INVESTMENT MANAGEMENT LEGAL + REGULATORY UPDATE

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REGULATION

Next on the SEC's Regulatory Agenda: A Chief Valuation Officer?

First, the SEC required funds to designate a chief compliance officer. Then, the SEC proposed that funds designate a liquidity risk manager and, after that, a derivatives risk manager. Can a chief valuation officer ("CVO") be far behind?

Looking into our crystal ball, this may be possible, especially since the regulatory model is already in place.

For a discussion and analysis, a *Learning Curve* article written by Jay Baris is available here.

FinCEN Finalizes Customer Due Diligence Rule for Legal Entity Customers

The Financial Crimes Enforcement Network ("FinCEN"), a bureau of the Department of the Treasury, recently published a Final Rule (the "Rule") on customer due diligence after a four-year rulemaking process. The Rule requires covered financial institutions, including banks, money services businesses, broker-dealers, mutual funds, and commodities brokers, to enhance their customer due diligence procedures by collecting and verifying information about the individuals who own or control the legal entity customers of the financial institution. These individuals are referred to in the Rule as "beneficial owners." The Rule also adds a "fifth pillar" to the minimum requirements of an anti-money laundering ("AML") compliance program by explicitly requiring financial institutions to develop and update customer risk profiles and customer information, and to conduct ongoing AML monitoring. As a concession to numerous commenters, the Rule provides a two-year compliance deadline instead of the one-year deadline in the proposed rule.

For additional discussion and analysis, our Client Alert is available here.

MORRISON FOERSTER

SEC Proposes Business Continuity and Transition Rules for Advisers While Staff Publishes Similar Guidance for Funds

The SEC's Division of Investment Management published regulatory guidance highlighting the need for registered investment company complexes to review their business continuity plans to ensure that they are sufficiently robust to mitigate potential exposures and disruptions and consider the backup processes and redundancies of critical service providers. On the same day, the SEC proposed rules that would require registered investment advisers to adopt and implement business continuity and transition plans reasonably designed to address risks related to an adviser's ability to operate in the event of a significant disruption.

For additional discussion and analysis, our blog post is available here.

The Metaphysics of Systemic Risk

The Financial Stability Oversight Council ("FSOC") again warned that asset managers present systemic risk to financial stability in five key areas:

- liquidity and redemptions;
- leverage;
- operational functions;
- securities lending; and
- resolvability and transition planning.

In a 27-page statement, the FSOC detailed its concerns and how regulators should respond to those risks.

In response, SEC Chair Mary Jo White, who also serves as a member of the FSOC, said she supported the FSOC's efforts, which she characterized as "complementary" to the SEC's current regulatory initiatives. She noted that the SEC evaluates systemic risks in reliance on its own studies by its Division of Economic and Risk Analysis ("DERA") and has responded with its own rule proposals independent of the FSOC's analysis.

For additional discussion and analysis, a *Law360* article written by Jay Baris and Oliver Ireland is available here.

SEC Chair White to FSOC: We're On It

In a recent keynote address before the Investment Company Institute, SEC Chair Mary Jo White signaled to the Financial Stability Oversight Council ("FSOC") that the SEC is "working hard" to finalize rules that address potential systemic risks in asset management.

The reminder follows FSOC's recent statements that it continues to focus on systemic risks in certain asset management products, and in advance of an anticipated statement by the Financial Stability Board ("FSB") on the same topic. Chair White noted that the SEC is finalizing proposed rules on fund reporting, liquidity risk management, and fund use of derivatives, which, among other things, are issues that FSOC and the FSB have publicly raised.

For additional discussion and analysis, our blog post is available here.

SEC Eases Regulatory Burden for Listing Actively Managed ETFs

The SEC recently took a step toward streamlining the approval process for actively managed ETFs by approving rule proposals from two securities exchanges.

The order issued to BATS Exchange, Inc. ("BATS") allows BATS to adopt "generic listing standards" for actively managed ETFs. Up until now, generic listing standards applied only to passively managed ETFs that track an index.

The SEC issued a similar order to NYSE Arca, Inc.

