# Investment Management Regulatory Update

July 31, 2018

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## Rules and Regulations

### SEC Proposes New ETF Rule

In a June 28, 2018 release (the "**Proposing Release**"), the Securities and Exchange Commission ("**SEC**") proposed new Rule 6c-11 (the "**Proposed Rule**") and form amendments to standardize and modernize the regulatory framework for most exchange-traded funds ("**ETFs**"). According to the Proposing Release, the SEC has issued over 300 exemptive orders allowing ETFs to operate under the Investment Company Act of 1940 (the "**Investment Company Act**") since 1992, and in that time the ETF market has grown significantly and now represents nearly 15% of net assets managed by investment companies. Under the Proposed Rule, ETFs that satisfy its conditions would be able to come directly to market without first obtaining an exemptive order under the Investment Company Act. The Proposed Rule is intended to "create a consistent, transparent, and efficient regulatory framework" for ETFs that "facilitate[s] greater competition and innovation among ETFs." Currently, for example, only certain sponsors operating under older exemptive orders can pick and choose which shares to accept from, or sell to, authorized participants during the creation and redemption process (i.e., use "custom baskets"). Most recent exemptive orders generally only allow funds to accept from, or sell to, authorized participants, a pro rata slice of the ETF's portfolio. The Proposed Rule would create a level playing field and allow all sponsors to use custom baskets.

**Scope of Proposed Rule**

According to the Proposing Release, the Proposed Rule would define an ETF as a "registered open-end management investment company that: (i) issues and redeems creation units to and from authorized participants in exchange for a basket and cash balancing amount (if any), and (ii) issues shares that are listed on a national securities exchange and traded at market-determined prices." The Proposing Release notes that an ETF that is delisted or suspended from its listing exchange would no longer be eligible to rely on the Proposed Rule. The Proposed Rule would be available only to ETFs organized as open-end funds, which constitute the vast majority of today's ETFs.

The Proposing Release states that ETFs that are (i) organized as unit investment trusts ("**UIT ETFs**"); (ii) structured as a share class of a multi-class fund; or (iii) leveraged ETFs (i.e., ETFs that seek directly or indirectly to provide returns at a multiple of a specific index over a fixed period of time, or, which seek to provide returns that "have an inverse relationship to the performance of a specific index over a fixed period of time") would not be able to rely on the Proposed Rule. The Proposing Release notes that because the "unique features" of these types of ETFs raise different considerations, the SEC believes "it is appropriate for ETFs that seek to utilize these structures to continue to request relief from the [SEC] through [the] exemptive application process, and for the [SEC] to continue to make facts-and-circumstances-based determinations regarding whether such relief is appropriate for any particular applicant."

The Proposed Rule would be available to both index-based and actively managed ETFs.

The Proposed Rule, however, would not include the Section 12(d)(1) relief provided by the typical ETF exemptive order. Instead, ETFs without existing relief from Section 12(d)(1) of the Investment Company Act would still be required to obtain an exemptive order to receive the benefits of that Section 12(d)(1) relief, which generally allows other registered investment companies to invest in the ETF beyond the limits imposed by Section 12(d)(1). The Proposing Release notes that the SEC is not "addressing this relief at this time," though it will not be rescinding exemptive relief related to Section 12(d)(1) that has been previously granted (other than as noted below with respect to master-feeder structures).

**Elimination of the Distinction between Index-Based and Actively Managed ETFs**

According to the Proposing Release, the Proposed Rule would not distinguish between index-based and actively managed ETFs, because the SEC believes that index-based and actively managed ETFs that comply with the Proposed Rule's conditions "function similarly with respect to operational matters, despite different investment objectives or strategies, and do not present significantly different considerations under the provisions of the [Investment Company] Act from which the [P]roposed [R]ule grants relief." The Proposing Release notes that eliminating the regulatory distinction between index-based and actively managed ETFs would provide a more "consistent and transparent regulatory framework" for ETFs organized as open-end funds and would be consistent with the way other types of open-end funds are regulated.

**Exemptive Relief under the Proposed Rule**

The Proposed Rule would provide ETFs within its scope with exemptions from certain provisions of the Investment Company Act, which exemptions are "generally consistent with the relief [the SEC has] given to ETFs under [its] exemptive orders." As discussed below, the Proposed Rule would allow ETFs that satisfy its conditions to: (i) redeem shares only in creation unit aggregations; (ii) permit ETF shares to be purchased and sold at market prices rather than at net asset value ("**NAV**") per share; (iii) engage in in-kind transactions with certain affiliates; and (iv) in limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days.

