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Skadden

Investment Management Update

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SEC Adopts Rules and Interpretations Related to Standards of Conduct for Broker-Dealers and Investment Advisers

On June 5, 2019, the Securities and Exchange Commission (SEC) voted to adopt a package of rules and interpretations related to standards of conduct for broker-dealers and investment advisers, including new Regulation Best Interest, new Form CRS, an interpretation of the fiduciary duties of investment advisers and an interpretation of the "solely incidental" clause of the broker-dealer exclusion under the Investment Advisers Act of 1940 (Advisers Act).

Regulation Best Interest — Standard of Conduct for Broker-Dealers[1]

The SEC voted to adopt new Regulation Best Interest, which will modify the broker-dealer standard of conduct beyond existing suitability obligations, requiring broker-dealers, among other things, to act "in the best interest of their retail customers when making a recommendation," including not placing their financial or other interests ahead of the interests of retail customers. The standard of conduct draws from key fiduciary principles and cannot be satisfied through disclosure alone. However, Regulation Best Interest does not impose a fiduciary duty on broker-dealers.[2] The rule incorporates disclosure obligations, care obligations, conflict of interest obligations and compliance obligations:

- **Disclosure Obligations:** A broker-dealer, prior to or at the time of making a recommendation, is required to provide to the retail customer, in writing, full and fair disclosure of (1) all material facts related to the scope and terms of the relationship with the retail customer and (2) all material facts relating to conflicts of interest that are associated with such recommendation.
- **Care Obligations:** A broker-dealer must exercise reasonable diligence, care and skill when making recommendations to retail customers. This requires the broker-dealer to consider the potential risks, rewards and costs in light of each customer's investment profile and to have a reasonable basis to conclude that the recommendation is in the customer's best interest. The SEC noted that the broker-dealer should consider alternatives in determining whether it has a reasonable basis for making its recommendation.
- **Conflict of Interest Obligations:** A broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to: (1) identify and disclose, or eliminate, all conflicts of interest associated with such recommendations; (2) identify and mitigate any conflicts of interest associated with such recommendations that create an incentive for an associated person of a broker-dealer to place the interest of the broker-dealer ahead of the interest of the retail customer; (3) identify and disclose any material limitations placed on the securities or investment strategies involving securities that may be recommended to a retail customer and any conflicts of interest associated with such limitations, and prevent such limitations and associated conflicts of interest from causing the broker-dealer to make recommendations that place the interest of the broker-dealer ahead of the interest of the retail customer; and (4) identify and eliminate any sales contests, sales quotas, bonuses and noncash compensation that are based on the sales of specific securities or specific types of securities within a limited period of time.

[1] On September 9, 2019, attorneys general from seven states and the District of Columbia filed a federal lawsuit in the U.S. District Court for the Southern District of New York seeking to vacate Regulation Best Interest. The plaintiffs allege that the SEC exceeded its authority in promulgating Regulation Best Interest, in violation of the Administrative Procedure Act, and claim that Regulation Best Interest "undermines critical consumer protections for retail investors, increases confusion about the standards of conduct that apply when investors receive recommendations and advice from broker-dealers or investment advisers, makes it easier for brokers to market themselves as trusted advisers (while nonetheless permitting them to engage in harmful conflicts of interest that siphon investors' hard-earned savings), and contradicts Congress's express direction." See the complaint.

[2] SEC, Regulation Best Interest: The Broker-Dealer Standard of Conduct, Release No. 34-86031 (June 5, 2019). ("There are also key differences between Regulation Best Interest and the Advisers Act fiduciary standard that reflect the distinction between the services and relationships typically offered under the two business models. For example, an investment adviser's fiduciary duty generally includes a duty to provide ongoing advice and monitoring, while Regulation Best Interest imposes no such duty and instead requires that a broker-dealer act in the retail customer's best interest at the time a recommendation is made ...") See final rule release.

- **Compliance Obligations:** A broker-dealer must establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

This rule became effective on September 10, 2019.

Form CRS Relationship Summary

The SEC voted to adopt new Form CRS, which will require investment advisers and broker-dealers to deliver to retail investors a relationship summary providing simple information about the services the firm offers, fees, costs, conflicts of interest, legal standard of conduct and whether the firm and its financial professionals have disciplinary history; and how to obtain additional information about the firm. The format allows investors to compare the differences between investment advisers and broker-dealers in a way that is distinct from other required disclosures.

This rule became effective on September 10, 2019.

Standard of Conduct for Investment Advisers

The SEC published an interpretation of the standard of conduct for investment advisers that, according to the SEC, reaffirms and in some cases clarifies the SEC's view of the fiduciary duty that an investment adviser owes to its clients. The release reflects decades of interpretations by the SEC and its staff in this area. The release seeks to provide greater clarity about the investment adviser's legal obligations by highlighting principles relevant to the fiduciary duty.

Fiduciary Duty. In the SEC's view, "an investment adviser's obligation to act in the best interest of its clients is an overarching principle that encompasses both the duty of care and the duty of loyalty." The investment adviser's fiduciary duty is broad and applies to the entire relationship between the investment adviser and the client. Moreover, the SEC explained that the "fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."

- **Duty of Care:** The release states that an investment adviser's duty of care includes, among other things, (1) the duty to provide advice that is in the best interest of the client, (2) 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, and (3) the duty to provide advice and monitoring over the course of the relationship.
- **Duty of Loyalty:** The release explains that an investment adviser's duty of loyalty requires that the investment adviser not subordinate its clients' interests to its own. To meet its duty of loyalty, an investment adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.

  The SEC explained that in order for disclosure to be full and fair, the disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent.

  Notably, in the proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, the SEC had framed the duty of loyalty as requiring "an investment adviser to put its client's interests first." In the final interpretative release, the SEC changed this to the "not subordinate" standard. This is an important clarification of investment adviser duties and, subject to clear disclosure, would appear to give investment advisers greater clarity as to the appropriateness of certain activities conducted for the advisers' own account.

"May" Disclosures. With respect to "may" disclosures, the SEC emphasized that disclosures stating that an adviser "may" have a particular conflict would not be adequate when the conflict actually exists. The release specifies that the use of "may" disclosures would not be appropriate: (1) when a conflict exists with respect to some (but not all) types or classes of clients, advice or transactions without additional disclosure specifying the circumstances with respect to which the conflict exists; and (2) if it precedes a list of all possible or potential conflicts regardless of likelihood, obfuscating actual conflicts to the point that a client cannot provide informed consent. In contrast, the word "may" could be appropriately used to disclose a potential conflict that does not currently exist but might reasonably present itself in the future. (For more information regarding the SEC's position with respect to "may" disclosures, see the *Robare v. SEC* discussion in our June 2019 *Investment Management Update*.)

Informed Consent. The release explains that disclosure regarding a conflict should enable the client to understand and provide informed consent to the conflict of interest. This informed consent can be either explicit or, depending on the facts and circumstances, implicit. The SEC noted, however, that an investment adviser cannot infer consent if the adviser was aware or reasonably should have been aware that the client did not understand the nature and import of the conflict.

Hedge Clauses. In a footnote to the release, the SEC withdrew the Heitman Capital Management LLC SEC staff no-action letter (February 12, 2007) (Heitman Letter), which discussed an investment adviser's ability to use a clause in an advisory agreement that purports to limit an investment adviser's liability under such agreement (also known as a hedge clause). The SEC staff in the Heitman Letter did not object to the use of hedge clauses and instead indicated that whether a hedge clause would violate the anti-fraud provisions set forth in Sections 206(1) and 206(2) of the Advisers Act depends on all of the facts and circumstances.

In the footnote to the release, the SEC stated that while the question of whether a hedge clause violates the Advisers Act's anti-fraud provisions depends on all of the surrounding facts and circumstances, including the particular circumstances of the client (*e.g.*, sophistication), the SEC warned that there are few (if any) circumstances in which a hedge clause in an agreement with a retail client would be consistent with the Advisers Act's anti-fraud provisions.

This interpretation became effective on July 12, 2019.

Interpretation of 'Solely Incidental'

The SEC published an interpretation of the "solely incidental" exclusion from the definition of investment adviser under the Advisers Act for broker-dealers. Section 202(a)(11)(C) of the Advisers Act excludes from the definition of investment adviser a broker-dealer "whose performance of such advisory services is *solely incidental* to the conduct of his business as a broker or dealer and who receives no special compensation" for those services (emphasis added). The interpretation confirms and clarifies the SEC's prior interpretation of the "solely incidental" broker-dealer exclusion under the Advisers Act. Specifically, it states that a broker-dealer's advice as to the value and characteristics of securities or as to the advisability of transacting in securities is included in the "solely incidental" prong of this exclusion if the advice is provided in connection with, and is reasonably related to, the broker-dealer's primary business of effecting securities transactions. The SEC noted that a "facts and circumstances test" would be applied to determine whether the advisory services provided by a broker-dealer satisfy the solely incidental exclusion and would involve examining the broker-dealer's business, the specific services offered, and the relationship between the broker-dealer and the customer. The SEC also confirmed that the quantum or importance of the investment advice is not determinative as to whether it is consistent with the solely incidental exclusion.

The SEC provided guidance on applying its interpretation of the solely incidental exclusion in the context of investment discretion and account monitoring, noting that these two examples of advisory services should not be viewed or interpreted in isolation. In the context of investment discretion, the SEC stated that there are situations where a broker-dealer may exercise temporary or limited discretion in a way that is not indicative of a relationship that is primarily advisory in nature; these are generally situations where the discretion is limited in time, scope or some other manner. A totality of the facts and circumstances would be applied to determine whether a broker-dealer's temporary or limited discretion is consistent with the solely incidental exclusion.

In the context of account monitoring, the SEC distinguished between ongoing account monitoring, which would not be solely incidental, and periodic accounting monitoring, which may be solely incidental depending on the facts and circumstances. In contrast, the SEC noted that when a broker-dealer, voluntarily and without any agreement with the customer, reviews the holdings in a retail customer's account for the purposes of determining whether to provide a recommendation to the customer, such actions are reasonably related to the broker-dealer's primary business of effecting securities transactions. The SEC noted that absent an agreement with the customer, it would not consider this to be account monitoring.

This interpretation became effective on July 12, 2019.

For additional information regarding these rules and interpretations, see our June 5, 2019, client alert "SEC Adopts Rules and Interpretations Related to Standards of Conduct for Broker-Dealers and Investment Advisers."

Update on Section 36(b) Litigation

In re Davis New York Venture Fund Fee Litigation

In an opinion unsealed on July 3, 2019, Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York granted summary judgment to a mutual fund adviser and dismissed an excessive fee claim brought under Section 36(b) of the Investment Company Act of 1940 (1940 Act). *In re Davis New York Venture Fund Fee Litigation*, No. 14-04318 (S.D.N.Y. 2019).

