Investment Management Regulatory Update

April 26, 2016

SEC Rules and Regulations

SEC Staff Grants No-Action Relief to Index-Linked ETF for Exceeding Ownership Percentage Limitations in Insurance Companies or Securities-Related Issuers under Sections 12(d)(2) and 12(d)(3) of the Investment Company Act

On March 28, 2016, the staff of the Securities and Exchange Commission (the "**SEC**") issued a no-action letter (the "**Letter**") giving relief under Sections 12(d)(2) and 12(d)(3) of the Investment Company Act of 1940, as amended (the "**Investment Company Act**") to SPDR S&P Dividend ETF (the "**Fund**"), a portfolio of the SPDR Series Trust (the "**Trust**"), to enable the Fund to (i) own more than 10% of the total outstanding voting stock of an insurance company and/or (ii) purchase more than 5% of an outstanding class of equity securities of an issuer that, in its most recent fiscal year, derived more than 15% of its gross revenues from securities related activities (a "**Securities-Related Issuer**"), subject the conditions set forth in the Letter.

According to the incoming letter (the "**Incoming Letter**"), the Trust is a registered open-end investment company under the Investment Company Act and offers investment portfolios that seek to track the performance of specified market sectors represented by various indexes sponsored by unaffiliated index providers. The investment objective of the Fund, according to the Incoming Letter, is to seek to provide investment results that, before fees and expenses, generally correspond to the total return performance

of the S&P High Yield Dividend Aristocrats Index (the "**Index**"), which is sponsored by Standard & Poor's Financial Services LLC (the "**Index Provider**").

The Incoming Letter represents that the Fund is not managed as a traditional actively managed fund, but that instead the Fund's investment adviser (the "**Adviser**") attempts to approximate the investment performance of the Index by investing in a portfolio of stocks with generally the same risk and return characteristics as those of the Index. The Incoming Letter argues, however, that the most efficient and accurate way to manage the Fund would be to employ a "replication" strategy, whereby the Adviser holds all of the constituents of the Index in approximately the same proportion as the issuers represent in the Index. According to the Incoming Letter, the Adviser has been unable to employ such a replication strategy because of the regulatory restrictions of Sections 12(d)(2) and 12(d)(3) of the Investment Company Act and Rule 12d3-1 thereunder ("**Rule 12d3-1**"), which generally limit the percentage amount an investment company may own of the outstanding voting stock of insurance companies or securities of Securities-Related Issuers.

Section 12(d)(2) of the Investment Company Act generally prohibits a registered investment company from purchasing or otherwise acquiring any security issued by any insurance company if, as a result of the purchase or acquisition, the registered investment company would own in the aggregate, or as a result of such purchase or acquisition will own, more than 10% of the total outstanding voting stock of the insurance company. The Incoming Letter states that the SEC historically has interpreted Section 12(d)(2) of the Investment Company Act as "prohibiting control of an insurance company by an investment company but permitt[ing] acquisition of stock of an insurance company upon assurance that there would be no such control." To address such concerns, the Incoming Letter represents, among other things, that the Fund will not own the securities of an insurance company in an amount exceeding the approximate proportion that the insurance company's stock represents in the Index, and that the Fund will not exercise a controlling influence over the management or policies of the insurance company and will either vote its shares in the insurance company (x) as directed by an independent third party or (y) in the same proportion as the vote of all other holders of the insurance company's shares.

Section 12(d)(3) of the Investment Company Act generally prohibits a registered investment company from purchasing or otherwise acquiring any security issued by a broker, dealer, an underwriter or an investment adviser registered under the Investment Advisers Act of 1940 (the "**Advisers Act**"). Rule 12d3-1 provides exemptions for acquisitions of securities issued by Securities-Related Issuers under certain conditions. One such condition is set forth in Rule 12d3-1(b)(1), which requires that an investment company, immediately after its acquisition of an equity security, own no more than 5% of the outstanding securities of a particular class of equity securities. The Advisor argued in the Incoming Letter that such condition would be difficult to comply with given the growth of the Fund.

The Incoming Letter argues that the SEC has previously identified two apparent congressional purposes for prohibiting investment company investments in securities issued by persons engaged in securities related activities: (i) to limit the exposure of registered investment companies to "entrepreneurial risk" peculiar to securities related business and (ii) to prevent potential conflicts of interest and reciprocal practices, such as directed brokerage. Regarding entrepreneurial risk, the Incoming Letter states that the SEC has acknowledged that such concerns are adequately addressed by prohibiting the acquisitions of general partnership interests, and paragraph (c) of Rule 12d3-1 effectively precludes a registered investment company from acquiring general partnership interests in a broker, dealer, registered investment adviser or underwriter.

