VedderPrice

August 2018

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

SEC STAFF GUIDANCE AND ALERTS

OCIE Publishes Risk Alert on Compliance Issues Relating to Best Execution

On July 11, 2018, the Office of Compliance Inspections and Examinations (OCIE) of the SEC published a National Exam Program Risk Alert (the Risk Alert) concerning compliance issues related to investment advisers' best execution obligations under the Investment Advisers Act of 1940 (the Advisers Act). The Risk Alert is intended to highlight for advisers risks and issues associated with best execution that OCIE staff has identified in deficiency letters from over 1,500 adviser examinations. OCIE "encourages advisers to reflect upon their own practices, policies, and procedures in these areas."

Background: Duty to Seek Best Execution

As fiduciaries, investment advisers owe their clients a duty of care, which includes, among other things, the duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades. To satisfy this obligation, an adviser must seek to obtain the execution of transactions for each of its clients such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances; that is, the adviser should maximize value for the client given the particular circumstances. As the SEC stated in its proposed interpretation regarding the standard of conduct for investment advisers issued in April,[1] maximizing value can encompass more than just minimizing cost—i.e., the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution. Thus, advisers should consider the full range and quality of a broker's services, including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser. The Risk Alert reminds advisers that they should periodically and systematically evaluate the execution quality of broker-dealers executing their clients' transactions.

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[1] *See* Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. 4889 (Apr. 18, 2018).

Compliance Issues Relating to Best Execution

Examples of common deficiencies associated with advisers' best execution obligations observed by OCIE staff include the following:

- **Not Performing Best Execution Reviews.** Advisers failed to conduct periodic and systematic evaluations of the execution performance of broker-dealers used or did not maintain adequate records demonstrating that such evaluations occurred.
- **Not Considering Materially Relevant Factors during Best Execution Reviews.** Advisers failed to adequately evaluate the full range and quality of a broker-dealer's services, including qualitative factors relating to a broker-dealer (such as execution capability, financial responsibility and responsiveness to the adviser), and did not solicit and review input from the adviser's traders and portfolio managers in the brokerage selection process.
- **Not Seeking Comparisons from Other Broker-Dealers.** Advisers used certain broker-dealers or a single broker-dealer—initially and/or on an ongoing basis—without considering the quality and costs of services available from other broker-dealers, or after only performing a superficial review.
- **Not Fully Disclosing Best Execution Practices.** Advisers failed to fully disclose their best execution practices, such as not disclosing that certain types of client accounts may trade the same securities after other client accounts and the potential impact of this practice on execution prices. OCIE also observed advisers that, contrary to their brochure disclosures, did not review trades to ensure that prices obtained fell within an acceptable range.
- **Not Disclosing Soft Dollar Arrangements.** Advisers failed to provide full and fair disclosure of their soft dollar arrangements in their brochures, including their use of such arrangements or the potential cost for clients (e.g., where certain clients may bear more of the cost of soft dollar arrangements than other clients).
- **Not Properly Administering Mixed Use Allocations.** Advisers did not appear to make reasonable allocations of the costs of mixed use products or services and/or did not document the reasoning for their decisions.
- **Inadequate Policies and Procedures Relating to Best Execution.** Advisers did not have sufficient best execution compliance policies and procedures or internal controls, demonstrated by the failure to monitor broker-dealer execution performance or policies not appropriately tailored to an adviser's business and/or investment activities.
- **Not Following Best Execution Policies and Procedures.** Advisers did not comply with their best execution policies and procedures, including as to best execution review, soft dollar allocation and ongoing monitoring of broker-dealer performance.

The Risk Alert notes that "[t]he examinations within the scope of this review resulted in a range of actions." In response to OCIE's observations, some advisers took remedial actions that included amending disclosures regarding best execution or soft dollar arrangements, revising compliance policies and procedures, or otherwise changing practices regarding best execution or soft dollar arrangements.

