Investment Management Regulatory Update

February 28, 2019

Rules and Regulations

SEC Proposes Expansion of "Testing the Waters" Provisions

On February 19, 2019, the Securities and Exchange Commission (the "**SEC**") proposed a broad expansion of the popular "testing the waters" provisions to *all* companies, including business development companies and other registered investment companies. If adopted, new Rule 163B under the Securities Act of 1933, as amended, would allow all companies, and any person authorized to act on their behalf – including underwriters – to engage in oral or written communications with qualified institutional buyers and other institutional accredited investors prior to or after the filing of a registration statement in order to gauge investor interest in a registered offering. For a detailed discussion of the proposed rule, please see the February 20, 2019 Davis Polk Client Memorandum, **Towards the Deregulation of Offers: SEC Proposes Broad Exemption for Pre-Filing Communications**.

- **See a Copy of the Rule Proposal**

Industry Update

Commissioner Hester Peirce Provides Remarks at the University of Missouri School of Law

On February 8, 2019, SEC Commissioner Hester M. Peirce provided remarks at "Protecting the Public While Fostering Innovation and Entrepreneurship: First Principles for Optimal Regulation," which took place at the University of Missouri School of Law.

Peirce discussed the, at times, incongruous relationship between entrepreneurship/innovation and regulation and how every innovation carries some risk and may cause unintended consequences. In connection with the role of capital markets in funding new ideas and products, Peirce emphasized her belief that regulators need to be open to innovation "that will make the capital markets function better and serve parts of the population that were previously not able to access those markets."

Peirce noted that the SEC has hired its first Advocate for Small Business Capital Formation, Martha Miller. Peirce stated that Miller brings "a much needed voice to an agency that has not been particularly open to thinking about the benefits that come from eliminating regulatory barriers to small issuers seeking capital."

Peirce next spoke about the "[SEC]'s opportunity to rethink its approach to innovation," noting that it partially "arises out of a decade of technological development related to blockchain and cryptocurrencies." She stated that regulators "can enable innovation on this new frontier to proceed without compromising the objectives of our securities laws—protecting investors, facilitating capital formation, and ensuring fair, orderly, and efficient markets." She then discussed the challenges posed by such innovation, including decentralization. Peirce acknowledged that the "new way of coordinating human action" offered by blockchain-based networks "does not fit…neatly within our securities framework." However, Peirce analogized such a network to "any other start-up" where a group of individuals must find investors and sell securities. In the current scenario, she noted that such individuals sell tokens that are securities if they are deemed to be investment contracts.

Peirce then discussed the test that arose out of the U.S. Supreme Court's decision in *SEC v. Howey*,[1] the tool used by the SEC to determine whether or not something is an investment contract, and how it informs the SEC's approach to digital assets. Peirce explained that *Howey* arose from a dispute about orange groves and that while the oranges themselves were not securities, "the 'opportunity to contribute money and to share in the profits of a large citrus enterprise managed and partly owned by [third parties]'" was a securities offering. Thus, Peirce stated that the Division of Corporation Finance, "will look to the nature of a token sale to determine whether a securities offering has occurred, and not just at the qualities of the token itself."

Peirce mentioned that the SEC's staff is working on "supplemental guidance to help people think through whether their crypto-fundraising efforts fall under the securities laws." Additionally, Peirce noted that people are also able to request no-action relief in connection with a particular token or project. Peirce noted that it was "important for the [SEC], in conjunction with Congress and its fellow regulators, to offer something more concrete and carefully considered[,]" rather than merely speaking through enforcement actions regarding token offerings. Peirce, however, also advised caution, as token offerings "do not always map perfectly onto traditional securities offerings." As an example, Peirce again discussed the decentralized nature of token offerings and how capital raised through token sales "may not be truly owned or controlled by a company." Thus, Peirce continued, adding that "[f]unctions traditionally completed by people designated as 'issuers' or 'promoters' under securities laws—which, importantly, bestow those roles with certain responsibilities and potential liabilities—may be performed by a number of unaffiliated people, or by no one at all."

Peirce expressed concern that the application of *Howey* to token offerings would be overly broad. She pointed to one prong of the *Howey* test, which asks "whether the investors were anticipating 'profits to come solely from the efforts of others,'" and how the word "solely" has been dropped in subsequent applications of the *Howey* test. Peirce mentioned the SEC's determination that "tokens issued by DAO, a decentralized organization based on a distributed ledger, were securities despite the fact that token-holders had certain roles [(e.g., mining and providing development services)] within the organization necessary to its operation." Peirce further cautioned the SEC against casting the *Howey* net so wide as to swallow the "efforts of others" prong entirely.

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[1] *SEC v. Howey*, 328 U.S. 293 (1946).

