

Investment Management Regulatory Update

January 31, 2020

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Rules and Regulations

SEC Proposes to Expand Access to Private Offerings

On December 18, 2019, the Securities and Exchange Commission (the “**SEC**”) proposed amendments to the definition of “accredited investor” in Regulation D, and the definition of “qualified institutional buyer” in Rule 144A, under the Securities Act of 1933, as amended (the “**Securities Act**”). The proposed amendments would expand private-offering access for individuals and entities beyond the restrictions of the existing definitions.

Davis Polk has published a [client memorandum](#) discussing the proposed amendments to the definition of “accredited investor” and “qualified institutional buyer.”

SEC Proposes Rule Changes for Auditor Independence Requirements

In a December 30, 2019 release, the SEC proposed amendments to Rule 2-01 of Regulation S-X to update certain auditor independence requirements in order to more effectively focus the auditor independence analysis on those relationships or services that are more likely to pose threats to an auditor’s objectivity and impartiality.

Davis Polk will publish a client alert discussing the proposed amendments shortly.

Industry Update

SEC's National Examination Program Releases Examination Priorities for 2020

On January 7, 2020, the National Examination Program (the “**NEP**”), administered by the Office of Compliance Inspections and Examinations (“**OCIE**”), published its examination priorities for 2020 (the “**Exam Priorities**”). The Exam Priorities fall into eight categories: (i) matters of importance to retail investors, including seniors and those saving for retirement; (ii) information security; (iii) financial technology and innovation, including digital assets and electronic investment advice; (iv) focus areas

involving registered investment advisers (“RIAs”) and investment companies; (v) focus areas involving broker-dealers and municipal advisors; (vi) anti-money laundering (“AML”) programs; (vii) market infrastructure; and (viii) select areas and programs of the Financial Industry Regulatory Authority (“FINRA”) and Municipal Securities Rulemaking Board (“MSRB”). For a discussion of the 2019 NEP Exam Priorities, please see the January 24, 2019 [Investment Management Regulatory Update](#).

Retail Investors, Including Seniors and Those Saving for Retirement

According to the Exam Priorities, the NEP plans to continue to focus on seniors and individuals saving for retirement, including examining firms that provide products and services to those investors. The Exam Priorities noted that the NEP will prioritize examinations of intermediaries that serve retail investors, namely RIAs, broker-dealers and dually registered firms, and examinations focused on investments marketed to or designed for retail investors, such as mutual funds and exchange-traded funds (“ETFs”), municipal securities and other fixed income securities and microcap securities.

Specific areas of focus will include:

Fraud, Sales Practices and Conflicts of Interest. The NEP plans to assess, among other things, whether disclosures required by the federal securities laws, including those relating to fees, expenses and conflicts of interest, are made as required and whether a firm’s actions match such disclosures. According to the Exam Priorities, the NEP will continue to review firms with practices that may create increased risks of inadequately disclosed fees. With respect to mutual fund share classes, the NEP will continue to evaluate financial incentives for financial professionals. Finally, the Exam Priorities noted a continued focus on conflicts of interest and examining whether RIAs are acting in a manner consistent with their fiduciary duty and contractual obligations. Examinations will review:

- Retail Investors: Recommendations and advice given to retail investors, especially senior investors, teachers and military personnel. In particular, examinations will focus on higher-risk products such as private placements and securities of issuers in new and emerging risk areas, including those that are complex or non-transparent; that have high fees and expenses; or where an issuer is affiliated with the registered firm making the recommendation.
- RIAs: (i) Whether RIAs have fulfilled their duties of care and loyalty, including by assessing whether RIAs provide advice in the best interests of clients and eliminate, or provide full and fair disclosure of, all conflicts of interest; and (ii) risks associated with fees and expenses, and undisclosed, or inadequately disclosed, compensation arrangements. According to the Exam Priorities, compensation-based conflicts of interest may take many forms, including revenue sharing arrangements between a registered firm and issuers, service providers and others, and direct or indirect compensation to advisory personnel for executing client transactions. The Exam Priorities also noted that breaches of the fiduciary duty of care may arise when an RIA does not aggregate certain accounts when calculating fee discounts in accordance with its disclosures.