The Risk Alert is available at: https://www.sec.gov/ocie/announcement/risk-alert-most-frequent-best-execution-issues-cited-adviser-exams-1

FINRA GUIDANCE AND ALERTS

FINRA Seeks Information on Member Firms' Activities Related to Digital Assets

On July 6, 2018, FINRA published Regulatory Notice 18-20 (the Notice) as part of its continuing efforts to ascertain the extent of FINRA member firm involvement in "digital assets," including cryptocurrencies and other virtual coins and tokens. FINRA cited the significant market growth for digital assets, especially among retail investors, as the reason behind the Notice as well as recent incidents of fraud and securities law violations involving these products and the platforms on which they trade.

Overall, the Notice provided a message that was twofold: First, to encourage member firms to promptly notify FINRA in writing if the firm, or its associated persons or affiliates, engages in or intends to engage in any activities related to digital assets.[2] Second, through July 31, 2019, to encourage firms to keep their Regulatory Coordinator abreast of any changes in the event the firm, or any of its associated persons or affiliates, determines to engage in activities related to digital assets, including digital assets that are non-securities. If a FINRA member firm already has submitted a continuing membership application (CMA) regarding its involvement in activities related to digital assets, or provided notification to its Regulatory Coordinator in response to a direct request, or by way of the 2018 Risk Control Assessment (RCA) Survey, then the firm need not provide additional notice unless a change has occurred.

The Notice identifies several examples of activities of interest to FINRA if undertaken (or planned) by a member firm, its associated persons or affiliates, including, but not limited to: (1) purchases, sales, or execution of transactions in digital assets; (2) purchases, sales or executions of transactions in a pooled fund investing in digital assets; (3) creation of, management of, or provision of advisory services for, a pooled fund related to digital assets; (4) derivative transactions tied to digital assets; (5) participation in initial or secondary offerings of digital assets (such as initial coin offerings or "ICOs"); (6) creation or management of a platform for secondary trading of digital assets; (7) custody of digital assets; (8) acceptance of cryptocurrencies from customers; and (9) clearing or settlement services for, or other activities involving, cryptocurrencies and other virtual coins and tokens.

In addition to the foregoing activities, FINRA requests prompt notification of activities subject to FINRA Rules 3270 and 3280—the rules relating to outside business activities of registered persons and private securities transactions of associated persons, respectively.[3]

The Notice is available at: http://www.finra.org/industry/notices/18-20

[2] An endnote to the Notice cautions firms that FINRA's notification request is separate from any existing regulatory obligations under FINRA rules that may apply to a firm regarding its involvement in activities relating to digital assets (e.g., trade reporting transactions in digital assets that meet the definition of a "security").

[3] FINRA is not requesting notification of passive investment activity in digital assets or activities of associated persons subject to the personal trading requirements of FINRA Rule 3210.

Litigation and Enforcement Actions and Initiatives

SECTION 36(B) LITIGATION

Third Circuit Affirms Lower Court Decision in Favor of Investment Adviser in Section 36(b) Excessive Fee Case

In August 2016, following a 25-day non-jury trial, the U.S. District Court for the District of New Jersey issued an opinion under the caption *Sivolella v. AXA Equitable Life Insurance Company* dismissing with prejudice claims brought under Section 36(b) of the Investment Company Act of 1940 (the 1940 Act) against AXA Equitable Funds Management Group, LLC (FMG) by holders of variable annuity contracts with AXA Equitable Life Insurance Company who had allocated assets to twelve mutual funds advised by FMG. The plaintiffs alleged that FMG had charged exorbitant fees for investment management and administrative duties while delegating substantially all of those same duties to sub-advisers and sub-administrators for nominal fees. In a lengthy analysis of testimony and evidence and a review of the facts through the framework outlined in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, the District Court concluded that the plaintiffs failed to meet their burden (1) to demonstrate that the defendants breached their fiduciary duty in violation of Section 36(b) of the 1940 Act, and (2) to have shown any actual damages. Following this decision, the plaintiffs appealed the decision of the District Court to the U.S. Court of Appeals for the Third Circuit.

