Davis Polk

CLIENT NEWSLETTER

Investment Management Regulatory Update

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Rules and Regulations

SEC Staff Releases Update to Investment Company Reporting Modernization FAQs

On November 14, 2018, the Division of Investment Management (the "**Division**") of the Securities and Exchange Commission (the "**SEC**") updated (the "**Update**") its responses to certain frequently asked questions (the "**FAQs**"), responding to several new questions relating to the investment company reporting modernization reforms adopted in October 2016 and revised in December 2017.

The Update includes guidance on topics related to the reporting modernization reforms, including:

Compliance Dates and General Filing Obligations

- According to the Update, the 2016 adopting release for fund liquidity programs amended Form N-CEN to add Items C.20 and E.5, which has a compliance date for responding to these of December 1, 2018 for larger entities. The Update clarifies that a fund with a fiscal year-end that falls before December 1, 2018 should not respond to these items in its report on Form N-CEN and instead should begin responding to these items on Form N-CEN filings only when its fiscal year-end falls on or after December 1, 2018.

Form N-PORT

- According to the Update, Item B.5(a) on Form N-PORT requires a fund's monthly total returns for each of the preceding three months to be reported "in accordance with the methodologies outlined in Item 26(b)(1) of Form N-1A, Instruction 13 to sub-Item 1 of Item 4 of Form N-2, or Item 26(b)(i) of Form N-3, as applicable." Forms N-1A and N-3 require sales loads and redemption fees charged to all shareholder accounts to be deducted when calculating such returns. The Update notes that Forms N-1A and N-3 disclosures are for annual reporting, while information provided on Form N-PORT is monthly. According to the Update, initial and deferred sales loads and redemption fees are deducted on a one-time basis, at the time of either the initial investment or the sale of the fund shares, so when funds report annual average total return performance on Forms N-1A and N-3, they reflect the effect of these loads and fees based on the form requirement's fixed periods of one, five, and ten years. However, the Update notes that Form N-PORT requires this information for a series of months, which "has raised questions regarding how funds would pro-rate sales loads and redemption fees to reflect them in each month's reported performance." According to the Update, the Division believes that deducting sales loads and redemption fees for each month in the series over an indefinite number of reports could give investors the impression that such fees are ongoing and overstate the effect on performance, and therefore, funds should not deduct these sales loads and redemptions fees. The Update clarifies that, to improve consistency of the monthly returns from funds that will report responses to Item B.5(a), funds may report monthly returns without deducting sales loads and redemption fees charged to all accounts. According to the Update, funds reporting returns without deducting sales loads and redemption fees should note this in the explanatory notes to Form N-PORT (Part E).
- According to the Update, if a registrant or series thereof has liquidated, merged or is otherwise terminated and has no remaining investors or investments, but the registrant has not yet deregistered, the fund is not required to file reports on Form N-PORT. According to the Update, the Division believes that requiring filing under those circumstances would "provide little relevant information" for the SEC, investors and other market participants.
- According to the Update, a new fund whose registration statement under the Securities Act of 1933 (the "**Securities Act**") has been declared effective or has become effective automatically under the Securities Act, but whose shares have not yet been publicly offered, is not required to file reports on Form N-PORT, as the Division believes that this will provide "cost savings to funds without the loss of information needed to protect investors."
- The Update clarifies that a new fund that publicly offers shares for the first time must file its first report on Form N-PORT no later than 30 days after the end of that month, reflecting the fund's portfolio as of the end of that month.

Regulation S-X

- According to the Update, Article 12 of Regulation S-X requires "a fund to assess, in certain circumstances, where the underlying asset is an index or basket of investments, whether the notional amount of a derivative contract exceeds [1%] of the net asset value of the registrant as of the close of the period." If so, the fund must disclose the 50 largest components in the index or custom basket, as well as any other components where the notional value for that component exceeds 1% of the "notional value of the index or custom basket." The Update provides the example below to illustrate how funds should perform these calculations:

  A fund that has entered into a swap on a custom basket that provides: (i) long exposure to ABC group of equity securities, whose components' aggregate notional value is $51; and (ii) short exposure to XYZ group of equity securities, whose components' aggregate notional value is $50.

Custom basket components	Notional value

Long exposure to ABC equity securities	$ 51
Short exposure to XYZ equity securities	$ 50
Notional Value of Custom Basket	$101

- According to the Update, the fund in this example would be required to determine whether the swap contract's notional amount, $101 in the example case, exceeds 1% of net asset value of the fund as of the close of the period, in order to conclude whether the fund must disclose the 50 largest components in the custom basket. If the fund is required to disclose the 50 largest components, the fund must also disclose any other components whose notional value exceeds 1% of the "notional value of the index or custom basket." According to the Update, the "notional value of the index or custom basket" in the example would be $101, the sum of the notional values of all the components of the index or custom basket. The fund would therefore, in that scenario, be required to disclose each component, in addition to the 50 largest, whose notional value exceeds $1.01.

- According to the Update, Article 12 of Regulation S-X requires funds holding "derivatives where the underlying asset is an index or custom basket of investments," in certain circumstances, to "disclose the percentage value attributed to certain of the components as compared to the custom basket's net assets." The Update clarifies that for purposes of calculating the percentage value attributed to certain components in an index or custom basket, a fund may either (i) disclose the value of the component compared to the value of the derivative on the custom basket, or (ii) disclose the value of the component relative to the fund's (as opposed to the custom basket's) net assets, provided that the heading clearly indicates what the information represents.

