Investment Management Regulatory Update

October 31, 2019

Rules and Regulations

- SEC Adopts Rule to Modernize ETF Regulation
- SEC Staff Releases Accounting and Disclosure Information Regarding Performance and Fee Issues
- SEC Investment Management Division Issues FAQs for Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation

Litigation

- SEC Settles with Private Equity Adviser for Management Fee Overcharges
- SEC Settles with Investment Advisers for Alleged Violations of Investment Company Act, Material Omissions in SEC application, and Violations of the Advisers Act Custody Rules
- Update: SEC Announces Additional Settlements Under the SEC's 12b-1 Fee Self-Reporting Initiative

Rules and Regulations

SEC Adopts Rule to Modernize ETF Regulation

On September 26, 2019, the Securities and Exchange Commission ("**SEC**") announced that it had unanimously adopted Rule 6c-11 (the "**Final Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), and related form amendments to standardize and modernize the regulatory framework for most exchange-traded funds ("**ETFs**").

The Final Rule was adopted in largely the same form as the rule proposed on June 28, 2018 (the "**Proposed Rule**"), with modifications intended to address the operational challenges identified by commenters in response to the Proposed Rule. In addition to the Final Rule's adoption, the SEC also granted an order for conditional exemptive relief from Section 11(d)(1) of the Securities Exchange Act of 1934 and rules 10b-10, 15c1-5, 15c1-6 and 14e-5 thereunder. The Final Rule and form amendments will be effective 60 days after publication in the Federal Register, with a one-year transition period for compliance with the form amendments.

Davis Polk has published a client memorandum discussing the Final Rule, including key differences from the Proposed Rule.

- **See a copy of the Client Memorandum**

SEC Staff Releases Accounting and Disclosure Information Regarding Performance and Fee Issues

On October 2, 2019, the staff of the Disclosure Review and Accounting Office of the Division of Investment Management of the SEC (the "**Staff**") released ADI 2019-09, entitled "Performance and Fee Issues" (the "**ADI**"), which described issues relating to performance and fee information in registered fund disclosure filings the Staff reviews and the related disclosure requirements. The Staff's objectives in publishing the ADI are to (a) encourage funds to closely review their performance and fee disclosures, (b) flag certain disclosure issues the Staff has observed and (c) inform the public about how the Staff uses the information collected. The Staff noted that the key takeaway of the ADI for registrants is to "verify the accuracy of your performance and fee disclosures prior to filing them with the Commission and providing them to investors."

According to the ADI, the Staff has observed the following issues in fund disclosure filings:

1. *Performance Presentations – Failing to Reflect Sales Loads:* The ADI noted that the Staff has observed "multiple funds that failed to reflect sales loads in their average annual returns table." Such errors, the ADI added, inflate these funds' performance as compared to other funds. The ADI noted that "the average annual returns table must reflect the deduction of the maximum sales load at the times, in the amounts, and under the terms disclosed in the fund's prospectus."

2. *Performance Presentations – Additional Issues:* The ADI continued by noting that the Staff has also observed negative performance shown as positive performance (in both the bar chart and average annual return table) and the transposing of the performance of fund classes and of multiple benchmark indices in error in the presentation of fees in the prospectus. The ADI recommended that, "given the importance of performance information to investors, funds should ensure that the performance information disclosed is accurate."

3. *Incorrectly Showing Net Expenses that Exceed Gross Expenses:* Next, the ADI noted that a fund's fee table must include the Total Annual Fund Operating Expenses ("**gross expenses**") and, if a fund has a fee waiver that reduces its fee for one year or more, the fund may include two additional line items disclosing the amount of the waiver and the Total Annual Fund Operating Expenses After Fee Waiver ("**net expenses**"). The ADI stated that the Staff has observed that some funds reflected an adviser's recoupment of expenses the adviser previously waived as a positive fee waiver that "causes their net expenses to be greater than their gross expenses." The Staff noted in the ADI that such an approach "is not consistent with the requirements of Form N-1A because two additional line items can only be shown if there is a reduction in gross fees." Instead, the ADI noted, such recoupments should be reflected in the fee table as a separate line item or included in Other Expenses and reflected in the fund's gross expenses because recoupments are expenses to the fund.