- Treatment of ETF Shares as Redeemable Securities – According to the Proposing Release, under the Proposed Rule, an ETF would be considered to issue a "redeemable security" within the meaning of Section 2(a)(32) of the Investment Company Act and any ETF operating in compliance with the Proposed Rule would meet the definition of an open-end company. ETFs relying on the Proposed Rule would be subject to the Investment Company Act requirements and SEC rules that apply to all open-end funds. The Proposing Release notes that only authorized participants may redeem ETF shares and only when shares are aggregated into creation units, except in limited circumstances. As exceptions, according to the Proposing Release, the Proposed Rule would allow an ETF to sell or redeem individual shares on the day of consummation of a merger, reorganization, conversion or liquidation. The Proposing Release also states that creations may be suspended "only for a limited time and only due to extraordinary circumstances, such as when the markets on which the ETF's portfolio holdings are traded are closed for a limited period of time," and that "an ETF could not set transaction fees so high as to effectively suspend the issuance of creation units."
- Trading of ETF Shares at Market Determined Prices – According to the Proposing Release, under the Proposed Rule, a dealer in ETF shares would be exempt from Section 22(d) of the Investment Company Act, which prohibits investment companies, their principal underwriters and dealers from selling a redeemable security to the public except at a current public offering price described in the prospectus, and from Rule 22c-1, which requires that a dealer selling, redeeming or repurchasing a redeemable security do so only at a price based on its NAV. The Proposing Release notes that Section 22(d) of the Investment Company Act and Rule 22c-1 thereunder were designed to, among other things, "prevent dilution caused by certain riskless trading practices among investors purchasing and redeeming fund shares . . . [and] prevent unjust discrimination or preferential treatment among investors purchasing and redeeming fund shares." Consistent with existing exemptive orders, the Proposed Rule would exempt a covered ETF from these provisions with regard to purchases, sales and repurchases of ETF shares at market-determined prices. The Proposing Release states that the concerns noted above are addressed by the Proposed Rule along with a properly functioning arbitrage mechanism.
- Affiliated Transactions – Section 17(a) of the Investment Company Act prohibits "an affiliated person of a registered investment company, or an affiliated person of such person, from selling any security or other property to or purchasing any security from the company." According to the Proposing Release, under the Proposed Rule, affiliates of an ETF would be exempt from Sections 17(a)(1) and (a)(2) of the Investment Company Act and would be allowed to enter into in-kind creation and redemption transactions with an ETF if they are affiliated with the ETF solely because the affiliate or its affiliates hold the power to vote 5% or more of the shares of the ETF or any investment company affiliate of the ETF. The Proposing Release notes that this relief is necessary, otherwise "an authorized participant . . . that becomes an affiliated person of the ETF due to its holdings would be prevented from engaging in arbitrage using an in-kind basket."
- Additional Time for Delivering Redemption Proceeds – According to the Proposing Release, the Proposed Rule would provide an exemption from Section 22(e) of the Investment Company Act to permit an ETF to delay satisfaction of a redemption request for more than seven days if "a local market holiday, or series of consecutive holidays, the extended delivery cycles for transferring foreign investments to redeeming authorized participants, or the combination thereof prevents, timely delivery of the foreign investment included in the ETF's basket." The ETF would be required to deliver foreign investments as soon as practicable, but no later than 15 days after the tender to the ETF. The Proposing Release notes that the exemption from Section 22(e) of the Investment Company Act would expire ten years from the effective date of the Proposed Rule unless the SEC takes action before then. According

to the Proposing Release, the SEC has included this sunset provision in light of the "continued movement toward shorter settlement times in markets around the world."

**Conditions for Reliance on the Proposed Rule**

The Proposed Rule's conditions include, among others:

- Portfolio Transparency – According to the Proposing Release, under the Proposed Rule, an ETF would be required to disclose prominently on its publicly available website the portfolio holdings that will form the basis for each calculation of NAV per share. The Proposing Release states that the term "portfolio holdings" means "an ETF's securities, assets, or other positions," meaning that an ETF would be required to disclose its cash holdings, "as well as holdings that are not securities or assets, including short positions or written options." This disclosure must be posted each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting creation and redemption orders. The Proposed Rule would require the basis for the ETF's NAV calculation to be the ETF's portfolio holdings as of close of business on the prior business day, meaning that "[c]hanges in an ETF's holdings of portfolio securities would therefore be reflected on a T+1 basis." However, the Proposed Rule would not require the disclosure of intraday changes in an ETF's portfolio holdings or the advance disclosure of portfolio trades because such changes "would not affect the composition of the ETF's portfolio that serves as the basis for NAV calculation until the next business day." The Proposed Rule would also require that this information be presented in the manner prescribed within Article 12 of Regulation S-X. The Proposing Release further states that "a fund or investment adviser that discloses the fund's portfolio securities may only do so consistent with the antifraud provisions of the federal securities laws and the adviser's fiduciary duties."
- Baskets Policies and Procedures – According to the Proposing Release, the Proposed Rule would require each ETF relying on the Proposed Rule to adopt and implement written policies and procedures that would form part of the ETF's Rule 38a-1 compliance program, and that would govern the construction of baskets and the process used for accepting baskets. The Proposing Release also notes that the policies and procedures should detail when and how the ETF would use representative samplings of its portfolio to create its basket, as well as how the ETF would replicate changes in its portfolio holdings as a result of rebalancing or reconstitution of the ETF's securities market index (if applicable).
- Custom Baskets Policies and Procedures – According to the Proposing Release, the Proposed Rule would allow ETFs "the flexibility to use baskets that differ from a pro rata representation of the ETF's portfolio if certain conditions are met." The Proposed Rule contemplates two types of custom baskets: (i) baskets that are not pro rata representations of the fund's portfolio (which includes baskets that do not reflect "a representative sampling of the ETF's portfolio holdings" or "changes due to a rebalancing or reconstitution of the ETF's securities market index, if applicable"); and (ii) baskets that differ from other baskets used in transactions on the same business day. Under the Proposed Rule, an ETF using custom baskets would be required to adopt written policies and procedures: (i) detailing the "parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders" and (ii) specifying the roles or titles of employees of the ETF's investment adviser who are tasked with reviewing the custom baskets for compliance with those parameters. According to the Proposing Release, these policies and procedures should detail the methodology that the ETF uses to construct baskets, including, for example, "the circumstances when the basket may omit positions that are not operationally feasible to transfer in kind." The Proposing Release also notes that the policies and procedures should also describe the ETF's "approach for testing compliance with the

custom basket policies and procedures," which should also include determining whether the parameters continue to provide custom baskets that are "in the best interest of the ETF and its shareholders." The Proposing Release further states that these "heightened process requirements" for ETFs using custom baskets are intended to protect against the "increased risk that the ETF may be subject to improper pressure by an authorized participant to create specific baskets that favor that authorized participant." Additionally, the Proposing Release notes that "the ETF's board of directors' oversight of the ETF's compliance policies and procedures, as well as their general oversight of the ETF, would provide an additional layer of protection for an ETF's use of custom baskets."