Davis New York is the latest summary judgment decision in a string of cases rejecting the so-called "subadvisory" or "reverse manager of managers" theory in excessive fee litigation. The court's opinion in *Davis New York* reinforces three key lessons from the most recent wave of Section 36(b) litigation.

First, the opinion is yet another nail in the coffin of the subadvisory theory in excessive fee liability. Specifically, the opinion supports the conclusion reached in prior Section 36(b) decisions that peer funds are a more apt benchmark than subadvised funds for evaluating fees. However, this case focused on a different type of comparison than most recent Section 36(b) litigation. Most litigation in the last two waves of cases rejected comparisons between retail funds and other products such as subadvised or institutional funds in favor of comparisons, compiled by third parties, to groups of funds managed by other advisers. *See*, *e.g*., *In re BlackRock Mut. Funds Adv. Fees Litig.*; *Goodman v. J.P. Morgan Investment Management, Inc*. Instead, *Davis New York* focused on comparisons between two or more retail funds managed by the same adviser. The adviser used such a comparison to show that the management fee was not excessive, and the court found the comparison more apt than the plaintiffs' comparison to subadvised funds.

Second, the opinion reaffirms the crucial importance of an independent, well-informed board that conducts a robust contract renewal process pursuant to Section 15(c) of the 1940 Act. The opinion serves as a reminder to advisers to provide sufficient information so that the board can appropriately inform itself about the scope of advisory and subadvisory services, and consider whether a comparison is apt. The court held that the adviser (1) provided the board with — and the board conscientiously reviewed — substantial materials on the differences in scope, scale and risk of advisory versus subadvisory services; (2) disclosed to the board services provided pursuant to contracts other than the investment advisory agreement; and (3) provided sufficient information to the board on advisory and subadvisory profit margins. Consequently, the court held that "the Board's review process was sufficiently robust to warrant a significant degree of deference to the Board's decision to approve [the adviser's] advisory fee."

Third, the opinion reaffirms that periods of underperformance and profit margins as high as 81% are not alone sufficient for excessive fees plaintiffs to survive a motion for summary judgment. With regard to performance, the court held that although the plaintiffs "proffered sufficient facts to enable a rational factfinder to conclude that [the fund's] performance was below standard to at least some degree," the plaintiffs failed to proffer "evidence that the Fund's deviation from its benchmark or negative Alpha was particularly dramatic or unusual, and this factor does not strongly favor liability even when all reasonable inferences are drawn in Plaintiffs' favor." With regard to profitability, the court held that the plaintiffs failed to proffer "evidence to demonstrate that, when viewed holistically in the context of the other *Gartenberg* factors, [the adviser's] profits [of 73-81%] were out of proportion to the services rendered."

For a more detailed discussion of this case, see our July 15, 2019, client alert "SDNY Rules in Favor of Mutual Fund Adviser, Dismisses Excessive Fee Claim."

Kennis v. Metropolitan West Asset Management

On August 5, 2019, Judge George H. Wu of the U.S. District Court for the Central District of California issued his post-trial ruling, dismissing an excessive fee claim brought under Section 36(b) of the 1940 Act. The decision followed a seven-day bench trial held in December 2018. *Thomas J. Kennis v. Metropolitan West Asset Management, LLC*, No. 15-08162 (C.D. Cal. 2019) (*MetWest*).

MetWest is the second of the "subadvisory" or "reverse manager of managers" theory trials[1] — the other was *In re BlackRock Mut. Funds Adv. Fees Litig*. (*BlackRock*). Like *BlackRock*, *MetWest* rejected the subadvisory theory and reinforced several key lessons from the recent waves of Section 36(b) litigation, building on that line of precedent.

First, while it reiterates the now-familiar tenet that the board should maintain a rigorous process involving ongoing and conscientious review of the *Gartenberg* factors, the *MetWest* court expressly held that a fund's board of trustees is not required to negotiate fee reductions to be entitled to substantial deference. Similarly, the *MetWest* court found that the board was not required to analyze metrics like cost and profitability data on a fund-by-fund basis, nor was it required to review the agreements for products managed under similar mandates as the funds at issue (here, subadvisory agreements). *MetWest* also further supports the principle set forth in prior Section 36(b) cases that trustees can and should refine their processes during litigation without facing any inference that the original process was deficient.

Second, *MetWest* is the latest installment in the recent wave of Section 36(b) cases finding that subadvisory and advisory services are not comparable and emphasizing the substantial differences in the scope and scale of the disparate services. In rejecting the subadvisory fee comparison, *MetWest* concludes not only that advisory and subadvisory services are different as a general matter, but that even similar services across product types — *e.g*., portfolio management — can require differing amounts of adviser resources. Ultimately, *MetWest* rejects the comparison in favor of third-party comparisons to peer funds.

Third, on economies of scale, *MetWest* contrasts the resources required to manage the small funds at issue with the much more substantial resources required to manage the large funds at issue as assets under management (AUM) increase. *MetWest* also reinforces the principle that the proper analysis to demonstrate the existence of economies of scale requires more than simply a comparison of AUM, profitability and expenses over time. It requires controlling for extraneous variables that could contribute to decreasing expenses in order to demonstrate that a decline in expenses was due to economies of scale. *MetWest* also supports the principle that any retained economies of scale can be properly shared through nonpecuniary mechanisms like investments in personnel, technology and infrastructure. Although the at-issue fund in *MetWest* lacked fee breakpoints and was priced "at scale" when launched, the court held that breakpoints and fee reductions are not required to show that economies of scale were properly shared with funds.

For a more detailed discussion of this case, see our August 8, 2019, client alert "Another Mutual Fund Adviser Prevails at Trial in Excessive Fee Case."

[1] Prior to trial, the court granted partial summary judgment in favor of the defendants on two *Gartenberg* factors: (1) fall-out benefits and (2) nature and quality of the services. The trial addressed all of the other *Gartenberg* factors.

SEC Issues Concept Release on Harmonization of Securities Offering Exemptions: Pooled Investment Funds

On June 18, 2019, the Securities and Exchange Commission (SEC) issued a concept release seeking comments on "possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections." This summary focuses on the portion of the concept release discussing the issues relating to limitations on retail investor access to pooled investment funds that invest in exempt offerings.

In the concept release, the SEC stated that pooled investment funds can serve as an important source of funding for issuers seeking to raise growth-stage capital. "Pooled investment funds," as used in the concept release, include investment companies, such as a closed-end fund (CEF), mutual fund or exchange-traded fund, registered under the Investment Company Act of 1940 (1940 Act), a business development company (BDC) or a private fund that operates pursuant to an exemption or exclusion from the 1940 Act. Highlighting the benefits of exempt offerings, the SEC noted that retail investors "who seek a broadly diversified investment portfolio could benefit from the exposure to issuers making exempt offerings, as these securities may have returns that are less correlated to the public markets." The concept release states that for retail investors that are not accredited investors, however, the ability to gain exposure to exempt offerings through a pooled investment fund is generally limited to exposure through registered investment companies and BDCs. Accordingly, certain areas in which the SEC is seeking comments include:

- the extent to which issuers view pooled investment funds as an important source of capital for exempt offerings, including whether certain types of pooled investment funds facilitate capital formation more efficiently than others;
- how recent market trends have affected retail investor access to issuers that do not seek to raise capital in the public markets; and to the extent that issuers are more likely to seek capital through exempt offerings, whether existing regulations make investor access to this market through a pooled investment vehicle difficult;
- whether there are regulatory provisions or practices that discourage participation by registered investment companies and BDCs in exempt offerings; for CEFs and BDCs, whether there are existing regulatory provisions or practices that discourage the introduction of investment products that focus on issuers seeking capital at key stages of their growth cycle;
- whether there should be restrictions on the ability of CEFs, including BDCs, to invest in private funds and to offer their shares to retail investors;
- whether changes should be made to the rules governing the operation of interval funds and tender offer funds;
- whether all types of pooled funds should be able to qualify as accredited investors without regard to satisfying any quantitative criteria;
- whether the issue of secondary market liquidity has a significant effect on investors' decision-making with respect to whether to invest in pooled investment vehicles, particularly with respect to CEFs and BDCs; and
- whether the SEC should consider any changes to its rules to encourage the establishment or improvement of secondary trading opportunities for CEFs or BDCs.

The questions the SEC raised in the concept release indicate a clear appreciation of the need to provide retail investors with sufficient access to exempt offerings to facilitate the ability to achieve their retirement goals.

Comments were due to the SEC by September 24, 2019.

See the concept release.

Joint Statement on Broker-Dealer Custody of Digital Asset Securities

On July 8, 2019, the staffs of the Securities and Exchange Commission's Division of Trading and Markets and the Financial Industry Regulatory Authority (FINRA) issued a joint statement on the application of federal securities laws and FINRA rules to broker-dealer custody of digital asset securities.[1] The staffs acknowledged that it may be challenging for market participants to custody digital asset securities in compliance with broker-dealer financial responsibility rules without putting in place significant technological enhancements and solutions unique to digital asset securities. However, the staffs noted that they intend to "continue their constructive engagement with market participants" and "to continue to engage with entities pursuing this line of business."

Noncustodial Broker-Dealer Models for Digital Asset Securities

The staffs provided the following examples of entities engaging in broker-dealer activities involving digital asset securities that do not involve a broker-dealer engaging in custody functions. These noncustodial activities involving digital asset securities do not raise the same level of concern regarding custody:

- **Private Placement:** A broker-dealer sends the trade-matching details (*e.g.*, identity of the parties, price and quantity) to the buyer and issuer of a digital asset security — similar to a traditional private placement — and the issuer settles the transaction bilaterally between the buyer and issuer, away from the broker-dealer. The broker-dealer instructs the customer to pay the issuer directly and instructs the issuer to issue the digital asset security to the customer directly (*e.g.*, the customer's "digital wallet").
- **Over-the-Counter Transactions:** A broker-dealer facilitates "over-the counter" secondary market transactions in digital asset securities without taking custody of or exercising control over the digital asset securities. The buyer and seller complete the transaction directly and, therefore, the securities do not pass through the broker-dealer facilitating the transaction.
- **Trading Platforms:** In a secondary market transaction, a broker-dealer introduces a buyer to a seller of digital asset securities through a trading platform where the trade is settled directly between the buyer and seller.

Considerations for Broker-Dealers Seeking To Take Custody of Digital Asset Securities

Customer Protection Rule. The staffs emphasized that a broker-dealer seeking to custody digital asset securities must comply with Rule 15c3-3(c) of the Securities Exchange Act of 1934 (Customer Protection Rule). The joint statement notes that the purpose of the rule is to:

- safeguard customer securities and funds held by a broker-dealer,
- prevent investor loss or harm in the event of a broker-dealer's failure, and
- enhance the SEC's ability to monitor and prevent unsound business practices.

