Investment Management Regulatory Update

February 28, 2018

Rules and Regulations

- SEC Grants No-Action Relief to Great Ajax Funding LLC Under Section 3(c)(5)(C) of the Investment Company Act to Permit Treatment of Interests in Securitization Trusts as Qualifying Interests in Real Estate
- SEC Extends Compliance Date for 1940 Act Liquidity Rule's Liquidity Classification Requirement

Industry Update

- SEC's National Examination Program Releases Examination Priorities for 2018
- SEC Releases Diversity Assessment Tool for SEC Regulated Entities

Litigation

- SEC Charges Fund Administrator with Fraudulent NAV Calculation
- SEC Charges Investment Adviser and Principals for Risk Disclosure Failures
- Investment Adviser Settles SEC Charges Relating to Undisclosed Principal Trades

Rules and Regulations

SEC Grants No-Action Relief to Great Ajax Funding LLC Under Section 3(c)(5)(C) of the Investment Company Act to Permit Treatment of Interests in Securitization Trusts as Qualifying Interests in Real Estate

On February 12, 2018, the staff of the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to Great Ajax Funding LLC ("**Ajax Funding**") confirming that the SEC will not recommend enforcement action against Ajax Funding if, under the circumstances described in the Letter, Ajax Funding relies on Section 3(c)(5)(C) of the Investment Company Act of 1940, as amended (the **"Investment Company Act**"), to operate without registering as an investment company under the Investment Company Act.

According to the incoming letter (the "**Incoming Letter**"), Ajax Funding is a wholly owned subsidiary of Great Ajax Operating Partnership L.P. (the "**Operating Partnership**"), a limited partnership through which Great Ajax Corp., a publicly traded real estate investment trust ("**Ajax Corp**"), conducts its business of acquiring, investing in and managing a portfolio of whole mortgage loans. According to the Incoming Letter, in order to facilitate securitization financing for Ajax Corp's business, the officers of the Operating Partnership, which are identical to those of Ajax Funding, periodically select and cause the transfer of whole mortgage loans held by the Operating Partnership to Ajax Funding, which in turn then transfers such loans to securitization trusts. Such trusts, according to the Letter, issue (i) Class A notes, which are senior, sequential-pay, fixed-rate notes issued to institutional investors in private offerings, (ii) Class B notes, which are subordinate, sequential pay, fixed-rate notes issued to Ajax Funding as consideration for the whole mortgage loans, and (iii) trust certificates representing residual interests in the trusts' assets ("**Trust Certificates**"). According to the Letter, Ajax Funding owns the Trust Certificates and, as holder of the Trust Certificates, Ajax Funding has significant control rights with respect to the trusts, including the right to redeem a trust's outstanding notes after a certain date, to instruct the trustee in respect of a trust's

operations, to acquire defaulted mortgage loans from a trust and foreclose on the underlying real estate and to dissolve and wind up a trust.

According to the Letter, Section 3(c)(5)(C) of the Investment Company Act provides an exclusion from the definition of investment company for any person that is primarily engaged in the business of "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." According to the Letter, the SEC has generally taken the position that an issuer may be able to rely on Section 3(c)(5)(C) if at least 55% of the issuer's assets consist of mortgages and other liens on interests in real estate ("**Qualifying Interests**") and at least 80% of the issuer's total assets consist of Qualifying Interests and real estate-type interests. According to the Letter, Qualifying Interests generally include mortgage loans fully secured by real estate, fee interests in real estate, second mortgages secured by real property, deeds of trust on real property, installment land contracts and leasehold interests secured solely be real property, but do not generally include a security-like interest in another issuer engaged in the real estate business.