- Intraday Indicative Value – According to the Proposing Release, the Proposed Rule would not require ETFs to disseminate an intraday indicative value, as required by certain exchange listing standards, in part because "market makers today typically calculate their own intraday value of an ETF's portfolio with proprietary algorithms that use an ETF's daily portfolio disclosure and available pricing information about the assets held in the ETF's portfolio." Additionally, the Proposing Release states that since the Proposed Rule includes a daily disclosure of portfolio holdings requirement, "this disclosure would promote the availability of information to market participants to support their ability to calculate an estimated intraday value of the ETF's portfolio holdings using their own methodologies."

- Website Disclosure – According to the Proposing Release, an ETF would be required to disclose certain information on its website, including the portfolio holdings information discussed above as well as information regarding a published basket "applicable to orders for the purchase or redemption of creation units" to be posted at the beginning of each business day. The Proposing Release notes that the published basket information should also include "one basket that it would exchange for orders to purchase or redeem creation units to be priced based on the ETF's next calculation of NAV per share each business day," as well as the estimated cash balancing amount, if any. In addition, the Proposed Rule would require disclosure of: (i) the ETF's NAV per share, market price (defined to mean (a) "the official closing price of an ETF share; or (b) if it more accurately reflects the market value of an ETF share at the time as of which the ETF calculates current NAV per share, the price that is the midpoint of the national best bid and national best offer, calculated as of the time NAV per share is calculated") and premium or discount, each as of the end of the prior business day; (ii) historical information regarding the median bid-ask spreads over the most recent fiscal year; and (iii) historical information about the extent and frequency, in a table and line graph, describing the ETF's premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year. According to the Proposing Release, under the Proposed Rule, if an ETF's premium or discount is greater than 2% for more than seven consecutive trading days, such ETF would also be required to post such information on its website, and disclose the "factors that are reasonably believed to have materially contributed to the premium or discount." This information must be posted on the "trading day immediately following the eighth trading day on which the ETF had a premium or discount greater than 2%," and must remain on the ETF's website for one year after its initial posting. According to the Proposing Release, these requirements are "designed to provide investors with key metrics to evaluate their investment and trading decisions in a format that is easily accessible and frequently updated."

- Recordkeeping – According to the Proposing Release, under the Proposed Rule, an ETF would be required to comply with certain recordkeeping requirements, including to preserve and maintain copies of all written authorized participant agreements. For each basket exchanged with an authorized participant, an ETF would be required to maintain a record including: (i) the names and quantities of positions comprising the basket; (ii) identification of the basket as a custom basket and stating that the custom basket complies with the ETF's

custom basket policies and procedures (if applicable); (iii) the cash balancing amount (if any); and (iv) the identity of the authorized participant. Under the Proposed Rule, an ETF would be required to maintain such records for at least five years, and do so in an easily accessible place for the first two years. The Proposing Release notes that these records "would allow our examination staff to evaluate whether the use of custom baskets is appropriate."

**Rescission of Certain ETF Exemptive Relief**

According to the Proposing Release, the Proposed Rule would rescind exemptive relief previously granted to ETFs eligible to rely on the Proposed Rule, as well as exemptive relief that currently permits ETFs to operate in a master-feeder structure (as the Proposing Release notes that few ETFs utilize this structure). The Proposed Rule would grandfather existing master-feeder arrangements involving ETF feeder funds, but prevent the formation of new ones. In order to "provide time for ETFs to transition" to the requirements of the Proposed Rule, rescission of existing orders would be effective one year from the effective date of the Proposed Rule. According to the Proposing Release, the SEC believes that rescinding exemptive relief in connection with the Proposed Rule would "result in a more transparent framework for covered ETFs, as those ETFs would no longer be subject to differing and sometimes inconsistent provisions of their exemptive relief." The Proposing Release would not rescind exemptive relief that permits ETF fund of funds arrangements, and would not rescind relief from Section 12(d)(1) of the Investment Company Act, which "generally limits the ability of registered investment companies (including ETFs) to acquire securities issued by other investment companies in excess of certain thresholds, and the ability of registered open-end investment companies (including ETFs) from knowingly selling securities to other investment companies in excess of certain thresholds."

**Proposed Form Amendments**

The Proposing Release notes that several amendments to Form N-1A, the registration form used by open-end funds to register under the Investment Company Act and to offer securities under the Securities Act of 1933 (the "**Securities Act**"), are also being proposed to "provide ETF investors who purchase ETF shares in secondary market transactions with additional information regarding ETFs," including with respect to costs borne by ETF investors that are not applicable to mutual fund investors (e.g., trading costs borne by investors when trading ETF shares). The amendments include, among others, changes to Item 3 of Form N-1A, that would require additional fee and expense disclosures in a Q&A format. The changes to Item 3 are proposed to "clarify that there are certain fees that are not reflected in the fee table for both mutual funds and ETFs." According to the Proposing Release, the following language would need to be added to the current disclosure for Item 3 of Form N-1A for all registrants: "You may pay other fees not described below, such as brokerage commissions and other fees to financial intermediaries, which are not reflected in the tables and examples below." Additionally, the Proposing Release notes that the newly proposed Q&A portion (only applicable to ETFs) will include information regarding costs associated with trading shares of an ETF, including information on the bid-ask spread and how that will impact investment returns. The proposed amendments to Form N-1A also include the requirement that an interactive calculator be made available on the ETF's website, which investors could use to "determine how the bid-ask spread would impact your specific investment." The Proposing Release also states that the SEC is proposing to rescind the portion of Item 6 that requires an ETF to disclose the number of shares it will issue or redeem in exchange for the deposit or delivery of baskets, as well as certain other portions of Form N-1A that are now deemed duplicative of information required elsewhere.

