Investment Management Regulatory Update

June 19, 2019

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Rules and Regulations

SEC Grants Exemptive Relief for Non-Transparent Active ETFs

On May 20, 2019, the Securities and Exchange Commission (the "**SEC**") issued an order granting the exemptive relief requested by Precidian Funds LLC ("**Precidian**") to permit a "novel type of actively managed" exchange-traded fund that is not required to disclose its portfolio holdings on a daily basis. The SEC previously issued a notice on April 8, 2019 indicating its intent to grant the relief. For a further discussion regarding the relief granted to Precidian, please see the April 30, 2019 **Investment Management Regulatory Update**.

- **See a copy of the Order**

SEC Adopts Regulation Best Interest, Form CRS and Interpretive Releases Related to an Investment Adviser's Fiduciary Duty and the "Solely Incidental" Prong of the Broker-Dealer Exclusion From the Definition of Investment Adviser

On June 5, 2019, the SEC adopted its long-awaited Regulation Best Interest ("**Reg BI**"), a new standard of conduct for SEC-registered broker-dealers and natural persons who are associated persons of a broker-dealer ("**Broker-Dealers**"). Reg BI requires Broker-Dealers to act in the best interest of retail customers when making recommendations regarding securities transactions or investment strategies involving securities. At the same time, the SEC adopted two interpretative releases (the "**Interpretations**") and a new relationship summary disclosure requirement on Form CRS. The first

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interpretative release discusses the fiduciary duty of investment advisers under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") and was intended to "reaffirm—and in some cases clarify—certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Advisers Act." The second interpretation discusses the scope of the "solely incidental" prong of the broker-dealer exclusion from the definition of "investment adviser" and applies to circumstances of broker-dealers exercising investment discretion and account monitoring. Form CRS is a "short and accessible disclosure for retail investors that helps them to compare information about firms' brokerage and/or investment advisory offerings and promotes effective communication between firms and their retail investors." Davis Polk is currently preparing a client memorandum that will more fully describe Reg BI, the Interpretations and Form CRS.

- **See a copy of the Reg BI Adopting Release**
- **See a copy of the Form CRS Adopting Release**
- **See a copy of the Fiduciary Duty Interpretation**
- **See a copy of the Solely Incidental Interpretation**

Industry Update

OCIE Issues Risk Alert Regarding Safeguarding Customer Records and Information in Network Storage

On May 23, 2019, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC issued a risk alert (the "**Risk Alert**") to provide investment advisers and registered broker dealers with information regarding common deficiencies in recent examinations with respect to the safeguarding of electronic customer records and information in network storage, specifically with regard to the use of third-party security features.

According to the Risk Alert, OCIE identified security risks associated with the storage of electronic customer records and information by broker-dealers and investment advisers in various network storage solutions, including those utilizing cloud-based storage. The Risk Alert warned that firms did not always use available security features and that weak or misconfigured security settings on a network storage device could result in unauthorized access to information stored on the device.

During examinations, OCIE staff identified three concerns that may raise compliance issues under Regulations S-P and S-ID: (1) misconfigured network storage solutions; (2) inadequate oversight of vendor-provided network storage solutions; and (3) insufficient data classification policies and procedures.

OCIE provided examples of several features of effective configuration management programs, including: (1) "Policies and procedures designed to support the initial installation, on-going maintenance, and regular review of the network storage solution"; (2) "Guidelines for security controls and baseline security configuration standards to ensure that each network solution is configured properly"; and (3) "Vendor management policies and procedures that include, among other things, regular implementation of software patches and hardware updates followed by reviews to ensure that those patches and updates did not unintentionally change, weaken, or otherwise modify the security configuration."

OCIE recommended that applicable parties review their practices, policies and procedures with respect to storage of electronic customer information and actively oversee any vendors they may be using for network storage to see if the service is sufficient to enable the firm to meet its regulatory responsibilities.