According to the Incoming Letter, Ajax Funding contends that it should be able to treat its interests in securities issued by the trusts as Qualifying Interests for purposes of Section 3(c)(5)(C) of the Investment Company Act because Ajax Funding is primarily engaged in the mortgage loan business—a type of business that Section 3(c)(5)(C) intended to exclude from regulation under the Investment Company Act. According to the Incoming Letter, Ajax Funding acquires the Class B notes and Trust Certificates, which are its sole assets and source of income, as a direct result of being in the business of acquiring and securitizing whole mortgage loans, since proceeds from the sale of Class A notes are used by the Operating Partnership to acquire more whole mortgage loans, some of which are then transferred to Ajax Funding which, in turn, transfers them to a trust. The SEC staff agreed with this position in the Letter, emphasizing that the focus is on the business activities (not the assets) of an issuer like Ajax Funding (i.e., acquiring securities of a securitization trust as a direct result of it being in the business of purchasing or otherwise acquiring whole mortgage loans, for the purpose of financing the acquisition of additional whole mortgage loans). The SEC staff highlighted, however, that its position may not cover securities issued by a securitization trust that are acquired in a different manner, such as from an unaffiliated third party, since such activity could appear more consistent with the issuer being engaged in an investment activity rather than a financing activity. Further, the SEC staff noted that it would be willing to entertain additional no-action requests to treat certain other mortgage-related assets (e.g., certain "A-Notes" and servicing rights) as Qualifying Interests when acquired as a direct result of the issuer's engagement in the business of purchasing or otherwise acquiring whole mortgage loans or to broaden the "primarily engaged" test to include factors other than the assets an issuer holds in considering whether an issuer is primarily engaged in the real estate finance business.

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

SEC Extends Compliance Date for 1940 Act Liquidity Rule's Liquidity Classification Requirement

On February 23, 2018, the SEC announced that it is extending the deadline by which open-end funds must comply with the classification-related elements of the liquidity risk management rule adopted under the Investment Company Act in October 2016. Larger fund groups will now have until June 1, 2019 to comply, and smaller fund groups will have until December 1, 2019. Compliance with the remaining requirements of the rule will follow the original schedule – December 1, 2018 for larger fund groups and June 1, 2019 for smaller fund groups. For a detailed discussion of the liquidity risk management rule, please see the **October 31, 2016 Davis Polk Investment Management Regulatory Update**.

- **See a copy of the press release**

Industry Update

SEC's National Examination Program Releases Examination Priorities for 2018

On February 7, 2018, the National Examination Program (the "**NEP**"), administered by the Office of Compliance Inspections and Examinations ("**OCIE**"), published its examination priorities for 2018 (the "**Exam Priorities**"). The Exam Priorities fall into five categories: (i) matters of importance to retail investors, including seniors and those saving for retirement, (ii) compliance and risks in critical market infrastructure, (iii) the Financial Industry Regulatory Authority ("**FINRA**") and Municipal Securities Rulemaking Board ("**MSRB**"), (iv) cybersecurity and (v) anti-money laundering programs. For a discussion of the 2017 NEP Exam Priorities, please see the **January 23, 2017 Investment Management Regulatory Update**.

Retail Investors, Including Seniors and Those Saving for Retirement

According to the Exam Priorities, the NEP plans to focus on seniors and individuals saving for retirement, including examining firms that cater to such investors, concentrating on higher risk products and the recent technological changes in how investment advice is delivered. Specific areas of focus will include:

Disclosure of the Costs of Investing. The NEP plans to assess, among other things, whether fees and expenses are calculated and charged in accordance with the disclosures provided to investors. In addition, according to the Exam Priorities, the NEP will review fees charged to advisory accounts, specifically those where the fee depends on the value of the account, to determine whether assets are being valued according to investor agreements, disclosures and the firm's policies and procedures.

Further, according to the Exam Priorities, the NEP plans to focus on firms with practices or business models that may make it more likely that investors will pay inadequately disclosed fees, expenses or other charges, including:

- Certain advisory personnel who may be incentivized to recommend particular share classes of mutual funds to investors, where such investors may pay higher sales loads or distribution fees and such conflict of interest may not be disclosed;
- Accounts covered by an investment advisory representative who has departed the firm and that have not been reassigned to a new representative for proper oversight;
- Advisers that modified how they charge fees from a commission on executed trades to a percentage of client assets under management; and
- Private fund advisers managing funds with a high concentration of investors investing for the benefit of retail clients, such as pension plans and non-profit organizations.

Electronic Investment Advice. The NEP plans to continue to examine investment advisers and broker-dealers offering advice through automated or digital platforms, including robo-advisers and other firms that interact primarily with clients online, with a focus on such registrants' marketing materials, investor data protection, disclosure of conflicts of interest and compliance programs, including the oversight of computer program algorithms that generate recommendations.

Wrap Fee Programs. The NEP will continue to examine registered investment advisers and broker-dealers that use wrap fee programs, focusing on whether investment advisers are acting in a manner consistent with their fiduciary duty and satisfying their contractual obligations to their clients. In particular, the NEP will focus on whether (i) the recommendations to invest in, or continue to invest in, a wrap fee program are reasonable, (ii) conflicts of interest are disclosed in compliance with applicable regulatory requirements and (iii) investment advisers are obtaining best execution and disclosing the costs related to executing trades through another broker-dealer.