In addition, the Proposed Rule would amend Form N-8B-2, the registration form used by UIT ETFs to register under the Investment Company Act, requiring disclosures that mirror the proposed disclosure changes in Form N-1A, in order to ensure that investors "receive consistent disclosures for ETF investments, regardless of the ETF's form of organization."

The Proposed Rule would also amend Form N-CEN to, among other things, add a requirement that ETFs report if they are relying on the Proposed Rule.

In addition to the proposed form amendments, the Proposing Release seeks comment on whether the SEC should create a new registration form specifically designed for ETFs or should consider other disclosure formats in a future rulemaking.

**Comparison of Current Proposed Rule and 2008 ETF Proposal**

The SEC had first proposed a version of Rule 6c-11 in 2008, "which was designed to codify the exemptive relief that had been issued to ETFs at that time." The original proposed rule, however, was never adopted. The following table compares the main elements of the current Proposed Rule and the SEC's 2008 proposal. According to the Proposing Release, comments received in response to the 2008 proposal, subsequent developments in the ETF market and interim SEC actions have informed the current Proposed Rule.

| Description of Provision | Current Proposed Rule | 2008 Proposal |
|---|---|---|
| **UITs** | Not included in automatic exemptive relief. | Not included in automatic exemptive relief. |
| **Actively Managed ETFs** | Included in automatic exemptive relief. | Included in automatic exemptive relief. |
| **Index ETFs** | Included in automatic exemptive relief. | Included in automatic exemptive relief. |
| **Leveraged ETFs** | Explicitly excluded from automatic exemptive relief. | Not discussed. |
| **Custom baskets** | Permits ETFs to construct baskets using cash, securities or other positions, provided that ETF satisfies certain specified conditions. | Not expressly contemplated, but allowed cash to be substituted for some or all of the basket securities in certain circumstances. |
| **Automatic Section 12(d)(1) relief** | Not included. | Included Proposed Rule 12d1-4, which "would provide an exemption to permit acquiring funds to invest in ETFs in excess of the limits of section 12(d)(1)," subject to certain specified conditions. |

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| **Portfolio transparency requirements** | Full portfolio transparency required for all ETFs. | Required actively managed ETFs to disclose identities and weightings of component securities and other assets held by the ETF on its website each business day (i.e., full portfolio transparency); required index-based ETFs to have a stated investment objective of obtaining returns that correspond to the returns of a securities index, whose provider discloses on its website the identities and weightings of the component securities and other assets of the index. |
| **Additional time for delivering redemption proceeds** | | |
| Allowance to delay redemption in certain scenarios for ETFs with foreign investments | As soon as practicable up to 15 days + 10-year sunset provision. | Up to 12 days + no sunset provision. |
| Requirement to disclose in registration statement the foreign holidays that may delay redemption | Not required. | Required. |
| Definition of “foreign investment” | Any security, asset or other position of the ETF issued by a foreign issuer (as defined by Rule 3b-4 under the Securities Exchange Act of 1934) for which there is no established U.S. public trading market. | Any security issued by a government or any political subdivision of a foreign country, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country, and for which there is no established United States public trading market. |

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|---|---|---|
| **Requirement to disseminate the Intraday Indicative Value (IIV) at regular intervals during the trading day** | Not required. | Required. |
| **Requirement to post at least one published basket on the ETF's website** | Required. | Not required. |
| **Rescission of exemptive orders** | Rescinds most (but not all) orders one year after the rule goes into effect, but preserves the Section 12(d)(1) relief provided in existing orders. | Did not rescind. |
| **Requirement to establish creation unit sizes reasonably designed to facilitate arbitrage** | Not required. | Required. |
| **Requirement to disclose in marketing materials that the ETF does not sell or redeem individual shares and that investors may purchase or sell individual ETF shares through a broker via a national securities exchange** | Not required. | Required. |

| Requirements to maintain (1) records of all authorized participation agreements and (2) certain records relating to baskets exchanged with authorized participants | Required. | Not required. |
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The SEC has requested public comments on the Proposed Rule and form amendments, to be received by the SEC on or before the 60th day after publication of the Proposing Release in the Federal Register.

- See a copy of the Davis Polk Client Newsflash
- See a copy of the Press Release announcing the Proposed Rule
- See a copy of the Proposing Release

## SEC Adopts Inline XBRL for Tagged Data

On June 28, 2018, the SEC adopted amendments to the requirements for operating companies and funds concerning eXtensible Business Reporting Language ("**XBRL**"), which require the use of Inline XBRL format ("**Inline XBRL**") for the submission of operating company financial statement information and fund risk/return summary information (the "**Amendments**"). Inline XBRL enables filers to "embed XBRL data directly into an HTML document, eliminating the need to tag a copy of the information in a separate XBRL exhibit." The amendments are effective 30 days after publication in the Federal Register.

The SEC intends the Amendments to (1) increase the efficiency and lower the cost of compliance with the existing XBRL requirements, and (2) improve the data's timeliness and quality. SEC Chairman Jay Clayton noted in a press release announcing the Amendments (the "**Press Release**") that "The [A]mendments reflect the Commission's effort to use developments in structured disclosure technology to lower costs borne by filers and investors."

### *Existing XBRL Requirements*

XBRL requirements currently apply to: (1) operating companies that prepare their financial statements in accordance with U.S. generally accepted accounting principles ("**GAAP**") or in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board ("**Operating Companies**"); and (2) mutual funds pursuant to Form N-1A and related rules under Regulation S-T ("**Funds**").

