Investment Management Regulatory Update

May 31, 2018

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Rules and Regulations

SEC Proposes Rule Change to Address Auditor Independence with Respect to Certain Loans or Debtor-Creditor Relationships

In a May 3, 2018 release (the "**Proposing Release**"), the Securities and Exchange Commission (the "**SEC**") proposed to amend its current auditor independence rule, Rule 2-01 of Regulation S-X, in order to "refocus the analysis" to determine independence when an auditor "has a lending relationship with certain shareholders of an audit client at any time during an audit or professional engagement period."

Rule 2-01 requires that auditors be independent of their audit clients "in fact and in appearance." Under Rule 2-01(b), to be considered independent, an auditor must be "capable of exercising objective and impartial judgment on all issues encompassed within the [auditor's] engagement." Rule 2-01(c) provides a non-exhaustive list of circumstances that the SEC considers to be inconsistent with independence. According to the Proposing Release, the restriction on debtor-creditor relationships articulated in Rule 2-01(c)(1)(ii)(A) (the "**Loan Provision**") provides that an accountant is not independent when the accounting firm, any covered person in the accounting firm or any of the covered person's immediate family members has any loan to or from: (i) an audit client; (ii) an audit client's officers or directors; or (iii) record or beneficial owners of more than 10% percent of the audit client's equity securities. Additionally, under Rule 2-01(f)(6), the definition of "audit client" includes any affiliate of the entity being audited, and pursuant to Rule 2-01(f)(4), "affiliates" include entities that control, are controlled by or are under common control with the audit client, as well as each entity within the audit client's "investment company complex" (the "ICC"). Thus, as the Proposing Release notes, an affiliate includes both an entity under common control with the audit client and each entity in an ICC where the audit client is part of that ICC. According to the Proposing Release, when the Loan Provision was first proposed, the SEC stated that such debtor-creditor relationship could be viewed as "creating a self-interest that competes with the auditor's obligation to serve only investors' interests."

The Proposing Release states that the SEC is aware the existing rule "may not be functioning as it was intended" such that there are circumstances where an auditor's objectivity and impartiality is not actually impaired despite a failure to comply with the Loan Provision. The Proposing Release identifies several practical challenges with the application of the current Loan Provision. The Proposing Release states that with respect to publicly traded shares, there are a relatively small number of financial intermediaries who are record owners of those shares for their clients, and certain of these intermediaries may also be lenders to public accounting firms, or could potentially be affiliates of intermediaries that may be lenders to such accounting firms. The Proposing Release goes on to state that, as a result of underlying customer activity in an omnibus account (or as a result of other record or beneficial owner activity), record ownership of a lender that is also a financial intermediary that holds fund shares for customers "may exceed, or conversely fall below, the 10 percent threshold within a given period without any affirmative action on the part of the financial intermediary."

The Proposing Release discusses the uses of loans by accounting firms, and the syndication of these loans among multiple financial institutions, which expands the number of lenders to an accounting firm. According to the Proposing Release, this may "multiply the number of lenders that may also be record or beneficial owners of securities in audit clients." This could lead to audit committees devoting substantial resources to evaluating potential noncompliance with the Loan Provision, the expenses of which ultimately are borne by fund shareholders.

The Proposing Release notes that compliance issues with the Loan Provision can be particularly disruptive for funds. For example, the Proposing Release points out that in order to make a continuous offering of securities, a registered open-end fund must maintain a current prospectus by periodically filing amendments to its registration statement that contain financial statements audited by an independent public accountant, and a registered investment company must distribute an annual report to shareholder that is certified by an independent registered public accounting firm. Thus, the Proposing Release states that noncompliance with auditor independence rules can result in (i) the inability of funds to sell shares, (ii) investors not having the ability to rely on affected financial statements, or (iii) funds (and indirectly, their investors) having to incur costs related to re-audits.

The Proposing Release notes that, as funds and their advisers were "most acutely affected by the Loan Provision," the SEC staff issued a no-action letter in 2016 to Fidelity Management & Research Company ("**Fidelity**"), which stated that it would not recommend enforcement action where certain Fidelity entities used audit firms that were not compliant with the Loan Provision, subject to certain specified conditions, including that the audit firm determined that it is objective and impartial.