4. *Failing to Disclose Acquired Fund Fees and Expenses:* The ADI further noted that, while the fee table in the prospectus must include the expenses associated with the fund's investments in other funds ("**Acquired Fund Fees and Expenses**"), the Staff has observed a number of funds that "failed to reflect the appropriate amount of Acquired Fund Fees and Expenses in their fee table."

5. *Failing to Correctly Calculate the Expense Example:* The Staff also noted that it is important for the expense example, a hypothetical calculation that shows an investor the estimated expenses it will pay for investing in a fund over various periods of time, to be calculated accurately because it "helps illustrate for investors the amount of fees they may pay." Multiple funds have calculated the expense example in error, the ADI noted, including with arithmetic errors, the failure to properly reflect fee waivers and the failure to include certain fee items, such as Acquired Fund Fees and Expenses.

6. *Failing to Correctly Tag the Risk Return Summary:* Finally, the ADI stated that while mutual funds and exchange-traded funds are required to tag their risk/return summaries in the prospectus in XBRL, the Staff has observed that some funds "incorrectly tag their information by using the wrong tags, enter the data incorrectly, or associate the tagged information with the wrong fund or

class." The Staff reminded funds that the tagged data files "carry the same liability as the related official filings."

In conclusion, the Staff noted that registrants are responsible for "ensuring the accuracy of their disclosures."

- **See a copy of the ADI**

SEC Investment Management Division Issues FAQs for Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation

On October 18, 2019, the SEC Division of Investment Management (the "**Division**") issued answers to frequently asked questions (the "**FAQs**") regarding the disclosure of certain financial conflicts related to investment adviser compensation. The FAQs provide guidance on topics related to compensation arrangements and conflicts of interest, and related disclosure obligations under an investment adviser's fiduciary duties and Form ADV requirements, including:

Disclosure of Conflicts Related to Compensation Received in Connection with Recommended Investments

The FAQs state that, in order to meet its duty of loyalty as a fiduciary, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship, and that an adviser must eliminate or disclose all conflicts of interest that might lead the adviser to provide advice that is not disinterested.

According to the FAQs, an adviser that receives, directly or indirectly, compensation in connection with the investments it recommends has a financial incentive to make recommendations that result in the receipt of that compensation, which can give rise to a conflict of interest. For example, such financial incentive may influence the types of investments, the fund families, the particular funds and the share classes of individual funds that the adviser recommends, as well as the extent of trading the adviser recommends.

The FAQs highlight specific direction provided in the Form ADV instructions concerning the information that an adviser must disclose about these types of conflicts. For example:

- General Instruction 3 for Part 2 provides that an adviser must disclose "sufficiently specific facts" to allow clients to understand the adviser's conflicts and business practices and give informed consent or reject them. This may require an adviser to disclose information not specifically required by Form ADV, or more detail than the Form ADV otherwise requires.
- General Instruction 2 for Part 2 provides that if a conflict or practice exists with respect to only certain classes of clients, advice or transactions, an adviser must indicate this in the disclosure, as opposed to disclosing that the adviser "may" have the conflict or engage in the practice. For example, if an adviser engages in a practice of recommending share classes with 12b-1 fees for its clients in one advisory program, the adviser must fully disclose this practice with respect to such program, even if such program represents a small percentage of the adviser's assets under management.
- Under Item 5.E of the firm brochure (Part 2A of Form ADV), an adviser must disclose whether it or its supervised persons accepts sales compensation, including asset-based sales charges or service fees. The FAQs noted that this item requires several specific disclosures, such as information about the conflict, how the adviser addresses the conflict and whether such compensation is offset against the adviser's advisory fees.

- Item 4 of the brochure supplement (Part 2B of Form ADV) requires an adviser to disclose other business activities conducted by the adviser's supervised persons, including the receipt of compensation such as commissions, bonuses or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative, and including distribution or service ("trail") fees from the sale of mutual funds.