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

Commissioner Hester Peirce Provides Remarks at the ETFs Global Markets Roundtable

On May 21, 2019, Commissioner Hester M. Peirce provided remarks at the ETFs Global Markets Roundtable in New York.

Peirce began by noting that since the first exchange-traded fund ("**ETF**") launched in 1993, they have proven to be one of the most useful and successful innovations in the registered fund space under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"). She also mentioned that ETFs registered with the SEC now have approximately $3.8 trillion in total net assets and that this growth can be attributed to the SEC's exemptive application process under which would-be sponsors have applied for exemptive orders for flexibility under securities laws enabling them to launch these ETFs.

Peirce spoke at length about the SEC's proposed rule to codify the exemptive relief, which would not only standardize the conditions of the relief, but would make it easier for fund sponsors to get their ETFs to market and in turn would fuel competition (the "**Proposed ETF Rule**"). For a detailed discussion of the Proposed ETF Rule, please see the July 31, 2018 **Investment Management Regulatory Update**. Peirce also acknowledged a similar prior rule that was proposed a decade ago, noting that it was one of the casualties of the financial crisis.

Peirce further discussed the length of time it has taken for the SEC to proceed toward implementing an ETF rule, noting that as with any new product, it takes the SEC time "to get comfortable with it[,]" and to "explore its many aspects, worry about its potential to harm investors and the markets, and analyze how best to condition the relief."

Peirce next discussed the growth in ETF assets and attributed the popularity to the "vast and diverse range of investment options, which are easy to enter and exit with low transaction costs." She noted some of the benefits that ETFs may offer, including "operating expenses that are lower than comparable mutual funds' expenses, tax efficiencies, and intra-day trading on the secondary market." She added that ETFs are not only convenient, but also cost-effective.

Next, Peirce explained why ETF assets are primarily concentrated in index-based funds, which she credited to the SEC's sluggishness in providing relief for non-indexed based ETFs to operate. Peirce admitted that the SEC's failure or delay in approving orders sometimes carries with it a "tinge of merit regulation" and questioned whether the SEC is substituting its own judgment for that of the market. Peirce mentioned her hope for the SEC to move expeditiously on the remaining outstanding requests for exemptive relief for non-fully transparent actively managed ETFs and reiterated her belief that "markets are good at merit regulation."

Peirce pointed to another example of the SEC's indecision in the ETF space, specifically its handling of leveraged and inverse ETFs, which she refers to as "geared ETFs." According to Peirce, "[l]everaged ETFs seek to provide returns that exceed the performance of a market index by a specified multiple over a period of time[,]" while inverse ETFs "seek to provide returns that have an inverse relationship to, or provide returns that are an inverse multiple of, the performance of a market index over a fixed period of time." Peirce noted that since 2008, the SEC has not issued orders to any sponsors allowing for the operation of these geared ETFs.

In discussing the SEC's failure to issue any further exemptive relief for geared ETFs, Peirce states that "[t]he [SEC] staff offered a reason for timidity in 2010, when it announced a review to evaluate the use of derivatives by registered investment companies, including ETFs. Pending completion of this review, the staff would defer consideration of exemptive requests under the Investment Company Act relating to ETFs that would make significant investments in derivatives, including certain actively-managed and leveraged ETFs." Peirce added that the moratorium still continues today with respect to new exemptive relief for these geared ETFs.

Peirce believes that refusing to allow geared ETFs to come to market is not a reasonable way to address concerns about these products. She added that one of the SEC staff's main concerns in reviewing these

applications was that retail investors did not comprehend that these products "reset" daily and are intended to attain their stated objectives on a daily basis. Peirce stated that the SEC's regulatory regime is based on disclosure of material information so that investors can make an informed decision, and the disclosures being made by leveraged or inverse ETFs to inform investors was straightforward. She discussed her reading of the earliest prospectuses, which, in her view, "clearly lay out their investment objective, strategy, risks, and target audience—which they underscore is not your typical buy and hold retail investor."

