Investment Management Regulatory Update

April 30, 2018

Rules and Regulations

Industry Update

Litigation

Rules and Regulations

Spending Bill Includes Reforms Impacting Business Development Companies

On March 23, 2018, Congress passed, and President Trump signed into law, the Small Business Credit Availability Act (the "**SBCAA**") as part of an omnibus spending bill. The SBCAA (i) lowers the asset coverage requirement (in certain circumstances) for business development companies ("**BDCs**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), and (ii) allows BDCs to use the securities offering and proxy rules available to other operating companies required to file reports under Section 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**").

Section 802 of the SBCAA lowers the current asset coverage requirement for BDCs to issue any class of senior security under the Investment Company Act from 200% to 150%, effectively doubling the amount of leverage that a BDC is allowed to incur, if certain conditions are met. According to the Act, in order for a BDC to take advantage of this change, it must satisfy the following approval and reporting requirements:

1. Approval of the application of Section 802 to the BDC by either (a) a majority of non-interested directors (which becomes effective one year after the date of such approval) or (b) more than 50% of the votes cast at a shareholder meeting at which a quorum is present (which becomes effective on the day after such approval);
2. Beginning no later than five business days after the date on which the approvals are obtained under (a) or (b) immediately above, the BDC must disclose that the requirements of the applicable section of the SBCAA have been approved, as well as the effective date of the approval, in any filing submitted to the SEC under Section 13(a) or 15(d) of the Exchange Act and on its website;
3. The BDC must disclose in each periodic filing required under Section 13(a) of the Exchange Act (a) the aggregate outstanding principal amount or liquidation preference, as applicable, of

the senior securities issued by it, and the asset coverage percentage as of the date of its most recent financial statements included in that filing, (b) the approval of the asset coverage requirements and (c) the effective date of the approval in (1)(a) or (1)(b) above; and

4. If the BDC is an issuer of common equity securities, each of its periodic filings required under Section 13(a) of the Exchange Act must include disclosures that are reasonably designed to ensure that shareholders are informed of: (a) the amount of senior securities (and the associated asset coverage ratios) of the BDC, determined as of the date of its most recent financial statements included in that filing, and (b) the principal risk factors associated with the senior securities described in (a) above, to the extent that such risk is incurred by the BDC.

Additionally, according to the SBCAA, if the BDC is not an issuer of common equity securities that are listed on a national securities exchange, the BDC must extend to each shareholder (as of the date of the applicable approval in (1)(a) or (1)(b) above) the opportunity to sell the securities held by such shareholder as of the applicable approval date, with 25% of those securities to be repurchased in each of the four calendar quarters following the calendar quarter in which the applicable approval takes place.

Section 803 of the SBCAA requires the SEC to revise certain rules promulgated under the Exchange Act, the Securities Act of 1933, as amended (the "**Securities Act**"), Regulation FD, Form N-2 and Schedule 14A to allow BDCs to take advantage of the offering and proxy rules available to other non-fund issuers that file reports under Section 13(a) and 15(d) of the Exchange Act. These revisions include:

- Allowing BDCs to qualify as "well-known seasoned issuers" ("**WKSIs**"), as defined under the Securities Act, and allowing those BDCs to file automatic shelf registration statements and "free writing prospectuses";
- Reducing disclosure requirements in shelf registration statements for BDCs that qualify as WKSIs;
- Removing BDCs from the list of issuers who are not eligible for exemptions related to (a) communications around the time of an offering and (b) communications of regularly released factual business information and forward-looking information;
- Allowing BDCs to incorporate by reference into Form N-2 periodic reports filed under the Exchange Act;
- Providing a process for a BDC to file a form of prospectus in the same manner as the process used by non-BDCs;
- Allowing BDCs to use the delivery and notice rules for prospectuses applicable to non-BDCs;
- Allowing BDCs to incorporate by reference into Schedule 14A certain previously filed information; and
- Allowing brokers and dealers to publish and distribute research reports about BDCs.

Section 803 of the SBCAA also requires the SEC to amend Regulation FD to provide that a failure to make a public disclosure required under the rules shall not affect whether, for purposes of Form N-2, the BDC is deemed to have filed all material required to be filed pursuant to Section 13 or 15(d) of the Exchange Act (or, where applicable, has made those filings in a timely manner).

Finally, Section 803 of the SBCAA provides that if the SEC fails to complete the required revisions within a year following the date of enactment, a BDC may deem those revisions to have been completed in accordance with the actions required to be taken by the SEC under the SBCAA.