According to the Proposing Release, the proposed amendments to Rule 2-01 seek to address some of these practical challenges and implement a rule that "would effectively identify those debtor-creditor relationships that could impair an auditor's objectivity and impartiality," but exclude certain "extended relationships that are unlikely to present threats to objectivity or impartiality." The Proposing Release proposes the following amendments to the Loan Provision:

- Focus the analysis on beneficial ownership, without considering record ownership;
- Replace the existing 10% bright-line shareholder ownership test with a "significant influence" test;
- Add a "known through reasonably inquiry standard" to identification of beneficial owners of an audit client's equity securities; and
- Amend the definition of "audit client" for a fund under audit to exclude funds that would otherwise be considered affiliates of the audit client.

Under the proposed amendment, the Loan Provision would apply only to beneficial owners of an audit client's equity securities and not to those who serve as record holders on behalf of beneficial owners. According to the Proposing Release, limiting the scope of the Loan Provision in this fashion would better identify shareholders who have a "special and influential role with the issuer" and hence better capture debtor-creditor relationships that may actually impair an auditor's independence.

Next, the Proposing Release states that the proposed amendment would also replace the 10% shareholder ownership test with a "significant influence" test, applying a qualitative factor to "broadly capture influence over an audit client." According to the Proposing Release, the current 10% test may be "both over- and under-inclusive" in identifying debtor-creditor relationships that impair independence. Under the proposed amendment, an auditor would not be independent when the accounting firm, any covered person in the firm or any immediate family member has any loan to or from an audit client, or an audit client's officers, directors or beneficial owners (known through reasonable inquiry) of the audit client's equity securities "where such beneficial owner has significant influence over the audit client." The Proposing Release does not define "significant influence" but notes that it appears in other parts of Rule 2-01 and that the SEC intends to use the term consistent with the principles published by the Financial Accounting Standards Board in ASC Topic 323 ("**ASC 323**"), meaning relevant parties are already familiar with this concept. According to the Proposing Release, the "significant influence" test would focus on a lender shareholder's ability to exert significant influence over the operating and financial policies and management of an audit client, based on the facts and circumstances. The Proposing Release states that significant influence may be indicated in various ways, including: (i) representation on the board of directors; (ii) participation in policy-making processes; (iii) material intra-entity transactions; (iv) interchange of managerial personnel; or (v) technological dependency.

The Proposing Release notes that the analysis would still consider a lender's beneficial ownership level, but a bright-line percentage ownership would no longer be dispositive. According to the Proposing Release, the "significant influence" test would apply ASC 323's rebuttable presumption that a lender who beneficially owns at least 20% of an audit client's voting securities has significant influence over such audit client. The Proposing Release goes on to state that if a lender beneficially owns less than 20% of an audit client's voting securities, there would be a rebuttable presumption that the lender does not have significant influence over the audit client. The Proposing Release also describes a number of data points that would suggest that a shareholder owning 20% or more of an audit client's voting securities would nonetheless be unable to exercise "significant influence."

The Proposing Release notes that in the fund context, operating and financial policies relevant to the "significant influence" test include a fund's investment policies and day-to-day portfolio management processes, including selecting, purchasing, selling and valuing investments, as well as distributing income and capital gains (the "**Portfolio Management Processes**"). The Proposing Release states that the analysis may consider the nature of services provided by a fund's investment adviser under the terms of an advisory contract with the fund as part of the analysis. The Proposing Release also notes that the ability to vote on the approval of a fund's advisory contract or fundamental policies on a pro rata basis with other shareholders should not lead to the determination that a shareholder has significant influence. Conversely, if a shareholder in a private fund has a side letter agreement allowing for participation in Portfolio Management Processes, the shareholder "would likely have significant influence." The Proposing Release adds that the analysis to determine "significant influence" should be monitored on an ongoing basis.

In addition, the proposed amendment adds a "known through reasonable inquiry standard" with respect to the identification of beneficial owners in order to address concerns regarding the accessibility of information regarding beneficial ownership. The Proposing Release states that an "audit firm, in coordination with its audit client, would be required to analyze beneficial owners of the audit client's equity securities who are known through reasonable inquiry," as the SEC believes that if the auditor, after reasonable inquiry, does not know that one of its lenders is also a beneficial owner of its audit client's equity securities, such auditor's objectivity and impartiality are not likely to be impacted by the underlying debtor-creditor relationship. According to the Proposing Release, this standard is consistent with regulations under the Investment Company Act of 1940, the Securities Act of 1933, as amended (the "**Securities Act**"), and the Securities Exchange Act of 1934, as amended (the "**Exchange Act**").