According to the adopting release announcing the Amendments (the "**Adopting Release**"), Operating Companies and Funds are currently required to submit an interactive data file, which includes the information tagged in XBRL, as an exhibit to the related official filing. The interactive data file must be filed and posted onto the filer's website within 15 business days of the related filing. While Operating Companies are required to submit "financial statements and any applicable financial statement schedules in XBRL as exhibits to certain [Securities] Exchange Act [of 1934] reports and Securities Act registration

statements," Funds are required to submit "risk/return summary information in XBRL as exhibits to registration statements and to prospectuses with risk/return summary information that varies from the registration statement."

***Inline XBRL***

The Amendments will now require that Operating Companies and Funds use Inline XBRL instead of XBRL. According to the Press Release, "Inline XBRL involves embedding XBRL data directly into the filing so that the disclosure document is both human-readable and machine-reachable," which makes the interactive data part of the EDGAR filing itself. As such, filers will not need to post the XBRL data on their websites or attach a separate XBRL exhibit. According to the Adopting Release, the Amendments also remove the 15 business day filing period for risk/return summary XBRL data, which is expected to help "improve the timeliness of the availability of risk/return summary XBRL information."

According to the Press Release, the scope of disclosures and filers subject to the XBRL requirements will not change under the Amendments. The Amendments also do not change existing SEC rules with respect to officer certification and auditor assurance under the Securities Exchange Act of 1934.

***Benefits of Inline XBRL***

According to the Press Release, the SEC expects the benefits of the Inline XBRL technology to include:

- reduced XBRL preparation time, effort, and costs by eliminating duplication and facilitating review of XBRL data;
- more control given to the preparer over the presentation of the XBRL disclosures within the HTML filing;
- reduced inconsistencies between the HTML and XBRL filings and increased quality; and
- enhanced accessibility and transparency for data users who no longer will have to view the XBRL data separately from the text of the documents.

***Phase-In Schedule***

According to the Adopting Release, the Amendments will go into effect in phases, according to the following schedules:

| Operating Companies | Compliance Date |
| --- | --- |
| Large accelerated filers that prepare their financial statements in accordance with U.S. GAAP | Fiscal periods ending on or after June 15, 2019 |
| Accelerated filers that prepare their financial statements in accordance with U.S. GAAP | Fiscal periods ending on or after June 15, 2020 |
| All other filers | Fiscal periods ending on or after June 15, 2021 |

| Funds | Compliance Date |
| --- | --- |
| | Any initial registration statement (or post-effective amendment that is an annual update to an effective registration statement) that |

| Funds | Compliance Date |
|---|---|
| | becomes effective on or after: |
| Large Fund Groups (Funds that, together with other investment companies in the same "group of related investment companies," have net assets of $1 billion or more as of the end of their most recent fiscal year) | • two years after the effective date of the Amendments |
| Small Fund Groups (all Funds other than those that are a part of a Large Fund Group) | • three years after the effective date of the Amendments |

***Other Amendments***

According to the Adopting Release, the Amendments will also terminate the 2005 XBRL Voluntary Program for financial statement information interactive data and make certain conforming changes related to the termination.

The Adopting Release notes that the SEC is also adopting: (1) technical, conforming changes to the rules for hardship exemptions; (2) changes to current public information under Rule 144(c)(1) of the Securities Act; (3) changes to form eligibility, consistent with the changes in format to the interactive data file and elimination of the website posting requirements; and (4) changes to Regulation S-T.

- **See a copy of the Press Release**
- **See a copy of the Adopting Release**

## SEC Adopts Amendments to the Liquidity Disclosure Rule

On June 28, 2018, the SEC adopted amendments (the "**Amendments**") to the public liquidity disclosure requirements that apply to registered open-end investment companies pursuant to Rule 22e-4 under the Investment Company Act of 1940 ("**Rule 22e-4**"). On March 14, 2018, the SEC proposed these amendments to Form N-PORT and Form N-1A in a release (the "**Proposing Release**") in an effort to improve the reporting and disclosure of liquidity information for these investment companies. For further discussion of the Amendments, please see the **March 30, 2018 Davis Polk Investment Management Regulatory Update.**

Originally, Rule 22e-4 required, among other things, that funds publicly report aggregate liquidity classification data about their portfolios on Form N-PORT. Under the Amendments, these funds would no longer be required to report this data publicly, but would have to disclose information regarding the operation and effectiveness of their liquidity risk management programs in their annual or semiannual reports to shareholders.

The SEC initially adopted Rule 22e-4 in October 2016, and, according to the release adopting the Amendments (the "**Adopting Release**"), they did so to enhance disclosure regarding fund liquidity and to promote effective liquidity risk management throughout the fund industry. For further discussion of Rule 22e-4, please see the **October 27, 2015 Davis Polk Investment Management Regulatory Update, October 31, 2016 Davis Polk Investment Management Regulatory Update, January 30, 2018 Davis Polk Investment Management Regulatory Update** and **February 28, 2018 Davis Polk Investment Management Regulatory Update.** Since the adoption of the rule, the SEC staff has engaged in outreach with the public to identify shortfalls of Rule 22e-4 and to gather feedback on how the rule could be implemented more effectively. The Amendments are a result of this outreach.

The Amendments will require funds to provide new narrative disclosure in their annual or semiannual shareholder reports in the form of a narrative discussion of the operation and effectiveness of such fund's liquidity risk management programs over the reporting period. This portion of the Amendments as adopted varies slightly from the Proposing Release, as the disclosure will now be moved from the "manager's discussion of fund performance" section, as initially proposed, to a new section of the report following the disclosure regarding approval of investment advisory contracts. According to the Adopting Release, if a liquidity event impacted performance during the relevant period, that would still require disclosure in the "manager's discussion of fund performance" section of the report.