This regulatory relief, originally proposed by the exchanges in November 2015, effectively removes a hurdle that actively managed ETFs faced when applying for a listing on the exchange.

For additional discussion and analysis, our blog post is available here.

SEC Staff Throws Funds a Lifeline on Auditor Independence (For Now)

The SEC's Division of Investment Management provided temporary relief from the headache created for funds when the failure to meet the provisions of the so-called "loan rule" may disqualify fund auditors from being independent.

In a no-action letter issued to Fidelity Management and Research, the staff said that it would not recommend enforcement action if a fund's auditor fails to meet the independence requirements of Rule 2-01(b) of Regulation S-X because it has a lending relationship with an entity that owns (beneficially or of record) more than 10 percent of the fund's equity securities (the "loan rule").

But the relief is only temporary: the staff's no action position expires in 18 months.

Under Regulation S-X, the SEC may not recognize an accountant as independent if the accountant is not, or a reasonable and knowledgeable investor concludes that they are not, capable of exercising objective and impartial judgment in the audit engagement. Among other things, violation of the loan rule is a non-exclusive example of a circumstance that the

SEC considers inconsistent with independence.

Several large fund managers recently created a kerfuffle when they disclosed that their funds' auditors may not qualify as independent because they may have technically violated the loan rule. These disclosures prompted funds and their independent auditors to scramble into action to stop a potential cascade of consequences, including calling into question the validity of fund audits and related pressure on fund audit committees.

What is the loan rule? In relevant part, it states: "An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has ... [a]ny loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities...."

Generally speaking, auditors maintain that simply having a lending relationship with a 10 percent owner of a fund client's shares does not call into question their ability to be objective and fair in an audit engagement. And, with appropriate disclosures, the funds' audit committees can reach the same conclusion.

The SEC staff agreed, for the time being. It said that it would not object if the funds rely on an audit opinion from an audit firm "that has identified a failure" to comply with the loan rule, provided three conditions have been satisfied:

1. The audit firm has complied with PCAOB Rule 3526(b)(1), which provides, in substance, that the auditor must describe in writing any relationships between the auditor and the fund that may be reasonably be thought to bear on independence; and PCAOB Rule 3526(b)(2), which requires the auditor to discuss with the fund's audit committee the potential effects of its relationships on its independence;
2. The non-compliance of the auditor is with respect only to the lending relationships; and
3. Notwithstanding non-compliance with the loan rule, the auditor has concluded that it is objective and impartial with respect to other issues encompassed within its engagement.

The staff clearly stated that the no-action assurances are temporary and expire in 18 months.

Can other fund groups rely on this no-action letter? Although the letter was addressed to only one fund complex, it would appear that any fund group with similar facts may also rely on it.

Our Take

The staff's no-action position applies only to investment companies that file financial statements certified by auditors who may not be independent by virtue of the loan rule, and only for 18 months. On its face, the relief does not extend to the auditors themselves. In the short term, the letter provides a soft landing to a potentially explosive and intractable problem for funds.

With the threat of potential future non-compliance hanging over their heads, auditors and funds may be encouraged to find an alternative solution that does not require regulatory intervention by the SEC staff. This will require some time — and creativity.

SEC Increases Net Worth Threshold for "Qualified Clients" under Rule 205-3 of the Advisers Act

The SEC recently issued an order (the "Order") to increase the net worth threshold for "qualified clients" under Rule 205-3 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), from $2 million to $2.1 million. Rule 205-3 currently allows an investment adviser to charge a client (a "qualified client") performance fees if:

- the client has at least a certain dollar amount in assets under management (currently, $1,000,000) with the investment adviser immediately after entering into the advisory contract;
- if the investment adviser reasonably believes, immediately prior to entering into the advisory contract, that the client either (A) had a net worth of more than a certain dollar amount (currently, $2,000,000) (the "net worth test") or (B) is a "qualified purchaser" as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940, as amended, at the time the advisory contract is entered into; or
- the client is (A) an executive officer, director, trustee, general partner, or person serving in a similar capacity of the investment adviser; or (B) is a "knowledgeable employee" of the investor adviser.