The Customer Protection Rule generally requires broker-dealers to implement appropriate safeguards for customer assets and to keep those assets separate from the broker-dealer's assets in order to increase the likelihood that customers' securities and cash can be returned

[1] The statement defines "digital asset" as an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins" and "tokens." A digital asset may or may not meet the definition of a "security" under the federal securities laws. However, a digital asset that is a security is a "digital asset security."

to them in the event of the broker-dealer's failure. The joint statement notes that a number of entities have approached FINRA seeking to register or amend their existing registrations in order to engage in broker-dealer activities involving digital asset securities. The staffs note that the "specific circumstances where a broker-dealer could custody digital asset securities in a manner that the [s]taffs believe would comply with the Customer Protection Rule remain under discussion."

Considerations for Digital Asset Securities. The joint statement discusses the following concerns relating to broker-dealers maintaining custody of digital asset securities:

- The manner in which digital asset securities are issued, held and transferred may create greater risk that a broker-dealer maintaining custody of them could be victimized by fraud or theft;
- A broker-dealer could lose "private keys" necessary to transfer customer digital asset securities or transfer a client's digital asset securities to an unknown or unintended address without meaningful recourse to invalidate fraudulent transactions, recover or replace lost property or correct errors; and
- A broker-dealer may have difficulty determining that it, or its third-party custodian, maintains custody of digital asset securities.

As the staffs noted, "[t]hese risks could cause securities customers to suffer losses, with corresponding liabilities for the broker-dealer, imperiling the firm, its customers, and other creditors."

The Books and Records and Financial Reporting Rules

Under applicable broker-dealer recordkeeping and reporting rules,[2] broker-dealers are required to make and keep current ledgers reflecting all assets and liabilities, including securities records that account for all securities carried by the broker-dealer, and to prepare financial statements. From the staffs' perspective, "[t]he nature of distributed ledger technology, as well as the characteristics associated with digital asset securities, may make it difficult for a broker-dealer to evidence the existence of digital asset securities for the purposes of the broker-dealer's regulatory books, records, and financial statements, including supporting schedules," particularly with an independent auditor. The staffs encourage broker-dealers to consider how the nature of the technology may impact their ability to comply with the broker-dealer recordkeeping and reporting rules.

[2] See Rules 17a-3 (record making rule), 17a-4 (record retention rule) and 17a-5 (financial reporting rule) under the Exchange Act.

Securities Investor Protection Act

Under the Securities Investor Protection Act of 1970 (SIPA), securities customers are eligible for up to $500,000 in protection if their broker-dealer is missing the customers' assets. The staffs noted that these SIPA protections apply to a "security" as defined in SIPA and cash deposited with the broker-dealer for the purpose of purchasing securities. They do not apply to other types of assets, including assets that are securities under federal securities laws but are excluded from the definition in SIPA (*e.g.*, an investment contract or interest that is not the subject of a registration statement with the SEC pursuant to the provisions of the Securities Act of 1933 is not considered a "security" under SIPA).

In the context of digital asset securities, the staffs explained that if a digital asset security does not meet the definition of "security" under SIPA, and in the event of the failure of a carrying broker-dealer, SIPA protection likely would not apply. The staffs warned that these consequences are likely to be inconsistent with the expectations of persons intending to use a broker-dealer to custody their digital asset securities.

Control Location Applications

In the statement, the staffs explained that they have received inquiries from broker-dealers regarding how to use an issuer or transfer agent as a proposed "control location" for purposes of the possession or control requirements under the Customer Protection Rule. In this context, the digital assets would be uncertificated securities where the issuer or a transfer agent maintains a traditional single master security holder list but also publishes as a courtesy the ownership record using distributed ledger technology. The staffs stated that to the extent a broker-dealer contemplates such an arrangement, the Division of Trading and Markets will consider whether the issuer or the transfer agent can be considered a satisfactory control location under the Customer Protection Rule.

See the public statement, "Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities."

Update on CEF Activism

Activists Continue To Target Closed-End Funds

On July 18, 2019, Saba entered into a standstill agreement with Massachusetts Financial Services Company (MFS) regarding the registered closed-end funds (CEFs) managed by MFS.[1] As of the date of this issue, this is the fourth publicly disclosed standstill agreement that Saba has entered into with registered CEFs and/or their advisers in 2019. The agreement with MFS arose out of discussions between Saba and MFS regarding potential liquidity events for the common shares of MFS California Municipal Fund (CCA), whereby MFS ultimately agreed to recommend that the board of trustees of CCA approve the termination and liquidation of CCA. In return, Saba agreed to vote at CCA's 2019 annual shareholder meeting in favor of the slate of trustees nominated by the board and to vote against any shareholder proposals not recommended for shareholder approval by the board, in addition to other standstill provisions.

The MFS standstill agreement was announced following two recent court decisions relating to proxy contests between Saba and three BlackRock CEFs and standstill agreements recently entered into with Invesco and three of its CEFs. Additionally, on July 24, 2019, and August 12, 2019, Saba submitted to two registered CEFs managed by Legg Mason Partners Fund Advisor, LLC and one registered CEF managed by Nuveen Fund Advisors, LLC, respectively, notice of its intention to present board declassification proposals and to nominate three candidates to each fund's board of trustees. Moreover, it was recently reported that the amount of money Saba manages in its CEF "arbitrage program" has roughly doubled since the beginning of 2019 and that Saba is actively seeking to fundraise for this "arbitrage program."[2]

Earlier this year, Saba submitted notice of its intention to nominate three candidates to the board of directors of Neuberger Berman High Yield Strategies Fund Inc. (NHS) and to present two shareholder proposals at the 2019 annual shareholder meeting: (1) a proposal to terminate the investment advisory agreement between NHS and the investment adviser; and (2) a proposal requesting that the board of NHS consider a self-tender offer for all outstanding common stock of the fund and, if more than 50% of the fund's outstanding common stock are submitted for tender, to cancel the tender offer and either liquidate the fund or convert it to an open-end fund.

Separately, on July 29, 2019, Bulldog Investors, LLC (Bulldog), owned by Phillip Goldstein, submitted to Vertical Capital Income Fund notice of its intention to solicit proxies for the upcoming annual meeting to oppose the approval of a new investment advisory agreement between the fund and the fund's investment adviser, and the re-election of the lead independent trustee of the fund.

Finally, on August 20, 2019, The Swiss Helvetia Fund, Inc. (SWZ) filed its proxy statement, which included a proposal to approve a proposed investment advisory agreement between SWZ and Bulldog. In 2017 and 2018, Bulldog ran successful proxy contests, resulting in the election of two members of Bulldog to the board of SWZ; and in 2018, Bulldog's shareholder proposal recommending that SWZ's board of directors authorize a self-tender offer for at least 50% of the outstanding common stock of the fund was approved by shareholders.

[1] In a Form 13D filed in January 2019, Saba reported a 13.9% ownership stake in MFS California Municipal Fund and noted that it may "engage in discussions with management, the Board of Directors, other shareholders of the Issuer and other relevant parties, including representatives of any of the foregoing, concerning the Reporting Persons' investment in the Common Shares and the Issuer, including, without limitation, matters concerning the Issuer's business, operations, board appointments, governance, management, capitalization and strategic plans and matters relating to the open or closed end nature of the Issuer and timing of any potential liquidation of the Issuer."

[2] "Strong Demand for Saba Strategy," Hedge Fund Alert (July 10, 2019).

Federal District Court Dismisses Class Action Regarding Allegations Relating to Adequacy of Mutual Fund Disclosures

On June 25, 2019, Judge Arthur D. Spatt of the U.S. District Court for the Eastern District of New York dismissed a class action against a mutual fund and its adviser, trustees and officers alleging that the adviser violated the Securities Act by investing the fund's assets in complex derivatives that were inconsistent with the fund's investment objective of capital preservation. *Emerson v. Mut. Fund Series Trust*, No. 17-2565 (E.D.N.Y. 2019).

In *Emerson*, the at-issue fund's investment objective was "capital appreciation and capital preservation in all market conditions." The plaintiffs characterized statements in the fund's offering documents, prospectuses and fact sheets as representing that these documents represented that the fund was low-volatility, not tied to movements in the equity markets, and had strict risk management procedures to mitigate losses. The plaintiffs alleged that these statements were materially false because the fund's "investment in naked call options rendered the Fund susceptible to large losses in rapidly rising equity markets."

In dismissing all of the plaintiffs' claims, the court grouped the contested statements into four categories: "(1) stated objective of capital preservation and portrayal as a low-risk, low-volatility investment with low correlation to equity markets; (2) options strategies and risks; (3) purportedly robust risk management procedures; and (4) past performance."

Categories (1) and (3). First, the court held that statements outlining the fund's investment objective were "non-actionable because they merely articulate the goals of the Fund, rather than promise a particular investment strategy." In so holding, the court reasoned that the investment objectives "made general and indefinite statements about the Fund's intentions, which reasonable investors would consider unimportant." The court applied the same reasoning to reject the plaintiffs' allegations regarding the fund's risk management procedures.

Category (2). Next, the court held that, contrary to the plaintiffs' claims, "the Defendants adequately disclosed that the Fund could and did write uncovered call options." In reaching its holding, the court emphasized that (1) the fund's "Offering Documents are replete with disclosures regarding the Fund's investment in uncovered call options and the associated risks," and (2) "the Fund issued a public disclosure every quarter publishing an itemized list of every single investment in its portfolio," which made it "plainly apparent ... that the Fund's portfolio consisted of a significant number of uncovered call options." The court also emphasized that "[h]aving disclosed all of the material information necessary for a reasonable investor to appraise himself or herself of the pertinent risks, the Defendants did not need to explain to the Plaintiffs how to read its portfolio."

Category (4). Last, the court held that "the Fund adequately disclosed the material differences between the Fund's [previous] operation as [a hedge fund] and [its current operation] as a larger mutual fund." In so holding, the court emphasized statements in the fund's prospectus noting that "the Fund was subject to different legal requirements than [its previous operation as a hedge fund]" and reasoned that the fund had no duty to "overtly criticiz[e] the soundness of their investment strategy" by stating, as the plaintiffs demanded, that the change from a hedge fund to a mutual fund "effectively limited [the fund's] ability to execute the stated strategy which had led to [the hedge fund's] spectacular performance."

In dismissing all of the plaintiffs' claims, the *Emerson* decision reinforces the principle that, while a mutual fund is required to provide sufficient information for reasonable investors to understand the investment strategy, risks and performance associated with the fund, reasonable investors have the burden to study the public disclosures issued by the fund and differentiate aspirational language from hard data on investment strategy, risks and performance.