Retail-Targeted Investments. According to the Exam Priorities, the NEP will continue to prioritize examinations of issues focused on retail investors, including issues related to mutual funds and ETFs, municipal securities and other fixed income securities, and microcap securities. Examinations will review:

- Mutual Funds and ETFs: Financial incentives provided to financial services firms and personnel that may influence the selection of particular mutual fund share classes and mutual fund fee discounts that should be provided to investors based on policies and contractual or disclosed breakpoints.
- Municipal Securities and Other Fixed Income Securities: Broker-dealer trading activity in municipal and corporate bonds for compliance with best execution obligations; fairness of pricing, mark-ups and mark-downs, and commissions; and confirmation disclosure requirements.

- Microcap Securities: Broker-dealers and transfer agents involved in selling stocks of companies with a market capitalization of under \$250 million, focusing on, among other things: manipulative schemes, compliance with Regulation SHO (governing short sales) under the Securities Exchange Act of 1934 (the “**Exchange Act**”) and compliance with Exchange Act Rule 15c2-11 (governing “the submission and publication of quotations by broker-dealers for certain over-the-counter equity securities”).

Standards of Care. According to the Exam Priorities, the SEC’s “June 2019 adoption of Regulation Best Interest, the Interpretation Regarding Standard of Conduct for Investment Advisers, and the Form CRS Relationship Summary will have a direct impact on the retail investor experience with broker-dealers and RIAs.” In order to assist broker-dealers before the June 30, 2020 compliance date for Regulation Best Interest and Form CRS, OCIE will work with broker-dealers during examinations on their progress on implementing the new rules and will address questions they may have. After the compliance date, OCIE examinations will assess implementation of the requirements, including policies and procedures regarding conflicts disclosures, and for broker-dealers and RIAs, the content and delivery of Form CRS.

Information Security

According to the Exam Priorities, the NEP plans to continue to focus on information security, including, among other things, “proper configuration of network storage devices, information security governance generally, and retail trading information security.” In the context of RIAs, examinations will focus on assessing RIAs’ protection of clients’ personal financial information. The NEP will also continue to focus on governance and risk management, access controls, data loss prevention, vendor management, training, and incident response and resiliency.

The Exam Priorities noted that for third-party and vendor risk management, the NEP also plans to focus on oversight practices related to service providers and network solutions, including cloud-based storage. In addition, examinations will focus on controls surrounding online access and mobile application access to customer brokerage account information, as well as safeguards around the disposal of retired hardware that may contain client information and network information that “could create an intrusion vulnerability.”

Financial Technology and Innovation, Including Digital Assets and Electronic Investment Advice

According to the Exam Priorities, the NEP plans to focus on firms’ use of “data sets and technologies to interact with and provide services to investors, firms, and other service providers and assess the effectiveness of related compliance and control functions.”

Digital Assets: The NEP will continue to identify and examine SEC-registered market participants engaged in the digital asset market, with examinations focused on, among other things, investment suitability, portfolio management and trading practices, safety of client funds and assets, pricing and valuation, effectiveness of compliance programs and controls, and supervision of employees’ outside business activities.

Electronic Investment Advice: For “robo-advisers,” RIAs that provide services to clients through automated investment tools and platforms, examinations will focus on, among other things: SEC registration eligibility; cybersecurity policies and procedures; marketing practices; adherence to fiduciary duty, including adequacy of disclosures; and effectiveness of compliance programs.

Focus Areas Involving RIAs and Investment Companies

According to the Exam Priorities, the NEP will continue to assess the compliance programs of RIAs, including the appropriateness of account selection, portfolio management practices, custody and safekeeping of client assets, best execution, fees and expenses, and valuation of client assets.

RIA Compliance Programs: The NEP plans to continue to review whether RIAs’ compliance programs and their policies and procedures are reasonably designed, implemented and maintained. The Exam

Priorities noted that OCIE will continue to prioritize examinations of RIAs dually registered as broker-dealers, or that have supervised persons who are registered representatives of unaffiliated broker-dealers. Areas of focus will include, among other things: “whether the firms maintain effective compliance programs to address the risks associated with best execution, prohibited transactions, fiduciary advice, or disclosure of conflicts regarding such arrangements.” In addition, the NEP plans to prioritize examining firms that engage third-party asset managers to advise clients’ investments and will assess these RIAs’ due diligence practices, policies and procedures. According to the Exam Priorities, “OCIE has a particular interest in the accuracy and adequacy of disclosures provided by RIAs offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria.”