Regarding conflicts of interest, such as purchasing the securities of a broker-dealer as a reward for selling an investment company's shares, the Incoming Letter argues that the Fund's investments do not raise such concerns as a practical matter. According to the Incoming Letter, the Adviser has limited discretion to choose the portfolio securities or the amount of such securities to be purchased as it is obligated to seek to track the performance of the Index, the components of which are determined by the Index Provider. Regarding directed brokerage, the Incoming Letter argues that because of the Fund's investment objective, it would be extremely unlikely that the number of brokerage transactions directed to any broker-dealer represented in the Index would have any significant or meaningful effect on such broker-dealer's market value or profitability. To further address concerns, the Incoming Letter represents

that the Fund will, among other things, (i) not use a Securities-Related Issuer as the executing broker for any Fund transaction, (ii) not acquire the securities issued by a Securities-Related Issuer in amounts exceeding the approximate proportion that the issuer represents in the Index, and (iii) if the Fund owns more than 5% of the value of outstanding securities issued by persons engaged in securities related activities (other than Securities-Related Issuers), comply with the provisions of Section 17(e) of the Investment Company Act and Rule 17e-1 thereunder when using that issuer, or any affiliated person of that issuer, as a broker.

According to the Letter, the staff agreed with the proposition in the Incoming Letter that the Fund's proposed activities do not raise the concerns that underlie Section 12(d)(3) of the Investment Company Act, and, further, stated that it would not be inconsistent with the intent of Sections 12(d)(2) and 12(d)(3) of the Investment Company Act if the Fund exceeded the limitations set forth in Rule 12d3-1, based on the facts and representations in the Incoming Letter. Therefore, the SEC staff stated that it would not recommend the SEC take enforcement action under Section 12(d)(3) of the Investment Company Act if the Fund owns securities issued by a Securities-Related Issuer, as described in the Incoming Letter.

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

Industry Update

Department of Labor's Final Rule Defining Fiduciary Investment Advice and Conflicts of Interest

On April 6, 2016, the U.S. Department of Labor (the "**DOL**") issued final regulations expanding the definition of a "fiduciary" with respect to pension and retirement plans, IRAs and other accounts under ERISA and the Internal Revenue Code. The regulatory package (collectively, the "**Final Rule**"):

- significantly expands the definition of who is a "fiduciary" under ERISA by reason of providing "investment advice" to ERISA plans or IRAs;
- introduces two new DOL "prohibited transaction" class exemptions that may be used by financial institutions that fall under the expanded definition of "fiduciary", including the Best Interest Contract Exemption (the "**BIC Exemption**"); and
- amends six existing DOL prohibited transaction class exemptions that are commonly used in the financial sector to limit their availability in certain circumstances and to impose additional conditions on the use of the exemptions.

If a firm is deemed to be a fiduciary, it will become subject to the prohibited transaction provisions of ERISA and the Internal Revenue Code, which would limit its ability to receive commissions, fees and other compensation. On a going forward basis, firms will need to consider whether their product and service offerings will (i) utilize a business model under which they will not be considered a fiduciary under the Final Rule (e.g., by providing only general educational information) or (ii) cause them to become an ERISA fiduciary, in which case they will need to adjust their business model to receive only a fee from the customer (and not revenues from products purchased) or comply with onerous requirements of the BIC Exemption or another prohibited transaction exemption. For further information regarding the Final Rule, please see the April 18, 2016 Davis Polk Client Memorandum, **Department of Labor's Final Rule Defining Fiduciary Investment Advice and Conflicts of Interest**.

SEC Division of Investment Management Issues Guidance on FAST Act Changes Affecting Investment Advisers to Small Business Investment Companies

In March 2016, the staff of the Division of Investment Management of the SEC (the "**Division**") issued an IM Guidance Update explaining how the Fixing America's Surface Transportation Act (the "**FAST Act**"), which was signed into law on December 4, 2015, affects the registration of investment advisers to small business investment companies ("**SBICs**").