The Amendments also allow funds the flexibility to provide more detailed information in the non-public portion on Form N-PORT in order to more accurately reflect information regarding their portfolio investments, by allowing funds the ability to "split a fund's portfolio holdings into more than one classification category," in certain specified circumstances where such reporting "equally or more accurately reflects the liquidity of the investment or eases cost burdens." Lastly, the Amendments will require that funds report holdings of cash and cash equivalents on Form N-PORT so that the SEC can monitor trends in the use of such holdings and better assess funds' liquidity profiles.

Finally, the Adopting Release notes that the SEC is amending the compliance dates for the disclosure in the shareholder reports from those discussed in the Proposing Release. According to the Adopting Release, "large entities" (i.e., funds that, together with other investment companies in the same "group of related investment companies," have net assets of $1 billion or more as of the end of the most recent fiscal year of the fund) are required to comply with (i) the Form N-PORT portion of the Amendments by June 1, 2019 (which corresponds to a Form N-PORT filing date of July 30, 2019) and (ii) the shareholder reporting portion of the Amendments by December 1, 2019. "Small entities" (i.e., funds that, together with other investment companies in the same group of related investment companies, have net assets of less than $1 billion as of the end of its most recent fiscal year) are required to comply with (i) the Form N-PORT portion of the Amendments by March 1, 2020 (which corresponds to a Form N-PORT filing date of April 30, 2020) and (ii) the shareholder reporting portion of the Amendments by June 1, 2020.

The Amendments will become effective sixty days after publication in the Federal Register.

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

## SEC Proposes Whistleblower Rule Amendments

On June 28, 2018, the SEC voted to propose amendments to the rules governing its whistleblower program. The proposed changes include expanding the types of resolutions covered by the program, giving the SEC discretion in modifying awards, eliminating potential double recoveries, adjusting the claims review process, and barring individuals who submit false information or make repeated frivolous claims. The proposed amendments would also expressly adopt the reporting requirements set forth in Digital Realty Trust, Inc. v. Somers, a recent Supreme Court decision which held that Dodd-Frank whistleblower protections apply only when a securities-law violation is reported to the SEC. For further discussion of the proposed amendments, please see the July 6, 2018 Davis Polk Client Memorandum, **SEC's Proposed Amendments to Its Whistleblower Program May Increase Reporting of Potential Securities-Law Violations to the SEC**.

## Industry Update

### OCIE Issues Risk Alert Regarding Investment Advisers and "Best Execution" Compliance Issues

On July 11, 2018, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC issued a risk alert (the "**Risk Alert**") to provide investment advisers, investors and other market participants with information regarding the most common deficiencies cited in recent examinations with respect to compliance with investment advisers' "best execution" obligations under the Investment Advisers Act of 1940 (the "**Advisers Act**").

Under the Advisers Act, advisers are subject to a fiduciary standard, which includes the obligation to obtain the "best execution" of client transactions in selecting broker-dealers and executing client trades, taking into account "the circumstances of the particular transaction." According to the Risk Alert, a client's securities transactions must be executed in such a way that the client's related costs or proceeds are the most favorable under the circumstances. According to the Risk Alert, the determinative factor for investment advisers in making a "best execution" analysis is that "the transaction represents the best qualitative execution," and not the lowest possible commission cost.

In the Risk Alert, OCIE identified some of the most common issues cited in investment adviser examinations related to the adviser's "best execution" compliance obligations:

- Not performing "best execution" reviews. The OCIE staff observed investment advisers that failed to demonstrate that they "periodically and systematically evaluated the execution performance of broker-dealers used to execute client transactions."
- Not considering materially relevant factors during "best execution" reviews. The OCIE staff observed investment advisers that did not properly evaluate the "full range and quality of a broker-dealer when directing brokerage." The OCIE staff observed investment advisers that failed to solicit and/or review "input from [their] traders and portfolio managers," and did not evaluate any qualitative factors, including the broker-dealer's execution capability, financial responsibility or responsiveness to the investment adviser.
- Not seeking comparisons from other broker-dealers. The OCIE staff noted investment advisers that utilized broker-dealers without seeking out or evaluating the quality and costs of services available from other broker-dealers. The OCIE staff observed that many investment advisers utilized "a single broker-dealer for all clients without seeking comparisons from competing broker-dealers." Additionally, the OCIE staff also observed investment advisers that only reviewed a brief summary of services provided by the broker-dealer, or advisers that only completed "cursory reviews of the broker-dealer's policies and prices."
- Not fully disclosing "best execution" practices. The OCIE staff observed investment advisers that failed to provide full disclosure of best-execution practices, such as failing to disclose that certain types of client accounts may trade the same securities after other client accounts and the potential impact of this practice on execution prices. The OCIE staff also observed that despite disclosure to the contrary, certain investment advisers "did not review trades to ensure that prices obtained fell within an acceptable range."
- Not disclosing soft-dollar arrangements. OCIE staff observed investment advisers who did not appear to provide full and fair disclosure in Form ADV of their soft-dollar arrangements, which included lack of disclosure regarding: (1) the use of soft-dollar arrangements; (2) the fact that certain clients may bear more of the cost of soft-dollar arrangements than others; and (3) products and services "acquired with soft dollars that did not qualify as eligible brokerage and research services under the Section 28(e) safe harbor."

- Not properly administering mixed-use allocations. OCIE staff observed investment advisers that failed to make a reasonable allocation of the cost of a mixed-use product or service according to its use and that did not produce support of its rationale for mixed-used allocations.
- Inadequate compliance policies and procedures or internal controls regarding "best execution." OCIE staff observed investment advisers: (1) without any policies relating to "best execution"; (2) with insufficient internal controls, including lack of monitoring of broker-dealer performance; and (3) with policies that "did not take into account the current business of the adviser, including the type of securities traded by the adviser."
- Not following internal "best execution" policies and procedures. Additionally, the OCIE staff provided several examples of its observations of investment advisers that failed to observe their own internal policies regarding: (1) "best execution" review, which includes failure to seek comparisons from competing broker-dealers "to test for pricing and execution"; (2) allocation of soft-dollar expenses; and (3) the continuous monitoring of a broker-dealer's research, execution price and responsiveness.