Finally, the Proposing Release discusses the exclusion from the definition of "audit client" of any other funds that are considered an affiliate of the audit client for purposes of the Loan Provision. The Proposing Release states that in the fund context, the current "expansive" definition of "audit client" may result "in non-compliance with the Loan Provision as to a broad range of entities, even where an auditor does not audit that entity," due to each entity in an ICC being considered "affiliates of the audit client." The Proposing Release notes that investors in funds do not typically possess the ability to influence any of the policies or management of another fund in the ICC.

The Proposing Release requests interested parties to submit comments to the SEC on the proposed amendments.

- **See a copy of the Proposing Release**

Industry Update

SEC Enforcement Division Issues FAQs for Share Class Selection Disclosure

On May 1, 2018, the SEC Division of Enforcement (the "**Division**") issued answers to frequently asked questions (the "**FAQs**") on the Share Class Selection Disclosure Initiative (the "**SCSD Initiative**"), providing guidance about adviser eligibility, settlement terms and disgorgement.

The SCSD Initiative was announced on February 12, 2018 and offers investment advisers favorable standardized settlement terms for self-reporting violations concerning failure to disclose conflicts of interest associated with the receipt of 12b-1 fees by an investment adviser, its affiliates, or its supervised persons for "investing advisory clients in a 12b-1 fee paying share class when a lower-cost share class of the same mutual fund was available for the advisory clients." For further discussion of the SCSD Initiative, please see the March 15, 2018 Davis Polk Client Memorandum, **SEC Announces Self-Reporting Initiative for Rule 12b-1 Disclosures**.

The FAQs provide guidance on topics related to compliance with the SCSD Initiative, including:

Adviser Eligibility

- According to the FAQs, the standardized settlement terms set forth in the SCSD Initiative Announcement (the "**Announcement**") will apply only to the conduct identified in the Announcement and only to those advisers that (i) meet the definition of a "Self-Reporting Adviser," as defined in the Announcement, and (ii) have self-reported their conduct in the manner outlined in the Announcement;
- According to the FAQs, there is no minimum threshold for the proposed disgorgement amount that an adviser may self-report;
- According to the FAQs, advisers that have been or are currently being examined by the Office of Compliance Inspections and Examinations (the "**OCIE**") for issues covered by the SCSD Initiative, but who have not been contacted by the Division as of February 12, 2018 regarding those issues, are still eligible for the SCSD Initiative – regardless of the outcome of the exam – provided that the adviser self-reports in the prescribed manner. Further, the FAQs note that interactions an adviser has with OCIE do not constitute self-reporting;
- The FAQs clarify that if the Division contacted an adviser on or after February 12, 2018, the adviser remains eligible for the SCSD Initiative. If the Division contacted an adviser before

February 12, 2018, the adviser should contact the attorney handling the investigation to determine whether the adviser is eligible to participate in the SCSD Initiative;

- According to the FAQs, the SCSD Initiative applies to conduct by investment advisers with respect to advisory clients, regardless of the type of account in which an advisory client's mutual fund investment is held;
- According to the FAQs, an adviser is eligible to participate in the SCSD Initiative if it failed to disclose conflicts associated with either (i) "making investment decisions in light of the receipt of 12b-1 fees," or (ii) "selecting the more expensive 12b-1 fee paying share class when a lower-cost share class was available for the same fund," or if the adviser fails to disclose both conflicts;
- According to the FAQs, the definition of a Self-Reporting Adviser does not differentiate between types of funds;
- The FAQs provide a non-exhaustive list of scenarios where Division staff would likely determine that a lower-cost share class was available for the same fund, including:
    - The client could have purchased a lower-cost share class for the same fund, as the investment met the applicable investment minimum or the fund.
    - There was or is language in the fund prospectus stating that the fund will waive the investment minimum for a lower-cost share class for the same fund for advisory clients.
    - There was or is language in the fund prospectus stating that the fund may waive the investment minimum for a lower-cost share class for the same fund for advisory clients, and the adviser had no reasonable basis to believe the fund would not waive the minimum for its advisory clients. The FAQ notes that if an adviser assumes that a fund would not waive the minimum without taking steps to confirm, that would not constitute a reasonable basis.
    - The adviser purchased a lower-cost share class of the same fund for similarly-situated clients.
- According to the FAQs, an adviser must notify the Division of its intent to participate in the SCSD Initiative by June 12, 2018; however, the adviser need only provide its name and contact information at that time.