According to the guidance, the FAST Act amended two provisions of the Advisers Act, thereby providing two additional exemptions for SBIC advisers to rely on in addition to the existing exemption in Section 203(b)(7) of the Advisers Act (the "**SBIC adviser exemption**"). First, according to the guidance, the FAST Act revised the existing exemption in Section 203(l) of the Advisers Act, which, prior to the enactment of the FAST Act, only permitted reliance by advisers to one or more "venture capital funds" (as defined in Rule 203(l)-1, "**venture capital funds**") (the "**venture capital fund adviser exemption**"). According to the Division, the FAST Act revised this exemption by deeming SBICs to be venture capital funds for purposes of the exemption. Thus, according to the guidance, advisers whose only clients are venture capital funds and/or SBICs may rely on the venture capital fund adviser exemption.

Second, according to the guidance, the FAST Act amended Section 203(m) of the Advisers Act (the "**private fund adviser exemption**") to exclude assets of SBICs that are private funds from counting toward the $150 million threshold under that exemption. Prior to the FAST Act amendments, generally only advisers solely to private funds that had assets under management in the United States of less than $150 million could rely on the private fund adviser exemption. According to the Division, with the FAST Act amendment, a private fund adviser may rely on the private fund adviser exemption so long as less than $150 million of its assets under management are attributable to non-SBIC private fund clients, regardless of the assets under management in the United States attributable to SBIC clients that are private funds. Therefore, according to the staff, an adviser relying on the SBIC adviser exemption may now, as a result of the FAST Act amendments, choose to rely instead on the venture capital fund adviser exemption and advise SBICs and/or venture capital funds or rely on the private fund adviser exemption and advise both SBIC private fund clients and non-SBIC private fund clients, subject to the $150 million assets under management threshold for non-SBIC private fund clients. The staff noted that a SBIC adviser that decides to rely on either the venture capital fund adviser exemption or the private fund adviser exemption will be required to submit reports to the SEC as an exempt reporting adviser.

The staff also noted that, as a result of the FAST Act amendments, an adviser that currently relies on either the venture capital fund adviser exemption or the private fund adviser exemption may now be able to advise SBIC clients as well. And, according to the guidance, certain advisers to SBICs that have previously registered may be able to withdraw their registration and begin reporting to the SEC as exempt reporting advisers under either the venture capital fund adviser exemption or the private fund adviser exemption.

The Division noted that it plans to recommend to the SEC amendments to Rules 203(l)-1 and 203(m)-1 of the Advisers Act to reflect the FAST Act amendments, and until any final rules are acted upon by the SEC, the staff of the Division would not object to an adviser relying on the FAST Act amendments to the affected exemptions, provided the adviser files the required reports as an exempt reporting adviser.

- **See a copy of the IM Guidance Update**

Treasury Proposes Overhaul of Related-Party Debt Rules

On April 4, 2016, the Internal Revenue Service (the "**IRS**") and the Treasury Department ("**Treasury**") released proposed regulations that, if finalized in their current form, would fundamentally rewrite the U.S. tax rules with respect to debt obligations between members of certain groups of related corporations and partnerships. The proposed regulations specify circumstances in which debt obligations would be recharacterized as equity, with a resulting loss of interest deductions, withholding taxes on payments treated as dividends and other consequences that could materially increase tax liabilities. The proposed regulations were released at the same time as final and temporary regulations addressing so-called "inversion transactions," but their application is not limited to companies that have engaged in inversion transactions. Moreover, very broad constructive ownership rules apply for purposes of determining whether entities are related for purposes of the proposed regulations.

Treasury and the IRS have requested comments on whether the scope of the proposed regulations should be broadened to cover certain debt commonly used by investment partnerships, including debt

issued by leveraged "blockers." However, given the breadth of the applicable ownership attribution rules, certain aspects of the proposed regulations would apply to many "blocker" entities used by private equity funds, even if the scope is not broadened.

Please see the April 11, 2016 Davis Polk Client Memorandum, **Treasury Proposed Overhaul of Intercompany Debt Rules**. For a discussion of the final and temporary regulations on inversion transactions, see the April 11, 2016 Davis Polk Client Memorandum, **Treasury Issues New Anti-Inversion Guidance**.