Never-Before-Examined Investment Advisers. The NEP plans to continue to take a risk-based approach to identify newly registered or never-before-examined investment advisers.

Senior Investors and Retirement Accounts and Products. The NEP will focus on how broker-dealers oversee their interactions with senior investors, including how they guard against the financial exploitation of such investors, and what internal controls firms have in place to supervise their representatives, especially relating to sales of products and services aimed at senior investors. Further, the NEP plans to continue to examine investment advisers and broker-dealers offering products and services to retirement account investors, with an emphasis on investment recommendations, sales of variable insurance products and sales and management of target date funds, as well as those providing services to retirement vehicles that primarily serve state and local government employees and non-profit employees, including 403(b) and 457 plans.

Mutual Funds and Exchange-Traded Funds ("ETFs"). The NEP plans to focus on mutual funds (i) with poor performance or liquidity issues relative to their peer groups, (ii) managed by advisers inexperienced in managing registered investment companies and (iii) holding securities that are potentially difficult to value during periods of market stress, including securitized auto, student or consumer loans or collateralized mortgage-backed securities. In addition, the NEP will examine mutual funds and ETFs that track custom-built indexes for potential conflicts between the adviser and the index provider and in connection with the adviser's role in selecting and weighting the index components. Finally, the NEP plans to focus on ETFs with little secondary market trading volume that are at risk of being delisted and having to liquidate assets, and examinations of ETFs will also analyze whether investment risk disclosures are sufficient.

Municipal Advisors and Underwriters. The NEP will continue to examine municipal advisers, focusing on their compliance with registration, recordkeeping and supervision requirements (especially municipal advisers that are not registered as broker-dealers), MSRB rules on professional qualification, continuing education requirements and core standards of conduct and duties when engaging in municipal advisory activities.

Fixed Income Order Execution. The NEP plans to examine broker-dealers to determine whether they have implemented satisfactory best execution policies and procedures for municipal bond and corporate bond transactions.

Cryptocurrency, Initial Coin Offerings ("ICOs"), Secondary Market Trading and Blockchain. The NEP will continue to monitor the sale of cryptocurrency products, and where such products are securities, the NEP will conduct examinations to assess regulatory compliance. Such examinations will, among other things, assess the controls and safeguards in place to protect cryptocurrency assets from theft or misappropriation and review whether there is adequate disclosure about the risks associated with cryptocurrency products, including investment losses, liquidity risks, price volatility and potential fraud.

Compliance and Risks in Critical Market Infrastructure

Clearing Agencies. The NEP will continue to annually examine clearing agencies designated as systematically important by the Financial Stability Oversight Council and for which the SEC is the supervisory agency, with a focus on compliance with the SEC's Standards for Covered Clearing Agencies, corrective action taken in respect to prior examinations and other areas identified in collaboration with the Division of Trading and Markets and other regulators.

National Securities Exchanges. The NEP plans to focus on (i) the internal audits conducted by the exchanges, (ii) the fees paid under section 31 of the Securities Exchange Act of 1934 and (iii) the governance and operation of certain National Market System plans.

Transfer Agents. The NEP will focus on transfers, recordkeeping and safeguarding of funds and securities by transfer agents, including transfer agents that serve as paying agents or that service microcap or crowdfunding issuers.

Regulation Systems Compliance and Integrity ("SCI") Entities. The NEP plans to examine SCI entities, including national securities exchanges, clearing agencies and certain alterative trading systems, to evaluate (i) how effectively such entities have implemented policies and procedures focused on their systems' capacity, integrity, resiliency, availability and security, in accordance with Regulation SCI, (ii) the controls around how their systems record the timing of transactions and how they synchronize with other systems; and (iii) their business continuity plan effectiveness, vendor risk management and enterprise risk management.

Focus on FINRA and MSRB

FINRA. The NEP plans to focus on FINRA's operations and regulatory programs and the quality of its examinations of broker-dealers and municipal advisors that are also registered broker-dealers.

MSRB. The NEP plans to evaluate the effectiveness of certain of MSRB's operational and internal policies, procedures and controls.

Cybersecurity

The NEP will continue to focus on governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response, among other things.

Anti-Money Laundering ("AML") Programs

The NEP will continue to focus on examining whether the entities the SEC regulates which are required to have AML programs have adapted their programs to address their obligations by reviewing, for example, the customer due diligence requirement, the timeliness, completeness and accuracy of the filing of Suspicious Activity Reports and the adequacy of the independent tests they run on their AML programs.