Next, Peirce noted that prohibiting new fund sponsors the ability to offer geared ETFs has created an oligopoly for the ETF sponsors who received exemptive relief for these products initially, since new sponsors "cannot enter the market and thus investors seeking to invest in leveraged and inverse [ETFs]" are forced to decide "among the suite offered by the two remaining ETF sponsors or from among the mutual funds that offer similar investment strategies." She further added that this same "protect them from their wild selves" thinking "courses through our accredited investor definition, which keeps most investors out of the private markets through which they could diversify their portfolios and gain exposure to companies during their early growth phase."

Peirce noted that the Proposed ETF Rule omitted geared ETFs and also failed to streamline the process involved in having an exchange receive approval of its listing standards under Rule 19b-4 of the Securities Exchange Act of 1934.

Finally, Peirce discussed the potential for gaining exposure to cryptocurrencies through a registered investment company, noting that "[d]espite interest from sponsors and investors, the [SEC] has yet to entertain an exemptive application for an ETF or approve an exchange rule allowing for the operation of crypto ETFs or other [exchange-traded products]." In discussing the SEC's stated concerns, which include market manipulation, custody and retail investor protection, she noted that "it is not the [SEC's] role to be the arbiter of what constitutes an appropriate investment or to act as an investment adviser." Peirce further discussed the SEC's focus on "the underlying characteristics of bitcoin and the spot markets in which it trades" when disapproving a proposed rule change to list and trade shares of the Winklevoss Bitcoin Trust. In encouraging the approval of a cryptocurrency ETF, she noted that the "ETF wrapper provides ease of investor movement into and out of the investment throughout each trading day, improved price arbitrage, and the possibility of increased participation by institutional investors with the attendant benefits their participation would provide[,]" in addition to ensuring direct regulation by the SEC. She concluded by noting that even if the SEC were to approve a cryptocurrency ETF to trade in our markets, that would not be a "seal of approval" and would still require investors to study product disclosures and assess their own appetites for risk.

- **See a transcript of the remarks**

SEC Chairman Jay Clayton Gives Keynote Remarks at the Mid-Atlantic Regional Conference

On June 4, 2019, Jay Clayton, Chairman of the SEC, gave the keynote remarks at the Mid-Atlantic Regional Conference in Philadelphia, Pennsylvania. Chairman Clayton discussed: (i) recent legal developments affecting the SEC; (ii) the use of data analytics to support the SEC's mission; and (iii) the importance of responsible collection and safeguarding of data.

Recent Legal Developments

Chairman Clayton discussed four significant court decisions related to the SEC's work: (i) *Kokesh v. SEC*; (ii) *Lucia v. SEC*; (iii) *The Robare Group, Ltd. v. SEC*; and (iv) *Lorenzo v. SEC*.[1]

Clayton noted that in *Kokesh,* the SEC brought an enforcement action based on fraud that "began in the 1990's and continued until 2009." He noted that the defendant argued that the SEC was "time-barred from seeking disgorgement, because the fraud began outside the five-year period under [the law]." Clayton stated that the Supreme Court held that the SEC's use of the disgorgement remedy was "penal in nature (rather than equitable) and as such was subject to the five-year limitations period applicable to penalties." He expressed concern that the decision will impact the SEC's ability to return funds fraudulently taken from "Main Street" investors. Clayton stated that *Kokesh* may cause the SEC to forgo up to approximately $900 million in disgorgement in already-filed cases for fiscal year 2018. The decision may especially affect the SEC's ability to recover the ill-gotten gains of long-running frauds such as Ponzi schemes.

Next, Clayton discussed the *Lucia* decision, in which the Supreme Court held that the SEC's Administrative Law Judges ("**ALJs**") had not been appointed in a manner consistent with the Constitution. He noted that after *Lucia*, "approximately 200 administrative proceedings had to be reassigned to new ALJs." Clayton noted that while resolving issues surrounding this decision will require substantial litigation resources, he characterized the result as a "speed bump, not a long-term issue." He added that while the SEC "has flexibility to bring many of its contested actions in district court or through administrative proceedings[,]" he is "committed to using the administrative process only for the cases that are most appropriate for that forum."