On July 10, 2018, the U.S. Court of Appeals for the Third Circuit issued a non-precedential opinion affirming the decision of the U.S. District Court for the District of New Jersey to dismiss the claims brought by the plaintiffs (i.e., the petitioners in the Third Circuit appeal).

The Third Circuit stated that the petitioners were effectively requesting that the Third Circuit overturn the District Court's factual findings and credibility determinations, which the Third Circuit refused to do. In considering the petitioners' arguments, the Third Circuit evaluated the District Court's findings with respect to five of the six *Gartenberg* factors. Specifically, the Third Circuit reviewed the District Court's conclusions with respect to (1) the independence, expertise, care and conscientiousness of the board in evaluating adviser compensation; (2) the nature and quality of the services provided to the funds; (3) any fall-out benefits; (4) comparative fee structures; and (5) the profitability of the funds to the adviser.4 After reviewing the District Court's conclusions, the Third Circuit affirmed the District Court's decision, stating that "the District Court wrote a thorough and comprehensive opinion that the Petitioners have failed to undermine."

The Third Circuit's opinion was issued under the caption *Sivolella v. AXA Equitable Life Ins. Co.*, Case No. 16-4241.

[4] The petitioners did not challenge the District Court's conclusions with respect to economies of scale.

INVESTMENT COMPANY STATUS

Ninth Circuit Panel Affirms District Court's Dismissal of Lawsuit on Grounds That There Is No Private Right of Action for Challenging the Continued Validity of an Investment Company Act Exemption

On July 12, 2018, a panel of the U.S. Court of Appeals for the Ninth Circuit affirmed the dismissal by the U.S. District Court for the Northern District of California of a lawsuit bringing derivative claims against the board of directors of Yahoo! Inc. (Yahoo!) and certain corporate officers, as well as a direct claim against Yahoo!, under the Investment Company Act of 1940 (the 1940 Act). UFCW Local 1500 Pension Fund, on its own behalf and on behalf of others similarly situated (UFCW), alleged that when Yahoo! invested in Alibaba.com, a Chinese e-commerce company, Yahoo! violated the conditions of an exemptive order issued by the SEC granting the company relief from the registration requirements of the 1940 Act. The Ninth Circuit panel held that UFCW failed to state a claim because the 1940 Act does not establish a private right of action for challenging the continued validity of a 1940 Act exemption.

Background—Investment Company Act Status

Under Section 3(a)(1)(C) of the 1940 Act, an issuer is a *prima facie* investment company if it is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value in excess of 40% of the value of the issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis. For this purpose, "investment securities" are defined to include all securities except government securities, securities issued by employees' securities companies and securities issued by majority-owned operating subsidiaries of the owner. Consequently, an operating company more than 40% of whose total assets are investment securities may be deemed an "inadvertent" investment company.

For purposes of the 40% test described in the foregoing paragraph, investment securities are sometimes referred to as "bad assets," in contrast to "good assets," which would not count toward the 40% limit. In this regard, Rule 3a-1 allows an operating company to treat interests in subsidiaries that it controls primarily as "good assets" so long as the company engages in non-investment company business through subsidiaries. Specifically, Rule 3a-1 provides an exemption from the definition of investment company if no more than 45% of a company's total assets consist of, and not more than 45% of its net income over the last four quarters is derived from, securities other than government securities and securities of majority-owned subsidiaries and companies it primarily controls.

Section 3(b)(2) of the 1940 Act provides that, notwithstanding Section 3(a)(1)(C), the SEC, upon application, may issue an order declaring an issuer to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities, resulting in the issuer not falling within the 1940 Act's definition of investment company. In determining whether a company is "primarily" engaged in a non-investment company business under Section 3(b)(2), the SEC considers (1) the applicant's historical development; (2) its public representations of policy; (3) the activities of its officers and directors; (4) the nature of its current assets; and (5) the sources of its present income, with factors (4) and (5) deemed the most important factors. Section 3(b)(2) further

provides that the SEC may revoke such an order when it, on its own motion or upon application "finds that the circumstances which gave rise to the issuance of an order granting an application [for a 1940 Act exemption] no longer exist."