According to OCIE, the areas of focus in the Exam Priorities are not comprehensive, and they remain open to addressing emerging and exigent risks to investors and the financial markets as they arise.

- **See a copy of the Press Release**
- **See a copy of the Exam Priorities**

SEC Releases Diversity Assessment Tool for SEC Regulated Entities

On January 25, 2018, the SEC's Office of Minority and Women Inclusion ("**OMWI**") introduced its Diversity Assessment Report for Entities Regulated by the SEC (the "**Report**"), which is intended to complement the June 2015 Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies (the "**Joint Standards**") established pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The Report is designed to, according to the SEC, assist regulated entities with assessing their diversity policies and practices using the Joint Standards and to provide a template for submitting information about such assessments to OMWI. According to the SEC, using the Joint Standards, conducting self-assessments and providing self-assessment information to OMWI are all voluntary. According to the SEC, regulated entities will receive an email from OMWI inviting them to complete the Report using a secure web portal. Should an entity choose to undertake a self-assessment and submit information to OMWI, the SEC may, according to the Report, use such information to identify those policies and practices included in the Joint Standards that have been adopted by SEC-regulated entities, as well as to note those diversity policies and procedures that have been successful. According to the Report, the SEC may publish information collected in the OMWI Annual Report to Congress, but no information that identifies a specific regulated entity would be published, nor would the SEC disclose any confidential business information. According to the SEC, a regulated entity that chooses to submit confidential business information and information that it considers sensitive may request confidential treatment in accordance with the SEC's procedures under the Freedom of Information Act.

OMWI has published a set of frequently asked questions to provide guidance to SEC-regulated entities that choose to self-assess with respect to the Joint Standards and the Report.

- **See a copy of the Report**
- **See a copy of the Final Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies**
- **See a copy of the FAQs**

Litigation

SEC Charges Fund Administrator with Fraudulent NAV Calculation

On January 22, 2018, the SEC issued an order (the "**Order**") instituting and settling cease-and-desist proceedings against Gemini Fund Services, LLC ("**Gemini**"), the fund administrator for GL Beyond Income Fund (the "**Fund**"), for calculating an inflated net asset value ("**NAV**") for the Fund and transmitting it to the public via NASDAQ, despite knowing (i) that the Fund's custodian did not have adequate proof of the existence of a number of (ultimately fake) assets and (ii) that there was a significant discrepancy between Gemini's own records and those of the Fund's custodian.

According to the Order, the Fund, which was registered under the Investment Company Act, pooled investor capital to purchase consumer loans and, in February 2013, the managing director ("**MD**") of the Fund's investment adviser, GL Capital Partners, LLC ("**GL Capital**"), began misappropriating investors' money by creating fictitious loans originated through a special purpose entity controlled by MD. From February 2013 through December 2014, Gemini, according to the Order, struck an inflated NAV for the Fund and transmitted such inflated NAV to the NASDAQ. According to the Order, Gemini included the fake loan assets of the Fund when striking the Fund's NAV based on the information it received from GL Capital and/or from GL Capital's affiliated loan servicer, and by December 2014, over 30% of the Fund's reported assets consisted of the fake loans. According to the SEC, although Gemini did not know that certain of the loans were fake when it struck the Fund's NAV, Gemini personnel knew that for extended periods of time the Fund's custodian did not have adequate proof of certain loans and was therefore not counting those loans as assets of the Fund. According to the Order, Gemini had knowledge of this lack of proof of the loans through its contractually required reconciliation process with the Fund's custodian, which showed a discrepancy between Gemini's own records and those of the custodian. However, according to the Order, Gemini continued to include the undocumented loans in the Fund's daily NAV calculation, despite being informed by the Fund's custodian that it could not book certain loans as assets of the Fund due to missing underlying loan documents. According to the Order, Gemini also did not report the non-reconciling asset values to the Fund's board of trustees or to the investing public.

According to the Order, as a result of the conduct described above, Gemini was a cause of MD's and GL Capital's violations of Section 206(1) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which prohibits any investment adviser from employing any device, scheme or artifice to defraud any client or prospective client, and Section 206(2) of the Advisers Act, which prohibits any investment adviser from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client.

Gemini consented to the entry of the Order without admitting or denying the findings and agreed to pay disgorgement of $147,334, prejudgment interest of $14,072 and a civil money penalty of $400,000. Gemini also agreed to retain, within 30 days of the date of the issuance of the Order, the services of an independent compliance consultant.