Peirce continued, stating that the *Howey* framework may not work for certain projects, noting a project known as "Basis," which announced that "it will shut down operations and return $133 million in capital to investors due to the difficulty—if not impossibility—of complying with securities regulations." While Peirce did not comment on the merits of Basis, or any other specific project, she expressed concern that "apparently legitimate projects [could not] proceed because our securities laws make them unworkable."

In exploring potential solutions, Peirce discussed how Congress may resolve the ambiguities related to *Howey,* noting the bill that was recently introduced in the House of Representatives by Congressmen Warren Davidson and Darren Soto, which would amend the federal securities laws, by requiring that at least some digital assets be treated as a separate asset class.

Additionally, Peirce spoke about how: (1) the market itself may demand the disclosures normally required by regulation because sponsors of initial coin offerings will want to signal the quality of their products through disclosure; and (2) the platforms that trade cryptocurrencies can play a role in forcing such disclosure.

Peirce concluded by reiterating her eagerness to make progress in this space, while voicing her concern that the current regulatory approach toward new products and innovation, such as digital assets, has been impulsive and inadequate.

- **See a Transcript of the Speech**

SEC Chairman Clayton Delivers Speech on SEC Rulemaking in 2018, the Road Ahead and Challenges Posed by Brexit, the LIBOR Transition and Cybersecurity Risks

On December 6, 2018, SEC Chairman Jay Clayton delivered remarks on the SEC's rulemaking in 2018, the 2019 regulatory agenda and the challenges the SEC faces related to Brexit, the LIBOR transition and cybersecurity risks.

Clayton began by reminding the audience of the SEC's statutory responsibility to provide disclosure on its priorities. To that end, Clayton reminded the audience that the SEC recently published a new, four-year strategic plan, as well as an annual report for fiscal year 2018. Clayton then outlined the topics for his remarks: progress made on the 2018 regulatory agenda, the 2019 regulatory agenda and observations on certain risks the SEC is monitoring going forward, namely, Brexit, the LIBOR transition and cybersecurity risks.

2018 Regulatory Agenda and Review of the SEC's Progress

Clayton reminded the audience of the SEC's duty to publish a regulatory agenda on a semi-annual basis pursuant to the Regulatory Flexibility Act ("**Reg Flex**"). To that end, Clayton reminded the audience that while the near-term portion of the Reg Flex agenda had become too aspirational, changes made in 2018 were aimed at making the agency's rulemaking more focused. According to Clayton, the 2018 Reg Flex agenda, for example, was crafted based on specific questions, including: "(1) what initiatives the [SEC] could reasonably expect to complete over the following 12 months[;] and (2) of those initiatives, which ones would have the most positive impact on our Main Street investors." According to Clayton, this resulted in an agenda composed of 26 initiatives covering a wide array of topics. He further noted that working with this more focused agenda, the SEC was able to advance 23 of the 26 rules in the near-term agenda. Moreover, Clayton indicated, the SEC was able to respond to issues not originally contemplated by the agenda, including: "guidance to public companies about disclosures of cybersecurity risks and incidents," a response to a congressional mandate that included the expansion of registration exemptions used by non-reporting companies to issue securities pursuant to compensatory arrangements and relief for those affected by Hurricane Florence.

Nevertheless, Clayton indicated that "Main Street" investors will not assess the SEC's success based on the "number or percentage of rules and initiatives we complete," but rather will focus on how the SEC's efforts impact those investors. To that end, Clayton moved on to discuss concrete examples of how the SEC helped those "Main Street" investors in 2018 by discussing some of the rulemaking and initiatives it had undertaken.

Regulation of Investment Professionals

Clayton next discussed the SEC's initiative in April whereby the agency proposed for public comment a collection of rules and interpretations applicable to broker-dealers and investment advisers. The proposals, Clayton said, were aimed at enhancing retail investor protections and decision-making by elevating standards of conduct and reaffirming fiduciary standards. More plainly, Clayton indicated, the SEC aims to bring "the regulation of conduct and communications in line with the reasonable expectations of our Main Street investors."

Specifically, Clayton indicated that the proposed rules aim to accomplish three goals: (1) to "require broker-dealers to act in the best interest of their retail customers, by expressly requiring that the investment professional not place her or his interests ahead of the interests of the client"; (2) to "reaffirm, and in some cases clarify, the fiduciary duty owed by investment advisers to their clients"; and (3) to "require both broker-dealers and investment advisers to state clearly key facts about their relationship, including their financial incentives." Clayton explained that the proposed rules were designed to preserve access for retail investors to a variety of services and products while also providing them with the tools necessary to select the relationship that is appropriate for their needs. Nevertheless, Clayton indicated that while the current disclosure regime needs improvement, "it is extensive and in many areas functions well for our Main Street investors, particularly as compared to other jurisdictions." For a detailed discussion of this collection of rules and interpretations, please see the May 7, 2018 Davis Polk Client Memorandum, **SEC Proposes Enhanced Standards for Advice to Retail Investors**.