The adjustment to the net worth threshold is being made pursuant to a five-year indexing adjustment required by Section 205(e) of the Advisers Act and Section 419 of the Dodd-Frank Act. The effective date of the increase to the net worth threshold is August 15, 2016.

Qualified clients that enter into advisory contracts in reliance on the net worth test prior to the effective date will be "grandfathered" under the prior net worth threshold.

A copy of the Order is available here.

SEC Approves FINRA's Educational Communication Rule

The SEC recently approved FINRA's new Rule 2273 (Educational Communication Related to Recruitment Practices and Account Transfers), which requires delivery of an educational communication prepared by FINRA to customers of a transferring representative. The rule will become effective on November 11, 2016.

FINRA recently released Regulatory Notice 16-18, which provides an overview of the new Educational Communication Rule and includes the rule text and the form of educational communication required by FINRA.

The rule requires a firm that hires or associates with registered representatives to deliver an educational communication to former customers of the representative when:

- the firm or its registered representative individually contacts a former customer of that representative regarding transferring assets to the new firm; or
- a former customer of the registered representative, absent individualized contact, seeks to transfer assets to an account assigned, or to be assigned, to the representative at the new firm.

For additional discussion and analysis, our blog post is available here.

FINRA Study: Investors Lack Financial Literacy

FINRA's Investor Education Foundation released the findings from its National Financial Capability Study, and the study suggests that, while in some ways Americans have increased their financial literacy, too many Americans are lacking in this area. For example, the study concluded that absolute levels of financial literacy are low, and financial literacy is slightly down from 2009 levels. In 2015, only 37 percent of respondents to the survey answered at least four of five financial literacy questions correctly. A summary infographic of the study's findings can be found here.

For additional discussion and analysis, our blog post is available here.

FINRA Proposes Initial Round of Amendments to Communications Rules

In May 2016, FINRA filed proposed revisions to its communications rules with the SEC. The proposed revisions included a few substantive revisions to existing rules, ease some burdensome filing requirements, and leave the door open for future changes.

The rules to be revised include:

- FINRA Rule 2210 (Communications with the Public);
- FINRA Rule 2214 (Requirements for the Use of Investment Analysis Tools); and
- the content and disclosure requirements in FINRA Rule 2213 (Requirements for the Use of Bond Mutual Fund Volatility Ratings).

For additional discussion and analysis, our Client Alert is available here.

"It's Not a Culture War" – Yet?

At FINRA's annual conference in Washington, D.C., Richard Ketchum, FINRA's chairman and CEO, delivered a speech that shed a little light on FINRA's recent sweep letter relating to firm culture.

According to Mr. Ketchum, FINRA remains principally in a fact-finding posture at present, and it is not yet ready to enact culture-related rules or engage in culture-related disciplinary actions. It remains to be seen, of course, whether such developments may occur in the future.

For additional discussion and analysis, our blog post is available here.

CFTC Proposed Registration Relief for Non-U.S. Futures Commission Merchants, Commodity Pool Operators, Commodity Trading Advisors, and Introducing Brokers

On July 27, 2016, the U.S. Commodity Futures Trading Commission ("CFTC") proposed amendments to its rules ("Proposed Rules") that loosen the conditions for exemption from registration as a futures commission merchant ("FCM"), commodity pool operator ("CPO"), commodity trading advisor ("CTA") and introducing broker ("IB") for non-U.S. persons who act solely on behalf of persons located outside the United States, or on behalf of certain international financial institutions ("IFIs"), in connection with commodity interest transactions (including swaps).

The Proposed Rules would codify and expand previously issued staff no-action relief. The Proposed Rules are subject to a 30-day comment period, which closes on September 6, 2016, and are available here.

If adopted, the Proposed Rules will provide welcome registration relief for non-U.S. asset managers and other intermediaries who effectuate transactions in U.S. derivatives markets (including bilaterally executed swaps) acting in the capacity of FCMs, IBs, CPOs, or CTAs solely on behalf of persons located outside the United States.