Form N-CEN

- According to the Update, as an alternative to submitting an Extensible Markup Language (or XML) file, the SEC is providing an online web-based form available on the EDGAR filer website to allow registrants to manually report data on Form N-CEN. Registrants may select the "File N-CEN" link on the EDGAR filer website and input responses to each question and item in the form.
- According to the Update, a registrant is required to file reports on Form N-CEN until it is deregistered, regardless of whether the registrant has filed or intends to file an application to deregister. The Update notes that the Division would generally expect registrants to file an application on Form N-8F with the SEC to deregister if the registrant has merged, liquidated or otherwise ceased to operate as a registered investment company.
- According to the Update, a registrant that does not yet have shareholders (other than shares issued in connection with an initial investment to satisfy section 14 of the Investment Company Act of 1940, as amended (the "**Investment Company Act**")) is not required to file reports on Form N-CEN. In addition, according to the Update, management companies that have filed Form N-54A to notify the SEC of their election to be regulated as a business development company are not required to file Form N-CEN, as that election would be automatically effective without SEC approval.
- According to the Update, for series of a multi-series registrant that were liquidated, merged or otherwise terminated during the reporting period, such registrants need not report the information requested by Part C (additional questions for management investment companies) as to those series. In addition, such registrant is not required to include in its response to Item B.6.a.i, which requests the registrant's number of series, any series that

were terminated during the reporting period. Terminated series must be identified in responses to Item B.6.a.ii. Furthermore, such registrants are not required to include in their responses to Item C.2.a, which requests the number of authorized classes of shares, any classes that were terminated during the reporting period. Instead, terminated classes must be identified in responses to Item C.2.c.

- According to the Update, a series should be listed as terminated in Item B.6.a.ii even in cases where substantially all of its assets have been transferred to another series of the registrant or to another registrant. The Update clarifies that the series name, Series ID and date of termination should be provided "because this will be the last filing the series is making as part of this registrant and with this Series ID."

- **See a copy of the FAQs**
- **See a copy of the Update**

SEC Proposes Rule Changes for Fund of Funds Arrangements

On December 19, 2018, the SEC proposed a new rule and related amendments "designed to streamline and enhance the regulatory framework for fund of funds arrangements." Among other things, the proposal would: (i) create new Rule 12d1-4 under the Investment Company Act, which would permit registered investment companies or business development companies to acquire the securities of other registered investment companies or business development companies beyond the limits contained in Section 12(d)(1) of the Investment Company Act, provided certain conditions have been met; (ii) rescind Rule 12d1-2 under the Investment Company Act, as well as most exemptive orders granting relief from Sections 12(d)(1)(A), (B), (C) and (G) of the Investment Company Act; and (iii) amend Rule 12d1-1 under the Investment Company Act to allow funds that primarily invest in funds within the same group to continue to invest in unaffiliated money market funds; and (iv) amend Form N-CEN to include a requirement that funds report whether they have relied on new Rule 12d1-4 or the statutory exemption contained in Section 12(d)(1)(G) of the Investment Company Act during the reporting period. Davis Polk is currently preparing a client memorandum that will more fully describe the SEC proposal.

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

Industry Update

Remarks from Commissioner Peirce before the Crypto Valley Summit

On November 7, 2018, Hester M. Peirce, Commissioner of the SEC, gave a speech via video conference to the Crypto Valley Summit (the "**CV Summit**") in Switzerland. Commissioner Peirce noted how the new generation in Switzerland has welcomed new technologies, and how it is an apt location to hold the CV Summit.

Peirce compared the regulatory environment of Switzerland to that of the United States, and remarked that the United States is much less supportive of cryptocurrency technology. She credited this situation to the fact that numerous state and federal regulators in the United States have taken different approaches with respect to cryptocurrency, causing uncertainty and ambiguity as to how the United States will handle new cryptocurrency advances going forward.

Peirce noted that regulators have not been coordinating with one another and are sending "mixed messages" to the crypto community. For example, she noted that while the Commodities Futures Trading Commission (the "**CFTC**") has allowed crypto-derivatives markets to develop, the SEC has not yet approved any exchange-traded product based on cryptocurrencies or crypto-derivatives to trade on U.S.

exchanges. She added that "the themes underlying the rejections [of these products] concern me." She noted that there is a "discomfort with the underlying markets in which cryptocurrencies trade, a skepticism of the ability of markets to develop organically outside of a traditionally regulated context, and a lack of appreciation for the investor interest in gaining exposure to digital assets as part of a balanced investment portfolio." She further noted that "regulators have an unfortunate habit of allowing their own conservatism and their legitimate fear that they will be blamed when investments go wrong to curtail investors' options."

Peirce stated that, while she understands why the SEC is taking a conservative approach to new technologies, she feels the SEC should allow informed investors to make their own decisions as to whether to invest in cryptocurrency-related products. Peirce also attributed some of the confusion to the fact that many of the approval requests for crypto-exchange-traded products are handled by SEC staff (through delegated authority) rather than by the commissioners themselves, and so the commissioners are not necessarily aware of all of the initial decisions being made in this space.

In another example, Peirce stated that the SEC recently suspended trading for ten days in two foreign exchange-listed crypto-based products that were being traded over-the-counter in the United States. However, she noted that the SEC failed to inform investors that after the ten-day window had passed, the products would not automatically resume trading in the same way they had prior to the suspension.

Peirce next noted that in an effort to address these challenges, last month the SEC launched the Strategic Hub for Innovation and Financial Technology ("**FinHub**"), a virtual forum for addressing regulatory changes associated with developing technologies. She stated that the SEC hopes to use FinHub as a way to improve the provision of information to people trying to understand the rules and regulations around the technology space. In addition, she discussed the SEC's use of securities laws to target fraudulent activity disguised as crypto-ventures, noting that this is "another positive development." These efforts are geared towards making the cryptocurrency space safer for investors to enter. She ended her speech by noting that the SEC has also recently appointed someone to "coordinate efforts across all SEC Divisions and Offices regarding the application of U.S. securities laws to emerging digital asset technologies and innovations[,]" which she hopes will help address some of the challenges discussed above.