- **See a copy of the Act**

SEC Proposes Enhanced Standards for Advice to Retail Investors

On April 18, 2018 the SEC proposed a set of rules and interpretations designed to enhance protections for retail investors when interacting with SEC-registered broker-dealers and investment advisers. Among other things, the proposal would (i) establish a new "best interest" standard of conduct for broker-dealers when recommending a securities transaction or investment strategy to a retail customer; (ii) reaffirm, and in some cases, clarify the fiduciary duty standard of conduct for investment advisers; (iii) require both broker-dealers and investment advisers to provide retail investors with a brief form summarizing the firm's relationship with the investor; and (iv) restrict broker-dealers and their associated persons from using the terms "adviser" or "advisor." Davis Polk is currently preparing a client memorandum that will more fully describe the SEC proposal.

- **See a copy of the Regulation Best Interest Proposal**
- **See a copy of the Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers**
- **See a copy of the Form CRS Relationship Summary Proposal**

Industry Update

Dalia Blass Delivers Keynote Address at ICI 2018 Mutual Funds & Investment Management Conference

On March 19, 2018, Dalia Bass, the Director of the Division of Investment Management of the SEC (the "**Division**"), delivered the keynote address at the ICI 2018 Mutual Funds & Investment Management Conference. Blass discussed the importance of data technology in the SEC's work, the SEC's "Board Outreach Initiative," a new rule for exchange-traded funds ("**ETFs**") and considerations related to index providers.

Blass began by discussing the importance of data analysis to the Division's work and the new tools that the SEC Analytics Office has developed to regulate the more than 20,000 registered funds and advisers within the Division's purview. One such tool – Monitoring and Analytics GUI for Investment Companies ("**MAGIC**") – compiles multiple data sets across registered funds so that information such as fund performance, flows and holdings can be reviewed and compared holistically. According to Blass, MAGIC can be used to identify which funds have exposure to certain asset classes, which allows the SEC to develop tailored approaches to reviewing disclosure. In addition, according to Blass, MAGIC is able to incorporate new data, such as information from Form N-PORT, into its processes, and the Analytics Office has also started adding machine learning capabilities. According to Blass, while MAGIC represents only one type of tool for the Division, data tools remain an indispensable part of understanding how policy will impact investors and other market participants.

Next, Blass discussed the Division's "Board Outreach Initiative," a project designed to collect information on the common challenges facing fund boards in order to improve their ability to serve shareholders. After meeting with fund boards and groups of independent directors for several months, certain themes consistently arose, and the Division staff, according to Blass, plans to address these themes by prioritizing an update of its valuation guidance and its standards for accounting, auditing and reporting, among others.

Next, Blass turned to a discussion of ETFs and how the regulatory approach has not kept pace with the market, resulting in a $3.5 trillion market operating under more than 300 individually issued exemptive orders. To address this mismatch, the Division, according to Blass, has begun work on a new ETF rule. Further, according to Blass, the use of the term "ETF" has expanded significantly over time, making it more difficult for investors to identify important differences in risk between true ETFs and different exchange-traded products.

Lastly, Blass raised the question of whether it is time to revisit whether certain index providers should be categorized as investment advisers, especially those providers who maintain bespoke or narrowly focused indices. Blass encouraged practitioners to take care when analyzing bespoke or narrowly focused indices going forward.

In closing, Blass noted that continued active engagement is essential to the Division's policy-making decisions, and she encouraged all practitioners and participants in the investment management area to continue to provide feedback and suggestions going forward.

- **See a transcript of the Speech**

Mutual Fund Firms Agree to Active Share Disclosure

Following an investigation by the New York Attorney General's Office into mutual fund fees and disclosures, thirteen large mutual fund firms have announced that they will begin to publish more information regarding their actively managed equity mutual funds. According to a report which followed an investigation by the Investor Protection Bureau of the New York Attorney General's Office (the "**Report**"), these surveyed firms will begin to disclose a metric known as "Active Share." The Report notes that Active Share measures the degree of overlap between a mutual fund's holdings and the holdings of its benchmark index. According to an April 5, 2018 press release regarding the investigation and release of the Report, Attorney General Eric T. Schneiderman stated that this type of disclosure will "help level the playing field," by providing retail investors access to "critical information before making investment decisions for themselves and their families."