Never-Before- and Not-Recently-Examined RIAs: The NEP will continue to take a risk-based approach to identify newly registered or never-before-examined RIAs. The NEP will also prioritize examination of RIAs that have not been examined in several years to focus on whether their compliance programs have been updated to reflect any substantial growth or changed business models.

Mutual Funds and ETFs: According to the Exam Priorities, the NEP will prioritize examinations of mutual funds and ETFs, activities of their RIAs and oversight practices of their boards. Examinations will focus on: “(1) RIAs that use third-party administrators to sponsor the mutual funds they advise or are affiliated with; (2) mutual funds or ETFs that have not previously been examined; and (3) RIAs to private funds that also manage a registered investment company with a similar investment strategy.”

RIAs to Private Funds: The NEP will continue to focus on RIAs that manage both separately managed accounts and private funds. In addition, examinations will assess compliance risks, “including controls to prevent the misuse of material, non-public information and conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses, and the use of RIA affiliates to provide services to clients.”

Focus Areas Involving Broker-Dealers and Municipal Advisors

Broker-Dealer Financial Responsibility: Examinations of select broker-dealers will continue to focus on adherence to the Customer Protection Rule and the Net Capital Rule under the Exchange Act, which restricts the use of customer assets.

Trading and Broker-Dealer Risk Management: According to the Exam Priorities, the NEP also plans to examine firms’ trading and risk management practices, such as trading and other activities in “odd lots” of under 100 shares, which “often represent retail interest and require special treatment by broker-dealers to ensure compliance with applicable laws and regulations, including best execution.” In addition, the NEP will continue to examine controls around the use of automated trading algorithms by broker-dealers, including how broker-dealers supervise algorithmic trading activities and the development, implementation and maintenance of the computer programs that support such automated trading activities.

Municipal Advisors: The NEP will continue to examine municipal advisors, focusing on their compliance with registration, professional qualification and continuing education requirements. The NEP will also continue to examine whether municipal advisors provided appropriate disclosures regarding conflicts of interest. Examinations will review compliance with recently effective MSRB rules, including those relating to advertising.

AML Programs

The NEP will continue to focus on examining broker-dealers and investment companies for compliance with their AML obligations, including “whether firms have established appropriate customer identification programs and whether they are satisfying their SAR filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs.”

Compliance and Risks in Critical Market Infrastructure

Clearing Agencies: According to the Exam Priorities, the NEP will continue annually to examine clearing agencies designated as systematically important by the Financial Stability Oversight Council and for which the SEC is the supervisory agency, focusing on compliance with the SEC’s Standards for Covered Clearing Agencies, corrective and timely action taken in response to prior examinations, and other areas identified in collaboration with the Division of Trading and Markets and other regulators. Areas of focus will include “liquidity risk management, collateral and investment risk management, default risk management, cyber security and resiliency, and recovery and wind down procedures more generally, among other things.”

National Securities Exchanges: The NEP plans to continue to examine the operations of national securities exchanges, particularly how they react to market disruptions and how they monitor member activity for compliance with the federal securities laws and rules.

Regulation Systems Compliance and Integrity (“SCI”) Entities: The NEP plans to continue to examine SCI entities to evaluate how effectively they have implemented written policies and procedures required by Regulation SCI under the Exchange Act. Areas of focus will include: information technology, inventory management and governance, incident response and third-party vendor management, including the utilization of cloud services.

Transfer Agents: The NEP will continue to focus on transfer agents’ core functions, including: transfers, recordkeeping and safeguarding of funds and securities by transfer agents, as well as the requirement for transfer agents to file annually a report by an independent accountant concerning the transfer agent’s accounting controls. According to the Exam Priorities, candidates for examination will include transfer agents that serve as paying agents for issuers, transfer agents developing blockchain technology and transfer agents that provide services to issuers of microcap securities, private offerings, crowdfunded securities or digital assets.

Focus on FINRA and MSRB

FINRA: The NEP will continue to conduct risk-based oversight examinations of FINRA and inspections of FINRA’s major regulatory programs. The NEP will also conduct “oversight examinations of the examinations FINRA conducts of certain broker-dealers and municipal advisors.”