Yahoo!'s Exemptive Order

In 2000, Yahoo! requested and obtained from the SEC an exemptive order under Section 3(b)(2). At that time, Yahoo! stated that its interest in Yahoo! Japan represented over 90% of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. In its application for exemptive relief, Yahoo! stated that it was unable to rely on Rule 3a-1 because, although it owned over 25% of the outstanding voting securities of Yahoo! Japan, it was not the primary owner of Yahoo! Japan because another entity owned a larger percentage of its voting securities. Thus, if the interest in Yahoo! Japan was deemed to be an "investment security," Yahoo! might have been deemed a *prima facie* investment company under Section 3(a)(1)(C). In connection with its application for exemptive relief, Yahoo! stated that it needed sufficient cash for bona fide business purposes, such as funding operations, funding research and development and improvements to its network and funding strategic non-controlling investments. The company also stated that it did not engage in speculative short-term trading with its cash and high-quality predominantly short-term debt instruments (together with cash items and government securities, Cash Management Investments). Thus, as a condition to its requested relief, Yahoo! agreed to continue to allocate and utilize its accumulated cash and Cash Management Investments for bona fide business purposes. In addition, Yahoo! agreed to refrain from investing or trading in securities for "short-term speculative purposes."[5] Yahoo!'s exemptive order has remained in place since 2000.

UFCW's Lawsuit

UFCW filed a lawsuit in January 2016, alleging that, by investing in Alibaba, Yahoo! had violated the condition of its 1940 Act exemption requiring the company to use its cash and Cash Management Investments for bona fide business purposes and, consequently, that Yahoo! had "been operating as an unregistered investment company" in violation of the 1940 Act since at least 2013. At that time, Yahoo!'s investment in Alibaba and other holdings represented approximately 90% of the value of Yahoo!'s total assets. UFCW sought to (1) rescind the employment contracts of certain executives; (2) enjoin Yahoo! from further performing contracts executed in violation of the 1940 Act and from selling any material assets, and (3) recover damages for unjust enrichment.

On October 19, 2016, the U.S. District Court for the Northern District of California granted the defendants' motion to dismiss the complaint, principally on the grounds that a federal court is not empowered to find, at the behest of a private litigant, that a company has lost the protection of a 1940 Act registration exemption.

In an amended complaint, UFCW cited an internal memorandum from the SEC's Office of Inspector General indicating that the staff of the SEC's Division of Corporation Finance considers exemptive orders not applicable if the conditions have not been adhered to—i.e., they are "self-executing." Nevertheless, on February 10, 2017, the District Court dismissed the amended complaint, stating in the opinion that although the memorandum introduces the "self-executing" language, it does not help UFCW's case because there is no indication that a private litigant can compel the court to find that a company has lost the protection of a 1940 Act exemption. Because the SEC

[5] *See* Yahoo! Inc., Investment Company Act Release Nos. 24459 (May 18, 2000) (notice of application) and 24494 (June 13, 2000) (order).

never revoked Yahoo!'s registration exemption, the District Court stated, Yahoo! never operated as an unregistered investment company, and UFCW's claims' fail as a matter of law. In a footnote, the District Court noted that the "self-executing" language refers to the Division of Corporation Finance, which provides exemptive relief under the securities registration and reporting sections of the Securities Exchange Act of 1934, not the Division of Investment Management, which provides exemptive relief under the 1940 Act and granted Yahoo!'s exemption in 2000.