For additional discussion and analysis, our blog post is available here.

Another Brick in the Wall: The Fed Reproposes Single-Counterparty Credit Limits for Large Banking Organizations

The Board of Governors of the Federal Reserve System (the "Fed") recently issued a Notice of Proposed Rulemaking ("NPRM"), inviting comment on reproposed rules (the "Reproposed Rules") that would establish single counterparty credit limits for U.S. bank holding companies ("BHCs") and foreign banking organizations ("FBOs") with at least $50 billion in total consolidated assets. Pursuant to Section 165(e) of Dodd-Frank Act, the Fed is required to prescribe rules that limit the amount of credit exposure that U.S. BHCs and FBOs can have to an unaffiliated company to reduce the risks that may arise from such a counterparty's sudden failure. In addition to the NPRM, the Fed also issued a white paper (the "White Paper") that provides the analytical and quantitative reasoning for the Reproposed Rules' more stringent 15 percent limit for credit exposures between systemically important financial institutions ("SIFIs").

For additional discussion and analysis, an article in *The Banking Law Journal* written by Oliver Ireland and Jared Kaplan is available here.

ENFORCEMENT + LITIGATION

OCIE Launches Share Class Initiative

OCIE recently published a National Exam Program Risk Alert highlighting the SEC staff's focus on advisers' responsibility to act consistently with their clients' best interests. According to OCIE, its latest sweep examination, the "Share Class Initiative," will "address the risk that registered advisers may be making certain conflicted investment recommendations to their clients."

Like other Risk Alerts published by OCIE, this notice highlights issues and risks that OCIE staff have identified in the course of its examination program.

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SPOTLIGHT ON BDCs

FINRA Announces Sweep of Broker-Dealers that Sell Non-Traded BDCs

In a notice published on its website on August 4, 2016, FINRA announced that it is conducting an inquiry of non-traded BDCs. FINRA asked that the member broker-dealers send the following documents and information by September 9, 2016:

- A list of each BDC offered by the member firm with information about the firm's role (dealer-manager, lead dealer, etc.);
- For each BDC offered, a list of all participating firms that have a selling agreement with the firm with respect to each registration statement and copies of form selling agreements;
- A spreadsheet listing all members that sold the BDCs to its customers with information about the scope of the offering; and
- A copy of the member firm's due diligence procedures and, if not already included, a description of those procedures that the firm conducts of the BDC initially and on an ongoing basis, together with a description of the due diligence procedures that the firm conducts with other firms with which it has a selling agreement.

The request covers the period from January 1, 2015 through June 30, 2016.

Our Take

FINRA's terse announcement may reflect a concern that non-traded BDCs are attracting more retail investors. Although FINRA did not indicate why it was requesting this information, the notice suggests that FINRA is looking more closely into the market for non-traded BDCs. We expect to see more to come from FINRA on this topic.

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SPOTLIGHT ON BDCS (CONTINUED)

Section 12(d)(1) and BDCs

BDCs face challenges raising money due to a quirk in the federal securities laws that limits how much mutual funds can invest in them. But if BDCs, mutual funds, (including ETFs), and other participants in the capital markets raise their voices, there is some hope that the SEC can ease the restriction so that BDCs can fulfill their statutory mission of raising capital for smaller companies that cannot otherwise find bank financing.

As investment companies, BDCs are subject to certain provisions of the Investment Company Act of 1940 (the "1940 Act"), including the limitations in Section 12 of the 1940 Act. Among other things, this section limits the ability of other registered investment companies (including ETFs) to acquire more than 3 percent of a BDC's total outstanding stock. Given the relatively small size of many BDCs, this meaningfully restricts their ability to raise money from key institutional investors. Unfortunately, the trickle-down effect of this restriction limits the ability of BDCs to use their capital to provide small and middle market businesses the ability to continue to develop and grow.

It may be time for the SEC—or its staff—to consider rule making or exemptive relief to address this limitation on the capital markets.

For additional discussion and analysis, our Client Alert is available here.