Settlement Terms

- According to the FAQs, the recommended settlement terms will not vary based on the "severity and scope" of an adviser's conduct.
- According to the FAQs, the requirements as to the timing of each distribution will be identified in the specific SEC order. The FAQs note that after the order is issued, a typical distribution requires a respondent to provide the staff, within 60 days of the entry of the order, with a calculation identifying how it plans to perform the distribution. Once the staff reviews the proposed calculation, firms generally have 90 days to distribute funds.
- According to the FAQs, in recommending a settlement to the SEC, the Division will consider the potential for "significant financial ramifications" to an adviser and its clients if the adviser is required to satisfy full monetary relief within a certain period of time. The FAQs note that if an adviser is concerned it will have "difficulty timely satisfying the monetary relief," the adviser "should identify such difficulty in its narrative provided as part of the Questionnaire, and be prepared to provide certain financial information to support its assertion."

- According to the FAQs, the settlement terms "require either an acknowledgement that the adviser has voluntarily taken certain steps (if the adviser completes these steps prior to the institution of the settled order) or will complete the necessary steps within 30 days of [the] institution of the order." The FAQs note that advisers may wish to consult with counsel regarding "potential collateral consequences" of entering into a proposed settlement.
- According to the FAQs, any settlement recommended to the SEC as part of the SCSD Initiative will require advisers to agree to a "willful" violation of the Investment Advisers Act of 1940 (the "**Advisers Act**").

Disgorgement

- The FAQs state that one of the standardized settlement terms of the SCSD Initiative includes "disgorgement by the investment adviser of its ill-gotten gain and prejudgment interest thereon."
- According to the FAQs, Division staff will determine an adviser's amount of disgorgement by reviewing the information provided in the Self-Reporting Adviser's questionnaire, which includes information regarding the 12b-1 fees the investment adviser received, either directly or indirectly, including the "amount of 12b-1 fees in excess of the lowest-cost share class available and the amount of ill-gotten gains the adviser proposes to disgorge."
  - The FAQs note that Division staff "anticipate having a dialogue with each [adviser] as to the appropriateness of the disgorgement amount included in the [Questionnaire]."
- The FAQs provide two examples to demonstrate when the Division may take into account that an adviser had reduced or offset its advisory fee by the amount of the 12b-1 fees. According to the FAQs, in a case where the adviser had an agreement with its client to charge an annual management fee of 1% and the adviser asserts that its management fee would have been 1.25% absent the receipt of 12b-1 fees, the Division does not anticipate recommending an offset to the disgorgement. However, the FAQs note that if the adviser applied a portion of the 12b-1 fees it received to reduce the annual management fee so that the client was charged a management fee of less than 1%, the Division may recommend an offset to the disgorgement. The FAQs state that the Division's recommendation will depend on the facts and circumstances.

► **See a copy of the FAQs**

SEC Launches Investor Protection Search Tool

On May 2, 2018, the SEC announced the launch of a new online search tool, designed to aid investors in researching whether a person trying to sell them investments has a judgment or order entered against them in an enforcement action. According to the press release announcing the launch (the "**Release**"), the SEC Action Lookup for Individuals ("**SALI**") was designed to aid retail investors in avoiding financial fraud.

According to the Release, SEC Chairman Jay Clayton hopes that SALI will not only aid investors in avoiding potentially fraudulent transactions, but also hopes that "Main Street Investors" will be able to act as an additional line of defense in detecting and preventing fraud. The Release notes that the search results offered by the tool not only include investment professionals, but also include individuals who have settled, defaulted on or contested enforcement actions brought by the SEC, provided that a final judgment or order was entered against them in a federal court or in an administrative proceeding. These results include individuals from SEC actions filed between October 1, 2014 and March 31, 2018, and will be updated periodically to include newly filed actions as well as earlier data.

The Release states that the SEC hopes that SALI will function as a supplement to existing investor education resources available on **http://www.investor.gov/**, which include a free investment professional search tool, alerts and bulletins, planning tools and frequently asked questions, prepared and provided by the Office of Investor Education and Advocacy.

- **Access the SEC Action Lookup for Individuals**

Dalia Blass Remarks at the 2018 PLI Investment Management Institute

On April 30, 2018, Dalia Blass, the Director of the Division of Investment Management of the SEC, addressed the 2018 PLI Investment Management Institute. Blass discussed the recently proposed standards of conduct for investment professionals and the previously proposed liquidity risk management rule.