- **See a copy of the proposed regulations**

Treasury Proposes Regulations on Taxation of Deemed Distributions on Convertible Debt and Other Equity-Linked Instruments

On April 12, 2016, the IRS and the Treasury released proposed regulations with respect to "deemed distributions" by a corporation to the holders of convertible debt and certain other instruments linked to the corporation's stock. For almost fifty years, the Internal Revenue Code (the "**Code**") has provided that certain adjustments to the equity-linked features of convertible debt and other equity-linked instruments (such as certain changes in the conversion ratio of convertible debt) result in deemed distributions. In the past, however, there have been widespread difficulties in complying with this rule, in significant part because of the difficulty of determining whether a triggering event had occurred.

The proposed regulations address the timing and amount of the deemed distributions and define (and to a certain extent, limit) the situations in which withholding agents, such as prime brokers, are required to withhold on deemed distributions. They do not, however, limit the tax liability or filing obligation of a non-U.S. beneficial owner, such as an offshore hedge fund, in situations in which a withholding agent would not be required to, or fails to, withhold. They are proposed to be effective for deemed distributions occurring after the date of finalization, although taxpayers are permitted to rely on them prior to that date.

General Overview

Under Section 305 of the Code,[1] certain distributions by a corporation of its stock, or of rights to acquire its stock, are treated as if they were cash distributions and therefore constitute dividends to the extent treated as paid out of the corporation's current or accumulated earnings and profits. Section 305(c) and existing Treasury regulations treat certain events relating to convertible debt, warrants and other similar instruments issued by a corporation ("**Stock-Right Instruments**"), such as a change in the conversion ratio, as a distribution by the corporation. Current guidance does not, however, address the amount or timing of the deemed distribution. In the case of any such deemed distribution, the holder of a Stock-Right Instrument is treated as a shareholder of the issuing corporation. If the holder is a non-U.S. person and the issuer is a U.S. corporation, a deemed dividend distribution would generally be subject to U.S. withholding tax at the rate of 30% (or at a lower rate provided by an applicable tax treaty).[2] Thus, for example, deemed distributions to an offshore hedge fund pursuing a convertible arbitrage strategy could have a significant effect on the fund's return.

The proposed regulations address an adjustment (called an "**applicable adjustment**") to any right to acquire stock of the corporate issuer of a Stock-Right Instrument, whether the Stock-Right Instrument will be settled in stock or in cash. Very generally, as under current law, an applicable adjustment that

[1] All "Section" references in this article are to the Code.

[2] By contrast, interest on a convertible debt obligation issued by a U.S. corporation would in many instances qualify as "portfolio interest," which is exempt from U.S. withholding tax.

increases the rights of holders of the Stock-Right Instrument relative to those of actual shareholders may result in a deemed distribution to the holders of the Stock-Right Instrument, while an applicable adjustment that decreases the rights of holders of the Stock-Right Instrument relative to those of actual shareholders may result in a deemed distribution to the actual shareholders. Also as under the current provisions, an applicable adjustment made pursuant to a *bona fide*, reasonable adjustment formula intended to prevent dilution in the case of stock distributions, stock splits and similar events will not be treated as a deemed distribution.

Amount of Deemed Distribution

Under the proposed regulations, the amount of the deemed distribution to a holder of a Stock-Right Instrument would be equal to the increase in the fair market value of the stock right as a consequence of the deemed distribution – that is, the applicable adjustment would be treated as a distribution of additional stock rights to the holder of the Stock-Right Instrument.[3] The preamble to the proposed regulations notes that the current regulations may reasonably be interpreted as providing either that the amount of the deemed distribution is equal to the fair market value of the additional stock right or that the amount of the deemed distribution is equal to the fair market value of the underlying stock. It states that, prior to the finalization of the proposed regulations, the IRS will not challenge either position.

Timing of Deemed Distribution

Under the proposed regulations, a deemed distribution would occur on the date the applicable adjustment became effective under the terms of the relevant Stock-Right Instrument, but not later than the date of the actual distribution that triggered the applicable adjustment. If the Stock-Right Instrument does not state when the applicable adjustment becomes effective, the deemed distribution would occur immediately before the opening of business on the ex-dividend date for the triggering distribution (in the case of a stock right relating to publicly traded stock that is publicly traded).

Withholding on Deemed Distributions to Non-U.S. Persons

The proposed regulations contain rules for withholding agents, which are intended to address the issues of (i) lack of knowledge that a deemed distribution has occurred and (ii) absence of cash payments in connection with a deemed distribution. These rules, as well as the rules with respect to the amount and timing of deemed distributions, would apply both for purposes of regular cross-border withholding under "chapter 3" and to withholding under "chapter 4," generally referred to as "FATCA."

