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November 28, 2017

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Industry Update

Treasury Department Publishes Recommendations on Regulation of Asset Management Industry

On October 26, 2017, the U.S. Department of Treasury (the "**Treasury**") issued a report (the "**Report**") on the status of the current U.S. regulatory regime governing the asset management and insurance industries. This update solely highlights recommendations relating to the asset management industry, which fall into four framework categories: (1) Systemic Risk and Stress Testing; (2) Efficient Regulation and Government Processes; (3) International Engagement; and (4) Economic Growth and Informed Choices.

Systemic Risk and Stress Testing

- *Systemic Risk*. According to the Report, due to fundamental differences between asset managers and prudentially regulated institutions (*e.g.*, banks), entity-based systemic risk evaluations of the asset management industry is unlikely to be an effective regulatory approach. Instead, the Report recommends that federal regulators focus on potential systemic risks arising from asset management products and activities and implement regulations that strengthen the overall industry.
- *Stress Testing*. According to the Report, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") requires certain non-bank financial companies, including investment advisers and investment companies, to conduct annual stress tests. The Report notes that stress testing raises significant implementation challenges in the asset management industry and argues that the spirit of Dodd Frank's stress testing requirements are already satisfied by the stress testing provisions currently applicable to registered investment companies under the Investment Company Act. The Report recommends that Dodd-Frank be amended to eliminate the stress testing requirement for investment advisers and investment companies.

Efficient Regulation and Government Processes

- *Liquidity Risk Management*. With respect to liquidity risk management, the Report recommends rejecting a highly prescriptive approach in favor of a principles-based approach to rulemaking. As an example of the type of rulemaking the Report would reject, the Report cites Rule 22e-4 of the Investment Company Act, which contains detailed rules surrounding illiquid asset thresholds and

liquidity risk management programs. The Report also specifically encourages further analysis by the SEC on swing pricing and its effects on investors.

- *Derivatives*. The Report notes that the SEC has proposed a new derivatives rule that generally allows mutual funds, exchange-traded funds ("**ETFs**") and closed-end funds to enter into derivatives transactions if they: (i) comply with one of two portfolio limitations to limit leverage obtained through derivatives; (ii) segregate an amount of qualifying coverage assets (*i.e.*, cash and cash equivalents) for derivatives; and (iii) establish a formalized derivatives risk management program. The Report recommends that the SEC consider eliminating the portfolio limit condition and broadening the types of assets that can be considered qualifying coverage assets.
- *Exchange-Traded Funds*. The Report recommends that the SEC propose a new rule to streamline the current ETF approval process and allow entrants access to the market without the cost and delay of obtaining exemptive relief orders.
- *Business Continuity and Transition Planning*. The Report notes that while investment advisers and investment companies are currently required under Rule 206(4)-7 of the Advisers Act and Rule 38a-1 of the Investment Company Act to maintain business continuity plans as a part of their compliance policies and procedures, the SEC recently proposed a new Rule 206(4)-4 under the Advisers Act, which would impose additional requirements on the content of business continuity plans. The Report argues that the existing rules regarding business continuity planning are sufficient and recommends that the current SEC proposal be withdrawn.
- *Dual SEC and CFTC Registration*. The Report notes that currently, many investment advisers and funds are required to dually register with the Commodity Futures Trading Commission ("**CFTC**") and the SEC, which subjects them to two distinct sets of reporting and regulatory requirements. The Report recommends amending the CFTC rules such that an investment company registered with the SEC and its adviser are exempt from dual registration and regulation by the CFTC.
- *Delivery of Registered Fund Disclosures*. The Report notes that registered investment companies are subject to an extensive set of disclosure requirements which, absent consent for electronic delivery, must be provided in paper by mail. The Report recommends that the SEC finalize proposed Rule 30e-3 under the Investment Company Act, which, among other things, would permit the use of implied consent to delivery by website in the absence of further instructions from shareholders of mutual funds. The Report further encourages the SEC to identify other areas where delivery of information through an electronic medium using implied consent is appropriate and consistent with investor protection.
- *Asset Management and Disclosure Requirements*. According to the Report, while reporting obligations are critical to ensure regulatory and public transparency into a fund's activities, duplicative reporting requirements can increase costs, which are then borne by investors. The Report recommends that regulators cooperate to combine duplicative forms and remove unnecessary data collection. Further, the Report recommends that all regulatory agencies focus on ensuring that their information security measures are meeting and/or exceeding standards set by Congress and other federal oversight bodies.
- *Volcker Rule*. The Report recommends that regulators reduce the burden of the Volcker Rule on asset managers and investors by not enforcing (i) the proprietary trading restrictions against foreign funds that are not "covered funds" under the Volcker Rule and (ii) the restriction on funds sharing a name with the bank entities that sponsor them. The Report further recommends that Congress revise the definition of "banking entity" to encompass only insured depositary institutions, their holdings companies, foreign banking organizations and affiliates and subsidiaries of such entities.