- **See a copy of the Order**

SEC Charges Investment Adviser and Principals for Risk Disclosure Failures

On January 23, 2018, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against AmericaFirst Capital Management, LLC ("**AFCM**"), its Chief Executive Officer (the "**CEO**") and its President and Chief Operating Officer (the "**President**") for failing to provide complete and accurate disclosure regarding AFCM's financial health to investors in connection with the sale of promissory notes to individual retail investors.

According to the Order, AFCM, a registered investment adviser based in California, served as the investment adviser to five mutual funds and more than 25 individual retail clients. AFCM, according to the Order, began experiencing cash flow issues in December 2012, since its ongoing business expenses exceeded the fees generated by its advisory business. To bridge this gap, according to the Order, the CEO decided to raise money by issuing unsecured promissory notes to individual retail investors, and from December 2012 through February 2015 the President solicited investors to invest in such promissory notes and to renew preexisting notes at maturity. According to the Order, while marketing these notes the President portrayed AFCM as a profitable business and the notes as investments that would provide predictable monthly interest at a high interest rate, despite knowing that AFCM likely would be unable to repay the notes when due. Further, according to the Order, the documents AFCM provided to investors at the time of investment or renewal failed to disclose the degree of risk investors faced in purchasing or renewing the notes.

According to the Order, as a result of the conduct described above, AFCM, the CEO and the President violated Section 17(a)(2) of the Securities Act of 1933, as amended (the "**Securities Act**"), which makes it unlawful to obtain money or property in the offer or sale of a security by means of an untrue statement of a material fact or omission to state a material fact that is necessary to make the statement not misleading. Further, according to the Order, AFCM and the CEO violated, and the President caused AFCM to violate, Section 206(2) of the Advisers Act, which makes it unlawful for an investment adviser to engage in a transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client.

AFCM, the CEO and the President consented to the entry of the Order without admitting or denying the findings therein. AFCM agreed to have its Chief Compliance Officer submit a written report regarding the status of all promissory notes and including recommendations for improvements to AFCM's disclosures to clients. AFCM also agreed to preserve all records relating to its compliance with the Order for no less than six years and to post the Order prominently on its website for 12 months. Further, AFCM agreed to send all noteholders since December 2012 a copy of the Order and to include a copy of this Order in any of AFCM's brochures to clients and prospective clients for two years.

Additionally, AFCM was censured and ordered to pay a civil money penalty of $50,000, and the CEO and President were each ordered to pay a civil money penalty of $25,000.

- **See a copy of the Order**

Investment Adviser Settles SEC Charges Relating to Undisclosed Principal Trades

On January 17, 2018, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against a former Managing Director (the "**MD**") of Newport Coast Securities, Inc. ("**Newport**"), an SEC dually registered investment adviser and broker-dealer, for executing over 2,000 trades between Newport's proprietary trading account and Newport advisory client accounts, without first providing written disclosure to, and obtaining prior consent from, such advisory clients, and for charging undisclosed mark-ups and mark-downs to such clients with respect to such trades.

According to the Order, from March 2013 through December 2015, the MD placed approximately 2,785 trades between a Newport proprietary trading account and advisory client accounts, in some instances

purchasing securities from the proprietary account for Newport advisory clients, and at other times selling securities from such advisory clients directly to the Newport proprietary account. In addition, according to the Order, the MD charged at least 25 basis points per unit purchased or sold by the advisory client, either via a mark-up when selling to a client or a mark-down when buying from a client, for the vast majority of these principal trades. According to the SEC, the MD failed to provide written disclosure of the principal nature of such trades and to obtain consent from his advisory clients, and in the instances where the MD did provide post-settlement notice to clients, such notices failed to inform clients of any mark-up or mark-down. According to the Order, the MD unlawfully obtained approximately $50,000 from advisory clients from the mark-ups and mark-downs associated with such trades.

According to the Order, as a result of the conduct described above, the MD willfully aided and abetted and caused Newport's violations of Section 206(3) of the Advisers Act, which prohibits an investment adviser, while acting as a principal for its own account, from knowingly selling to or purchasing from a client a security without first disclosing to such client in writing the capacity in which the investment adviser is acting and obtaining the client's consent for each such transaction.

The MD was censured and ordered to pay disgorgement of $50,000, prejudgment interest of $3,652.09 and a civil money penalty of $25,000.

- **See a copy of the Order**

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