The Investor Protection Bureau of the New York Attorney General's Office conducted an investigation related to fund fees and investor disclosure, targeted at over 2,000 actively managed mutual funds, in order to understand if a fund's fees reflect a fund's opportunity to outperform its benchmark. The Report states that while index funds traditionally aim to track the performance of a benchmark index, actively managed funds rely on the skills and expertise of a portfolio manager in making decisions about how to allocate assets in a fund with the aim of outperforming the fund's benchmark index.

According to the Report, actively managed mutual funds generally charge higher fees than index funds. The Report states that, on average, fees on investments in actively managed mutual funds cost investors almost 4.5 times more per year than fees on investments in passive mutual funds. However, the Report indicates that higher fees do not necessarily correlate with a higher level of active management measured by a mutual fund's Active Share. The Report notes that some actively managed mutual funds with high management fees actually tracked closer to their benchmark index than some funds with lower management fees, illustrating that Active Share varies widely for actively managed mutual funds with high fees.

The Report also discloses that while all of the fourteen mutual fund firms surveyed use Active Share to some extent in managing their investment portfolios, and offer Active Share information to institutional investors, most do not currently disclose their Active Share to retail investors. According to the Report, in response to the investigation's findings, thirteen of the fourteen mutual fund firms surveyed have volunteered to begin posting their quarterly Active Share information on their websites. The Report notes that that the fourteenth firm already publishes such information.

- **See a copy of the Press Release**
- **See a copy of the Report of the Investor Protection Bureau**

OCIE Issues Risk Alert on Most Frequent Advisory Fee and Expense Compliance Issues Identified in Investment Adviser Examinations

On April 12, 2018, the Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert (the "**Risk Alert**") detailing a list of compliance issues relating to fees and expenses charged by investment advisers registered with the SEC that were most frequently identified in deficiency letters sent to advisers.

According to OCIE, an adviser that fails to adhere to disclosures relating to fees and expenses charged to clients (which are typically contained in advisory agreements and disclosed in an adviser's Form ADV and certain other materials that may be provided to clients), or otherwise engages in inappropriate fee billing and expense practices, may violate the Investment Advisers Act of 1940 (the "**Advisers Act**") and the rules promulgated thereunder, including the antifraud provisions. Additionally, the Risk Alert adds that advisers must comply with Rule 206(4)-7 under the Advisers Act, which requires advisers to adopt and implement written policies and procedures reasonably designed to prevent such violations.

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

- *Fee-Billing Based on Incorrect Account Valuations.* According to the Risk Alert, OCIE staff found instances of advisers incorrectly valuing certain assets in clients' accounts, resulting in overbilled advisory fees, as such fees are generally based on a percentage of the value of clients' assets. According to the Risk Alert, examples include:
  - Valuation of assets based on a different metric than the metric provided in the client's advisory agreement, such as valuing an illiquid asset at original cost rather than at its fair market value; and
  - Valuation of assets using a different process than the process provided in the client's advisory agreement, such as using the market value at the end of a billing cycle instead of the average daily balance of the account over the billing cycle, or including assets in the management fee calculation that should have been carved out pursuant to an advisory agreement.
- *Billing Fees in Advance or with Improper Frequency*. According to the Risk Alert, OCIE staff also found instances where the timing and frequency for which advisers billed clients were inconsistent with such clients' advisory agreements or the disclosures they received. According to the Risk Alert, examples include:
  - Billing advisory fees on a monthly basis instead of on a quarterly basis, or in advance instead of in arrears, contrary to what was provided in the advisory agreement or disclosed in the adviser's Form ADV Part 2; and
  - Billing a new client for advisory fees in advance for an entire billing cycle when advisory services began mid-billing cycle, or not reimbursing a client a prorated portion of the advisory fees when the client terminated the advisory services mid-billing cycle, despite disclosures to the contrary in the adviser's Form ADV Part 2.
- *Applying Incorrect Fee Rate*. According to the Risk Alert, OCIE staff found instances of advisers applying an incorrect fee rate when calculating the advisory fees, such as applying a higher rate than what was agreed on in the advisory agreement, double-billing a client or charging performance-based fees to non-qualified clients in contravention of Section 205(a)(1) of the Advisers Act and Rule 205-3 thereunder.
- *Omitting Rebates and Applying Discounts Incorrectly*. According to the Risk Alert, OCIE staff found instances of advisers neglecting to apply certain rebates and discounts to their clients' advisory fees as provided in the advisory agreements or as disclosed in their Form ADVs, including:

    - Not aggregating client account values for members of the same household, which would have qualified such clients for discounted fees;
    - Not reducing a client's fee rate when the value of such client's account reached a prearranged breakpoint; and
    - Charging clients additional fees (e.g., brokerage fees) when such clients were in the adviser's wrap fee program and the transactions qualified for the program's bundled fee.
- *Disclosure Issues Involving Advisory Fees*. According to the Risk Alert, OCIE staff found several issues with respect to advisers' disclosures of fees or billing practices, including:
    - Inconsistency between disclosures in the Form ADV and actual practices (e.g., exceeding a maximum advisory fee rate disclosed in the Form ADV in advisory agreements with certain clients); and
    - Lack of disclosure for certain additional fees or markups in addition to advisory fees, such as collecting expenses for third-party execution and clearing services that exceeded the actual fee charged for those services, receiving additional compensation on certain asset purchases for client accounts or failing to disclose fee sharing arrangements with affiliates.
- *Adviser Expense Misallocations*. According to the Risk Alert, OCIE staff found instances where advisers misallocated expenses (e.g., distribution and marketing expenses, regulatory filing fees and travel expenses) to the funds in lieu of the adviser, contrary to the advisory agreements, operating agreements or other disclosures applicable to such clients.

According to the Risk Alert, OCIE's objective in publishing the Risk Alert is to encourage advisers to assess their advisory fee and expense practices, including the related disclosures and the adequacy of their compliance programs, in order to ensure that they are complying with the Advisers Act and their fiduciary duty. The Risk Alert notes that OCIE staff has observed that some advisers have elected to change their practices, enhance policies and procedures and reimburse clients for overbilled amounts of advisory fees and expenses in response to OCIE staff observations.

- ▸ **See a copy of the Risk Alert**

Litigation

Voya Advisers Settle SEC Charges Relating to Undisclosed Securities Lending Conflict

On March 8, 2018, the SEC issued an order (the "**Voya Order**") instituting and settling administrative and cease-and-desist proceedings against two investment adviser subsidiaries of Voya Holdings Inc.—Voya Investments LLC and Directed Services LLC (collectively, the "**Voya Advisers**")—for failing to disclose conflicts of interest and making misleading disclosures in connection with their alleged practice of recalling securities on loan so their affiliates could receive tax benefits.

According to the SEC, Voya Advisers served as investment advisers to certain mutual funds offered to annuity and life insurance customers through insurance companies affiliated with the advisers. The SEC alleged that, from August 2003 to March 2017, the Voya Advisers lent securities held by the mutual funds to parties looking to borrow the securities, a practice that generated additional income for the funds and their investors. The SEC further alleged that the Voya Advisers recalled loan securities before their dividend record dates so that insurance companies affiliated with Voya Advisers, who were the record shareholders of the funds' shares, could receive a tax benefit based on the dividends received. However, in the SEC's view, the recall practice caused the mutual funds and their investors to lose securities lending income during the recall period, while they received no offsetting benefit. According to the Voya

Order, since June 2011, the insurance company affiliates received a tax benefit of nearly $2.6 million while the mutual funds lost nearly $2 million in securities lending income due to the alleged practice.

The SEC asserted that Voya's practice of recalling loaned securities created a conflict of interest between Voya and the funds. While the funds' boards of directors asked Voya for information concerning conflicts of interest and to identify benefits to Voya or its affiliates because of their relationships with the funds, Voya did not disclose to the boards the loss of income to the funds. Accordingly, the SEC asserted that the recall practice resulted in a conflict of interest that the Voya Advisers failed to disclose to the funds' boards of directors. In addition, while funds' prospectuses disclosed that a fund may lend its portfolio securities, that the loans earn income for the funds, and that the loans could be terminated or recalled at any time, the SEC alleged that the Voya Advisers failed to specifically disclose that they had a practice of recalling securities that provided a tax benefit to insurance company affiliates and deprived the funds and their investors of securities lending income.

As a result of the alleged conduct, the SEC charged Voya Advisers with willfully violating Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder. Without admitting or denying the findings, the Voya Advisers consented to a cease-and-desist order and agreed to pay approximately $3.1 million in disgorgement and prejudgment interest to the affected mutual funds for the benefit of their investors, and a $500,000 civil penalty.

The Voya Order highlights the SEC's continued enforcement focus on undisclosed conflicts of interest by investment advisers, and broad view of the types of adviser activities that may generate conflicts of interest between advisers and investors. It also emphasizes the importance of proactively identifying benefits to advisers or their affiliates that may generate a conflict of interest between the adviser and managed funds, and ensuring that such conflicts are disclosed to both fund boards and fund investors.

- **See a copy of the Order**

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