International Engagement

The Report highlights the importance of a multilateral approach to addressing structural vulnerabilities from asset management activities that could potentially present financial stability risks. According to the Report, liquidity mismatch and leverage are the key vulnerabilities that merit increased regulatory attention. The Report further recommends that the U.S. play a leading role on international standard-setting bodies such as the Financial Stability Board and the International Organization of Securities Commissions, and that U.S. agencies with seats on such international bodies coordinate their representation on behalf of the U.S.

Economic Growth and Informed Choices

According to the Report, the Treasury supports current efforts at the Department of Labor to delay full implementation of its fiduciary rule (the "**Fiduciary Rule**") in order to re-examine the full scope of its implications on the market. The Report encourages adopting regulations that address conflicts of interest faced by fiduciaries while preserving access to a wide range of asset classes, investment products, business models, distribution channels and other relevant features of financial services. For a detailed discussion of the DOL Fiduciary Rule, please see the April 5, 2017 Davis Polk Financial Regulatory Reform Blog Post, **DOL Fiduciary Rule: Officially Delayed for Now, with More to Come**.

- **See a copy of the Report**

LabCFTC Releases Primer on Virtual Currencies

On October 17, 2017, the CFTC's newly formed financial technology innovation group, LabCFTC, released a **Primer on Virtual Currencies** (the "**Primer**"). Notably, the Primer provides guidance on the scope of the CFTC's jurisdiction over virtual currencies both in relation to the SEC and in regard to specific instances of virtual currency activities, though it is not intended to describe the CFTC's official policy or position.

First, the Primer notes that the federal commodity laws and the federal securities laws are not necessarily mutually exclusive in their application to virtual currencies. Citing the **DAO Report**, in which the SEC concluded that the particular tokens involved in the initial coin offering, or ICO, were "securities" under the federal securities laws, the Primer states:

> "There is no inconsistency between the SEC's analysis and the CFTC's determination that virtual currencies are commodities and that virtual tokens may be commodities or derivatives contracts depending on the particular facts and circumstances. The CFTC looks beyond form and considers the actual substance and purpose of an activity when applying the federal commodities laws and CFTC regulations."

Accordingly, those engaged in virtual currency activities may be subject to either or both legal frameworks, depending on the facts and circumstances.

Second, the Primer discusses the scope of the CFTC's jurisdiction. The Primer notes that the CFTC's jurisdiction is implicated "when a virtual currency is used in a derivatives contract," or if there is "fraud or manipulation involving a virtual currency traded in interstate commerce." Accordingly, beyond instances of fraud or manipulation, the Primer states, the CFTC generally does not oversee "spot" or cash market exchanges and transactions involving virtual currencies that do not utilize margin, leverage, or financing. The Primer then goes on to describe "permitted" and "prohibited" activities within the scope of the CFTC's jurisdiction. Permitted virtual currency activities, according to the Primer, involve CFTC-regulated platforms—for example, the Primer cites Ledger X, an institutional trading and clearing platform for swaps and options on virtual currencies, which is registered with the CFTC as a swap execution facility. Prohibited virtual currency activities, according to the Primer, include (i) price manipulation of a virtual currency traded in interstate commerce, (ii) pre-arranged or wash trading in an exchange-traded virtual currency swap or futures contract, (iii) a futures or option contract or swap traded on an

unregistered platform and (iv) certain schemes involving virtual currency marketed to retail customers, such as off-exchange financed commodity transactions with persons who fail to register with the CFTC.