Blass began by discussing the standards of conduct for investment professionals. She noted that the SEC recently proposed for public comment an updated set of standards relating to the standards of conduct for investment professionals. Blass discussed providing clarity to retail customers about investment professionals, including the requirement that firms take measures such as communicating to clients what kind of firm they are (i.e., a registered investment adviser, a registered broker-dealer, or both). According to Blass, the proposed changes would also restrict stand-alone broker-dealers and their financial professionals from holding themselves out as “advisers” or “advisors,” given that potential investors may confuse these terms with “investment advisers.” Additionally, firms would now be required to provide investors with a short-form summary disclosure to educate potential investors on the type of firm they are engaging with, the services offered, legal standards of conduct applicable to that entity and the potential conflicts of interests that may exist. Blass indicated that discussion surrounding the proposal has already begun, and she invited the public, including retail investors themselves, to provide its thoughts on the proposed rules.

Another aspect of the proposed regulation is called Regulation Best Interest. According to Blass, this regulation would create a duty under the Exchange Act for broker-dealers to act in the best interests of their retail customers. Blass discussed the reason for not defining “best interest” in the proposal, noting that despite this, the “contours of the obligation” have been defined, and include a broker-dealer not putting its interests ahead of the retail customer’s, as well as requiring the broker-dealer to comply with disclosure, care and conflict of interest obligations. In discussing how this approach differs from the suitability standards for broker-dealers in FINRA rules, Blass states that this approach “goes beyond suitability,” with respect to the aforementioned disclosure, care and conflict obligations. Additionally, in discussing the difference between the requirement for both broker-dealers and investment advisers to act in the best interest of a retail customer, Blass notes that the broker-dealer’s obligation is tied to the recommendation given, while the investment adviser’s obligation applies to the ongoing relationship with the client.

Additionally, Blass discussed another aspect of the proposed regulation, whereby the SEC would reaffirm and, in some cases, clarify the SEC’s views on the investment adviser fiduciary duty standards. Blass notes that this proposal is intended to reaffirm that investment advisers must act in the best interests of their clients and that they owe a duty of care and a duty of loyalty to their clients. According to Blass, this means that an investment adviser may not favor its own interests over those of a client, and it cannot unfairly favor one client over another. The proposal also goes on to require investment advisers to avoid conflicts of interest with their clients, or at a minimum, require disclosure of such conflicts. Blass notes that the intent of this particular proposal was to “draw together a range of sources and provide advisers with a reference point for understanding their obligations to clients.”

Blass added that the SEC is seeking investor feedback on all of the above proposals.

Next, Blass discussed liquidity risk management and the steps the SEC has taken to facilitate managing liquidity of fund portfolios. In 2016, the SEC adopted a rule that (i) required funds to adopt liquidity risk management programs, (ii) updated and enhanced existing guidance regarding the 15% limitation on illiquid investments for mutual funds, and (iii) introduced a new requirement for each fund to classify the liquidity of each investment into different “buckets.” Blass noted that the rule also strengthened liquidity risk reporting to the SEC. Since adopting the rule, the SEC has solicited feedback from funds and investors regarding the proposed implementation and certain unintended consequences related to the rule’s adoption. In response to this feedback, the SEC has released frequently asked questions, extended the compliance date for certain elements of the rule by six months and modified certain of the classification and reporting requirements.

Overall, Blass continued to solicit feedback from both investors and firms, and highlighted the SEC’s work to help improve clarity and efficiency in a market that heavily involves retail investors. She noted that she is also working on a variety of other proposals including, for example, in the exchange-traded fund space, as well as in the design, delivery and content of disclosures to fund shareholders.

- **See a transcript of the speech**

Jay Clayton: The Evolving Market for Retail Investment Services and Forward-Looking Regulation – Adding Clarity and Investor Protection While Ensuring Access and Choice

On May 2, 2018, SEC Chairman Jay Clayton provided remarks to Temple University, outlining the importance of the relationship between investment professionals and their retail customers and clients.

Clayton began by emphasizing the importance of facilitating long-term, broad retail participation in capital markets through effective and pragmatic regulation. He discussed the importance of preserving and protecting our capital markets, as well as noting that individuals are largely responsible for funding their own higher education and retirements. Clayton noted that although it is more important than ever for people to save for their futures – given prolonged life expectancy and increased health care and living costs – over half of Americans do not have retirement account savings. Clayton then began to underscore the critical importance of access to personal investment advice. He next noted that this access can help less experienced and informed investors, by bridging the “knowledge, information, and comfort gap” that exists today.

In describing how he frames the SEC’s job in regulating the capital markets for the benefit of retail investors, Clayton outlined three objectives:

- ensure investors can get clear, plain-language answers from investment advisers and broker dealers;
- require that investment professionals follow standards of conduct that embody key fiduciary principals tailored to the client relationship; and
- have effective enforcement tools if investment professionals do not follow the standards of conduct or provide false or misleading information.