The proposed regulations provide that a withholding agent (other than the issuer of the relevant instrument) is required to withhold on a deemed distribution only if, before the due date for the return on which the withholding agent would otherwise report the withholding, which is March 15 of the calendar year following the year in which the deemed distribution occurred (the "**Form 1042 filing date**"):[4]

- the issuer has either furnished a statement to the withholding agent containing information with respect to the deemed distribution or publicly reported this information; or
- the withholding agent has actual knowledge that the deemed distribution occurred.

[3] By contrast, a deemed distribution to an actual shareholder as a consequence of an applicable adjustment to a Stock-Right Instrument would be equal to the fair market value of the stock that is deemed to have been distributed.

[4] This return is made on IRS Form 1042.

The proposed regulations would also modify the existing cost basis reporting rules[5] by providing that, if an otherwise reportable event results in a deemed distribution under Section 305(c), the issuer is required to provide statements to all holders of the relevant security (including otherwise "exempt recipients," such as C corporations and foreign persons) unless the issuer elects to report the information publicly.[6]

Once a withholding agent becomes required to withhold on a deemed distribution under the proposed regulations, the withholding must generally be done on the earliest of:

- the next date on which a payment of cash is made with respect to the relevant Stock-Right Instrument;
- the date on which the relevant Stock-Right Instrument is sold, exchanged or otherwise disposed of (including through a transfer to an account not maintained by the withholding agent or a termination of the relevant account relationship); and
- the Form 1042 filing date.

If no payment is made on the relevant Stock-Right Instrument, or the relevant Stock-Right Instrument is not sold, prior to the Form 1042 filing date, or if the amount of any such payment, or the amount of proceeds from any such sale, is less than the amount of the withholding tax, the withholding agent may satisfy its withholding tax obligation by withholding on other cash payments to the beneficial owner, selling other property it holds for the beneficial owner or obtaining "contributions" of property directly or indirectly from the beneficial owner.

Substitute Dividends

Under current Treasury regulations, a substitute dividend payment made pursuant to a securities lending transaction or sale-repurchase transaction (a "repo") is sourced for U.S. federal income tax purposes in the same manner as the underlying dividend. Thus, if the underlying dividend is paid by a U.S. corporation, the substitute dividend payment is a U.S.-source payment, which will generally be subject to U.S. withholding tax if made to a non-U.S. person. The proposed regulations provide that, for this purpose, a deemed distribution on the underlying security pursuant to Section 305(c) will give rise to a deemed substitute dividend payment. The proposed regulations apply to these deemed substitute dividend payments in the same manner as they apply to deemed distributions.

Effective Date

As noted above, the proposed regulations would apply to deemed distributions occurring after the regulations are finalized (the "**publication date**"). However, taxpayers, including withholding agents, are permitted to rely on them prior to the publication date, in which case, they are also permitted to treat the amount of a deemed distribution occurring prior to the publication date as equal either to the fair market value of the additional stock right or the fair market value of the underlying stock (which would generally be significantly easier to determine).

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[5] Section 6045B of the Code and the Treasury regulations thereunder provide that an issuer of a "specified security" (including, for example, stock, a convertible debt instrument or a warrant) must report, both to the IRS and the holders of the specified security, certain information relating to any corporate action that affects the basis of the specified security.

[6] Under existing withholding rules, certain non-U.S. entities (such as "qualified intermediaries" or "withholding foreign partnerships") may assumed the primary obligation for certain U.S. withholding taxes. The proposed regulations provide that such a foreign entity would be required to withhold on a deemed distribution, and a U.S. withholding agent would be permitted to treat such a non-U.S. entity as having the withholding obligation with respect to a deemed distribution, only if (i) within ten (10) days after receiving an issuer statement with respect to the deemed distribution, the U.S. withholding agent provides the foreign entity with a copy of the statement or (ii) the issuer has met the applicable public reporting requirements with respect to the deemed distribution publicly. If neither of these conditions is met, the U.S. withholding agent would be required to withhold on the deemed distribution, subject to the exceptions described above.