The FAQs remind advisers that (i) both an adviser's fiduciary duties and the Form ADV instructions require the adviser to disclose conflicts of interest related to compensation it receives, directly or indirectly, in connection with its investment recommendations, (ii) where conflicts exist, an adviser must disclose how it addresses those conflicts, (iii) an adviser's fiduciary duty may require disclosures that are in addition to those required in the Form ADV and (iv) the Form ADV brochure is meant to promote effective communication between the adviser and its clients, and should be written in plain English, appropriate for the clients' level of financial sophistication, i.e., *longer* disclosure may not be *better* disclosure.

Disclosure of Material Facts Related to an Adviser's Practices in Recommending Investment Products with Different Compensation Structures (e.g., Mutual Fund Share Classes)

According to the FAQs, an adviser must disclose conflicts of interest when multiple share classes are available to a client and the adviser receives, directly or indirectly, compensation based on the share class it recommends to the client. The FAQs provide several categories of material facts that, in the SEC staff's view, advisers should disclose about its practices related to recommending investments or services with different adviser compensation characteristics:

- *The Existence and Effect of Different Incentives and Resulting Conflicts:* According to the FAQs, the adviser should disclose (i) the fact that different share classes are available and that different share classes of the same fund represent the same underlying investments, (ii) how differences in sales charges, transaction fees and ongoing fees would affect a client's investment returns over time, and (iii) the fact that the adviser has financial interests in the choice of share classes that conflict with the interests of its clients.

- *The Nature of the Conflict:* The FAQs indicate that advisers must disclose the nature of the conflict—for example, whether the conflict arises as a result of differences in the compensation the adviser and its affiliates receive, or from the existence of any incentives shared between the adviser and the clearing broker or custodian (e.g., offsets, credits, or waivers of fees and expenses). The adviser should also disclose whether there are any limitations on the availability of share classes to clients that result from the business of the adviser or the service providers that the adviser uses, and whether the adviser's practices with respect to recommending share classes differ when making an initial investment in a fund as compared to converting to another share class or buying additional fund shares.

- *How the Adviser Addresses the Conflict:* According to the FAQs, advisers should disclose the circumstances under which the adviser recommends share classes with different fee structures and the factors that the adviser considers in making recommendations to clients (for instance, how the adviser would choose between recommending a share class with a 12b-1 fee but no transaction fee, vs. a share class of the same fund with a transaction fee but no 12b-1 fee). The FAQs also indicate that advisers should disclose whether they have a practice of offsetting or rebating the additional costs for a client (e.g., 12b-1 fees or sales charges), the impact of such offsets or rebates, and whether such practice differs depending on the class of client, advice or transaction.

Disclosure of Material Facts Related to an Adviser's Practices Related to Revenue-Sharing Arrangements

According to the FAQ, under Item 14.A of Part 2A of Form ADV, if a person other than a client provides an economic benefit to an adviser for providing investment advice or other advisory services to its clients, the adviser must generally describe the arrangement, explain the conflicts of interest, and describe how it addresses the conflicts of interest. For example, an adviser that receives payments from a custodian based on the value of client assets maintained at that custodian would need to provide disclosure under this item. The FAQs provide examples of material facts that, in the SEC staff's view, advisers should disclose about its practices related to revenue-sharing arrangements:

- According to the FAQ, an adviser should disclose the existence of any incentives provided to the adviser or shared between the adviser and others (e.g., clearing brokers, custodians, funds' investment advisers or service providers). For example: any agreements to receive payments from a clearing broker for recommending that clients invest in no-transaction-fee mutual fund share classes offered on the clearing broker's platform, and any agreements to receive payments and/or expense offsets from a custodian for recommending that the adviser's clients maintain assets at the custodian.

- The FAQs remind advisers that disclosing that an adviser "may" have a conflict as a result of revenue-sharing payments is not adequate when the conflict actually exists.

Material Changes in Form ADV Annual Update

The FAQs note that Form ADV requires, in Item 2 of Part 2A, that if an adviser materially amends or supplements its disclosure regarding share class recommendations or revenue-sharing in its annual update, the adviser must identify and discuss those changes (for instance, on the cover page of the brochure, on the page immediately following the cover page, or as a separate document).

- **See a copy of the FAQs**

Litigation

SEC Settles with Private Equity Adviser for Management Fee Overcharges

On September 27, 2019, the SEC issued an order (the "**ECP Order**") instituting and settling cease-and-desist proceedings against ECP Manager LP ("**ECP**"), a private equity fund adviser, for alleged management fee overcharges.