On appeal, the Ninth Circuit panel affirmed the District Court's dismissal of the lawsuit. In finding that the 1940 Act does not establish a private right of action to challenge the continued validity of an exemption, the Ninth Circuit noted that the 1940 Act provisions related to registration with the SEC and 1940 Act exemptions "do not have rights-creating language." The Ninth Circuit also rejected UFCW's argument for a private right of action under Section 47(b) of the 1940 Act, which provides that a "contract that is made, or whose performance involves, a violation of [the 1940 Act], or of any rule, regulation, or order thereunder, is unenforceable by either party" to the contract unless "a court" makes certain findings. The Ninth Circuit asserted that Section 47(b) "on its face merely establishes what it says: that contracts formed in violation of [the 1940 Act] are usually unenforceable." Moreover, the Ninth Circuit stated that the 1940 Act empowers the SEC to enforce all provisions of the statute by granting the SEC broad authority to investigate suspected violations, and that Congress explicitly created private rights of actions to enforce particular sections, such as derivative suits against an investment company's adviser for breach of certain fiduciary duties, clearly indicating that Congress never intended further private enforcement of the 1940 Act.

The opinion was issued under the caption *UFCW Local 1500 Pension Fund v. Mayer*, Case No. 17-15435.

Legislative Developments

House Passes JOBS and Investor Confidence Act of 2018 (JOBS Act 3.0)

On July 17, 2018, in a 406-4 vote, the U.S. House of Representatives passed the JOBS and Investor Confidence Act of 2018, commonly referred to as the JOBS Act 3.0 (the Bill). The Bill combines provisions of 32 individual pieces of legislation that passed the House or the House Financial Services Committee.

In a press release, the Committee stated that, in order to foster economic growth and to remain competitive with countries like China, the Bill, among other things, would "ease regulations on 'angel investors' and expand the definition of 'accredited investors' to make it easier for startup companies and small businesses to attract investments needed to grow and create jobs; make it easier for companies to go public by extending on-ramp exemptions for emerging growth companies to give them more time to financially sustain costs and requirements associated with full compliance; ease securities regulations on IPOs to increase opportunities for everyday investors; and cut red tape on asset managers so that Main Street investors don't have to shoulder the costs of burdensome, unnecessary regulations."

Notably, the Bill incorporates certain provisions of interest to the investment management industry, including the following:

H.R. 79, Helping Angels Lead Our Startups (HALOS) Act

These provisions would define "angel investor group" for purposes of the federal securities laws and exclude from the prohibition on "general solicitation" and "general advertising" of securities offerings under Regulation D under the Securities Act of 1933 (the 1933 Act) presentations at certain events made by issuers in which no specific securities offering is referenced, including events sponsored by angel investor groups. As noted by Chairman Hensarling, these provisions are intended to "stimulate venture capital" by allowing angel investors and entrepreneurs to "interact without running afoul of securities laws."

H.R. 1585, Fair Investment Opportunities for Professional Experts Act

These provisions would broaden the definition of "accredited investor" under the 1933 Act, with conforming amendments to Regulation D under the 1933 Act, in order to expand the pool of investors who can invest in private offerings. Specifically, the revised definition provides for an automatic inflation adjustment to the $1,000,000 net worth requirement and includes, as a new category of accredited investor, "any natural person the [SEC] determines, by regulation, to have demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment, and whose education or job experience is verified by [FINRA] or an equivalent self-regulatory organization." Notably, this new category of accredited investor, unlike the current categories, focuses exclusively on the investor's experience and expertise, rather than on the investor's income or net worth.

H.R. 4566, Alleviating Stress Test Burdens to Help Investors Act

These provisions are partially incorporated into the Bill and would amend the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) to exempt nonbank financial companies not under the supervision of the Board of Governors of the Federal Reserve System, including mutual funds and investment advisers, from the Dodd-Frank Act's stress-testing requirements, in an effort to relieve such entities of burdensome requirements that are "structured and designed for banks and do not appropriately reflect risks to nonbanks." These provisions would still allow, but not require, the SEC and the Commodity Futures Trading Commission to issue regulations requiring stress-testing. (The Alleviating Stress Test Burdens to Help Investors Act was described in our April 2018 issue, after passing the House in March 2018.)

The Bill will next go to the U.S. Senate for consideration.

The text of the Bill is available at: https://www.congress.gov/bill/115th-congress/senate-bill/488/text

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