Certain Observations

- While the proposed regulations provide an exception to *withholding* obligations in the absence of information from the issuer, they do not contain any similar exception for the beneficial owner of the relevant instrument. If a withholding agent does not withhold tax on a deemed U.S.-source dividend distribution to a non-U.S. beneficial owner, the beneficial owner will be required to file a U.S. federal income tax return and pay the tax itself. In situations in which the issuer has not either furnished statements or provided a public report with respect to a deemed distribution, and withholding agents are therefore not required to withhold, it will generally be difficult for the beneficial owner of a Stock-Right Instrument to determine whether a deemed distribution has occurred or the amount of the deemed distribution.
- The proposed regulations address substitute dividend payments made pursuant to securities lending transactions and repos, but they do not address payments made on a "swap" that references a Stock-Right Instrument. Presumably, a deemed dividend distribution under Section 305(c) with respect to the underlying Stock-Right Instrument would give rise to a withholding obligation in respect of the "swap" pursuant to Section 871(m), which imposes withholding on "dividend equivalent" payments on certain instruments, including "swaps," but the language of the Treasury regulations under Section 871(m) is not entirely clear in this regard.
- The proposed regulations would impose additional compliance burdens and expenses on issuers of Stock-Right Instruments. In particular, issuers will presumably need to enlist the assistance of investment banks or other financial institutions in order to determine the fair market value of any stock rights that are deemed to be distributed.
- The proposed regulations and the preamble do not make clear what withholding agents and beneficial owners are required to do under current law in order to satisfy their obligations with respect to deemed distributions. Moreover, the preamble states that, in permitting taxpayers to rely on the proposed regulations prior to the publication date, the IRS and Treasury intend no inference as to current law.

  ▸ **See a copy of the proposed regulations**

SEC Director Grim Addresses Investment Company Institute's 2016 Mutual Funds and Investment Management Conference

On March 14, 2016, David Grim, Director of the Division of Investment Management of the SEC (the "**Division**"), delivered remarks to the Investment Company Institute's 2016 Mutual Funds and Investment Management Conference. Grim discussed several of the SEC's pending rulemakings as well as certain forthcoming proposals.

Grim opened with a brief overview of the Division's accomplishments in 2015. First, Grim highlighted the several SEC rulemakings in the investment management space in the last year, including proposals to modernize reporting and disclosure by registered investment companies, promote liquidity-risk management in the open-end fund industry and improve the regulation of funds' use of derivatives. Next, Grim noted the Division's continuing efforts to facilitate productive and candid discussions with the executive leadership and boards of funds and asset managers through its Senior Level Engagement program. Finally, Grim highlighted the Division's efforts in 2015 to issue approximately 26 no-action letters, act on 156 applications for exemptive relief, publish five guidance updates and review filings covering more than 12,000 funds.

Grim next discussed the pending rulemakings the Division is pursuing to help better fulfill the SEC's mission to protect investors, maintain fair, orderly and efficient markets and facilitate capital formation. Grim began by discussing the liquidity-risk management and swing pricing proposal. According to Grim, the Division has received a number of comments acknowledging the benefits of requiring liquidity-risk

management programs and implementing swing pricing, but some commenters also questioned whether alternative approaches might better achieve the proposal's goal, especially with respect to the proposal's liquidity classification framework and the three-day minimum liquidity requirement. Grim assured commenters that the Division closely analyzes the comments received and potential alternatives proposed, especially in light of recent periods when mutual funds and global bond funds experienced sharp upticks in outflows and one open-end fund witnessed total suspension of redemptions. Next, Grim discussed the proposal to modernize and enhance the reporting framework for investment companies and investment advisers, which, according to Grim, is vital to the Division's mission, since it would assist in broadening both the Division's and investors' understanding of funds and how they operate in a rapidly evolving industry. Grim noted that a number of commenters acknowledged the benefits of the proposal, but some raised a concern that the SEC's collection of portfolio information from funds will make the SEC a target for cyber criminals. Turning briefly to the topic of cybersecurity, Grim noted that the SEC has taken several steps to ensure that the SEC's cybersecurity protocols are as robust as possible. According to Grim, SEC Chair Mary Jo White has requested additional funding from Congress to maintain and enhance the SEC's cyber capabilities, and the SEC is implementing certain cybersecurity protocols that are consistent with the recommendations of the National Institute of Standards and Technology. Further, according to Grim, the SEC continues to focus on enhancing awareness of its information security status, which is consistent with the federal government's Information System Continuous Monitoring methodology, and the SEC plans to focus on strengthening its ability to quickly respond to and address any unauthorized intrusions. Finally, Grim briefly noted that the comment period for the proposal on funds' use of derivatives would be ending shortly and that the staff was looking forward to closely reviewing the comments and data received. For further discussion of the enhanced reporting proposal, please see the June 18, 2015 Davis Polk Client Memorandum, **SEC Proposes Rules to Modernize and Enhance Information Reported by Investment Companies and Investment Advisers**. For more information about the proposed rule regarding liquidity risk management, please see the **October 27, 2015 Investment Management Regulatory Update**. And for further discussion of the proposal on funds' use of derivatives, please see the December 29, 2015 Davis Polk Client Memorandum, **SEC Proposes New Limits on Registered Funds' Derivatives Use**.