Clayton next discussed the *Robare* decision*,* stating that "the D.C. Circuit held that an investment adviser does not "willfully" omit material facts under Section 207 of the Advisers Act if the adviser acted "negligently." Clayton conceded that while *Robare* does require the SEC to carefully consider the appropriate standard for cases brought under the Advisers Act, the decision did not disturb the decades-old standard "that a willful violation of the securities laws means that the person intentionally committed the act that constitutes the violation, with no requirement that the person also be aware that they are violating the law."

Finally, Clayton discussed the SEC's victory in *Lorenzo*, where the Supreme Court affirmed the SEC's position that "a person could be liable under the anti-fraud provisions for the knowing dissemination of false or misleading statements, even if he or she did not make the statements." Clayton hailed this as a victory for the SEC, as it reinforces the SEC's ability to bring charges against those who disseminate misstatements.

Clayton closed this section by discussing the questions that the Division of Enforcement ("**Enforcement**") asks themselves to measure success, which include: (i) "Are we deterring future harm by bringing meaningful cases that send clear and important messages to market participants?"; (ii) "Are we protecting investors and markets by holding individuals accountable for wrongdoing and removing bad actors from the securities markets?"; (iii) "Are we stripping wrongdoers of their ill-gotten gains and returning money to victims?"; and (iv) "Are we acting quickly to stop frauds, prevent future losses, and return ill-gotten gains to harmed investors?"

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[1] *Kokesh v. SEC, 137 S. Ct. 1635 (2017); Lucia v. SEC., 138 S. Ct. 2044 (2018); Robare Grp., Ltd. v. SEC, 922 F.3d 468 (D.C. Cir. 2019); and Lorenzo v. SEC, 139 S. Ct. 1094 (2019).*

The Use of Data Analytics to Support the SEC's Mission

Clayton next discussed certain challenges faced by the SEC, including the agency-wide hiring freeze and government shutdown, and how those challenges "make our data analytics work more important than ever." He stated that in order to be effective, "data analytics needs smart people to support and advance the work of our experienced and dedicated staff[,]" noting that "our people—our human capital—are our most important resources."

Clayton next discussed how both OCIE and Enforcement are using data analytics to accomplish their goals, but warned that "[t]o remain a trusted, respected, and effective regulator, we must be mindful of the volume of data we collect, and its sensitive nature, and be principled and responsible users of data."

Clayton described OCIE's risk-based strategy in employing its National Examination Program, which uses data analytics to efficiently channel its limited resources. For example, he discussed the National Exam Analytics Tool, which "allows examiners to collect and analyze large datasets of trading records to identify potentially problematic activity" and has been expanded to provide analysis of "broker-dealer trading records and anti-money laundering practices." Clayton next discussed the High Frequency Analytics Lab, which enhances the SEC's ability to monitor "market microstructure including high-frequency trading[,]" by generating reports which identify registrants engaging in potentially unfair market practices.

Next, Clayton discussed Enforcement's use of data analytics tools to "identify suspicious trading and abuses perpetrated on retail investors by financial professionals." Clayton highlighted Enforcement's use of "trading pattern recognition" to uncover a scheme, as well as the charging of nine defendants for their alleged roles in a scheme to hack the EDGAR system, an effort made possible by the use of "careful analysis of trading in the window between when the material nonpublic information was extracted and when it was disseminated to the public." Additionally, he stated that the SEC staff is able to use data analytics to trace digital asset transactions on the blockchain. Further, Clayton noted Enforcement's establishment of the Retail Strategy Task Force, which is tasked with the goals of: (i) developing data-driven strategies to identify practices harmful to retail investors; and (ii) "to collaborate within and beyond the SEC on retail investor advocacy and outreach." Finally, Clayton pointed to the ATLAS program, which was developed by OCIE working with Enforcement, and allows staff to "harness multiple streams of data, including blue sheets, pricing, and public announcements." He further discussed the ATLAS team's use of advanced data analysis technology to "identify firms that failed in their obligation to submit accurate blue sheet data to the SEC."