Acquired Fund Fees and Expenses and BDCs

The requirement that registered open-end funds to disclose "acquired fund fees and expenses" ("AFFE") of other funds they invest in, including BDCs, is useful to revisit at this time in light of the recent release of the U.S. Department of Labor's final fiduciary rule (the "DOL final rule"). The DOL final rule, among other things, prohibits a fiduciary providing investment advice to a plan subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), from causing the fiduciary or any of its affiliates to receive commission or transaction-based compensation unless there is an available exemption.

Investments in BDCs are not a restricted asset class under the DOL final rule, and one available exemption is the "best interest contract exemption" ("BICE"). However, the requirements of the BICE limit its practical benefit for investments in BDCs and will likely result in ERISA plans avoiding such investments, whether directly or indirectly through an index. This in turn will further reduce the level of institutional ownership in BDCs.

The decline of institutional ownership in BDCs, which has contributed to the volatility of BDC stocks, can be traced to the establishment of the AFFE requirement and was further exacerbated by the removal of BDCs from the Russell 2000 Index in March 2014.

For additional discussion and analysis, our Client Alerts are available here and here.

Proposed Financial Disclosure Changes Could Affect Funds and BDCs

At an open meeting, the SEC voted to propose changes to certain disclosure rules affecting public issuers including, among others, investment companies and BDCs.

The proposed rules would require disclosure changes when requirements in SEC rules or forms are substantially similar to or closely related to disclosure required by U.S. generally accepted accounting principles ("GAAP"), International Financial Reporting Standards ("IFRS") or other SEC disclosure requirements. The proposed changes seek to eliminate redundant or duplicative disclosure requirements, or to integrate related disclosure requirements that require incremental information. The SEC also noted its intent to simplify compliance efforts related to the various requirements. Importantly, the SEC intends to ensure that issuers provide substantially the same information to investors.

The Risk Alert reminds advisers that, as fiduciaries, they have an obligation to act in their clients' best interests and must disclose material conflicts of interest, "such as the receipt of compensation for selecting or recommending mutual fund share classes." Accordingly, the Share Class Initiative will focus on advisers' practices related to share class recommendations and compliance oversight of that process.

The Share Class Initiative will be risk-based and focus on the following high-risk areas:

- **Fiduciary Duty and Best Execution.** Examiners will review advisers' investment practices to confirm that they are acting in their clients' best interests and seeking best execution in connection with recommending investments in mutual funds.

- **Disclosures.** Examiners will evaluate advisers' disclosures to clients (including, without limitation, Part 2 of an adviser's Form ADV) to ensure that they adequately disclose whether the adviser (or its supervised persons) accepts compensation for the sale of investment products, including asset-based sales charges or service fees from the sale of mutual funds. This disclosure should adequately explain any conflict of interest inherent in the receipt of such compensation.

- **Compliance Program.** Examiners will review an adviser's Rule 206(4)-7 compliance program to determine if it adequately addresses the selection of mutual fund share classes.

Our Take

OCIE's published 2016 examination priorities include a focus on investor protections and adequately addressing conflicts of interest, and the SEC has brought several enforcement actions related to advisers causing clients to purchase more expensive share classes of mutual funds. Over the last couple of years, FINRA has brought similar actions for failures of broker-dealers to apply eligible sales charge waivers. It is therefore not surprising that OCIE would focus on this issue. Advisers should take the opportunity to review their compliance policies, and the implementation of such policies, to ensure that they adequately address the matters identified in the Risk Alert. Doing so quickly — and promptly making any necessary changes or improvements identified in such review — could mitigate any issues identified by the staff.

SEC Charges Private Fund Administrator With "Gatekeeper Failures"

Add fund administrators to the list of service providers the SEC expects to act as "gatekeepers." In two separate settled actions, the SEC found that a private fund administrator "caused" the managers' unregistered private equity funds to violate the Investment Advisers Act.

According to the SEC, the administrator missed or ignored clear "red flag" indications of fraud while carrying out its responsibilities to keep records and prepare financial statements and investor account statements.