Conflicting Approaches to Bad Actor Waivers

Bad Actor Disqualification Act

On June 19, 2019, Rep. Maxine Waters, chair of the House Financial Services Committee, introduced draft legislation titled the Bad Actor Disqualification Act of 2019 (Disqualification Act). The Disqualification Act would make it significantly more difficult for the Securities and Exchange Commission (SEC) to grant "bad actor" waivers. Under the law, the SEC could initially grant only a 180-day temporary waiver upon a showing that the waiver application has demonstrated "immediate irreparable injury." Following the 180-day temporary waiver period, the SEC would be required to publish adequate notice of the waiver petition in the Federal Register and hold a public hearing. The SEC would then have the authority to grant a waiver if it determines that such waiver "(i) is in the public interest; (ii) is necessary for the protection of investors; and (iii) promotes market integrity." During this process, the SEC would be prohibited from advising the petitioner of the likelihood of a waiver petition being granted or denied.

The Disqualification Act would require the SEC to establish and maintain a public database of all "ineligible persons" that the SEC has denied a waiver to or that have indicated their ineligibility in any disclosure to the SEC. Additionally, the Disqualification Act would require the comptroller general of the United States to carry out a study on the SEC's existing waiver process and the standard used by the SEC in granting waivers under Section 9(c) of the Investment Company Act of 1940.

See the draft legislation.

SEC Statement Regarding Offers of Settlement

On July 3, 2019, SEC Chairman Jay Clayton issued a public statement, which may have been prompted by the proposed Disqualification Act, indicating that the SEC is changing its approach to processing settlement offers that are accompanied by contemporaneous requests for "bad actor" waivers. This new policy would effectively allow a settling party to condition its offer of settlement on whether the SEC grants a requested bad actor waiver. If the waiver is not granted, the settling party can retract its offer of settlement. Clayton stated that he recognized that "a segregated process for considering contemporaneous settlement offers and waiver requests may not produce the best outcome for investors in all circumstances" and that "a settling entity can request that the Commission consider an offer of settlement that simultaneously addresses both the underlying enforcement action and any related collateral disqualifications."

In the public statement, Clayton discussed the factors that drive appropriate settlements, including (1) the cost of litigation, (2) the SEC's demonstrated willingness to litigate zealously if a timely and reasonable offer of settlement is not made, (3) the importance of promptly remedying harm to investors, and (4) the desire for certainty (specifically the SEC's ability to provide a full and final resolution of a matter).

Clayton explained that a successful SEC enforcement action can trigger certain disqualifications under the federal securities laws. He noted that enforcement actions can trigger significant collateral consequences for the settling entity, the effects of which can vary depending on the scope of the businesses and operations of the entity. As indicated in a footnote to the public statement, such collateral consequences can include:

- loss of well-known seasoned issuer status for the purposes of securities offerings; loss of statutory safe harbors under the Securities Act and the Securities Exchange Act for forward-looking statements;

- loss of private offering exemptions provided by Regulations A, D and Crowdfunding under the Securities Act;
- loss of the exemption from registration under the Securities Act for securities issued by certain small business investment companies and business development companies provided by Regulation E; and
- the prohibition on a registered investment adviser from receiving cash fees for solicitation under Rule 206(4)-3 of the Investment Advisers Act of 1940.

In many cases, the SEC has the authority to grant a waiver of these collateral consequences, either in full or subject to conditions, if it is "necessary or appropriate in the public interest, and is consistent with the protection of investors." In practice, although settlement offers and waiver requests have been made contemporaneously, the SEC has considered these matters on a segregated basis, which Clayton noted can add complexity and "substantially complicate and lengthen the negotiating process."

According to the public statement, going forward, the SEC will consider an offer of settlement that includes a simultaneous waiver request negotiated with all relevant divisions as a single recommendation from the staff. Clayton noted that this approach will "honor substance over form and enable the Commission to consider the proposed settlement and waiver request contemporaneously, along with the relevant facts and conduct, and the analysis and advice of the relevant Commission divisions to assess whether the proposed resolution of the matter in its entirety best serves investors and the Commission's mission more generally." Clayton did emphasize, however, that the SEC is under no obligation to accept any settlement offer and may determine not to accept a simultaneous offer of settlement and waiver request on the basis of form alone.

See the public statement, "Statement Regarding Offers of Settlement."

SEC Provides Guidance on the Proxy Voting Responsibilities of Investment Advisers

On August 21, 2019, the Securities and Exchange Commission (SEC) approved guidance regarding the proxy voting responsibilities and fiduciary duties of investment advisers under the Investment Advisers Act of 1940. The SEC stated that where an investment adviser has assumed the authority to vote on behalf of its client, that adviser, among other things, must have a reasonable understanding of the client's objectives and must make voting determinations that are in the best interest of the client. The SEC also noted that for an investment adviser to form a reasonable belief that its voting determinations are in the best interest of the client, it should conduct an investigation reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information.

The guidance, structured in a Q&A format, discusses the following topics:

- The ability of an investment adviser and its client, in establishing their relationship, to agree to a variety of different proxy voting arrangements, so long as there is "full and fair disclosure and informed consent." The SEC explained that an investment adviser is not required to accept voting authority for client securities, regardless of whether the client undertakes to vote the proxies itself. Additionally, the SEC noted that if an investment adviser does accept voting authority, it may agree with the client on the scope of the voting arrangements, including the types of matters for which the investment adviser will exercise proxy voting authority. The SEC stated that on investment adviser that does assume voting authority must make voting determinations consistent with its fiduciary duties and with Rule 206(4)-6 under the Advisers Act.
- Methods by which an investment adviser that has assumed voting authority can demonstrate that it is making voting determinations in its client's best interest and in accordance with its own proxy voting policies and procedures. The SEC noted that many investment advisers have multiple clients with different investment objectives and strategies. The SEC stated that where an investment adviser has assumed voting authority on behalf of multiple clients, the investment adviser should consider whether it should have different proxy voting policies and procedures for different categories of its clients, depending on each's investment objectives and strategies. Additionally, the SEC stated that an investment adviser that has retained a proxy advisory firm to provide voting recommendations or execution services should consider taking additional steps to ensure that its voting determinations are in the client's best interest and consistent with its voting policies and procedures. Finally, as part of an investment adviser's ongoing compliance program, the SEC noted that the adviser should review, no less than annually, the adequacy of its voting policies and procedures.
- Certain considerations that an investment adviser should take into account if it retains a proxy advisory firm to assist it in discharging its proxy voting duties, such as whether the proxy advisory firm: (1) is capable of adequately analyzing matters for which the investment adviser is responsible for voting; (2) has an effective process for seeking timely input from issuers and proxy advisory firm clients; (3) has adequately disclosed its methodology in formulating voting recommendations to the investment adviser; and (4) has policies and procedures for identifying and addressing conflicts of interest.

The SEC explained that the steps an investment adviser should take to determine whether to retain or continue retaining a proxy advisory firm could depend on, among other things, the scope of the investment adviser's voting authority and the types of services that the proxy advisory firm has been retained to perform.

- When retaining a proxy advisory firm, the steps an investment adviser should consider taking to address potential factual errors, incompleteness or methodological weaknesses in the proxy advisory firm's analysis that may materially affect the investment adviser's voting determinations. The SEC stated that an investment adviser's policies and procedures should be reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information. Additionally, the SEC stated that an investment adviser should consider the effectiveness of the proxy advisory firm's policies and procedures for obtaining current and accurate information upon which it bases its voting recommendations.

- The evaluation of the services provided by the proxy advisory firm an investment adviser has retained. The SEC explained that an investment adviser should adopt and implement policies and procedures that are reasonably designed to sufficiently evaluate the proxy advisory firm, including the proxy advisory firm's conflicts of interest (which can arise on an ongoing basis) and continued capacity and competency to provide voting services.
- Whether an investment adviser that has assumed voting authority on behalf of a client is required to exercise every opportunity to vote. In particular, the SEC identified the following two situations where an investment adviser would not be required to exercise voting authority it has assumed on behalf of its clients: (1) the investment adviser and its clients have agreed in advance to limit the conditions under which the investment adviser would exercise voting authority, or (2) the investment adviser has determined that refraining is in the best interest of the client, which could be the case where the investment adviser determines that the cost to the client of voting the proxy exceeds the expected benefit to the client. However, the investment adviser may not ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies and cannot fulfill its fiduciary responsibilities to its clients by merely refraining from voting the proxies.

For more information on this guidance, see our August 26, 2019, client alert "SEC Provides Guidance on Investment Advisers' Proxy Voting Responsibilities, Proxy Voting Advice Rules" and the guidance.

Spate of ERISA Proprietary Fund Settlements

On July 26, 2019, SEI Investments (SEI) filed a motion for preliminary approval of a class action settlement in a case alleging that SEI breached its fiduciary duties under the Employee Retirement Income Security Act (ERISA) by offering high-cost and underperforming proprietary investment options in its retirement plan for current and former employees. The settlement provides that SEI will pay $6.8 million, and that for a period of three years, it will (1) retain the services of an unaffiliated investment consultant to provide an evaluation of the design of the plan's investment lineup and to review the plan's investment policy statement; (2) continue to pay all recordkeeping fees associated with the plan that it is currently paying and that would otherwise be payable from plan assets; and (3) ensure that Investment Committee members participate in a training session on ERISA's fiduciary duties.

SEI's settlement is the most recent in a spate of similar litigations filed against asset managers alleging breaches of fiduciary duties in connection with proprietary investment products included in the managers' retirement plans. Similar recent class action settlements include:

- Citigroup, Inc.: $6.9 million, final approval received in January 2019;
- Deutsche Bank: $21.9 million, final approval received in March 2019;
- Jackson National Life Insurance Company: $4.5 million, final approval received in April 2019;
- Waddell & Reed Financial: $4.875 million, final approval received in April 2019;
- Edward D. Jones: $3.175 million, final approval received in April 2019;
- BB&T Corporation: $24 million, final approval received in May 2019;
- Eaton Vance: $3.45 million, preliminary approval received in May 2019;
- Franklin Templeton: $13.85 million, preliminary approval received in June 2019; and
- Massachusetts Financial Services Company: $6.875 million, preliminary approval received in June 2019.

Shareholders Sue Highland Fund Board and Adviser for Breach of Fiduciary Duty

This case is a derivative shareholder class action filed on September 5, 2018, and pending in the U.S. District Court for the Northern District of Texas. In their complaint, the plaintiffs asserted breach of fiduciary duty and breach of contract claims against the Highland Global Allocation Fund, its adviser and trustees for using fund assets to buy shares in another fund (the Highland Energy MLP Fund) managed by the same adviser. The plaintiffs alleged that the Highland Energy MLP Fund was failing, and that the defendants breached their fiduciary duty to the investors by using Highland Global Allocation Fund assets to "save the [Highland Energy] MLP Fund from collapsing and stem the losses incurred by the investment advisor when oil prices dropped and the [Highland Energy] MLP Fund plummeted in value."