The Importance of Responsible Collection and Safeguarding of Data

Chairman Clayton next described the SEC's efforts to protect the data entrusted to the SEC by registrants and the public. First, Clayton discussed the creation of the Consolidated Audit Trail ("**CAT**"), which will provide "a single, comprehensive database enabling regulators to more efficiently and thoroughly track all trading activity in equities and options throughout the U.S. market." He noted that given certain substantial and serious concerns "about the protection of investors' personally identifiable information[,]" he supports eliminating the requirement to maintain social security numbers in the CAT. Next, Clayton discussed the SEC's recent hiring of two key personnel—a Chief Risk Officer, tasked with assisting with the coordination of the SEC's risk management efforts, and a Senior Advisor for Cybersecurity Policy. Finally, Clayton stressed the need for the SEC's continued collaboration with its state and federal partners with regard to security in data sharing arrangements, noting that it is important to ask the following questions: (i) "Are best efforts being used to safeguard the data?"; (ii) "Have we carefully considered the extent to which [personally identifiable information] is needed or whether a more tailored, narrow set of information could suffice?"; (iii) "Are there any safeguards in place to protect the confidentiality of the information?"; and (iv) "How can we work together if there is an unauthorized disclosure?"

- **See a transcript of the remarks**

Litigation

SEC Settles with Former Investment Adviser for Material Omissions in Disclosures to Clients and Overcharging Advisory Fees

On May 28, 2019, the SEC issued an order (the "**Anderson Order**") instituting and settling cease-and-desist proceedings against Stephen Brandon Anderson ("**Anderson**"), owner and operator of River Source Wealth Management, LLC ("**River Source**"), a registered investment adviser.

According to the Anderson Order, Anderson is alleged to have overcharged River Source clients advisory fees of at least $367,000 between 2015 and 2016. River Source's advisory fees were supposed to be based on a percentage of each client's assets under management ("**AUM**"), subject to a maximum fee set forth in a fee schedule attached to each client's signed investment advisory agreement. In September 2012, Anderson allegedly sent a letter notifying clients that River Source was raising its maximum annual advisory fee from 1.0% to 1.25% for clients with less than a million dollars in AUM. Anderson allegedly sent a similar letter in December 2015 raising River Source's maximum advisory fee from 1.25% to 1.5%. The Anderson Order states that in 2015 and 2016, River Source charged a majority of its clients advisory fees higher than these stated maximums, and that River Source received $185,816 in overcharges in 2015 and $181,360 in overcharges in 2016.

Anderson is also alleged to have prepared, signed and filed materially misstated Form ADVs in 2015 and 2016. According to the SEC, River Source's 2015 Form ADV reported that River Source had $227.2 million in AUM, which overstated River Source's AUM by roughly $34 million, and River Source's 2016 Form ADV reported that River Source had $235.6 million in AUM, an overstatement by at least $61 million. The SEC also stated that River Source's 2015 and 2016 Forms ADV failed to disclose two lawsuits that were filed by River Source clients against Anderson and River Source, and instead falsely reported that neither River Source, nor any of its employees, partners or directors were involved in any proceeding that could "result in an adverse finding related to investment activities."

The SEC also alleged that Anderson failed to keep true, accurate and current books and records relating to River Source's investment advisory business, failed to adopt and implement required compliance policies and procedures and failed to annually review the adequacy of River Source's policies and procedures to assess their effectiveness. Among other compliance failures, the SEC alleged: (i) that Anderson had purchased River Source's compliance policies "from a third party," making them unable to be "tailored to its business"; (ii) that River Source failed to update its policies regularly; and (iii) that River Source had not implemented any policies with respect to calculating client fees, maintaining and backing up client files and preventing the overcharging of advisory fees and the misrepresentations of AUM.