MSRB: The NEP plans to continue to evaluate the effectiveness of certain of MSRB’s operational and internal policies, procedures and controls.

- [See a copy of the Press Release](#)
- [See a copy of the Exam Priorities](#)

SEC Issues Orders Granting Exemptive Relief for Certain Non-Transparent Actively Managed ETFs

On December 10, 2019, the SEC issued orders (the “**Orders**”) granting exemptive relief for certain non-transparent actively managed ETFs (the “**Funds**”) in response to exemptive relief requests by 1) T. Rowe Price Associates, Inc. and T. Rowe Price Equity Series, Inc.; 2) Natixis ETF Trust II, et al.; 3) Fidelity Beach Street Trust, et al.; and 4) Blue Tractor ETF Trust and Blue Tractor Group, LLC (together, the “**Applicants**”). The SEC previously issued notices on November 14, 2019 (the “**Notices**”) indicating its intent to grant the relief. Each Applicant requested, and each Order permitted, the ETFs to operate without being subject to a daily portfolio transparency condition. According to the Notices, the Applicants believe that the Funds “would allow investors to access active investment strategies offered by certain investment advisers that are currently only available via mutual funds, while also taking advantage of the traditional benefits of ETFs (e.g., lower fund costs, tax efficiencies and intraday liquidity).”

The Notices stated that in granting exemptive relief to actively managed ETFs in the past, the SEC has required that “a mechanism exist to ensure that ETF shares would trade at a price that is at or close to the [net asset value (“NAV”)] per share of the ETF” because “ETFs do not sell or redeem their individual shares at NAV per share as required by the [Investment Company Act of 1940].” The Notices stated that, although the Funds would not disclose their portfolio holdings on a daily basis, each day, each Fund would “publish a basket of securities and cash that, while different from the Fund’s portfolio, is designed to closely track its daily performance.” Such a basket would, in the absence of daily transparency with respect to each Fund’s portfolio, “serve as a pricing and hedging tool for market participants to identify and take advantage of arbitrage opportunities,” and would serve as “the creation/redemption basket when Authorized Participants exchange creation units” with each Fund, according to the Notices. Furthermore, the Applicants stated that the basket would “serve as a pricing signal to identify arbitrage opportunities when its value and the secondary market price” of shares of the Fund diverge. In addition, according to the Notices, in order to facilitate arbitrage, the Funds may only invest in certain exchange-traded securities, which would allow market participants to accurately price and readily trade the securities in the basket “for purposes of assessing the intraday value of the Fund’s portfolio holdings and to hedge their positions in the Fund’s shares.”

The Notices stated that the Applicants have agreed to comply with certain conditions in addition to those included in prior ETF exemptive orders, including providing “certain public disclosures to explain to investors how they differ from traditional ETFs,” and complying with the requirements of Regulation Fair Disclosure “prohibiting selective disclosure of any material nonpublic information.” The Funds would also take “remedial actions as necessary if the Funds do not function as anticipated.” For example, for the first three years after launch, each Fund would establish certain threshold levels for its tracking error (e.g., measuring the difference between the basket’s per share NAV and the Fund’s per share NAV), premium/discounts, and spreads. If a threshold is crossed, the Fund’s adviser would present to the Fund’s board, or a designated committee, its proposals for remedial measures, and the board or such committee would consider “the continuing viability of the Fund, whether shareholders are being harmed, and what, if any, action would be appropriate.”

The Notices went on to state that despite the concern that “the proposed arbitrage mechanism may not facilitate effective arbitrage, which could result in significant deviations between the secondary market price and NAV per share of a Fund,” the SEC “believes that the alternative arbitrage mechanism proposed by the Applicants can work in an efficient manner to maintain a Fund’s secondary market prices close to its NAV” and that, “as long as arbitrage continues to keep the Fund’s secondary market price and NAV close, and does so efficiently so that spreads remain narrow, the [SEC] believes that investors would benefit from the opportunity to invest in active strategies through a vehicle that offers the traditional benefits of ETFs.” The SEC also noted in the Notices that each Fund will provide disclosures that the basket is not the Fund’s portfolio holdings so as not to misrepresent the Fund’s holdings or create investor confusion. Finally, the Notices noted that, in order to address the concern that market participants may be able to reverse engineer current activity in a Fund’s holdings and use such information to the disadvantage of the Fund and other market participants, the Applicants have represented that “they will operate the Funds in a manner designed to minimize such risk” and the SEC anticipates that the Funds will have the ability to minimize such risk.