- **See a transcript of the speech**

SEC Chairman, Commissioners Deliver Remarks at Proxy Process Roundtable

On November 15, 2018, the SEC hosted a public roundtable to discuss the proxy process and rules, with a particular emphasis on current proxy voting mechanics and technology, the shareholder proposal process and the role and regulation of proxy advisory firms. Chairman Jay Clayton, Commissioner Kara M. Stein and Commissioner Elad L. Roisman each delivered remarks at the roundtable; their remarks are summarized below.

Remarks by SEC Commissioner Kara M. Stein

Commissioner Stein began her opening remarks by reminding participants of the SEC's mission in the capital markets, "to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation." According to Stein, the rules and laws that govern a shareholder's ability to influence the companies in which it holds shares is critical to that mission, and the SEC's proxy rules allow for such influence. Moreover, according to Stein, shareholders who exercise such influence have a direct impact on the corporate bottom line and allow the capital markets to remain "vibrant and stable."

Stein next stated that the current proxy regime is outdated, noting that this was a result of complicated proxy material distribution mechanisms and the way in which investors hold their shares (through broker-dealers or other intermediaries). According to Stein, this complexity creates a regime that includes an array of third parties, including broker-dealers, banks, custodians, transfer agents and proxy advisors, rather than just a company and its shareholders. She pointed out that the result is a proxy system that is not as transparent as it could be.

Stein then signaled the three areas of focus for the roundtable: (i) proxy voting mechanics and technology; (ii) shareholder proposals; and (iii) proxy advisors. Stein then posed questions to facilitate discussion amongst the roundtable panelists with respect to the three areas of focus. First, she indicated her interest in learning how technology can help proxy voting mechanics, including two related questions: (i) whether distributed ledgers or blockchain technology could help companies reach shareholder bases more efficiently; and (ii) whether standing voting instructions would allow companies to hear from their retail investors more effectively. Second, Stein indicated a willingness to learn more about how the SEC's guidance has buttressed or inhibited shareholder proposals that might enhance company values and asked whether such guidance has remained true to the SEC's values. Finally, Stein indicated a desire to better understand the role of proxy advisors in the scheme of the proxy process, particularly vis-à-vis ongoing legislation that may seek to require the SEC to regulate proxy advisors under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**").

Remarks by SEC Chairman Jay Clayton

During his remarks, Chairman Clayton highlighted the importance of: (i) the American capital markets regulatory environment, which is built on both state corporate law and federal securities laws and regulations, in the world economy; and (ii) the regulatory environment and its effectiveness in addressing principal-agent problems inherent in the pooling of capital. According to Clayton, that effectiveness has been accomplished "in a way that fosters broad investor participation and nimble flows of capital and labor, relying on the bedrock principles of transparency, materiality, clarity of law, and efficient decision making." He then questioned whether the existing system can be improved and for whom the regulatory system needs to be improved. Clayton closed by stating that he believes the answer is the long-term "Main Street" investor, and urged the roundtable participants to keep them in mind during discussions.

Remarks by Commissioner Elad L. Roisman

Commissioner Roisman opened his remarks by reminding the participants of the importance of the proxy process and inviting the participants to effectively use the roundtable to provide specific examples, data and facts, in conjunction with the information presented by the panel, to submit data and suggestions on improving the proxy process to the SEC.

Roisman then outlined areas of focus for each of the three panels at the roundtable. For the panel on the proxy voting process and technology, Roisman outlined the following items for consideration: (i) what changes would be made if the proxy voting process could start again from scratch; (ii) distinctions between brokers, who generally may not cast votes on non-routine matters without the explicit instruction of beneficial owners, and passive index fund managers, who may vote shares without an obligation to reach out to individual investors regarding voting preferences, and questioned whether such a distinction makes sense; and (iii) the importance of proper vote counting, which is critical to the proxy process, and questioned the various responsibilities of companies, voting intermediaries and participants, particularly in cases where outcomes are based on narrow voting margins.

For the second panel, which was focused on shareholder proposals, Roisman began by underscoring the importance of the shareholder proposal process. Roisman reminded the participants that, as owners of the company, shareholders have a right to have their voices heard. According to Roisman, there are many cases where the right to vote is not enough. He noted specific examples, including instances when the board is unaware of a matter important to shareholders or is unwilling to bring such a matter to vote. Roisman reminded participants, however, that a balance needs to be struck between shareholders trying to increase shareholder value for all shareholders and those looking to exploit the shareholder voting process to further their own personal agenda. Roisman then focused on the eligibility requirements for shareholder proposals, where he asked whether the current monetary threshold and holding period is still appropriate, and whether resubmission thresholds should be reconsidered. Finally, Roisman questioned the practice of "proposal by proxy," noting that the Division of Corporation Finance believes proposal by proxy is consistent with Rule 14a-8 under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"). Roisman further questioned whether a proposal by proxy is helpful to shareholders when the person bringing the proposal is not a shareholder and/or cannot qualify to bring the proposal on his or her own.