The OCIE staff noted that the examinations which produced the information above resulted in "a range of actions," and certain investment advisers amended their disclosures regarding "best execution," revised their related compliance policies and procedures or amended their related practices. In publishing the Risk Alert, OCIE "encourages advisers to reflect upon their practices, policies and procedures in these areas and to promote improvements in [their] compliance programs."

▸ **See the Risk Alert**

## SEC Releases Strategic Plan for Fiscal Years 2018–2022

On June 19, 2018, the SEC released its draft proposed strategic plan for fiscal years 2018 through 2022 (the "**Strategic Plan**"). According to the Strategic Plan, the SEC has three main goals: first, to improve its focus on the long-term interests of "Main Street" investors; second, to recognize the significant developments in the evolving capital markets and to effectively allocate the SEC's resources; and third, to enhance the agency's analytical capabilities and development of human capital.

With regard to the first goal, the Strategic Plan notes that the SEC would like to improve its understanding of how Main Street investors use and interact with the capital markets in order to better tailor its educational and outreach efforts. According to the Strategic Plan, the agency will focus on enforcement and examination initiatives that aim to protect retail investors. It will focus on modernizing disclosure requirements, including the "design, delivery, and content," so that this information is more accessible and comprehensible for Main Street investors. The Strategic Plan also states that the SEC will try to identify ways to increase the number of investment options that are suitable for, and available to, these Main Street investors.

The second goal of the SEC is a focus on technological developments and their impact on the capital markets. The SEC will work to update rules and procedures in light of new technology and marketplace operations, as well as focus on risks that arise from these new technological developments (e.g., cybersecurity). According to the Strategic Plan, the SEC will also try to better identify and understand market developments, and, in light of these, replace outdated procedures that are not "functioning as intended." The SEC will review and update, where necessary, its emergency response capabilities and will provide regular training and testing.

Lastly, the third goal of the Strategic Plan is aimed at enhancing the SEC's analytics and development of human capital. According to the Strategic Plan, the SEC will focus internally on promoting diversity, inclusion and equal opportunities among its staff. The Strategic Plan notes that the SEC will also develop a data management system which "treats data as an SEC-wide resource with appropriate data

protections," and enhance its use of analytics. The SEC also intends to further develop its internal controls and risk management capabilities in order to better protect against security threats. The Strategic Plan also states that the SEC intends to promote collaboration and communication both within and across different offices and will reevaluate internal processes in order to enhance staff collaboration.

The Strategic Plan was prepared according to the Government Performance and Results Modernization Act of 2010, pursuant to which federal agencies must outline their strategic goals for each four-year period. The SEC released the Strategic Plan to the public and welcomes comments and feedback.

- **See the SEC Strategic Plan**

## Litigation

### SEC Charges New York-based Investment Adviser for Failing to Disclose Conflicts of Interest Related to Compensation Obtained from Third Parties

On June 4, 2018, the SEC issued an order (the "**DVU Order**") against deVere USA, Inc. ("**DVU**"), a New York-based investment adviser, instituting and settling administrative and cease-and-desist proceedings for failing to disclose to its clients and prospective clients conflicts of interest regarding compensation obtained from third-party product and service providers.

According to the DVU Order, DVU provided investment advice to its clients, who were primarily U.S. residents or citizens with U.K. pensions, in connection with transferring their U.K. pension assets to certain overseas retirement plans for which DVU would provide ongoing investment advice. When DVU clients transferred their funds to the plans recommended by DVU and its representatives, the third-party firms charged the clients a fee. Half of the fee was then paid to the DVU representative that made the recommendation. DVU also recommended that certain clients convert their U.K. pensions to other currencies; DVU received a portion of the fees that third-party foreign exchange providers received for the conversion. The SEC alleged that, between June 2013 and March 2016, DVU failed to disclose to its clients that its representatives would receive payments from the firms to which DVU's clients transferred their assets or used for currency conversion, and that the undisclosed compensation was the primary form of compensation that DVU's representatives received for their advisory services.

In addition to the allegations relating to DVU's failure to disclose conflicts of interest, the SEC also alleged that DVU investment adviser representatives made materially misleading statements concerning the benefits of transferring U.K. pension assets to one of these overseas retirement plans.

The DVU Order also states that DVU failed to tailor its compliance policies to its actual business by failing to address the conflicts of interest posed by receiving compensation from the third parties with whom it recommended that its clients do business.

Based on the conduct described above, the SEC alleged that DVU willfully violated Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Section 207 of the Advisers Act, which prohibits any person from willfully making misstatements or omissions of material fact in any registration application or report filed with the SEC. Additionally, the SEC alleged that DVU also willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require, among other things, that a registered investment adviser adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons.

DVU consented to the entry of the DVU Order without admitting or denying the findings and agreed to be censured, to cease and desist, and to pay a civil money penalty in the amount of $8 million. In addition, DVU agreed to comply with its disclosure obligations under the Advisers Act, provide training to DVU employees, and retain an independent compliance consultant.

The DVU Order emphasizes the SEC's continued focus on failures to disclose conflicts of interest arising from compensation received by investment advisers from third parties, as well as the importance of ensuring that compliance policies and procedures are reviewed and revised in light of a firm's business.