Clayton further indicated that these goals should be accomplished while also aligning investor expectations with legal standards and ensuring a variety of investment advice services at reasonable cost to “Main Street” investors. He further stated that he had tasked the SEC staff to review the status of the market for retail investors with this framework in mind.

Next, Clayton discussed three key issues with respect to the provision of investment advice to retail investors:

- *Confusion and Lack of Clarity*. Clayton acknowledged that there are a number of different titles that firms use to advertise their advisory services, including “financial advisor,” “financial consultant” and “wealth manager.” However, Clayton stressed that from the SEC’s perspective, the federal securities laws recognize and the SEC regulates two different legal entities: investment advisers and brokers-dealers. He discussed key differences between the two, including, for example, that investment advisers typically charge an ongoing management fee (usually a percentage of the assets that are being managed), while broker-dealers generally charge a commission that is associated with each transaction. Clayton noted that this legal distinction has real-world consequences for retail investors in terms of both fees paid to the investment professional and services received. Clayton underscored that many investors are not aware of whether they are dealing with an investment adviser or a broker-dealer, especially in situations where a firm is dually licensed. Thus, Clayton stated that investors may end up signing up for a relationship or account type that does not match their expectations and can be more costly.

- *Professional Obligations, Conflict Disclosures and Mitigation, and Other Investor Protection Requirements*. Clayton highlighted the need to clarify and bring the legal obligations owed by investment professionals in line with what a reasonable investor would expect. Clayton discussed the different legal standards that are applicable to investment advisers and broker-dealers and how those standards diverge from what retail customers would reasonably expect. He noted that generally, investment advisers owe a duty of care and a duty of loyalty, which includes a duty to fully and fairly disclose material conflicts of interest and obtain retail customers' informed consent. He added that broker-dealers are generally required to make recommendations that are "suitable" for their customers, which requires the broker-dealer to understand the product, determine that the product is suitable for the client and not excessively trade in the client's account. Clayton noted that under this requirement, a broker-dealer can recommend a security to a client that may be "suitable," but that makes the broker-dealer more money, as compared to a different security that may be a better fit for an investor's investment needs. He also stated that it is important to note that neither investment advisers nor broker-dealers are required to give "conflict-free advice." He suggested amending current regulations to require both investment advisers and broker-dealers to disclose conflicts of interest in plain language and in reasonable detail so that a retail client can understand the financial incentives of his or her investment professional.
- *Multiple Regulators, Lack of Regulatory Consistency and Coordination*. Clayton next listed examples of numerous regulatory bodies that may regulate a retail investor's relationship with his or her investment professional, including the SEC, FINRA, the Department of Labor, state insurance regulators, state securities regulators, state attorneys general and federal and/or state banking regulators. Clayton emphasized that inconsistent and uncoordinated regulation imposes compliance costs on investment professionals, which are then passed on to the consumer. Clayton stated that "it is incumbent on . . . regulators to work together to ensure a seamless relationship from the perspective of the customer."

Clayton then identified a two-pronged solution to the aforementioned issues: eliminate the gaps between investor expectations and understandings on the one hand, and the market and legal realities on the other hand. He noted the balance that must be struck between correcting the issues without adversely affecting the market or eliminating access to a "broad range of high quality, low cost investment advice." Clayton proposed to address these objectives through a variety of regulatory tools:

- *Disclosure Mandate*. Clayton discussed a proposed disclosure mandate that would require investment advisers and broker-dealers to disclose the key aspects of their relationship to the client in a form that is "clear, short, and complete." This mandate would require investment professionals to be transparent about a number of data points, including the type of professional that they are, the services provided, fees charged and conflicts of interest they may have. Clayton also discussed steps that investors can take to protect themselves, including by checking to confirm if an investment professional is registered, and whether they have any disciplinary history.
- *Conduct Mandate*. Clayton discussed a proposed rule to heighten the broker-dealer standards of conduct by requiring that broker-dealers act in a retail investor's best interest. Under this proposed rule, Clayton stated that a broker-dealer must (1) disclose material facts

about the relationship, including conflicts of interests, types of services provided, and fees charged; (2) exercise "reasonable diligence, care, skill, and prudence to make recommendations that are in the best interests of the retail customer"; and (3) eliminate, or disclose and mitigate, "conflict of interests related to financial incentives." Clayton further noted that the obligations of investment advisers have also been addressed by proposing an interpretation to "address in one release and reaffirm and, in some cases, clarify" certain specific aspects of the fiduciary duty owed to a client by their financial adviser.