For the last panel, which discussed proxy advisory firms, Roisman began by discussing the increased importance of such advisory firms and how they influence outcomes for fund investors in particular. Roisman indicated that assessing conflicts of interest for these advisory firms is crucial to better regulating them. For example, Roisman pointed out that many proxy advisors have notable conflicts of interest that arise from certain affiliations, and he questioned how the firms are managing conflicts when formulating voting recommendation, as well as how the conflicts are disclosed to customers. He also questioned whether certain proxy advisors that are also SEC-registered investment advisers operate under different obligations than proxy advisors that are not SEC-registered investment advisers. Roisman further questioned whether proxy advisory firms are becoming standard setters in influencing corporate behavior. Next, Roisman emphasized the importance of accurate information in providing voting recommendations and asked what controls proxy advisors have in place to ensure that recommendations are based on accurate information and, relatedly, how companies can correct information on which a recommendation may be based. Finally, Roisman questioned how advisory firms' voting guidelines serve the interests of investors and whether current regulations adequately address how proxy advisors prioritize the varying interests of investors.

Finally, Roisman turned to the role of fund managers in the proxy voting process. According to Roisman, managers of diversified passive funds in particular, hold shares in thousands of public companies on behalf of millions of investors and have a fiduciary duty to the funds they advise. He expressed his hope that the panels would discuss how such fund managers fulfill their fiduciary duties in the context of proxy voting. Specifically, Roisman questioned whether fund managers were seeking to vote proxies in ways that would maximize the value of stock for shareholders, and, if so, what data they were using to justify those decisions. Further, he questioned whether an adviser who manages funds with different objectives casts votes on the same proxy proposals differently for different funds. Next, Roisman questioned the extent to which managers rely on proxy advisor recommendations as a means to minimize a fund's costs of analyzing and voting proxies. Finally, he questioned whether managers analyze how past votes have affected shareholder value or otherwise served a fund's objectives, especially with respect to merger and acquisition activities, and what guidance the SEC should provide in such a context.

Roisman concluded his remarks by noting that he looked forward to hearing suggestions for improvement and reminded the audience that the SEC must take a balanced approach to rulemaking in order to facilitate the SEC's aforementioned mission.

- **See a copy of Clayton's remarks**
- **See a copy of Stein's remarks**
- **See a copy of Roisman's remarks**

SEC Public Statement on Digital Asset Securities Issuance and Trading

On November 16, 2018, the SEC's Divisions of Corporation Finance, Investment Management, and Trading and Markets (the "**Divisions**") issued a public statement on digital asset securities issuance and trading (the "**Statement**").

Throughout the Statement, the Divisions emphasize that they encourage technological innovations that benefit investors and the capital markets, but affirm that "market participants must still adhere to [the] well-established and well-functioning federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain."

In the Statement, the Divisions highlight several recent SEC enforcement actions involving the intersection of the application of federal securities laws and emerging technologies, including those actions involving CarrierEQ, Inc. ("**AirFox**"), Paragon Coin, Inc. ("**Paragon**"), Crypto Asset Management

LP (“**Crypto Asset Management**”), TokenLot LLC (“**TokenLot**”) and EtherDelta. The Divisions state that the issues raised in these aforementioned actions fall into three categories: “(1) initial offers and sales of digital asset securities (including those issued in initial coin offerings (“**ICOs**”)); (2) investment vehicles investing in digital asset securities and those who advise others about investing in these securities; and (3) secondary market trading of digital asset securities.”

Offers and Sales of Digital Asset Securities

The Divisions highlight two key questions underlying the SEC’s actions involving offerings of digital asset securities: (1) “when is a digital asset a ‘security’ for purposes of the federal securities laws” and (2) “if a digital asset is a security, what [SEC] registration requirements apply?”

The Divisions discuss the SEC’s recent settled orders against AirFox and Paragon in connection with their unregistered offerings of tokens. According to the Statement, AirFox and Paragon must pay penalties and undertake to register the tokens as securities under Section 12(g) of the Exchange Act as well as file periodic reports with the SEC. AirFox and Paragon also agreed to compensate investors who purchased the tokens in connection with the illegal offerings if an investor elects to make such a claim. For a further discussion of the AirFox and Paragon orders, please see the November 20, 2018 Davis Polk Client Memorandum, **SEC Debuts Roadmap for Resolving Illegal ICOs**.

The Divisions stated that the required registration undertakings “are designed to ensure that investors receive the type of information they would have received had these issuers complied with the registration provisions of the Securities Act of 1933 prior to the offer and sale of tokens in their respective ICOs.” The Divisions explain that the ongoing disclosure provided for by the Exchange Act (vis-à-vis registration) will enable investors who previously purchased the tokens in the ICOs to make a more informed decision as to “whether to seek reimbursement or continue to hold their tokens.”

The Statement notes that the remedial measures in these matters “demonstrate that there is a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities.”

Investment Vehicles Investing in Digital Asset Securities

The Statement discusses the SEC’s September 11, 2018 Crypto Asset Management order, which found that “the manager of a hedge fund formed for the purpose of investing in digital assets had improperly failed to register the fund as an investment company” under the Investment Company Act. According to the Statement, the manager “engaged in an unlawful, unregistered, non-exempt, public offering of the fund[,]” by “investing more than 40 percent of the fund’s assets in digital asset securities and engaging in a public offering of interests in the fund,” and “the manager caused the fund to operate unlawfully as an unregistered investment company.” The Statement further noted that the fund’s manager was an investment adviser which had violated the antifraud provisions of the Advisers Act by “making misleading statements to investors in the fund.”

The Divisions conclude that investment vehicles holding digital asset securities and those who advise investors on digital asset securities, including managers of investment vehicles, “must be mindful of registration, regulatory and fiduciary obligations under the Investment Company Act and the Advisers Act.”

Trading of Digital Asset Securities

The Statement discusses SEC actions and staff statements regarding secondary market trading of digital asset securities, which have focused on “what activities require registration as a national securities exchange or registration as a broker or dealer, as those terms are defined under the federal securities laws.”