The SEC staff said that fund administrators are "responsible for ensuring that fund records provide accurate information about the value and existence of fund assets." The staff found that the failure of the administrator in these cases to do so "essentially enabled the schemes to persist . . . until the SEC stepped in." The SEC found that the administrator's failure to take action on the red flags presented by the managers' actions was actionable, notwithstanding that fund administrators are not registered with the SEC.

The administrator agreed to the settlement without admitting or denying the charges and paid disgorgement, penalties, and interest of approximately $350,000.

Our Take

It appears that it is not enough for policies and procedures to simply address the operational functions of administration contracts. Administrators must ensure that they have implemented compliance and supervisory structures that provide a structure for raising concerns about client accounts. Moreover, investment advisers should ensure that their due diligence processes question whether administrators have appropriate policies in place and understand how they work.

FINRA Sanctions Investment Firm Following Unsuitable Sales of Nontraditional ETFs

On June 7, 2016, FINRA settled proceedings against a New York-based investment firm for alleged violations of its suitability and related rules, namely NASD Rule 2310 and FINRA Rules 2111 and 2010.

According to FINRA, the firm allegedly failed to, among other things:

- establish, maintain, and enforce a reasonably designed supervisory system and written supervisory procedures ("WSPs") regarding nontraditional ETFs; or

- enforce its WSPs.

Without admitting or denying FINRA's findings, and to settle the proceedings, the firm consented to a censure and a $2,250,000 fine, in addition to $716,831.80, plus interest, in restitution for certain of its customers.

Nontraditional or "alternative" ETFs, such as leveraged, inverse, and inverse-leveraged ETFs, utilize investment strategies that often entail returns and performance that can differ significantly from those of their underlying indices or benchmarks during the same period of time. In FINRA Regulatory Notice 09-31, FINRA advised broker-dealers and their representatives that nontraditional ETFs "typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets." FINRA has previously sanctioned broker-dealers in somewhat similar circumstances.

For additional discussion and analysis, our blog post is available here.

Private Equity Fund Manager Sanctioned for Acting as Unregistered Broker-Dealer

On June 1, 2016, the SEC issued an administrative order (the "Order") sanctioning a registered investment adviser and its managing member and principal owner for acting as an unregistered broker-dealer, as well as engaging in certain conduct which violated the Investment Advisers Act of 1940. Without admitting or denying the allegations, the parties consented to issuance of the Order and imposition of the sanctions.

For additional discussion and analysis, our Client Alert is available here.

Massachusetts Securities Division Searches for Rogue Brokers

According to recent news reports, the Massachusetts Securities Division (the "Division") recently sent a "sweep letter" to firms asking broker-dealers to report information about their hiring policies and procedures. The Division, led by Secretary of the Commonwealth William Galvin, sent this letter to firms in which more than 15 percent of their representatives have at least one current misconduct report on their records; this figure is said to be above the average for Massachusetts-registered broker-dealers.

These 241 brokerage firms were asked to disclose hiring information dating back to January 1, 2014. The Division seeks information about how many representatives were terminated or placed on heightened supervision since then, with the intention of "keeping the rogue broker out of the industry," according to Mr. Galvin.

This review follows FINRA's February 2016 issuance of its own sweep letter, requesting information about member firms' compliance culture. FINRA's focus on the securities industry culture aims to protect investors and market integrity through heightened scrutiny of broker-dealers, and state regulators like the Division have also taken increased market regulatory measures. In 2012, for example, the Division regulated structured product sales, imposing fines on a broker-dealer for sales of non-traditional ETFs.

TIDBITS

- For practice pointers on shelf offerings by BDCs, see our article available here.
- On July 21, 2016, the SEC named Wesley R. Bricker Interim Chief Accountant. In this role, Bricker is responsible for the activities of the Office of the Chief Accountant.
- On July 20, 2016, the SEC named Kurt Gottschall Associate Regional Director for enforcement in the Denver, Colorado office.
- On June 28, 2016, the SEC named C. Dabney O'Riordan co-chief of the SEC's Division of Enforcement's Asset Management Unit.

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