PMC an advisory fee of 0.03% of total net assets and disclosed "acquired fund fees and expenses" (the "**AFFE**") ranging from 0.59% to 0.75% of the Lifetime Fund's total net assets. The AFFE reflected the Underlying Funds' total expenses, including management fees paid by the Underlying Funds to PMC, weighted by the percentage of shares that each Lifetime Fund held in the Underlying Funds. ACE alleged that the AFFE were unfair, excessive and not negotiated at arm's length, and thus constituted a breach of PMC's fiduciary duty under Section 36(b) of the Investment Company Act.

Section 36(b) of the Investment Company Act generally provides that a shareholder of a registered investment company may bring suit against the registered investment company's investment adviser for breach of fiduciary duty in respect of compensation for services or payments of a material nature paid by the registered investment company or its shareholders to the investment adviser. In its complaint, ACE argued that it had standing to challenge the AFFE because they were indirectly paid by shareholders of the Lifetime Funds. The District Court rejected this argument, finding that ACE did not have "statutory standing" under Section 36(b) of the Investment Company Act because the AFFE were paid by the Underlying Funds and ACE was not a shareholder of the Underlying Funds.

According to the Opinion, on appeal, ACE also made a policy argument that the District Court's ruling would allow excessive fees to be "buried" at the underlying fund level and be protected from challenges under Section 36(b). The Appeals Court dismissed this argument, noting that (i) under the relevant facts, unaffiliated investors held varying percentages of the outstanding shares of the Underlying Funds and (ii) even without such unaffiliated investors, the independent directors of each Underlying Fund would still have the responsibility to rigorously review advisory fees and the SEC would still have the authority to bring actions against the investment adviser under Section 36(b).

- **See a copy of the Opinion**

SEC Charges Chief Compliance Officer for Failure to Verify Accuracy of Securities Filings

On August 15, 2017, the SEC issued an order (the "**Order**") settling administrative and cease-and-desist proceedings against David I. Osunkwo ("**Osunkwo**") for making inaccurate securities filings with the SEC and failing to verify information contained in such filings while serving as Chief Compliance Officer (CCO) of two registered investment advisers.

According to the Order, in 2010 and 2011, Osunkwo was a principal at Strategic Consulting Advisors, LLC ("**SC Consulting**"), which offered compliance consulting and CCO services to investment advisers. During this period, two affiliated registered investment advisers, Aegis Capital, LLC ("**Aegis**") and Circle One Wealth Management, LLC ("**Circle One**"), retained SC Consulting to provide assistance with certain compliance functions as well as to provide an outsourced CCO. Osunkwo was designated as CCO to both Aegis and Circle One and, in this capacity, assisted them in preparing and filing their Forms ADV.

However, according to the Order, Osunkwo failed to prepare and file any Form ADV update or amendment for Aegis for the 2010 fiscal year. Circle One, on the other hand, filed an annual amendment to its Form ADV in April 2011 that was intended to reflect a merger between Aegis and Circle One. The Order alleged that this Form ADV amendment stated that Circle One and Aegis had a combined $182 million in assets under management (AUM) and 1,289 advisory accounts, when in reality the combined AUM was around $119 million and the number of advisory accounts was less than 300. According to the Order, Osunkwo had relied on an email from the Chief Investment Officer (CIO) of Circle One in preparing the Form ADV without taking steps to verify the information. In addition, the Order claimed that Osunkwo had, without the CIO's confirmation, listed the CIO as the signatory to the Form ADV certifying that its contents were true and correct.

According to the Order, Osunkwo's actions caused Aegis to violate Section 204 of the Advisers Act and Rule 204-1(a)(1) thereunder, which generally require a registered investment adviser to amend its Form

ADV "at least annually, within 90 days of the end of [its] fiscal year . . . ." Moreover, the Order alleged that Osunkwo's actions violated Section 207 of the Advisers Act, which generally makes 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.

Osunkwo consented to the entry of the Order without admitting or denying the findings and agreed to (i) a suspension from association with brokers, dealers and other investment advisers for twelve months, (ii) a suspension from serving as an employee or in other capacities at registered investment companies or affiliated persons of such companies, (iii) a suspension from participating in any offerings of a penny stock and (iv) a civil money penalty of $30,000.

- **See a copy of the Order**

SEC Charges Adviser for Improper Allocation of Consulting and Other Fees

On August 16, 2017, the SEC issued an order (the "**CDI Order**") instituting and settling administrative and cease-and-desist proceedings against Capital Dynamics, Inc. ("**CDI**"), an investment adviser registered with the SEC, for improperly allocating certain legal, hiring and consulting expenses to a private fund managed by CDI (together with its parallel investment vehicles, the "**Solar Fund**").

According to the CDI Order, CDI established the Solar Fund in 2010 for the purpose of investing in solar energy assets and related businesses. CDI served as the investment manager to the Solar Fund and its affiliates served as the general partners (the "**Solar GPs**") of the Solar Fund. The Solar Fund raised approximately $282 million from investors between 2010 and 2012 and was governed by three documents: a Private Placement Memorandum, a Limited Partnership Agreement and a Management Agreement (collectively, the "**Organizational Documents**"). According to the CDI Order, the Organizational Documents provided that the Solar GPs and CDI would be responsible for their own operating expenses, including routine and recurring expenses such as employee expenses and consultant fees, while the Solar Fund would be responsible for its own organizational, operating and marketing expenses. The CDI Order alleged that CDI improperly allocated certain of its expenses to the Solar Fund that should not have been charged to the Solar Fund pursuant to the Organizational Documents. Such expenses included consultant fees and expenses as well as legal expenses incurred by CDI employees in connection with negotiating an agreement with CDI to manage the Solar Fund. In total, the CDI Order claimed that CDI improperly allocated $1,273,148 in expenses to the Solar Fund from March 2011 to July 2015. Finally, the CDI Order alleged that while CDI had an internal document called the "Solar Fund Bible" that purportedly governed the allocation of expenses among CDI, the Solar GPs and the Solar Fund, this document was insufficiently detailed regarding the review or approval of expenses and failed to establish an oversight mechanism for expenses charged by investment personnel to the Solar Fund.