The defendants filed a motion to dismiss earlier this year, which was fully briefed as of June 10, 2019. In their motion to dismiss, the defendants argued that in 2015, a committee of independent trustees and an independent law firm conducted a three-month investigation into the plaintiffs' claims and found no wrongdoing. They contended that the decision whether to pursue litigation on behalf of the fund belonged to the board of trustees, and their decision not to litigate was made after a thorough investigation.

Splitting With Others, Second Circuit Finds Private Right of Action Under Section 47(b)

On August 5, 2019, the U.S. Court of Appeals for the Second Circuit found that Section 47(b) of the Investment Company Act of 1940 (1940 Act) creates a private right of action to seek rescission for alleged violations of the 1940 Act. *Oxford University Bank v. Lansuppe Feeder LLC*, No. 16-4061 (2d. Cir. Aug. 5, 2019). This decision creates a split with the U.S. Court of Appeals for the Third Circuit, which held in 2012 that no such private right of action exists, as well as with several lower courts.

Section 47(b) provides that contracts that violate the 1940 Act or any rules or regulations thereunder are "unenforceable by either party." 15 U.S.C. § 80a-46(b)(1). To the extent that performance has been rendered under such a contract, Section 47(b) further provides that "a court may not deny rescission at the instance of either party unless such court finds that under the circumstances the denial of rescission would produce a more equitable result than its grant and would not be inconsistent" with the 1940 Act. 15 U.S.C. § 80a-46(b)(2).

In *Oxford University Bank*, a junior noteholder in a special purpose investment vehicle organized as a trust brought suit under Section 47(b), seeking to rescind the trust indenture because the trust failed to properly register as an investment company under the 1940 Act. In reversing the district court's determination that no private right of action exists under Section 47(b), the Second Circuit found that the text of Section 47(b) "unambiguously evinces Congressional intent to authorize a private action." Most notably, the court found that statute's provision that "a court may not deny rescission at the instance of any party necessarily presupposes that a party may seek rescission in court by filing suit." Examining the legislative history of Section 47(b), the court found another indication that Congress intended it to provide a private cause of action. Accordingly, the court found that "any party" to an illegal contract under the 1940 Act could sue to rescind it.

Prior to *Oxford University Bank*, the Third Circuit held in *Santomenno ex rel. John Hancock Trust v. John Hancock Life Insurance Company* that Section 47(b) does not provide a private right of action because, among other things, it did not have express language like that in Section 36(b) creating such a right. Lower courts in New York, Massachusetts and California have similarly held that Section 47(b) provided only a remedy — rescission — and not a private right of action or a basis for liability. Stated differently, these courts held that Section 47(b) provided only a remedy for a substantive violation of another part of the 1940 Act and not an independent cause of action. The *Oxford University Bank* court considered these cases but found their reasoning unpersuasive in light of the express text of Section 47(b).

A new private right of action under the 1940 Act suggests that advisers and funds face an increased risk of litigation within the Second Circuit. Because the party seeking rescission must be a party to the illegal contract, however, *Oxford University Bank*'s practical reach may be limited. Nonetheless, the plaintiffs' bar will not only seek to expand the geographic reach of *Oxford University Bank*'s holding but will likely assert creative theories to capitalize on the case and expand its reach to all manner of contracts. For example, under the right circumstances, a shareholder might attempt to bring derivative claims seeking to void or rescind performance under a contract alleged to violate the 1940 Act and seeking to avoid the pre-suit demand requirement, asserting that the board entered the challenged contract or refused to void or rescind the contract, at least in part, in its own self-interest. Accordingly, advisers and their counsel would be wise to monitor the fallout carefully in the coming years.

SEC Charges Investment Adviser for Failure To Disclose Conflicts of Interest Related to Revenue Sharing Agreement

On August 1, 2019, the Securities and Exchange Commission (SEC) filed a complaint against Commonwealth Equity Services, LLC (Commonwealth), a registered investment adviser and broker-dealer based in Waltham, Massachusetts, in the U.S. District Court for the District of Massachusetts, alleging that Commonwealth failed to disclose material conflicts of interest related to revenue sharing that it received for client investments in certain share classes of "no transaction fee" and "transaction fee" mutual funds.

According to the SEC's complaint, since at least March 2007, Commonwealth has had a revenue sharing agreement with a clearing broker pursuant to which Commonwealth received a portion of the money that certain mutual fund companies paid to the clearing broker to be able to sell their funds through the clearing broker's platform if Commonwealth invested client assets in certain share classes of those funds. The SEC noted in an accompanying press release that from at least July 2014 and December 2018, Commonwealth received over $100 million in revenue sharing from the clearing broker related to client investments in certain share classes of "no transaction fee" and "transaction fee" mutual funds. The SEC stated in the complaint that "Commonwealth did not ... disclose that mutual funds that were part of the no transaction fee program for which it received revenue sharing from [the clearing broker] were generally more expensive for clients [and] did not disclose that there were instances in which a mutual fund in [the clearing broker's] no transaction fee program otherwise had a lower-cost share class available, for which Commonwealth would receive less or no revenue sharing, and that it thus had conflicts of interest associated with those investment decisions."

The SEC noted that subsequent amended disclosure by Commonwealth that funds available through the clearing broker's "no transaction fee" program" "*could* present a potential conflict of interest" and that Commonwealth "*may* have an incentive to recommend those products" was misleading because "Commonwealth had an *actual* conflict that did create those incentives" (emphasis added). (For more information regarding the SEC's position with respect to "may" disclosures, see the *Robare v. SEC* discussion in our June 2019 *Investment Management Update*.)

The SEC's complaint alleges that Commonwealth breached its fiduciary duty to clients in violation of Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act) by failing to tell its clients that (1) there were mutual fund share class investments that were less expensive to clients than some of the mutual fund share class investments that resulted in revenue sharing payments to Commonwealth, (2) there were mutual fund investments that did not result in any revenue sharing payments to Commonwealth, and (3) there were revenue sharing payments to Commonwealth under the broker's "transaction fee" program. The SEC contended that as a result of these material omissions, Commonwealth's advisory clients invested without a full understanding of the firm's compensation motives and incentives. Additionally, the SEC alleged that Commonwealth failed to adopt and implement written policies and procedures reasonably designed to ensure proper identification and disclosure of these conflicts of interest, which the SEC stated were violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

See the complaint.

SEC Charges Investment Adviser for Failure To Disclose Conflict of Interest Related to Investment Recommendations

On July 1, 2019, the Securities and Exchange Commission (SEC) charged Fieldstone Financial Management Group LLC (Fieldstone) and its principal, Kristofor R. Behn, with defrauding retail investment advisory clients by failing to disclose conflicts of interest related to their recommendations to invest in securities issued by Aequitas Commercial Finance, LLC, one of numerous entities affiliated with the Aequitas enterprise, the ultimate parent of which is Aequitas Management, LLC (collectively, Aequitas). Behn was also charged with fraudulently misusing investor funds to pay personal expenses.

According to the SEC's order (the Fieldstone Order), from 2014 to early 2016, on Behn's recommendation, approximately 40 retail clients of Behn and Fieldstone invested more than $7 million in Aequitas securities, which were the subject of a previous SEC enforcement action. The Fieldstone Order found that Behn and Fieldstone failed to disclose to their clients that Aequitas had provided Fieldstone with a $1.5 million loan and access to a $2 million line of credit under terms that created an incentive for Behn and Fieldstone to recommend Aequitas securities to their clients. The Fieldstone Order also found that Behn and Fieldstone made material misstatements and omissions in the Form ADVs filed with the SEC, including false representations that the repayment terms of the loan from Aequitas were not contingent on Fieldstone clients investing in Aequitas.

The Fieldstone Order additionally found that Behn and Fieldstone fraudulently induced a client to invest $1 million in Fieldstone. The order stated that within days of Fieldstone receiving the $1 million, Behn used approximately $500,000 to pay his personal taxes and make other payments to himself or for his personal benefit.

Without admitting or denying the SEC's findings, Fieldstone and Behn agreed to pay, on a joint-and-several basis, disgorgement and prejudgment interest of $1,047,971 and a penalty of $275,000, all of which will be distributed to harmed investors. Behn will also be permanently barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization.

See the Fieldstone Order.

Joint Statement on Opportunistic Strategies in the Credit Derivatives Market

On June 24, 2019, the Securities and Exchange Commission, the Commodity Futures Trading Commission (CFTC) and U.K. Financial Conduct Authority issued the following joint statement regarding opportunistic strategies in the credit derivatives markets:

"The continued pursuit of various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as 'manufactured credit events,'[1] may adversely affect the integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally. These opportunistic strategies raise various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns."

The agencies agreed to work collaboratively to address market manipulation concerns and "foster transparency, accountability, integrity, good conduct and investor protection" in the credit derivatives markets.

See the "Joint Statement on Opportunistic Strategies in the Credit Derivatives Market."

[1] In 2018, the CFTC released a statement on manufactured credit events in which it emphasized that "[m]anufactured credit events may constitute market manipulation and may severely damage the integrity of the CDS markets ..." A manufactured credit event generally involves a buyer of credit default swap (CDS) protection arranging with an underlying corporate borrower to deliberately trigger a narrowly tailored credit event under the CDS agreement in order to increase payment made to the buyer by the CDS seller.

SEC Settles With Private Fund Manager and Chief Investment Officer Over Valuation Policy and Procedures

On June 4, 2019, the Securities and Exchange Commission (SEC) announced that Deer Park Road Management Co. (Deer Park), a Colorado-based private fund manager, agreed to pay a $5 million penalty to settle charges stemming from compliance deficiencies that contributed to the firm's failure to ensure that certain securities were valued properly in its flagship fund. Deer Park's chief investment officer also agreed to pay a $250,000 penalty.

According to the order (the Deer Park Order), Deer Park, in connection with its flagship fund, failed to adopt and implement reasonably designed compliance policies and procedures relating to the valuation of fund assets. The Deer Park Order noted that from at least October 2012 through December 2015 (the Relevant Period), Deer Park's policies failed to sufficiently address how to conform the firm's valuations to generally accepted accounting principles (U.S. GAAP). Additionally, the Deer Park Order stated that the company's policies were not reasonably designed for either its business practices, given its use of valuation models and third-party pricing vendors, or to avoid the potential conflict of interest arising from traders' ability to determine the fair value assessment of a portion of the positions they manage. The SEC alleged that Deer Park's policies and procedures did not sufficiently address the risk that traders might value a position without maximizing observable inputs or that they may fail to calibrate Deer Park's model-derived valuations to trade other market information. Additionally, the policies and procedures did not provide sufficient guidance and lacked controls concerning price challenges from pricing vendors.