<u>Exchange Registration</u>

The Statement notes the Division of Trading and Markets' ongoing concerns regarding the "failure of platforms that facilitate trading in digital asset securities to register with the SEC absent an exemption from registration," and discusses the SEC's recent enforcement action against the founder of EtherDelta, one such platform.

The SEC's order states that EtherDelta, which was not registered with the SEC, "provided a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders, and a smart contract run on the Ethereum blockchain." Additionally, EtherDelta's "smart contract was coded to, among other things, validate order messages, confirm the terms and conditions of orders, execute paired orders, and direct the distributed ledger to be updated to reflect a trade." The SEC found that such activities "clearly fell within the definition of an exchange and that EtherDelta's founder caused the platform's failure either to register as a national securities exchange or operate pursuant to an exemption to registration as an exchange."

The Statement explains that an entity that provides a marketplace to bring together buyers and sellers of securities must determine whether its activities meet the definition of an exchange under federal securities laws, notwithstanding how it characterizes itself, its activities or the technology used.

The Statement discusses Rule 3b-16(a)'s "functional" exchange analysis, which includes an inquiry into the "totality of activities and technology used to bring together orders of buyers and sellers for securities using 'established non-discretionary methods….'" According to the Statement, under this analysis, a system brings together buyers and sellers by, for example, displaying or representing "trading interest entered on a system to users or if the system receives users' orders centrally for future processing and execution." A system uses "established non-discretionary methods" if it provides a "trading facility or sets rules." The Statement then provides that "an entity that provides an algorithm, run on a computer program or on a smart contract using blockchain technology, as a means to bring together or execute orders" may be found to be providing a trading facility.

The Divisions emphasize that entities using blockchain or distributed ledger technology for trading digital assets should "carefully review their activities on an ongoing basis to determine whether the digital assets they are trading are securities and whether their activities or services cause them to satisfy the definition of an exchange[,]" and "should also consider other aspects of the federal securities laws (and other relevant legal and regulatory issues) beyond exchange registration requirements."

<u>Broker-Dealer Registration</u>

The Statement continues by noting that an entity that facilities the issuance of digital asset securities in ICOs and secondary trading in digital asset securities may also be acting as a "broker" or "dealer" and therefore be required to (a) register with the SEC and (b) become a member of a self-regulatory organization (such as FINRA) and be subject to additional legal and regulatory requirements of broker-dealers.

The Statement describes how under Section 15(a) of the Exchange Act, it is unlawful for any broker or dealer to "induce or attempt to induce the purchase or sale, of any security unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act." The Statement goes on to explain that Section 3(a)(4) of the Exchange Act generally defines a "broker" to mean any person engaged in the business of effecting transactions in securities for the account of others and that Section 3(a)(5) of the Exchange Act generally defines a "dealer" to mean any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. Further, the Statement notes that a "functional approach" (which takes into account all of the relevant facts and circumstances) is applied in assessing whether an entity constitutes a broker or dealer, notwithstanding how that entity characterizes itself, its activities or the technology used in providing its services.

The Statement discusses the SEC's recent TokenLot order, which the Divisions state illustrates the application of the above requirements to "entities trading or facilitating transactions in digital asset securities, even if they do not meet the definition of an exchange." The Statement explains that, according to the order, TokenLot was a self-described "'ICO superstore' where investors could purchase digital assets, including digital asset securities, during or after an ICO, including in private sales and pre-sales." The Statement goes on to note that "the parties' brokerage activities included marketing and facilitating the sale of digital assets, accepting investors' orders and funds for payment, and enabling the disbursement of proceeds to the issuers." The Statement further notes that the parties "received compensation based on a percentage of the proceeds raised in the ICOs, subject to a guaranteed minimum commission[,]" and that TokenLot "acted as a dealer by regularly purchasing and then reselling digital tokens for accounts in TokenLot's name that were controlled by its operators."

Conclusion

The Statement concludes by expressing the Divisions' support of innovation and the application of beneficial technologies in the securities markets. However, the Divisions recommend that "those employing new technologies consult with legal counsel" and contact SEC staff (as necessary) for assistance in discerning the application of the federal securities laws in this novel and quickly-advancing digital asset arena.

- **See a copy of the public statement**

OCIE Issues Risk Alert regarding Investment Adviser Examinations Relating to Electronic Messaging

On December 14, 2018, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC issued a risk alert (the "**Risk Alert**") relating to a limited-scope examination initiative of registered investment advisers (each an "**RIA**" and together, "**RIAs**") that OCIE conducted to better understand the forms of electronic messaging used by RIAs and their personnel, the risks of such use and the challenges in complying with certain provisions of the Advisers Act. According to the Risk Alert, OCIE conducted this initiative in response to RIA personnel's "increasing use of various types of electronic messaging…for business-related communications."

According to the Risk Alert, Advisers Act Rule 204-2 (the "**Books and Records Rule**") requires RIAs to produce and retain certain books and records relating to their investment advisory business, including accounting and other business records. In addition, according to the Risk Alert, Advisers Act Rule 206(4)-7 (the "**Compliance Rule**") requires RIAs to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder. The Compliance Rule also requires RIAs to review, at least annually, the adequacy of the RIA's compliance policies and procedures and the effectiveness of their implementation.

The Risk Alert noted that OCIE's examinations surveyed firms to determine the types of electronic messaging used by firms and their personnel, and reviewed firms' policies and procedures to assess how RIAs address the risks presented by evolving forms of electronic communication. For purposes of the initiative, "electronic messaging" or "electronic communication" included written business communications conveyed electronically (*i.e.* by text/SMS messaging, instant messaging, personal email and personal or private messaging). According to the Risk Alert, OCIE included communications when conducted on the RIA's systems or third-party applications or platforms sent using the RIA's computers, mobile devices issued by advisory firms or personally owned computers or mobile devices used by the RIA's personnel for business purposes. According to the Risk Alert, OCIE staff excluded email use on RIAs' systems from the review because "firms have had decades of experience complying with regulatory requirements with respect to firm email, and it often does not pose similar challenges as other electronic communication methods because it occurs on firm systems and not on third-party apps or platforms."