According to the ECP Order, ECP served as the manager of ECP Africa Fund II PCC (the "**Fund**") as well as other private equity funds. The SEC alleges that under the governing Shareholders Agreement, ECP was permitted to charge, on a semiannual basis, a management fee equal to 2% of the total invested capital contributions, with exceptions for certain triggering events, including write-offs of specific portfolio investments. In June 2010, the Fund received warrants on the common stock of an African mining company; approximately $3.41 million of the Fund's invested capital contributions was attributable to these warrants. The ECP Order states that the Fund's financial statements valued these warrants at zero beginning with the period ending March 31, 2014, and that the warrants expired as worthless in mid-June 2014, meaning that ECP had written off the investment in the warrants by June 30, 2014.

The SEC alleges that despite having written off the warrants by June 30, 2014, ECP nonetheless included the approximately $3.41 million of invested capital contributions attributable to the warrants in the amount used to calculate management fees owed and charged to the Fund as of July 1, 2014, January 1, 2015, and July 1, 2015. According to the SEC, this failure to take into account the write-off of the warrants in accordance with the Shareholders Agreement caused the Fund and its shareholders to pay $102,304 more in management fees than they should have paid.

The SEC alleges that this conduct violated Section 206(2) and 206(4) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act"**) and Rule 206(4)-8 thereunder, which prohibit investment advisers from engaging in any practices which operate as deceit or fraud upon clients or investors. The SEC ordered ECP to cease and desist from any further violations and ordered ECP to pay $122,656 in disgorgement and prejudgment interest to the affected shareholders as well as a $75,000 penalty.

- **See a copy of the ECP Order**

SEC Settles with Investment Advisers for Alleged Violations of Investment Company Act, Material Omissions in SEC application, and Violations of the Advisers Act Custody Rules

On September 13, 2019, the SEC issued an order (the "**Garrison Order**") instituting and settling cease-and-desist proceedings against Garrison Investment Group LP ("**GIG**") and Garrison Capital Advisers LLC ("**GCA**"), for alleged violations of the Investment Company Act's prohibitions on an investment company participating in joint enterprises with affiliate, for alleged material omissions in an application for an order permitting such joint enterprises, and for violations of the custody rules of the Advisers Act and rules thereunder.

According to the Garrison Order, GIG is a registered investment adviser affiliated with several relying advisers, including GCA; GIG managed $3.13 billion in assets as of March 2019, and acted as adviser to several private funds (the "**Private Funds**"); GCA managed $504 million in assets invested in its one advisory client, Garrison Capital, Inc. ("**GARS**"), a publicly-listed closed-end investment company regulated as a business development company under Section 54(a) of the Investment Company Act. GIG's Private Fund clients invest in debt securities and loans; GIG from time to time seeks co-investors to invest in loans alongside the Private Funds.

The Garrison Order states that rule 17d-1 under the Investment Company Act prohibits affiliates of registered investment companies from participating alongside the registered investment company in any joint enterprise, joint arrangement, or profit-sharing plan unless the investment company first obtains an order from the SEC permitting the joint enterprise. The SEC alleges that GIG and GCA first applied in November 2012 for an order that would allow GARS to participate in commercial loan transactions alongside the Private Funds and co-investors. In nine transactions involving GARS that occurred while this application was pending, the borrowers allegedly paid an upfront fee of 1% to 2% of the face value of the loan; these fees were distributed pro rata among the Private Funds, GARS, and co-investors based on their respective capital contributions. GARS and the Private Funds allegedly received their shares of fee revenue, while the co-investors paid their share of the fee revenue to GIG. Because these nine transactions took place before the SEC issued any order permitting the joint enterprise, the SEC found that GIG and GCA violated Rule 17d-1.

In a "sixth amended and restated" application for an order permitting such joint enterprise transactions filed in December 2014, GIG and GCA allegedly failed to state that GIG would receive upfront fee revenue from co-investors participating in the loan transactions, and failed to reflect certain changes in ownership of the participants in these transactions. In January 2015, the SEC granted an order allowing such loan transactions on the condition that no advisers would receive additional compensation or remuneration of any kind in connection with or as a result of a co-investment transaction, except for advisory fees paid under an advisory agreement.