The Deer Park Order also stated that Deer Park failed to implement its existing policy, which required that Deer Park maximize the use of relevant observable inputs in accordance with U.S. GAAP. During the Relevant Period, Deer Park at times failed to ensure that certain residential mortgage-backed securities were valued in accordance with U.S. GAAP. Specifically, Deer Park may have undervalued certain client assets by failing to maximize relevant observable inputs, such as trade prices.

The SEC also alleged that Deer Park's chief investment officer improperly approved valuations submitted to him by Deer Park traders that at times demonstrated failures to implement the firm's valuation policy. Specifically, the SEC noted that the traders submitted valuations to the chief investment officer along with explanations that suggested that the traders were not maximizing observable inputs.

In determining to accept Deer Park's offer of settlement, the SEC considered remedial measures undertaken by Deer Park, including that Deer Park hired a new chief compliance officer with relevant expertise in compliance and valuation and that Deer Park revised certain aspects of its valuation policies and procedures. Deer Park also undertook to conclude its work with an independent compliance consultant, who was hired during the SEC's investigation to conduct a comprehensive review of Deer Park's policies and procedures for valuing assets in its private funds and processes for complying with U.S. GAAP in such valuations.

As a result of the conduct described in the Deer Park Order, the SEC alleged that Deer Park willfully violated Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act) and Rule 206(4)-7 thereunder, which requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. Without admitting or denying the findings in the Deer Park Order, Deer Park consented to a censure, and Deer Park and the chief investment officer agreed to cease and desist from committing or causing any violations and future violations of a provision of the Advisers Act requiring reasonably designed policies and procedures.

See the Deer Park Order.

SEC Proposes To Modernize Disclosures of Business, Legal Proceedings and Risk Factors Under Regulation S-K

On August 8, 2019, the Securities and Exchange Commission (SEC) proposed amendments to modernize the description of business, legal proceedings and risk factor disclosures that registrants, including registered investment companies and business development companies (BDCs), are required to make pursuant to Items 101, 103 and 105 of Regulation S-K. The SEC stated in the proposing release that the "proposed amendments are intended to improve the readability of disclosure documents, as well as discourage repetition and disclosure of information that is not material."

Item 101(a) — Description of the General Development of the Business

Item 101(a) currently requires a description of the general development of the registrant's business during the past five years, including disclosure of specified events. The proposed amendments would, among other changes:

- make the item largely principles-based by providing a nonexclusive list of disclosure topics that a registrant may need to disclose, and by requiring disclosure of a topic only to the extent such information is material to an understanding of the general development of a registrant's business;
- include as a listed disclosure topic, to the extent material to an understanding of the registrant's business, transactions and events that affect or may affect the company's operations, including material changes to a registrant's previously disclosed business strategy;
- eliminate a prescribed time frame for this disclosure; and
- permit a registrant, in filings made after a registrant's initial filing, to provide only an update of the general development of the business that focuses on material developments in the reporting period, and with an active hyperlink to the registrant's most recent filing that, together with the update, would contain the full discussion of the general development of the registrant's business.

Item 101(c) — Narrative Description of the Business

Item 101(c) requires a narrative description of the business done and intended to be done by the registrant and its subsidiaries, with a focus on the registrant's dominant segment or each reportable segment about which financial information is presented in the financial statements. The proposed amendments would, among other changes:

- clarify and expand its principles-based approach by including disclosure topics drawn from a subset of the topics currently contained in Item 101(c);
- include, as a disclosure topic, human capital resources, including any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant's business, such as — depending on the nature of the registrant's business and workforce — measures or objectives that address the attraction, development and retention of personnel; and
- refocus the regulatory compliance requirement by including material government regulations, not just environmental provisions, as a topic.

Item 103 — Legal Proceedings

Item 103 requires disclosure of any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. The proposed amendments would, among other changes:

- triple the dollar threshold for environmental proceedings involving governmental parties from $100,000 to $300,000 to adjust for inflation; and
- clarify that hyperlinks or cross-references to legal proceedings disclosure elsewhere in the document (*e.g.*, notes to the financial statements) are permitted to avoid duplication.

Item 105 — Risk Factors

Item 105 requires disclosure of the most significant factors that make an investment in the registrant or offering speculative or risky, and specifies that the discussion should be concise and organized logically. The proposed amendments would, among other changes:

- require a summary if the risk factors section exceeds 15 pages;
- replace the disclosure standard from "most significant" to "material" risk factors to focus on risks that are important to investors in making an investment decision; and
- require risk factors to be organized under relevant headings, with risks generally applicable to an investment in securities at the end under a separate caption, to help investors better understand lengthy risk factor disclosures.

Affected Forms

For registered investment companies and BDCs, the proposed amendments would affect Forms 10-K and 10-Q and Schedule 14A. BDCs, as filers of Forms 10-K, 10-Q and Schedule 14A, would be impacted by the proposed amendments. Specifically, the SEC estimated that the proposed amendments would affect approximately 100 BDCs. Notably, the proposed amendments to Item 105 would create a different standard between Form N-2 and Form 10-K and impact a BDC's ability to incorporate all risk factors by reference. Registered investment companies, as filers of Schedule 14A, would be required to comply with proposed amendments to Item 101 and 103.

The proposed rule amendments are subject to a 60-day public comment period.

For more information on these proposed amendments, see our August 14, 2019, client alert "SEC Proposes to Modernize Business, Legal Proceeding and Risk Factor Disclosure Requirements Under Regulation S-K" and the proposing release.

SEC Proposes Amendments to Financial Disclosures Regarding Acquired and Disposed Business

On May 3, 2019, the Securities and Exchange Commission (SEC) proposed rule amendments to the financial statement disclosure requirements for the acquisition and disposition of businesses under Rule 3-05 and other rules of Regulation S-X. The proposed amendments are intended to improve the financial information provided to investors regarding acquired and disposed businesses, facilitate more timely access to capital and reduce the complexity and cost to prepare the disclosure. For investment companies, including business development companies (BDCs) in particular, the SEC proposed adding a definition of "significant subsidiary" that is tailored for investment companies as well as adding new Rule 6-11 and amending Form N-14 to cover financial reporting for fund acquisitions by investment companies and BDCs. This summary focuses on financial disclosure regarding acquisitions specific to investment companies.

Overview

Investment companies, including BDCs, are subject to the general provisions of Regulation S-X, unless the special rules set forth in Article 6 of Regulation S-X apply. Article 6, however, does not contain specific rules or requirements for investment companies relating to the financial statements of acquired funds. Investment companies currently apply the general requirements of Rule 3-05 and the *pro forma* financial information requirements in Article 11. The proposing release notes that it is often unclear how these requirements should be applied in the context of acquired funds. Accordingly, investment company registrants frequently consult with SEC staff on the application of these requirements as part of the registration or filing process to seek relief from those requirements, which the SEC noted can be a time-consuming process for both the registrant and the SEC staff.

Amendments to Significant Subsidiary Tests for Investment Companies

Investment companies currently are required to use the three significant subsidiary tests in Rule 1-02(w) when applying Rule 3-05 and other rules of Regulation S-X. However, the SEC stated that tests in Rule 1-02(w) were not written for the specific characteristics of investment companies. There is a different definition of significant subsidiary set forth in Rule 8b-2 of the Investment Company Act (1940 Act) applicable to the filing of registration statements and reports under the 1940 Act, which the SEC noted creates inconsistencies with the definition under Regulation S-X. Rule 8b-2 under the 1940 Act has two different tests — the Rule 8b-2 investment test and the Rule 8b-2 income test — for the definition of a significant subsidiary; calculations for both tests are made using values determined under generally accepted accounting principles (U.S. GAAP). The SEC proposed adding new Rule 1-02(w)(2) to create a separate definition of significant subsidiary for investment companies in Regulation S-X, which would use an investment test and income test, but not an asset test, and the proposed definition would use a modified version of the current Rule 8b-2 tests.

Investment Test. The current investment test under Rule 8b-2 looks to whether value of the investments in and advances to the subsidiary by its parent and the parent's other subsidiaries, if any, exceed 10% of the value of the assets of the parent or, if a consolidated balance sheet is filed, the value of the assets of the parent and its consolidated subsidiaries. The proposed investment test would compare whether the value of the registrant's and its other subsidiaries' investment in and advances to the tested subsidiary exceeds 10% of the value of the total investments of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year. The value of the investments would be determined in accordance with U.S. GAAP and, if applicable, Section 2(a)(41) of the 1940 Act.[1] The SEC

[1] Section 2(a)(41) of the 1940 Act defines "value" to mean the market value of securities "for which market quotations are readily available" and, for other securities or assets, the "fair value as determined in good faith by the board of directors." However, if the investment company controls the company whose securities are being valued, the investment company's "board of directors may in good faith determine the value of such securities," so long as the calculated value does not exceed the market value.

noted that it believes that using the value of total investments rather than total assets for the proposed investment test more appropriately focuses the significance determination on the impact to the registrant's investment portfolio as opposed to other noninvestment assets that may be held.

Income Test. The current income test under Rule 8b-2 looks to whether total investment income of the subsidiary or, in the case of a noninvestment company subsidiary, the net income exceeds 10% of the total investment income of the parent or, if consolidated statements are filed, 10% of the total investment income of the parent and its consolidated subsidiaries. The proposed income test for investment companies modifies the numerator to include the following amounts for the most recently completed pre-acquisition fiscal year of the tested subsidiary: (1) investment income, such as dividends, interest and other income; (2) the net realized gains and losses on investments; and (3) the net change in unrealized gains and losses. The SEC also proposed to amend the significance threshold for the income test in Rule 1-02(w) as it applies to investment companies. Specifically, a tested subsidiary would be deemed significant under the proposed income test for investment companies if the test yields a condition of greater than either (1) 80% by itself or (2) 10%, and the investment test for investment companies yields a result of greater than 5% (alternative income test). The SEC noted that to the extent that a registrant exceeds the 80% threshold and believes that the tested subsidiary is not significant, the registrant can engage with the SEC staff and seek to omit separate financial statements for that subsidiary or substitute financial statements. For situations where the 80% threshold is not exceeded but the impact of a tested subsidiary's income may be significant, the SEC stated that it believes that the alternative income test would appropriately capture significance for financial reporting purposes.

Asset Test. The SEC also proposed eliminating the Asset Test from Regulation S-X as a measure of significance for investment companies, noting that the Asset Test is generally not meaningful or straightforward for investment companies.