Clayton noted that the SEC is looking to "harmonize" the conduct standard applicable to broker-dealers by applying "consistent, fiduciary principles across the spectrum of investment advice." He added that, while investment advisers are already required to act in the investor's best interest, broker-dealers will now be as well. He noted that certain underlying obligations may differ, as the relationships with these professionals differ. Finally, he added that he believes the approach taken by the SEC "puts us in a good position to work with our fellow … regulators to seek consistency and cohesion across the entire spectrum of investment professionals and products…" Clayton concluded his speech by underscoring the importance of input from the public.

- **See a transcript of the speech**

Litigation

SEC Charges Investment Adviser for Failing to Disclose Revenue-Sharing Arrangement with Service Provider to Portfolio Companies

On April 24, 2018, the SEC issued an order (the "**WCAS Order**") instituting and settling administrative and cease-and-desist proceedings against WCAS Management Corporation ("**WCAS**"), a New York-based investment adviser, for failing to disclose to its private equity clients conflicts of interest surrounding its receipt of a percentage of the revenues from certain services provided to portfolio companies of its managed funds.

According to the WCAS Order, WCAS entered into an agreement with a group purchasing organization (the "GPO"), which is a company that aggregates companies' spending to obtain volume discounts from participating vendors. The SEC alleged that, under this agreement, the GPO paid WCAS compensation based on a share of the fees that the GPO received from vendors as a result of the WCAS portfolio companies' purchases through the GPO. Further, the SEC alleged that, while negotiating this agreement, the GPO suggested it would enter into the agreement if one of WCAS's portfolio companies signed a separate agreement to purchase services from the GPO's affiliate. According to the WCAS Order, from September 2012 through December 2016, WCAS received $623,035 pursuant to its agreement with the GPO. The SEC alleged that WCAS failed to disclose its receipt of fees from the GPO in fund organizational documents and failed to disclose to fund investors that it had an incentive to recommend the GPO's services to portfolio companies and to encourage a portfolio company to enter into an agreement with the GPO's affiliate, because WCAS stood to receive a share of revenue generated for the GPO.

As a result of the conduct described above, the SEC alleged that WCAS willfully violated Section 206(2) of the Advisers Act, which prohibits investment advisers from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The SEC further alleged that WCAS willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which make it unlawful for any investment adviser to a pooled investment vehicle to "[m]ake any untrue statement of material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle" or "engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle."

Without admitting or denying the findings, WCAS consented to entry of the cease-and-desist order and a censure, and agreed to pay disgorgement of $623,035, prejudgment interest of $65,784, and a civil monetary penalty of $90,000.

The WCAS Order is only the latest in a number of enforcement settlements arising out of actual or potential conflicts of interest created when an investment adviser receives a financial incentive (including a discount on services to the adviser) from a service provider to its advised funds' portfolio companies.

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

SEC Charges Investment Adviser for Fraudulent Valuations and Insider Trading

On May 8, 2018, the SEC issued an order (the "**Visium Order**") instituting and settling administrative and cease-and-desist proceedings against Visium Asset Management, LP ("**Visium**") for (1) engaging in a scheme to inflate asset values, and (2) benefiting from insider trading by two of its portfolio managers.

Inflated Valuations

According to the Visium Order, from at least July 2011 through December 2012, two Visium portfolio managers falsely inflated the value of assets held by one of Visium's advised funds, which resulted in inflated performance and management fees. The SEC alleged that the Visium portfolio managers would contact one or more of three "friendly" brokers, and ask the brokers to provide a sham quote for certain securities. The Visium portfolio managers would then solicit a quote, receive the prearranged price as the broker's own quote (so-called "U-turn" quotes), and then provide the sham quote to Visium's accounting department as a legitimate quote to be used to value the relevant securities.

The Visium Order states that the inflated quotes caused the advised fund's month-end net asset value to be routinely overstated. As a result of this overstatement, Visium obtained an additional $2,622,709 in performance fees, and $533,700 in management fees. In addition to rendering Visium's disclosed performance and assets under management to be false and misleading, the mismarking scheme demonstrated that Visium did not follow its disclosed valuation methodology. The Visium Order charged Visium with failing to follow its disclosed procedures by:

- not seeking to establish the "fair value" of the advised fund's holdings;
- failing to base its valuation methodology on GAAP;
- failing to determine value independently of the trading and portfolio management functions;
- failing to rely on "established pricing sources" for asset pricing;
- permitting the portfolio managers to "override" prices determined from third-party sources and to replace these prices with "U-turn" quotes; and
- failing to document the findings of Visium's valuation committee concerning the pricing overrides.