In the Risk Alert, the OCIE staff identified best practices across four topics that may help RIAs satisfy their record retention obligations under the Books and Records Rule and their implementation and design of policies and procedures under the Compliance Rule:

Policies and Procedures

- Permitting only those forms of electronic communication for business purposes that the RIA determines can be used in compliance with the requirements of the Books and Records Rule;
- Prohibiting any business use of apps and other technologies that can be easily misused, such as those that allow: (i) employees to send messages or communicate anonymously; (ii) automatic destruction of messages; or (iii) prohibit third-party viewing or back-up;
- If employees receive electronic messages using a form of communication prohibited by the firm for business purposes, firm procedures should require that employees move those messages to another electronic system that the RIA determines can be used in compliance with its books and records obligations, and should include specific instructions to employees on how to do so;
- RIAs that allow for the use of personally owned mobile devices for business purposes should adopt and implement policies and procedures addressing such use regarding social media, instant messaging, texting, personal email, personal websites and information security;
- RIAs that permit their personnel to use social media, personal email accounts or personal websites for business purposes should adopt and implement policies and procedures for the monitoring, review, and retention of such communications;
- Including a statement in the policies and procedures informing employees that violations may result in discipline or dismissal.

Employee Training and Attestations:

- Requiring personnel to complete training on the RIA's policies and procedures regarding restrictions placed on the use of electronic messaging and apps and the RIA's consequences of violating these procedures;
- Obtaining attestations from personnel at the start of employment and regularly thereafter that employees: (i) have completed all required training on electronic messaging; (ii) have complied with all requirements; and (iii) have committed to do so in the future;
- Issuing regular reminders to employees of what is permitted and prohibited under the RIA's policies and procedures for electronic messaging; and
- Soliciting feedback regarding what forms of messaging are requested by clients and service providers in order for the RIA to assess risks and how those forms of communication may be incorporated into its policies.

Supervisory Review:

- RIAs that permit use of social media, personal email or personal websites for business purposes should contract with software vendors to: (i) monitor social media posts, emails or websites; (ii) archive business communications to ensure compliance with record retention rules; and (iii) ensure that they have the ability to identify any changes to content and compare postings to a lexicon of key words and phrases;
- Regularly reviewing popular social media sites to identify if employees are using the platform in a manner not permitted by the RIA's policies;

- Conducting regular internet searches or setting up automated alerts to notify the RIA when an employee's or the RIA's name appears on a website, in order to identify potentially unauthorized advisory business being conducted online; and
- Establishing a reporting program or other confidential means by which employees can report concerns about a colleague's electronic messaging, website or use of social media for business communications.

Control over Devices:

- Requiring employees to obtain approval from the RIA's information technology or compliance staff before they access firm email servers or other business applications from personally owned devices;
- Loading security apps or other software on company-issued or personally owned devices prior to allowing them to be used for business communications, including software that enables RIAs to: (i) push mandatory cybersecurity patches to devices; (ii) monitor for prohibited apps; and (iii) wipe devices of locally stored information if the device were lost or stolen; and
- Allow employees to access the RIA's email servers or other business applications only by virtual private networks or other security apps to segregate remote activity.

OCIE staff also encouraged RIAs to review their risks, practices, policies and procedures regarding electronic messaging and consider any improvements to their compliance programs that would facilitate compliance with their regulatory requirements. OCIE staff finally noted that while this initiative was limited to examinations of RIAs and the Risk Alert only referenced regulatory provisions under the Advisers Act, other regulated financial services firms may face similar challenges.

- **See a copy of the Risk Alert**

Litigation

CFTC Obtains Consent Order, Default Judgment Against Principals of Fictitious "Algorithmic Hedge Fund"

Judge Loretta A. Preska of the U.S. District Court for the Southern District of New York entered two orders (together, the "**Orders**") in a civil enforcement action filed by the Commodity Futures Trading Commission against Algointeractive Inc. ("**Algointeractive**"), Kevin P. Whylie ("**Whylie**"), and Matthew James Zecchini ("**Zecchini**"). The Orders include a consent order approving a settlement between Whylie and the CFTC on October 23, 2018 (the "**Consent Order**"), and a default judgment against Zecchini and Algointeractive on November 13, 2018 (the "**Default Judgment**").

According to the Orders, Zecchini and Whylie fraudulently solicited over $300,000 from at least four members of the public, promising to invest participants' funds in Algointeractive's "Algorithmic Hedge Fund" that purported to utilize a specially developed algorithm for trading futures contracts. The Orders alleges that Algointeractive, Zecchini, and Whylie made numerous false representations about their expertise, Algointeractive's historical returns and assets under management. Further, according to the Orders, instead of using the funds solicited to make investments, the defendants misappropriated over $200,000 of the amount solicited for unauthorized purposes, including credit card and restaurant bills, train tickets, personal bank account deposits and dividend payments to other participants in the manner of a Ponzi scheme. For example, according to the Orders, just one day after an investor deposited $50,000 into an Algointeractive bank account, that same account was used to wire a $2,000 "dividend" to a separate investor.

The Orders state that the defendants provided investors with fictitious monthly charts and account statements claiming to show Algointeractive's profitability. The Orders note that the defendants materially misrepresented that the investors' funds would be pooled and invested for the benefit of the investors and misrepresented their own experience, track record and amount of assets under management in order to solicit funds. According to the Orders, the fraction of investors' funds that were invested never achieved profitability, but instead lost thousands of dollars through trading stock and exchange-traded fund options and commodity futures. The Orders further note that only $59,450 of the amount solicited was ever returned to investors.