Next, Grim discussed the decision of Third Avenue Management to wind down its Focused Credit Fund last December and how such events underscore the importance of the SEC's liquidity risk rule proposal. According to Grim, the wind-down highlights the need for funds to implement robust policies and procedures to ensure their investment strategies are appropriate for an open-end structure, both at inception and throughout the life of the fund. Further, according to Grim, some in the industry have stated that certain asset classes are too illiquid to be held in large concentrations by open-end funds and may be more well suited for closed-end or private funds. Grim noted that the SEC's liquidity risk proposal could be quite effective in improving a fund's ability to manage the liquidity risks of its portfolio, since the proposed rules would require open-end funds to apply a standard set of factors when assessing liquidity risk and adopt a board-reviewed written program reasonably designed to assess and manage these risks. In addition, according to Grim, the proposal would provide insight into open-end funds' liquidity profiles generally to both the SEC and investors.

Grim next turned to the Division's most recent IM Guidance Update, which Grim noted is intended to assist mutual funds, exchange-traded funds and other registered investment companies (collectively, "**Funds**") in providing investors with risk disclosure that remains robust even when market conditions are in flux. According to Grim, the recent guidance outlined basic practices to help Funds evaluate their disclosure in changing market conditions, including routinely monitoring market conditions and assessing the impact on the Funds and the Funds' investments, determining whether any market developments are significant enough to be considered material to investors and, if so, updating the Funds' disclosures as necessary and communicating such changes to investors. Grim underscored the recommendation to Funds in the guidance to consider all appropriate avenues for communicating to investors, including less formal methods, such as posting updates to the Funds' website or sending letters directly to investors. For more information about the recent IM Guidance Update, please see the **March 29, 2016 Investment Management Update**.

Finally, Grim discussed the Division's current initiatives, which include preparing a proposal requiring registered investment advisers to create and implement transition plans and a recommendation, as

required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, for a new requirement for stress testing by large investment advisers and investment companies. Noting how funds increasingly rely on technologies and services provided by third parties, Grim emphasized the need for funds to be better prepared for the possibility that a critical service provider could suffer an outage. Grim highlighted the importance of conducting thorough due diligence on third-party service providers, both at the start of and throughout the relationship, including reviewing the provider's business continuity and disaster recovery protocols. In addition, Grim noted that fund complexes should consider how best to monitor whether a service provider has experienced a significant continuity event or cybersecurity breach, how such an event could impact fund operations and investors and the communication protocols and other steps necessary to successfully manage such events. Finally, Grim underscored the importance in fund complexes implementing detailed plans to respond to various disruptions both internally and at key service providers.

- **See a copy of the Speech**

SEC Announces Creation of Office of Risk and Strategy for Its National Exam Program

On March 8, 2016, the SEC announced the creation of the Office of Risk and Strategy within its Office of Compliance Inspections and Examinations ("**OCIE**"). The new office will consolidate and streamline OCIE's risk assessment, market surveillance and quantitative analysis teams and provide operational risk management and organizational strategy for OCIE. Peter B. Driscoll will lead the office and has been named as its first Chief Risk and Strategy Officer. In this role, Mr. Driscoll will manage the new office and the Investment Adviser/Investment Company examination staff based in Washington, D.C.

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

Litigation

SEC Charges AIG Affiliates with Mutual Fund Shares Conflicts

On March 14, 2016, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against three affiliates of American International Group, Inc.: Royal Alliance Associates, Inc., Sage Point Financial Inc. and FSC Securities Corporation (together the "**Companies**"), with violations related to steering their clients into more expensive mutual fund shares when lower fee alternatives were available. The SEC also found that the Companies failed to implement policies and procedures to prevent "reverse churning" or the maintenance of inactive client funds in fee-based or "wrap" advisory accounts.