The SEC alleges that in seven loan transactions post-dating the SEC order, GIG originated loans that included co-investment vehicles not reflected in its application, and that in four of these transactions, GIG received the co-investors' share of the upfront fees paid by the borrowers—which the SEC alleges did not comply with the SEC order permitting these transactions. According to the Garrison Order, GIG's Chief Compliance Officer identified in 2016 that co-investment parties had been omitted from the application, and took steps to ensure that GIG and GCA would comply with the order thereafter.

Separately, the Garrison Order found that GIG violated the custody rules of Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder because GIG maintained custody of the Private Funds' assets through a wholly owned subsidiary but failed to have an independent public accountant conduct a surprise examination of the subsidiary.

As a result of the alleged violations of the Investment Company Act, Advisers Act, and rules thereunder, the Garrison Order finds that GIG and GCA willfully violated Section 57(a) of the Investment Company Act and rule 17d-1 thereunder, which prohibit joint participant transactions, Section 34(b) of the Investment Company Act, which prohibits making untrue statements of material fact, or omissions of material facts, in filings with the Commission, and custody rules of section 206(4) of the Advisers Act and rule 206(4)-2 thereunder.

GIG and GCA agreed to be ordered to cease and desist from future violations, to be censured, and to pay a civil money penalty of $250,000. The Garrison Order stands somewhat apart from many other orders scrutinizing advisers' receipt of fees from co-investments by the absence of any allegation regarding the amount of fees that GIG received on account of the co-investments, and that the Order does not require Garrison to disgorge any amounts of the fees it received, including the fees it received in connection with the transactions that the SEC found to be in violation of the Investment Company Act.

- **See a copy of the Garrison Order**

Update: SEC Announces Additional Settlements Under the SEC's 12b-1 Fee Self-Reporting Initiative

In February 2018, the SEC unveiled the "Share Class Selection Disclosure Initiative" (the "**SCSD Initiative**"). The SCSD Initiative built on several years of Office of Compliance Inspections and Examinations emphasis on identifying situations in which an adviser does not adequately disclose that it receives compensation for purchasing, or recommending a client purchase, mutual fund shares of a share class that pays fees under Rule 12b-1 when a less expensive share class is available and appropriate for the client. As explained in our **March 15, 2018 memo**, under the SCSD Initiative the SEC offered "favorable" standardized settlement terms to investment advisers who self-reported potential share class selection violations by June 2018. Our **March 2019 Update** noted that the SEC announced, on March 11, 2019, that it had settled with 79 investment advisers by that time, and that the settled charges would result in more than $125 million being returned to advisory clients.

On September 30, 2019, the SEC announced that it had reached additional settlements with 16 investment advisers under the SCSD Initiative. Under the standardized terms offered to these advisers, each adviser that participated in the SCSD Initiative agreed to:

- "Review and correct as necessary" all relevant disclosures regarding mutual fund share class selection and 12b-1 fees;
- Evaluate whether clients should be moved into lower-fee share classes;

- "Evaluate, update (if necessary) and review for the effectiveness of their implementation" policies and procedures designed to prevent violations of the Advisers Act in connection with share class selection;
- Notify affected investors;
- Within 40 days, certify, in writing, that it had complied with these undertakings;
- Pay disgorgement and prejudgment interest in the amount of excessive fees, and distribute this disgorgement to affected investors.

Under the terms of the SCSD Initiative, the SEC did not impose civil penalties on the advisers who voluntarily self-reported under the initiative.

The SEC also announced that it had settled similar charges with an adviser that, while eligible to participate in the SCSD Initiative, did not. That adviser agreed to undertake the same remedial steps required of advisers participating in the initiative, and, in addition was also ordered to pay a $300,000 civil penalty.

C. Dabney O'Riordan, Co-Chief of the Asset Management Unit, stated that the additional settlements "reaffirm the benefits to advisers and their clients for self-reporting as part of the Initiative" and also "demonstrate the Commission's commitment to holding advisers accountable for selecting more expensive investments that eat away at their clients' investment returns without proper disclosure."

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

Davis Polk

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