Facilitating Capital Formation

In addition to improving the SEC's approach to the regulation of investment professionals, Clayton indicated that the SEC has also taken steps to help facilitate capital formation for certain companies. As an example, Clayton indicated that the SEC had expanded the definition of "smaller reporting company," which will now allow nearly 1,000 additional companies to take advantage of less onerous disclosure requirements. For a detailed discussion of this amendment, please see the July 3, 2018 Davis Polk Client Memorandum, **SEC Lowers Threshold to Qualify as a Smaller Reporting Company**.

Additionally, Clayton indicated that the SEC adopted final rules that eliminated "outdated, overlapping or duplicative" requirements of other SEC rules or U.S. generally accepted accounting principles. He noted that such final rules will, in many cases, serve to enhance the quality of information available to investors.

Monitoring and Reacting to Our Evolving Securities Markets

In addition to more visible rule and definitional changes, Clayton indicated the SEC has also been monitoring the markets and market structures to make sure they are meeting the needs of "Main Street" investors. As an example, Clayton indicated that the newly inaugurated Fixed Income Market Structure Advisory Committee—which is focused on improvements to the fixed-income markets—had a highly productive year, which included four public meetings and five recommendations to the SEC.

Similarly, the Division of Trading and Markets held three roundtables, focused on: (1) "the market structure for the securities of smaller, more thinly traded companies"; (2) "regulatory approaches to combating retail fraud"; and (3) "access to markets and market data."

Additionally, Clayton noted that the SEC adopted amendments in July aimed at enhancing the transparency requirements that govern alternative trading systems, and that such amendments will provide investors, brokers and other market participants with increased visibility into the operations of equity trading marketplaces. For a detailed discussion on the adoption of these amendments, please see the August 21, 2018 Davis Polk Client Memorandum, **SEC Adopts New Transparency Requirements for NMS Stock Alternative Trading Systems**.

Significant Initiatives for 2019

After recapping the 2018 accomplishments, Clayton turned to the SEC's 2019 goals, underscoring his desire to achieve a similar level of success with respect to the 2019 Reg Flex agenda.

Completing Work on Rules Relating to the Standards of Conduct for Financial Professionals

Clayton next emphasized the importance of rules related to the standards of conduct for financial professionals. Clayton indicated that the SEC has engaged with "Main Street" investors nationwide to discuss their experiences, including via a series of seven roundtables aimed at soliciting investor suggestions on improvements to the proposed rules. Additionally, Clayton indicated the SEC has launched a webpage where investors can review samples of the proposed disclosure form and submit feedback. Moreover, he added that the Office of the Investor Advocate engaged the RAND Corporation to conduct investor testing of the proposed disclosure form, and indicated that the report is publicly available for review and comment.

Proxy Process

Clayton next indicated that improvements to the proxy process are a significant initiative for 2019. Clayton reminded the audience that the SEC held a proxy roundtable in November to discuss: "(1) the proxy solicitation and voting process; (2) shareholder engagement through the shareholder proposal process; and (3) the role of proxy advisory firms." Clayton indicated that there was consensus among the panelists that the proxy "plumbing" needed a major overhaul, and he encouraged market participants to explore such an overhaul and consideration of how technology could improve such an overhaul. Though a major overhaul will take time, Clayton reminded the audience that the comment box for the roundtable remains open, and he encouraged all those interested in improving the proxy "plumbing" to share their suggestions on means of improvement.

Clayton also indicated his interest in reviewing ownership and resubmission thresholds for investor proposals. Currently, Clayton indicated, there is a $2,000 ownership threshold, which was adopted 20 years ago, and the resubmission thresholds have been in place since 1954. Clayton underscored the importance of keeping long-term retail investors in mind and making sure proposing shareholders have their interests aligned with those of the company's long-term investors.

Next, Clayton discussed proxy advisory firms, and emphasized the importance of "greater clarity regarding the division of labor, responsibility and authority between proxy advisors and the investment advisers they serve." Clayton further indicated his interest in better understanding the analytical and decision-making processes advisers employ in their proxy processes.

Clayton also noted that other issues raised at the roundtable were important to consider, including: (1) "the framework for addressing conflicts of interests at proxy advisory firms[;] and (2) ensuring that investors have effective access to issuer responses to information in certain reports from proxy advisory firms."