- See a copy of the DVU Order

## SEC Charges Fund Managers for Failing to Offset Portfolio Company Fees, Disclosures Regarding Accelerated Fees

Since 2014, the SEC has charged a number of venture capital and private equity firms for failing to adequately disclose the practice of receiving accelerated consulting or management fees upon the sale or initial public offering of a portfolio company, or for failing to credit or offset such fees as disclosed in the fund's governing documents.[1] While the frequency of such settlements has decreased, on June 29, 2018, the SEC issued two such orders, one against Aisling Capital LLC (the "**Aisling Order**") and one against THL Managers V, LLC and THL Managers VI, LLC (the "**THL Order**"). These orders underscore that the SEC continues to require advisers to disclose any potential conflicts of interest before investors commit capital, and that advisers should ensure that they are following their disclosed fee allocation practices.

### The Aisling Order

According to the Aisling Order, Aisling Capital LLC ("**Aisling**") provided investment advisory services to two venture capital funds that made investments in life sciences companies. Under the funds' governing documents, Aisling may receive fees, such as transaction fees or consulting fees, from portfolio companies, and is required to offset 50% or 70% (depending on the fund) of the fees received against the management fee that the funds pay Aisling.

The Aisling Order alleges that from 2008 to 2013, Aisling received more than $2.3 million in consulting fees from certain fund portfolio companies and failed to offset these amounts against Aisling's management fees, causing the funds to pay approximately $760,000 more in management fees than they would have paid had Aisling offset the fees.

After the SEC's Enforcement Division contacted Aisling in January 2017, Aisling voluntarily reimbursed the funds' investors for the entirety of the management fees that should have been offset, plus interest. Aisling also named a new chief compliance officer and implemented new controls to ensure the accurate calculation of management fee offsets.

The SEC charged Aisling with violations of Section 206(2) and 206(4) of the Advisers Act, and ordered Aisling to pay a civil penalty of $200,000.

### The THL Order

The THL Order alleges that in 2000 and 2006, THL Managers V, LLC and THL Managers VI, LLC (together, "**THL**") launched two THL-managed private equity funds without adequately disclosing that THL might receive "lump sum" management fees from fund portfolio companies. THL typically entered into agreements with portfolio companies under which THL received periodic fees in exchange for providing certain services to the companies; under some of these agreements, THL would receive an accelerated, lump sum of future fees upon a sale or IPO of the portfolio company.

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[1] *See generally*, ***Leor Landa & James H.R. Windels, Allocating Fees and Expenses: The SEC is Paying Close Attention,* 5 Int'l Comp. Legal Guide to Alternative Inv. (2017)**.

The SEC notes that the relevant THL funds' disclosures stated that THL entered into agreements with, and received fees from, portfolio companies, and that a majority percentage of such fees would be offset against management fees while THL retained the remainder. In addition, for one of the funds, THL entered into side letters with "more than three quarters" of the fund's investors stating that THL may receive fees upon the sale or IPO of a portfolio company. THL also disclosed the amount of accelerated fees in its semiannual reports to all investors.

The SEC nonetheless asserted that THL did not adequately disclose to all limited partners "prior to their commitment of capital" that THL may receive accelerated fees, and that the receipt of such fees created "at least a potential conflict of interest" between THL and the funds. Because this potential conflict was not disclosed before capital was committed, the SEC states, THL could not consent to the potential conflict, and thereby "negligently breached" its fiduciary duties under Section 206(2) of the Advisers Act. The THL Order notes that THL cooperated with the Staff's investigation, but does not identify any remedial measures undertaken during the investigation. THL agreed to pay disgorgement of $4,806,016 (including $200,000 in prejudgment interest) to investors, as well as a civil penalty of $1.5 million.

- **See a copy of the Aisling Order**
- **See a copy of the THL Order**

## SEC Charges a Financial Institution with Failure to Detect or Prevent Misappropriation of Client Funds

On June 29, 2018, the SEC issued an order (the "**Order**") against a financial institution instituting and settling administrative and cease-and-desist proceedings for failing to protect against misappropriation of client funds by personnel of the financial institution.

According to the Order, from at least 2009 to the present, the financial institution permitted its investment adviser representatives and registered representatives, which the financial institution referred to as "financial advisors," to initiate third-party disbursements from client accounts of up to $100,000 per day per account based on an attestation by financial advisors that he or she had received a verbal request from the client. The SEC alleged that, while the financial institution provided for certain reviews of disbursement requests, such reviews were not reasonably designed to detect or prevent such misconduct.

The SEC claimed that the financial institution's insufficient policies and procedures contributed to its failure to detect or prevent one financial advisor from misappropriating funds from client accounts for a period of nearly one year. According to the Order, from December 2015 until November 2016, this financial advisor allegedly initiated $7 million in unauthorized transactions out of his clients' accounts and, through these unauthorized transactions, misappropriated over $5 million.

According to the Order, in November 2016, a representative of the defrauded clients contacted the financial institution concerning the transactions in their accounts. As the Order notes, the financial institution promptly conducted an internal investigation, terminated the financial adviser involved in the misappropriation, and reported the fraud to the SEC and other law enforcement agencies. The Order further states that the financial institution entered into settlement agreements with the defrauded clients in which it fully repaid the clients plus interest. Additionally, according to the Order, the financial institution developed significant enhancements to its policies, procedures, systems and controls relating to preventing or detecting conversion of third-party cash disbursements from client funds, increased its anti-fraud program expenditures, and hired additional fraud operations personnel.

As a result of the conduct described above, the SEC charged the financial institution with willfully violating Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, which require, among other things, that a registered investment adviser adopt written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its

supervised persons. The SEC also charged the financial institution for failing to reasonably supervise one of its financial advisors within the meaning of Section 203(e)(6) of the Advisers Act.

Without admitting or denying the findings, the financial institution consented to the entry of the Order and agreed to be censured, to cease and desist, made undertakings related to the firm's policies and procedures and to pay a civil money penalty in the amount of $3.6 million.

The Order highlights the SEC's willingness to charge financial institutions offering investment advisory services for failing to prevent the misconduct of their investment advisory personnel.

- **See a copy of the Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


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