As a result of the conduct described above, the SEC alleged that Anderson willfully violated Sections 206(2) and 207 of the Advisers Act, which make it unlawful "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client" and "for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the [SEC]…or willfully to omit to state in any such application or report any material fact which is required to be stated therein[,]" respectively. The Anderson Order further alleged that Anderson willfully aided and abetted and caused River Source's violation of Section 204 of the Advisers Act and Rule 204-2 thereunder, which require that investment advisers registered with the SEC maintain and preserve certain books and records, and make available such books and records as the SEC or its representatives may reasonably request. Additionally, the Anderson Order alleged that Anderson violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require, among other things, that investment advisers registered with the SEC adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, in addition to reviewing the adequacy of those policies and procedures annually. Anderson agreed to pay $367,176 in disgorgement, including prejudgment interest of $38,205, and a civil monetary penalty of $100,000. Anderson also

consented to the entry of the Anderson Order and agreed to cease and desist from future violations, to not act in a supervisory or compliance capacity of certain regulated entities and to provide copies of the Anderson Order to advisory clients.

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

SEC Settles with Private Fund Manager and CIO for Improper Valuation Policy

On June 4, 2019, the SEC announced that Deer Park Road Management Co. ("**Deer Park**"), a private fund manager that invests in mortgage-backed securities, has agreed to pay a $5 million penalty to settle charges stemming from compliance deficiencies that contributed to the firm's failure to ensure that certain securities were valued properly in its flagship fund.

In the order (the "**Deer Park Order**"), the SEC alleged that Deer Park, which manages $2.5 billion in assets, did not properly value certain mortgage-backed securities in its STS Partners' fund in violation of Generally Accepted Accounting Principles ("**GAAP**"). The Deer Park Order alleges that Deer Park failed to implement its existing valuation policy, which stipulated that Deer Park must maximize the use of relevant observable inputs, such as trade prices, in accordance with GAAP, which may have resulted in the undervaluation of certain assets.

Moreover, the SEC alleged that Deer Park's valuation policy was not reasonably designed and did not adequately ensure that valuations conformed to GAAP. While Deer Park traders were given significant discretion regarding valuation, its policy lacked procedures designed to promote consistency and reduce potential conflicts of interest and did not include relevant calibration requirements or mention any valuation techniques or methodologies. The SEC also alleged that Deer Park did not properly guard against certain valuation-related risks, such as the possibility that traders might undervalue securities and sell for a "profit" when needed, or that traders might provide inaccurate information to pricing vendors while also using those prices to value securities. Although Deer Park's chief executive officer directed traders to maximize observable inputs, such as actual trading prices, the SEC order notes that traders used valuations that deviated from such observable inputs.

The SEC alleged that Deer Park's Chief Investment Officer, Scott Burg, improperly approved valuations that the traders flagged as "undervalued" with notations to "mark up gradually." The SEC further alleged that Deer Park's Risk Management Committee, which was comprised of the principal's relatives and others, lacked the expertise to determine whether bonds were valued in accordance with GAAP.

The Deer Park Order noted that Deer Park has undertaken remedial efforts to revise its valuation policy and procedures and has hired a new Chief Compliance Officer with expertise in compliance and valuation.

As a result of the conduct above, the SEC alleged that Deer Park willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Without admitting or denying the findings in the Deer Park Order, Deer Park and Burg have agreed to cease and desist from committing or causing any future violations of a provision of the Advisers Act requiring reasonably designed policies and procedures; Deer Park agreed to pay a monetary penalty of $5 million, and Burg agreed to pay a monetary penalty of $250,000. Deer Park also consented to undertakings including retaining an independent compliance consultant to review and revise its valuation policies and procedures.

- **See a copy of the Deer Park Order**

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