Proposed Rule 6-11 of Regulation S-X

The SEC proposed new Rule 6-11 of Regulation S-X, which would only apply to the acquisition of a fund, including any investment company as defined in Section 3(a) of the 1940 Act, any private fund that would be an investment company but for the exclusions provided by Sections 3(c)(1) or 3(c)(7) of the 1940 Act, or any private account managed by an investment adviser.

Among other things, proposed Rule 6-11 would (1) require only one year of audited financial statements for fund acquisitions, a change from the existing Rule 3-05 requirements that require between one and three years of audited financial statements; (2) require Article 12 schedules to be provided for an acquired or to-be-acquired fund; and (3) consider acquisitions of a group of related funds to be a single acquisition and allow a registrant the option of presenting the required financial statements either on an individual or combined basis for any periods they are under common control or management.

The SEC noted that to determine whether financial statements of a fund acquired or to be acquired must be provided under proposed Rule 6-11, the conditions specified in the definition of significant subsidiary under proposed Rule 1-02(w)(2) would be applied, using the proposed investment test and the alternative income test for investment companies and substituting 20% for 10% for each place it appears therein. The SEC also noted that the income test for investment companies with the 80% condition would not be used for purposes of proposed Rule 6-11 because the SEC believes that, "in the acquisition context, significance matters principally with respect to the portfolio investments and the amount of assets being acquired, since investment income and realized and unrealized gains/losses from the investments acquired will be immediately reflected in the daily net asset value of the registrant."

Pro Forma Financial Information and Supplemental Financial Information

The SEC proposed eliminating the current requirements for investment company registrants to provide *pro forma* financial information in connection with fund acquisitions. Under new proposed Rule 6-11, investment company registrants would be required to provide certain supplemental information, including: (1) a *pro forma* fee table, setting forth the post-transaction fee structure of the combined entity; (2) if the transaction will result in a material change in the acquired fund's investment portfolio due to investment restrictions, a schedule of investments of the acquired fund modified to show the effects of such change and accompanied by narrative disclosure describing the change; and (3) narrative disclosure about material differences in accounting policies of the acquired fund when compared to the newly combined entity.

Comments on the proposed rule amendments were due July 29, 2019.

For general information regarding the proposed changes to the financial disclosure requirements for business acquisitions and dispositions, see our May 13, 2019, client alert "SEC Proposes Changes to Financial Disclosure Requirements for Acquisitions and Dispositions" and the proposing rule release.

SEC Adopts Amendments to Auditor Independence Rules for Funds

On June 18, 2019, the Securities and Exchange Commission (SEC) adopted amendments (effective October 3, 2019) to Rule 2-01 of Regulation S-X (Loan Rule), which sets forth the SEC's auditor independence standards, to "refocus the analysis that must be conducted to determine whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client at any time during an audit or professional engagement period." In the adopting release, the SEC noted that the amendments will, among other things, (1) focus the analysis on beneficial ownership rather than on both record and beneficial ownership; (2) replace the existing 10% bright-line shareholder ownership test with a "significant influence" test; (3) add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities; and (4) exclude from the definition of "audit client," for a fund under audit, any other funds that otherwise would be considered affiliates of the audit client under the rules for certain lending relationships. Until the amendments are effective, firms will continue to be able to rely on the no-action relief granted to Fidelity Management & Research Company *et al.*, in a letter dated June 20, 2016, as extended by the SEC staff's letter dated September 22, 2017.

The final amendments make the following changes to the Loan Rule:

- **Focus the Analysis on Beneficial Ownership.** The amendments eliminate the concept of record ownership from the Loan Rule. In the final release, the SEC stated that it "continue[s] to believe that tailoring the Loan Provision to focus on the beneficial ownership of the audit client's equity securities would more effectively identify shareholders 'having a special and influential role with the issuer' and therefore better capture those debtor-creditor relationships that may impair an auditor's independence."
- **Significant Influence Test.** The amendments replace the existing 10% bright-line test with a "significant influence" test. While the term "significant influence" is not specifically defined, the SEC noted that this term appears in other parts of Rule 2-01. The SEC noted that audit firms should consider the nature of the services provided by a fund's investment adviser under the terms of any relevant advisory contract. Additionally, the final release provides specific guidance with respect to registered funds, private funds, exchange-traded funds and closed-end funds.
- **Reasonable Inquiry Compliance Threshold.** The amendments require auditors to analyze beneficial owners of the audit client's equity securities who are known through reasonable inquiry. If an auditor does not know after reasonable inquiry that one of its lenders is also an investor of the audit client's equity securities, the SEC noted that the auditor's objectivity and impartiality may be less likely to be impacted by its debtor-creditor relationship with the lender.
- **Excluding Other Funds That Would Be Considered Affiliates of the Audit Client.** Until the effective date of the amendments, the definition of "audit client" under Rule 2-01 includes all affiliates of the audit client. The amendments exclude from the definition of "audit client," for a fund under audit, any other funds that otherwise would be considered affiliates of the audit client under the Loan Rule.

Next Steps and Potential Additional Rulemaking

The adopting release notes that Chairman Jay Clayton has directed the SEC staff to formulate recommendations to the SEC for possible additional changes to the auditor independence rules in a future rulemaking. This directive comes in response to the following categories of comments submitted in connection with the proposing release: (1) relating to the Loan Rule, but not the significant compliance challenges that need to be immediately addressed (*e.g.*, other types of loans that commenters suggested should be excluded from the Loan Rule, such as student loans); (2) broadly impacting provisions of the auditor independence rules, including comments relating to the "covered person" and "affiliate of the audit client" definitions; or (3) broadly impacting provisions of the auditor independence rules (*e.g.*, suggestions for narrowing the look-back period for domestic initial public offerings so that the period is similar to that for foreign private issuers).

See the Fidelity letter and the September 2017 letter. See also the adopting release.

Joint Statement on Libor Transition

On July 12, 2019, the staffs of the Securities and Exchange Commission's (SEC) Division of Corporation Finance, Division of Investment Management, Division of Trading and Markets, and Office of the Chief Accountant issued a statement to highlight certain risks associated with the expected discontinuation of the London Interbank Offered Rate (Libor) after 2021 and to encourage market participants to begin to manage their transition away from Libor.

Managing the Transition From LIBOR

Existing Contracts. The SEC staff advised market participants to begin identifying existing contracts that extend past 2021 to determine whether there are any interest rate provisions that reference Libor. The SEC encouraged market participants to consider the following questions:

- Do you have or are you or your customers exposed to any contracts extending past 2021 that reference Libor? For companies considering disclosure obligations and risk management policies, are these contracts, individually or in the aggregate, material?
- For each contract identified, what effect will the discontinuation of Libor have on the operation of the contract?
- For contracts with no fallback language in the event Libor is unavailable, or with fallback language that does not contemplate the expected permanent discontinuation of Libor, do you need to take actions to mitigate risk, such as proactive renegotiations with counterparties to address the contractual uncertainty?
- What alternative reference rate (for example, the secured overnight financing rate) might replace Libor in existing contracts? Are there fundamental differences between Libor and the alternative reference rate — such as the extent or absence of counterparty credit risk — that could impact the profitability or costs associated with the identified contracts? Does the alternative reference rate need to be adjusted (by the addition of a spread, for example) to maintain the anticipated economic terms of existing contracts?
- For derivative contracts referencing Libor that are utilized to hedge floating-rate investments or obligations, what effect will the discontinuation of Libor have on the effectiveness of the company's hedging strategy?
- Does use of an alternative reference rate introduce new risks that need to be addressed? For example, if you have relied on Libor in pricing assets as a natural hedge against increases in costs of capital or funding, will the new rate behave similarly? If not, what actions should be taken to mitigate this new risk?

New Contracts. The statement advises that for new contracts, market participants consider whether to reference an alternative rate to Libor or include effective fallback language if the contracts reference Libor.

Other Business Risks. The statement advises that market participants consider other consequences that the discontinuation of Libor may have on their businesses, including, for example, on strategy, products, processes and information systems. The staffs noted: "Depending on a market participant's exposure to LIBOR, prudent risk management may necessitate the establishment of a task force to assess the impact of financial, operational, legal, regulatory, technology, and other risks. Each market participant should examine its individual circumstances and consider whether it faces risks beyond those identified in this [] [s]tatement."

Division-Specific Guidance — Division of Investment Management

The statement also includes specific guidance from other divisions of the SEC, including from the Division of Investment Management.

The division's staff stated that the discontinuation of Libor may impact the functioning, liquidity and value of the instruments referencing Libor, such as floating rate debt, bank loans, Libor-linked derivatives and certain asset-backed securities. The extent of the impact will depend on the specific types of investments. Additionally, the staff noted that the interest rate provisions of these investments may need to be renegotiated. The statement advised funds to consider assessing any impact on the liquidity of their investments, including how those investments are classified and whether this could alter the effectiveness of their liquidity risk management programs, to ensure compliance with Rule 22e-4 under the Investment Company Act of 1940.

The staff explained that the discontinuation of Libor may impact funds that do not invest in instruments linked to Libor. The staff noted that closed-end funds and business development companies that engage in direct lending, for example, may need to renegotiate the terms of contracts extending past 2021 that do not address the discontinuation of Libor. Additionally, the staff stated that funds that have received exemptive orders that reference Libor (such as certain interfund lending orders) should consider evaluating possible implications for the terms and conditions of their relief.

The staff also stated that funds and advisers should consider whether the impacts and other consequences of the discontinuation of Libor are risks that should be disclosed to investors and encouraged affected funds to provide investors with tailored risk disclosure that specifically describes the impact of the transition on their holdings. In relation to instruments extending past 2021 and referencing Libor, the staff noted that advisers should consider the effect the discontinuation of Libor will have on these instruments when recommending them to clients or monitoring them for clients.

See the public statement, "Staff Statement on LIBOR Transition," and our July 25, 2019, client alert "SEC Staff Encourages Proactive Approach to Libor Transition Issues."

OCIE Risk Alerts

Observations From Examinations of Investment Advisers: Compliance, Supervision and Disclosure of Conflicts of Interest

On July 23, 2019, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) issued a risk alert relating to an examination initiative that assessed the oversight practices of registered investment advisers that previously employed or currently employ an individual with a history of disciplinary events.

The risk alert focused on registered investment advisers' practices in the following areas:

- **Compliance Programs and Supervisory Oversight Practices:** The OCIE staff reviewed whether compliance policies and procedures of investment advisers "were reasonably designed to detect and prevent violations of the Investment Advisers Act of 1940 by the firm and its supervised persons, particularly those policies and procedures covering the activities of certain previously-disciplined individuals."
- **Disclosures:** The OCIE staff reviewed whether disclosures in public statements and filings were "full and fair, included all material facts, and were not misleading."
- **Conflicts of Interest:** The OCIE staff reviewed whether the investment adviser "identified, addressed, and fully and fairly disclosed all material conflicts of interest that could affect the advisory relationship."