Accordingly, the Orders permit: (a) the Funds to issue shares (“**Shares**”) redeemable in large aggregations only (“**creation units**”); (b) secondary market transactions in Shares to occur at negotiated market prices rather than at NAV; (c) the Funds to pay redemption proceeds, under certain circumstances, more than seven days after the tender of Shares for redemption; (d) certain affiliated persons of a Fund to deposit securities into, and receive securities from, the Fund in connection with the purchase and redemption of creation units; and (e) certain registered management investment companies and unit investment trusts outside of the same group of investment companies as the Funds to acquire Shares of the Funds.

SEC Commissioners Robert J. Jackson and Allison Herren Lee commented in a November 15, 2019 statement (the “**Statement**”) that the SEC’s work on the Applicant’s applications produced “important guardrails that will help protect investors from the risks of non-transparent funds.” Their Statement acknowledged that the Applicants have “come a long way” to answer the question of “how can an ETF ensure that the price investors get reflects the fund’s value when the ETF is not transparent about its assets?” The Statement warned, however, that non-transparent ETFs “come with real risk that, in moments of limited liquidity, ordinary investors will face wider spreads and hence get prices that do not accurately reflect the value of their shares. By targeting largely liquid assets and adopting guardrails to address these issues, these applicants have helped mitigate that concern. But we would be skeptical of non-transparent funds focused on different asset classes that lack those characteristics.” Commissioners Jackson and Lee also noted that it would be important to “keep close watch over the appropriate disclosure regime for non-transparent ETFs” to ensure that investors receive the information they need to be able to evaluate such ETFs.

- **See a copy each Notice**
 - [T. Rowe Price Associates, Inc. and T. Rowe Price Equity Series, Inc.](#)
 - [Natixis ETF Trust II, et al.](#)
 - [Fidelity Beach Street Trust, et al.](#)
 - [Blue Tractor ETF Trust and Blue Tractor Group, LLC](#)
- **See a copy of each Order**
 - [T. Rowe Price Associates, Inc. and T. Rowe Price Equity Series, Inc.](#)
 - [Natixis ETF Trust II, et al.](#)
 - [Fidelity Beach Street Trust, et al.](#)
 - [Blue Tractor ETF Trust and Blue Tractor Group, LLC](#)
- **See a copy of the Statement**

Litigation

Second Circuit Decision and Proposed Legislation On Insider Trading Law

Second Circuit Lowers the Bar for Charging Criminal Insider Trading

On December 30, 2019, the United States Court of Appeals for the Second Circuit affirmed the convictions of four individuals charged with disclosing and trading on nonpublic government information, adding a new twist to decades of judicial precedent on the definition of insider trading. The court held that the “personal-benefit” test for insider trading established by the Supreme Court in *Dirks v. SEC*¹¹ does not apply to wire and securities fraud under Title 18 of the U.S. Code. The ruling will make it easier for the government to prosecute insider trading even when there is no clear benefit to the source who provided the information.

Davis Polk published a detailed analysis of this decision, available [here](#).

¹¹ 463 U.S. 646 (1983).

House Passes 8-K Trading Gap Act

Earlier this month, the House overwhelmingly passed legislation aimed at closing what lawmakers have called a “loophole” for insider trading—corporate insiders trading between the occurrence of a corporate event and its disclosure through a Form 8-K filing (the “**8-K Gap**”). The 8-K Trading Gap Act (the “**Bill**”) passed with broad bipartisan support. If passed by the Senate and enacted into law, it would require public companies to adopt policies and procedures reasonably designed to prevent corporate insiders from trading before Form 8-K disclosures. Although most or all public companies already have internal policies to prevent insider trading, the Bill would require policies as a matter of law, would create a new risk of SEC enforcement action if a company’s policies are deemed unreasonable, and would require that policies extend to some announcements even if they do not involve material information.

Davis Polk’s Client Alert on the Bill is available [here](#).

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