Insider Trading

The Visium Order also charges Visium with trading on inside information obtained from industry consultants. According to the order, one Visium portfolio manager retained an industry consultant, and knew that the consultant deceptively obtained inside information from a friend and colleague. Another Visium portfolio manager retained a consultant who provided Visium with confidential government information regarding Medicare reimbursement rates. The Visium Order states that the two portfolio managers knowingly traded on this information, and that Visium obtained nearly $1.6 million in performance fees based on the insider trades. Visium also failed to enforce its written compliance policies aimed at preventing insider trading, including policies that required portfolio managers to alert Visium's Chief Compliance Officer if they obtained material, non-public information.

The Visium Order charged Visium with violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Sections 204A, 206(1), 206(2), 206(4), and 207 of the Advisers Act. Visium agreed to pay disgorgement of $4,755,223, prejudgment interest of $720,71, and a civil monetary penalty of $4,755,223. Visium also undertook to withdraw its registration as an investment adviser. One of the portfolio managers involved in the scheme was convicted of securities fraud in January 2017 and sentenced in June 2017 to 18 months imprisonment and to pay a $1 million fine.

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

SEC Sues Investment Adviser, CEO, Portfolio Manager, and Trader for Scheme to Inflate Asset Values; U.S. Attorneys' Office Pursues Criminal Charges

On May 9, 2018, the SEC filed a complaint in the U.S. District Court for the Southern District of New York against Premium Point Investments, LP ("**Premium Point**"), a registered investment adviser, Premium Point's CEO, Anilesh Ahuja ("**Ahuja**"), Amin Majid ("**Majid**") the portfolio manager of one of Premium Point's managed funds, and Jeremy Shor ("**Shor**"), a Premium Point trader, for engaging in a scheme to inflate the value of assets held by Premium Point funds.

The SEC alleges that Ahuja and Majid sought to hide poor performance of Premium Point funds by pressuring Shor and another Premium Point trader into falsely inflating the prices of securities held by Premium Point's funds.

According to the complaint, Premium Point disclosed to investors that the holdings of its managed funds would be valued in accordance with GAAP, using third-party pricing sources such as dealers and pricing vendors. Premium Point allegedly generally followed this policy until mid-2015, when Premium Point began suffering from poor performance. Ahuja and Majid allegedly created "performance targets" for preceding months, and pressured Premium Point traders to meet these targets through several fraudulent valuation practices.

First, Premium Point allegedly asked "friendly" brokers to obtain specific marks on bonds held by the Premium Point funds to falsely inflate the value of the bonds. The traders used the "performance targets" set by Ahuja and Majid to determine the prices that they would request the brokers provide. Email and text messages among the employees of the broker and Premium Point showed that Premium Point understood they could "mark the bonds anywhere," that this practice was "very wrong . . . obviously" and that the brokers giving the false marks expected that Premium Point would direct trades to the broker to allow it to earn commissions.

Second, Premium Point allegedly inflated securities prices by "imputing" a midpoint price based on bid-side prices for certain securities. Premium Point would impute the midpoint price from the bid price by obtaining a generic bid/ask spread for bond sectors, and then adding half of the spread to the bid price for the relevant security. Premium Point would also obtain an inflated bid price from a friendly broker, then further inflate this price by adding one-half of the bid/ask spread for the relevant class of assets.

The SEC alleges that these valuation schemes dramatically inflated the net asset value of Premium Point's managed funds, and that Premium Point did not disclose to investors that it was determining prices based on imputed midpoints. Premium Point also used the inflated net asset values in its disclosures to investors and advertising materials in an attempt to raise a new fund. According to the complaint, the scheme collapsed in April 2016 when the auditor of the Premium Point funds became concerned that Premium Point had significantly overstated the funds' valuations.

Based on these allegations, the complaint asserts claims under Section 10(b) of the Exchange Act, Section 17(a) of the Securities Act, and Sections 206(1), 206(2), 206(4), 206(4)-2, and 206(4)-8 of the

Advisers Act. The SEC seeks various forms of equitable relief, disgorgement, and civil monetary penalties.

Each of Ahuja, Majid, and Shor have also been indicted on charges of conspiracy to commit securities fraud, conspiracy to commit wire fraud, securities fraud, and wire fraud based on the alleged scheme.

- **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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