According to the Order, each of the Companies is dually registered as a broker-dealer and registered investment adviser. The SEC found that the Companies, from 2012 to 2014, invested the assets of their advisory clients in mutual fund shares charging 12b-1 fees to pay for shareholder services costs and marketing expenses. The Order stated that because the advisory clients were not in accounts that were qualified retirement or ERISA accounts, the 12b-1 fees were not rebated. According to the Order, the Companies received approximately $2 million in 12b-1 fees in their capacity as broker-dealers that they would not otherwise have received if the advisory clients had been placed in lower-fee share classes. The SEC found that the Companies failed to disclose the conflict that arose from the Companies' incentive to place clients in the higher-fee share classes, and therefore, the Companies breached their fiduciary duties to the clients they invested in the higher-fee share classes. The SEC also found that the Companies failed to adopt compliance policies and procedures governing share class selection for its mutual fund clients.

The SEC further found that the Companies failed to implement the compliance policies and procedures they had established to prevent "reverse churning" of fee-based or "wrap" advisory accounts. Such

accounts generally charge a fee that includes both advisory fees and trading costs, and the Companies' policies were designed to ensure that such accounts remained in the best interest of clients. Finally, the SEC found that for the three-quarter period of the fourth quarter of 2012 to the second quarter of 2013, the Companies failed to conduct the inactive account reviews required by their compliance policies and procedures.

According to the Order, as a result of its disclosure violations, the Companies willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon a client. In addition, according to the SEC, the Companies violated Rule 206(4)-7 under the Advisers Act, which requires an investment adviser to adopt an implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

The Companies consented to the SEC's order without admitting or denying the SEC's findings. The SEC ordered the Companies to pay disgorgement of $2,049,859 for improperly charged fees and prejudgment interest. In addition, the Companies were ordered to pay a $7,500,000 civil money penalty.

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

CFTC Charges Alternative Fund Manager with Various Disclosure Violations

On March 16, 2016, the Commodity Futures Trading Commission (the "**CFTC**") issued an order (the "**Order**") filing and settling charges against Equinox Fund Management, LLC ("**Equinox**"), a Denver-based registered investment adviser specializing in managed futures strategies, for material misstatements and omissions related to its multi-advisor commodity pool, the Frontier Fund (the "**Fund**") and other disclosure-related violations.

According to the Order, the Fund operates as a series trust, with numerous series engaged in separate trading strategies. The CFTC found that Equinox incorrectly disclosed its basis for charging management fees in the Fund's disclosure documents. According to the Order, the Fund's disclosure documents from 2004 through March 2011 stated that Equinox charged its management fee on the net asset value of each series, but in reality, Equinox charged management fees to the Fund based on the notional value of the assets in each series. The CFTC found that the false disclosure resulted in $5.4 million in overcharged management fees. The CFTC also found that certain of the Fund's reports misstated its valuation methodology for options, failed to disclose a material subsequent event and misstated the valuation method used to value an option transferred between two series of the Fund. For more information about the violations and the SEC order against Equinox, please see the **February 18, 2016 Investment Management Regulatory Update**.

According to the Order, Equinox violated Section 4*o*(1)(B) of the Commodity Exchange Act, which prohibits commodity pool operators ("**CPOs**") from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant. The CFTC also found that Equinox violated Regulations 4.24(d) and 4.24(i) under the Commodity Exchange Act. Regulation 4.24(d) generally requires a CPO's disclosure document to include the break-even point per unit of the initial investment. Regulation 4.21(i) generally requires that the disclosure document include a complete description of each fee, commission or other expense that the CPO knows or should know has been incurred by the pool for its preceding fiscal year and is expected to be incurred in the current fiscal year. According to the Order, if any fee is determined by reference to a base amount, such as net assets, the CPO must explain how that base amount is calculated, in a manner consistent with the calculation of the break-even point. The CFTC further found that Equinox violated Regulation 4.22(c) under the Commodity Exchange Act, which generally requires a CPO's annual report to contain footnote disclosure and such further material information necessary to make the required statements not misleading.

The CFTC ordered Equinox to disgorge $5,404,004 of wrongfully paid fees and a $250,000 civil money penalty. The Order further provided that Equinox will be credited for any disgorgement pursuant to the related SEC settlement.

- See a copy of the Press Release
- 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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