The Orders require the defendants to pay $240,550 in restitution, with the Consent Order requiring Whylie to pay a $100,000 civil monetary penalty, and the Default Judgment requiring Zecchini and Algointeractive to pay a $721,650 civil monetary penalty. The Orders also impose permanent trading bans on the defendants.

- **See a copy of the Consent Order**
- **See a copy of the Default Judgment**

SEC Settles with Former Investment Adviser for Failing to Adopt and Implement Reasonably Designed Policies and Procedures Regarding Advisory Fees

On November 19, 2018, the SEC issued an order (the "**RCS Order**") instituting and settling cease-and-desist proceedings against Retirement Capital Strategies, Inc. ("**RCS**"), a former registered investment adviser. According to the RCS Order, RCS charged more than 290 client accounts higher fees than disclosed in its fee schedule.

According to the RCS Order, between January 2010 and February 2018, RCS offered its clients optional investment advisory services on its Strategic Wealth Management ("**SWM**") platform at an additional fee. The RCS Order notes that these fees were disclosed in RCS's fee schedule (the "**Fee Schedule**"), which was calculated using a percentage of the market value of assets under management in each client's SWM account. The Fee Schedule applied a declining rate between 1.5% and 0.40% on all assets under management, which meant that the more money a client held in an account, the lower that client's advisory fee rate. The RCS Order notes that RCS was required to provide a copy of its Fee Schedule to clients, describe in its client brochure how it was compensated for services and disclose whether such fees were negotiable. According to the RCS Order, the SEC alleged that, even though RCS told its clients it would enclose its Fee Schedule, the schedule was never enclosed with its client brochure, and instead, clients would only receive a "standalone copy" upon request.

The SEC further alleged that RCS failed to implement written policies and procedures designed to prevent RCS from favoring certain clients. According to the RCS Order, in order to achieve the advisory fee breakpoint discounts disclosed in the Fee Schedule, RCS would advise certain clients that it would allow related advisory account balances held by the same client, or advisory clients in the same household, to be aggregated. The RCS Order alleges that RCS failed to include this benefit in its written policies and procedures manual and failed to "consistently and timely" aggregate household accounts for all of its clients. Consequently, the RCS Order alleges that certain clients were "treated more favorably than other clients, who did not receive the benefit of account aggregation and thus discounted advisory fees."

According to the RCS Order, following an SEC examination and commencement of an enforcement investigation, RCS reviewed its records and refunded excess fees, with interest, retained a compliance consultant and updated compliance policies and procedures. The SEC alleged that RCS violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging directly or indirectly in any transaction that operates as a fraud upon a client. RCS consented to the entry of the RCS Order and, without admitting or denying the findings, agreed to cease and desist from future violations and further agreed to be censured and to pay a civil money penalty of $50,000.

▸ See a copy of the RCS Order

SEC Resolves Administrative Proceedings Against Investment Adviser for Improper Allocation of Expenses and Inadequate Quality Control Reviews

On December 3, 2018, the SEC issued an order (the "**FSM Order**") instituting and settling administrative and cease-and-desist proceedings against Fifth Street Management, LLC ("**FSM**"), a Greenwich-based investment adviser. According to the FSM Order, FSM improperly allocated the rent and employee compensation expenses of FSM to FSM's business development company clients, and failed to accurately value certain investments. The FSM Order joins a lengthy series of SEC enforcement actions alleging improper allocations of adviser expenses to advisory clients.[1]

According to the FSM Order, FSM's investment advisory agreements with two of its public business development company clients (each a "**BDC**" and together, the "**BDCs**") provided that FSM was responsible for paying "the compensation and routine overhead expenses" of FSM personnel. The SEC alleged that the BDCs and FSM shared employees and office space, and that, although FSM employed the majority of employees, from June 2013 through September 2014, FSM allocated to the BDCs all of the rent for the office space shared with FSM, amounting to just over $1.2 million. The SEC further alleged that FSM allocated to the BDCs $118,895 in compensation for employees that performed work unrelated to the BDCs. According to the FSM Order, these misallocations contradicted the language in the BDC advisory agreements regarding allocation of compensation and overhead, as well as language in FSM's Form ADV that did not disclose that the BDCs would pay such overhead for FMS, which the SEC viewed as a form of "compensation" to FSM. The FSM Order alleges that as a result of these allocations, the BDCs' books and records were inaccurate for these periods and FSM's Form ADV contained false information.

Additionally, the FSM Order describes several instances of FSM failing to adequately perform a quality review function over the valuation of one of the FSM-advised BDC's investment portfolio. According to the FSM Order, FSM analysts were integrally involved in valuing such BDC's portfolio, which comprised many illiquid assets whose values could not be determined by reference to market prices. The FSM Order states that, among other functions, FSM's analysts were responsible for uploading the most recently available financial information regarding companies in the BDC's portfolio to a shared FSM network and performing quality control reviews of the valuation before the BDC's board ultimately decided on the portfolio's value. According to the FSM Order, FSM analysts failed in both regards. The FSM Order alleges that in one instance, an FSM analyst failed to upload the most recent financial information regarding a company in the BDC portfolio and over the course of three quarterly reviews, failed to recognize that the valuation used was based on increasingly inaccurate financial projections from the prior year. According to the FSM Order, as a result of this and other failures, the BDC filed materially inaccurate financial statements and issued overvalued equity.