The Primer is the first in a series of publications aimed at providing "fundamental, and essential, information" about financial technology, or FinTech, innovation.

Litigation

SEC Charges Former Partner at Investment Adviser with Fraudulently Charging Personal Expenses to Fund Clients

On October 25, 2017, the SEC filed a complaint (the "**Complaint**") in the U.S. District Court for the Southern District of New York against a former senior partner (the "**Defendant**") at a well-known investment adviser (the "**Firm**"), for intentionally misappropriating approximately $290,000 from certain private equity fund clients (the "**Relevant Funds**") by charging such funds for personal, non-business related expenses.

According to the Complaint, from 2010 to 2013, the Defendant charged the Relevant Funds thousands of dollars in expenses and falsified receipts related to several personal vacations, consumer electronics, personal meals at restaurants, the cost of personal visits to a hair salon and reimbursement for clothing purchases for himself and his family members by claiming that such charges were legitimate business expenses related to travel, meals and gifts with or for clients. According to the Complaint, during this time, the Defendant was an active investment adviser who sourced, evaluated and recommended investment opportunities to his clients at the Firm, including the Relevant Funds, and received millions of dollars per year related to his advisory services.

The Complaint alleged that during this time, the Relevant Funds' governing documents only permitted expenses related to the Relevant Funds' investments and operations to be charged to such funds. In addition, the Complaint stated that the Firm's travel and expense reimbursement policies and procedures provided that employees could only charge clients for reasonable business and travel expenses incurred in the performance of their duties, and listed specific examples of the types of expenses that were not reimbursable (many of which were the types of expenses the Defendant submitted for reimbursement under another classification). According to the Complaint, the Defendant signed annual certifications that he had completed the Firm's compliance trainings, which included such expense reimbursement policies; the Defendant also signed the Firm's code of ethics, which prohibited the falsification of documents and specifically prohibited any false personal expense statement or claim.

According to the Complaint, the Defendant's actions first came to light in 2010, when the chief financial officer (CFO) of the Firm was made aware of questionable expense reports and conducted a six-month review of the Defendant's expense entries. As a result of this review, the Defendant agreed to pay back approximately $8,000 he had received as reimbursement for personal expenses and was warned by the CFO not to repeat the conduct. However, according to the Complaint, a second review of the Defendant's expenses took place in 2012 after it was reported that the Defendant had once again submitted suspicious expenses. The Complaint alleged that the Defendant was again required to reimburse the Firm for improperly charged personal expenses and told that such charges were prohibited; however, the Defendant was not placed on leave until a third review in 2013 in which the Firm identified additional improper charges and the Defendant admitted that over $220,000 in business expenses that he had charged to his fund clients were personal expenses (in addition to the amount he paid back in 2010). As a result of this 2013 review, the Firm again credited the Relevant Funds for all such charges billed to them and the Defendant reimbursed the Firm.

According to the Complaint, the Defendant's actions, as described above, violated, or aided and abetted the Firm's violation of, Sections 206(1) and 206(2) of the Advisers Act, pursuant to which an investment

adviser has a duty not to employ any device, scheme or artifice to defraud any client or prospective client and may not engage in transactions, practices or courses of business which operate as a fraud or deceit upon any client or prospective client. The Complaint seeks a permanent injunction preventing the Defendant from further violations of Sections 206(1) and 206(2) of the Advisers Act, along with civil money penalties.

- **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.

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