According to the CDI Order, as a result of the conduct described above, CDI violated (i) Section 206(2) of the Advisers Act, which generally prohibits an investment adviser from engaging in any transaction, practice or course of business that operates as a fraud upon any client or prospective client, (ii) Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which generally prohibit an investment adviser from making any untrue statement of material fact or omitting a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to any investor or prospective investor, and (iii) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which generally 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.

CDI consented to the entry of the CDI Order without admitting or denying the findings and agreed to pay civil penalties of $275,000. The CDI Order noted that the SEC considered remedial acts undertaken by CDI in accepting CDI's offer of settlement, including its voluntary reimbursement of $1,405,537, including

interest, to the Solar Fund, as well as its replacement of the Solar Fund Bible with a comprehensive compliance regime that included, among other things, multiple levels of review for expense allocations.

- **See a copy of the CDI Order**

SEC Charges Hedge Fund with Failing to Prevent Insider Trading

On August 21, 2017, the SEC issued an order (the "**Deerfield Order**") instituting and settling administrative and cease-and-desist proceedings against Deerfield Management Company, L.P. ("**Deerfield**"), an investment adviser registered with the SEC, for failing to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of material, non-public information by its employees, particularly information from research firms specializing in political intelligence.

According to the Deerfield Order, from 2012 to 2014, Deerfield provided advisory services in the healthcare sector to its associated hedge funds and, as part of its business, regularly engaged research firms and their political intelligence analysts to provide information regarding upcoming regulatory and legislative decisions. During this period, Deerfield had in place a compliance manual that included policies on preventing the misuse of material, nonpublic information. Such policies, according to the Deerfield Order, included specific requirements surrounding consultations with experts in scientific, medical, commercial, legal and other fields, including that (i) before consulting with an expert or expert network, Deerfield must first conduct "due diligence" to evaluate the compliance controls of such expert or expert network, (ii) at the beginning of any expert consultation, the consulting Deerfield employee must provide an oral reminder to the expert not to disclose material, nonpublic information, and (iii) at the end of any expert consultation, the consulting employee must submit a report of the discussion into Deerfield's database. However, according to the Deerfield Order, Deerfield provided training to its employees in 2012 that specifically excluded research firms from the requirements applicable to expert consultations and stated that in conducting diligence on research firms, Deerfield would rely on such firms to police their own conduct. According to the Deerfield Order, this exclusion of research firms from the expert consultation requirements was incorporated into a revised compliance manual in 2013, which only required research firms to demonstrate that they "observe policies and procedures to prevent the disclosure of material non-public information or any information in breach of a duty" and "refresh" such policies and procedures from time to time. However, the Deerfield Order asserted that this revised compliance manual did not explain what Deerfield's review of research firms should entail (such as how Deerfield personnel would verify that a research firm had adopted the requisite policies and procedures), and that it further instructed employees that it was not necessary to obtain fresh terms and conditions, provide a cautionary statement to research firms regarding disclosure of material, nonpublic information, or document each interaction with a research firm in Deerfield's database.

According to the Deerfield Order, Deerfield also did not enforce the policies and procedures described above, which resulted in trading on material, nonpublic information provided by at least one research firm. The Deerfield Order alleged that Deerfield did not review the policies and procedures of the relevant research firm for at least four years and, when it did receive such policies, continued to retain the firm's services despite numerous red flags, including the conflict of interest posed by the research firm's political intelligence analyst also serving as its chief compliance officer. In addition, the Deerfield Order highlighted several email communications with the research firm's political intelligence analyst that contained material, nonpublic information from sources at the Centers for Medicare and Medicaid Services ("**CMS**"). This information was, according to the Deerfield Order, used by Deerfield analysts as the basis for trading recommendations, including shorting shares of companies that offered products and services related to certain medical treatments (e.g., radiation oncology and kidney dialysis) in advance of announcements that CMS would cut Medicare reimbursement rates for such treatments, and purchasing such shares when CMS deliberations suggested a positive development for the affected companies. Between 2012 and 2013, these trades resulted in almost $4 million of profits to hedge funds advised by Deerfield and approximately $714,100 in performance-based compensation to Deerfield.

According to the Deerfield Order, as a result of the conduct described above, Deerfield willfully violated Section 204A of the Advisers Act, which generally requires registered investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by such investment adviser or any person associated with such investment adviser. Deerfield was censured for these actions.

Deerfield consented to the entry of the Deerfield Order without admitting or denying the findings and agreed to pay disgorgement of $714,110, prejudgment interest of $97,585 and a civil money penalty of $3,946,267. The SEC noted that the SEC considered remedial acts undertaken by Deerfield in accepting Deerfield's offer of settlement.

- **See a copy of the Deerfield 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.

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**