The risk alert noted that the examinations did not focus solely on supervisory practices as they relate to individuals with prior disciplinary histories, but rather focused on supervisory practices firmwide.

Examination Observations

According to the risk alert, the OCIE staff identified deficiencies across a range of topics, including:

- **Observations Specific to Disciplinary Histories**
  - Full and Fair Disclosure: The OCIE staff observed that nearly half of the disclosure deficiencies stemmed from firms providing inadequate information regarding prior disciplinary events.
  - Effective Compliance Programs: The OCIE staff observed that many investment advisers did not adopt and implement compliance policies and procedures that addressed the risks associated with hiring and employing individuals with disciplinary records.
- **Additional OCIE Staff Observations**

  The OCIE staff reviewed the firmwide practices of investment advisers and observed the following issues that they believed may not be attributed directly to the firms' hiring and supervising of individuals with disciplinary records.

  - Compliance and Supervision
    - Supervision: The OCIE staff observed that many investment advisers did not adequately supervise or establish appropriate standards of conduct for supervised persons. In particular, their policies and procedures did not sufficiently document the responsibilities of or expectations for supervised persons.
    - Oversight: The OCIE staff observed that many investment advisers failed to confirm that supervised persons identified as responsible for performing certain compliance policies and procedures were actually performing these duties.

- Compliance Policies and Procedures: The OCIE staff observed that several investment advisers adopted policies and procedures that were inconsistent with their actual business practices and related disclosures, including those addressing commissions, fees and expenses.
- Annual Compliance Review: The OCIE staff observed that certain investment advisers' annual reviews were insufficient because they did not adequately document the review and appropriately assess risk areas applicable to the firms, or identify certain risks at all.

- Disclosure of Conflicts of Interest
  - Compensation Arrangements: The OCIE staff observed that several advisers had "undisclosed compensation arrangements, which resulted in conflicts of interests that could have impacted the impartiality of the advice the supervised persons gave to their clients."

Best Practices

The risk alert identified best practices that may assist firms in addressing the weaknesses discussed above, including:

- adopting written policies and procedures that specifically address what must occur prior to hiring supervised persons that have reported disciplinary events to the adviser;
- enhancing due diligence practices associated with hiring supervised persons to identify disciplinary events;
- establishing heightened supervision practices when overseeing supervised persons with certain disciplinary histories;
- adopting written policies and procedures addressing client complaints related to supervised persons; and
- including oversight of persons operating out of remote offices in compliance and supervisory programs, particularly when supervised persons with disciplinary histories are not located in the main office.

See the OCIE risk alert.

Safeguarding Customer Records and Information in Network Storage — Use of Third-Party Security Features

On May 23, 2019, the OCIE issued a risk alert regarding the storage of electronic customer records and information by broker-dealers and investment advisers in various network storage solutions.

Examination Observations

According to the risk alert, the OCIE staff identified a number of concerns that may raise compliance issues under Regulations S-P and S-ID, including failures by firms to:

- adequately configure the security settings on their network storage solution to protect against unauthorized access and implement policies and procedures addressing the security configuration of their network storage solution;
- ensure, through policies, procedures, contractual provisions or otherwise, that the security settings on vendor-provided network storage solutions were configured in accordance with the firm's standards; and
- identify (in the firm's policies and procedures) the different types of data stored electronically by the firm and the appropriate controls for each type of data.

Best Practices

The risk alert provided examples of effective configuration management programs, data classification procedures and vendor management programs, including:

- policies and procedures designed to support the initial installation, ongoing maintenance and regular review of the network storage solution;
- guidelines for security controls and baseline security configuration standards to ensure that each network solution is configured properly; and
- vendor management policies and procedures that include, among other things, regular implementation of software patches and hardware updates followed by reviews to ensure that those patches and updates did not unintentionally change, weaken or otherwise modify the security configuration.

In the risk alert, OCIE recommends that registered broker-dealers and investment advisers review their practices, policies and procedures with respect to the storage of electronic customer information to consider whether any improvements are necessary, and to actively oversee any vendors they may be using for network storage to evaluate whether the service provided by the vendor is sufficient to enable the firm to meet its regulatory responsibilities.

See the OCIE risk alert.

SEC Chairman Considers Impact of Recent Legal Decisions on SEC Enforcement Efforts

On June 4, 2019, Securities and Exchange Commission (SEC) Chairman Jay Clayton delivered the keynote address at the Mid-Atlantic Regional Conference in Philadelphia, Pennsylvania. In his address, he highlighted the impacts of four recent legal decisions on the SEC's enforcement efforts.

Kokesh v. SEC

Clayton noted that in *Kokesh*, the SEC brought an enforcement action based on fraud that "began in the 1990's and continued until 2009." The defendant had argued that the SEC was time-barred from seeking disgorgement, because the fraud began outside the applicable five-year period under the law. Clayton stated that the U.S. Supreme Court held that the SEC's use of the disgorgement remedy was "penal in nature (rather than equitable) and as such was subject to the five-year limitations period applicable to penalties." He expressed concern that the *Kokesh* decision has impacted the SEC's ability to "return funds fraudulently taken from our Main Street investors." In particular, he stated that for fiscal year 2018, the decision may have caused the SEC to forgo up to approximately $900 million in disgorgement in filed cases.

Lucia v. SEC

Clayton stated that in *Lucia*, the Supreme Court held that the SEC's administrative law judges (ALJs) had not been appointed in a manner consistent with the U.S. Constitution. Clayton noted that after *Lucia*, "approximately 200 administrative proceedings had to be reassigned to new ALJs." Clayton stated that while many of those proceedings have now been substantially resolved, the remaining reassigned proceedings may require substantial litigation resources, an issue he characterized as a "speed bump, not a long-term" concern. He noted that while the SEC has the "flexibility to bring many of its contested actions in district court or through administrative proceedings," he is "committed to using the administrative process only for the cases that are most appropriate for that forum."

The Robare Group, Ltd. v. SEC

Clayton stated that in *Robare*, "the D.C. Circuit held that an investment adviser does not "willfully" omit material facts under Section 207 of the Investment Advisers Act of 1940 (Advisers Act) if the adviser acted "negligently." Clayton noted that *Robare* "did not disturb the decades-old standard that has been adopted by most courts of appeals — that a willful violation of the securities laws means that the person intentionally committed the act that constitutes the violation, with no requirement that the person also be aware that they are violating the law." He acknowledged, however, that the decision requires the SEC to carefully consider the appropriate standard for future cases brought under the Advisers Act.

For more information on *Robare*, see the *Robare v. SEC* discussion in our June 2019 *Investment Management Update*.

Lorenzo v. SEC

Clayton discussed the SEC's victory in *Lorenzo*, in which the Supreme Court affirmed the SEC's position that "a person could be liable under the anti-fraud provisions [of the federal securities laws] for the knowing dissemination of false or misleading statements, even if he or she did not make the statements." He noted that *Lorenzo* reinforces the SEC's continued ability to bring charges against those involved in the dissemination of misstatements.

At the end of this portion of his address, Clayton stated that the Division of Enforcement measures its success by asking itself the following questions:

- Are we deterring future harm by bringing meaningful cases that send clear and important messages to market participants?
- Are we protecting investors and markets by holding individuals accountable for wrongdoing and removing bad actors from the securities markets?
- Are we stripping wrongdoers of their ill-gotten gains and returning money to victims?
- Are we acting quickly to stop frauds, prevent future losses and return ill-gotten gains to harmed investors?

Other Discussion Topics

Clayton also discussed the use of data analytics to support the SEC's mission and the importance of safeguarding data collected by the SEC in his keynote address.

See "Keynote Remarks at the Mid-Atlantic Regional Conference."

SEC Spring 2019 Regulatory Flexibility Agenda

On May 22, 2019, the Securities and Exchange Commission (SEC) released its spring 2019 Regulatory Flexibility Agenda, which identifies the rule-marking initiatives of the SEC over the next 12 months and longer term. The short- and long-term agendas reflect Chairman Jay Clayton's priorities as of March 18, 2019, when the agendas were compiled.

Short-Term Agenda

Highlights from the initiatives on the short-term agenda include:

- **Harmonization of Securities Offering Exemptions:** The SEC recently issued a concept release seeking public comments on ways to simplify, harmonize and improve the exempt offering framework. (See "SEC Issues Concept Release on Harmonization of Securities Offering Exemptions: Pooled Investment Funds.")
- **Amendments to Financial Disclosures About Acquired Businesses:** In May 2019, the SEC proposed rule amendments to improve the information that investors receive regarding the acquisition and disposition of businesses. (See "SEC Proposes Amendments to Financial Disclosures Regarding Acquired and Disposed Business.")
- **Use of Derivatives by Registered Investment Companies and Business Development Companies:** The SEC's Division of Investment Management is considering recommending that the SEC re-propose a new rule designed to enhance the regulation of the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds, closed-end funds and business development companies.
- **Rule 14a-8 Amendments:** The SEC's Division of Corporation Finance is considering recommending that the SEC propose rule amendments regarding the initial and resubmission threshold levels for shareholder proposals.
- **Amendments to Procedures for Applications Under the Investment Company Act of 1940 (1940 Act):** The SEC's Division of Investment Management is considering recommending that the SEC propose amendments to Rule 0-5 under the 1940 Act, to establish an expedited review procedure for certain applications.

Long-Term Agenda

Highlights from the initiatives on the long-term agenda include:

- **Corporate Board Diversity:** The SEC's Division of Corporation Finance is considering recommending that the SEC propose amendments to the proxy rules to require additional disclosure about the diversity of board members and nominees. The division had previously published interpretative guidance regarding board diversity disclosures. (See our February 12, 2019, client alert "SEC Staff Issues Interpretive Guidance on Board Diversity Disclosures.")
- **Modernization of Investment Company Disclosure:** The SEC's Division of Investment Management is considering recommending that the SEC propose rule and form amendments to improve and modernize the current disclosure framework of funds under the 1940 Act to improve the investor experience.
- **Investment Company Summary Shareholder Report:** The SEC's Division of Investment Management is considering recommending that the SEC propose a new summary shareholder report under the 1940 Act.
- **Stress Testing for Large Asset Managers and Large Investment Companies:** The SEC's Division of Investment Management is considering recommending that the SEC propose new requirements for stress testing by large asset managers and large investment companies. Such rules would implement Section 165(i) of the Dodd-Frank Act.

For information regarding the rule-making initiatives, see the short-term agenda and the long-term agenda.