Based on the conduct described above, the SEC alleged that FSM violated Sections 204A, 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-7(a) and 206(4)-8(a)(2) thereunder. Additionally, the SEC alleged that FSM caused the BDCs to violate Section 17(a)(2) of the Securities Act and Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder. Further, the FSM Order alleges that FSM violated Section 31(a) of the Investment Company Act and Rule 31a-1 thereunder. According to the FSM Order, FSM agreed to pay $1.9 million in disgorgement, including prejudgment interest, and a civil money penalty of $1.65 million.

[1] For an overview of fee and expense allocation settlements, see 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).

While the number of fee and expense settlements in 2018 is significantly lower than the numbers in 2015–2016, the FSM Order stands as a reminder that the SEC is still paying attention to fee and expense allocation, and of the importance of adopting and adhering to written policies regarding expense allocation and portfolio valuation.

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

SEC Settles with Business Development Company for Financial Reporting Failures and Ineffective Internal Accounting Controls

On December 4, 2018, the SEC issued an order (the "**KCAP Order**") instituting and settling cease-and-desist proceedings against KCAP Financial, Inc. ("**KCAP**"), a closed-end investment company that has elected to be treated as a business development company whose common stock trades on the NASDAQ Global Select Market. According to the KCAP Order, KCAP failed to analyze whether distributions it received from its wholly owned asset manager affiliates ("**AMAs**") were paid from current or accumulated tax basis earnings and profits, resulting in material errors in KCAP's reporting of tax-basis distributable income, an important metric in assessing business development companies.

According to the KCAP Order, from at least 2010 through the third quarter of 2014, KCAP invested in as many as four AMAs. The KCAP Order states that KCAP reported its AMA investments at fair value in its financial statements and includes the AMAs' consolidated financial statements in its annual Form 10-K filings. The KCAP Order alleged that KCAP improperly recorded and distributed the entirety of the approximately $35.8 million it received from its AMAs as taxable dividends, when in reality, approximately $22.3 million, or 62.3%, of the funds were actually return of capital. According to the KCAP Order, the AMAs, in turn, allegedly determined the amount of cash available for distributions simply by reviewing their bank statements and deducting the funds necessary to pay outstanding bills. The KCAP Order notes that KCAP did not determine whether they had tax-basis earnings and profits as defined by generally accepted accounting practices in the United States ("**GAAP**") and federal tax rules governing dividends.

The KCAP Order alleged that KCAP failed to act on information that should have prompted it to record portions of the AMA distributions as a return of capital instead of dividends. For example, the KCAP Order states that spreadsheets KCAP prepared tracking the AMAs' tax accruals revealed that certain AMAs had taxable losses and accumulated net operating losses. Thus, according to the KCAP Order, KCAP should have known it was not possible that all of the cash distributions from the AMAs to KCAP were made from tax-basis earnings and profits (current or accumulated).

As a result of these alleged errors, the KCAP Order alleges that KCAP failed to accurately disclose to its shareholders the actual source of its shareholder distributions during the relevant period. In addition, the KCAP Order notes that, acting at least partially on the advice of counsel, KCAP decided not to provide shareholders with contemporaneous written statements explaining the sources from which the shareholder distributions were made. Instead, the KCAP Order alleges that KCAP disclosed the sources of shareholder distributions in tax Forms 1099 issued to shareholders in January of the following year, but those Forms 1099 were inaccurate because of KCAP's earlier accounting errors.

According to the KCAP Order, in early 2015, KCAP's new auditor requested that it complete an Earnings and Profits Analysis (the "**E&P Analysis**"), for which KCAP hired new external tax advisors to conduct. The KCAP Order notes that the March 2015 E&P Analysis uncovered KCAP's accounting errors, and, on March 31, 2015, KCAP filed its 2014 Form 10-K which restated its financial statements for fiscal years 2010–2013, all quarters in 2013 and the first three quarters of 2014. According to the KCAP Order, in its restatement, KCAP determined that its accounting error was material because it impacted the tax-basis distributable income, which KCAP identified as one of the main metrics used by analysts and investors to evaluate business development companies. The KCAP Order notes that, in its Regulation S-K Item 301 disclosure, KCAP identified approximately $22.3 million of its approximately $35.8 million dividend as return of capital for the relevant period. The KCAP Order goes on to note that KCAP's restatement disclosed that its management identified a material weakness in its internal control over financial reporting related to its recorded distributions from its AMAs. Further, the KCAP Order states that a KCAP internal review memo explained that there was a design deficiency in its financial reporting system and there was no control in place to ensure that the AMA distributions were properly recorded.

Based on the conduct described above, the SEC alleged that KCAP violated Section 13(a) of the Exchange Act and Rules 13a-1, 13a-11, 13a-13 and 12b-20 thereunder, which require registered securities issuers to file accurate annual, current and quarterly reports as well as include further material information necessary to make those statements not misleading. Additionally, the SEC alleged that KCAP violated Section 13(b)(2)(A) of the Exchange Act, which requires registered securities issuers to keep accurate records and accounts that reflect transactions and dispositions related to the issuer's securities, in addition to Section 13(b)(2)(B) of the Exchange Act, which requires registered securities issuers to maintain adequate internal accounting controls to assure that transactions recorded in financial statements conform with GAAP. Finally, the SEC alleged that KCAP violated Section 19(a) of the Investment Company Act and Rule 19a-1 thereunder, which prohibit investment companies from paying dividends, wholly or partly, from sources other than current-year or accumulated net income unless the payments are accompanied by contemporaneous written statements to shareholders disclosing the sources of the distributions, as well as Rule 38a-1, which requires registered investment companies and business development companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the registered investment company and business development company. KCAP consented to the entry of the KCAP Order, acknowledged that it violated federal securities laws and agreed to cease and desist from future violations.

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

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