Capital Formation and Access to Investment Opportunities

Clayton next indicated the SEC's focus on ensuring that "Main Street" investors are provided a range of opportunities that allow them to save for retirement, emphasizing the shift investors have largely made away from traditional defined benefit pension plans to defined contribution plans, such as 401(k) plans and individual retirement accounts. Clayton emphasized that the SEC has made changes that parallel congressional legislation, including, for example, the so-called "JOBS Act 3.0," which includes provisions to expand testing-the-waters and to study the SEC's quarterly reporting regime, both of which are on the 2019 agenda. Furthermore, Clayton indicated that the Division of Corporation Finance is looking at the private offering framework and working on a concept release to solicit input about key topics, including whether the "accredited investor" definition is appropriately tailored to address concerns regarding investment opportunities and investor protections.

Encouraging Long-Term Investment

Clayton then briefly discussed the importance of long-term investments by alluding to the ongoing debate regarding the "adequacy and appropriateness of mandated quarterly reporting and the prevalence of optional quarterly guidance…." Clayton then encouraged market participants to share their opinions on whether other regulations drive a focus on short-term investments.

Distributed Ledger Technology, Digital Assets and Initial Coin Offerings

Clayton next emphasized the time the SEC has spent focused on the distributed ledger, digital asset and initial coin offering space, indicating that that focus is likely to continue into 2019. Although Clayton conceded the importance of these new technologies, he also underscored the concerns over a lack of sufficient investor protections in the area. To that end, Clayton emphasized the importance of the new Strategic Hub for Innovation and Financial Technology within the SEC, which is staffed by SEC staff members and serves as a public resource for fintech-related issues.

Market Risks

Clayton then turned to the market risks that the SEC is currently monitoring, which include: (1) the impact to reporting companies of the United Kingdom's exit from the European Union (better known as Brexit); (2) the transition away from LIBOR as a reference rate for financial contracts; and (3) cybersecurity.

Brexit

Clayton began by discussing the potential effects of Brexit both on U.S. investors and markets and on global financial markets more broadly. Clayton noted that "the potential adverse effects of Brexit are not well understood and/or are underestimated." He further stated that "the actual effects of Brexit will depend on many factors, some of which may be beyond the control of regulators." Additionally, he stated that the "actual effects of Brexit are likely to manifest themselves in advance of implementation dates[,]" and that the "actual effects of Brexit will depend in large part on the ability of UK, E.U. and E.U. member state officials to provide a path forward that allows for adjustment without undue uncertainty, disruption or cost." Though Clayton reiterated that the concerns related to Brexit were his own, he noted how they are reflective of the SEC's approach to Brexit more generally. Moreover, Clayton indicated that the SEC's responsibility is primarily related to the effects of Brexit on the capital markets, and he reminded the audience that he has directed the staff to focus on "the disclosures companies make about Brexit and the functioning of market utilities and other infrastructure." Clayton also indicated a desire to see more robust disclosure about how company management is considering Brexit and the impact it may have on such companies and their operations. Clayton also added that the SEC participated in discussions after the 2016 Brexit vote with other U.S. financial authorities and market participants, as well as UK and E.U. financial authorities, in order to plan for Brexit-related impacts on U.S. investors and markets, and he expects those discussions to continue. For further information regarding Brexit, please see **Lex et Brexit**, the Davis Polk newsletter focused on Brexit developments.

Transition Away from LIBOR

Clayton next emphasized another risk that the SEC is monitoring: the shift away from LIBOR as a benchmark reference for short-term interest rates. He stated that the Alternative Reference Rate Committee, which was convened by the Federal Reserve, has proposed an alternative rate to replace LIBOR—the Secured Overnight Financing Rate, or "SOFR." Nevertheless, Clayton emphasized the risks associated with transitioning from LIBOR to a new benchmark like SOFR, as more than $35 trillion in notional contracts tied to LIBOR are expected to still be outstanding by the end of 2021, when the banks that report information used to set LIBOR are no longer obligated to do so. Although the SEC and other U.S. regulators are monitoring the risks associated with the transition, Clayton emphasized the importance of market participants planning and acting appropriately to deal with this change.

Cybersecurity

Finally, Clayton turned to the risk of cybersecurity. Clayton emphasized the importance of cybersecurity risks from an investor perspective, and reiterated that the SEC had provided guidance in 2018 to assist companies in preparing cybersecurity disclosures. For a detailed discussion on the adoption of these amendments, please see the February 23, 2018 Client Newsflash, **SEC Issues Updated Cybersecurity Guidance**.

From a market oversight perspective, Clayton discussed the ways in which the SEC prioritizes cybersecurity in its examinations of market participants, by assessing how companies: (1) prepare for cybersecurity threats; (2) safeguard customer information; and (3) detect red flags for potential identity theft. He added that the SEC has focused on areas such as "risk governance, access controls, data loss prevention, vendor management and training, among others." Clayton also noted that the SEC is focused on assessing and improving its own cybersecurity risk profile, which includes a new Chief Risk Officer and the promotion of a culture that emphasizes the importance of data security throughout the SEC's divisions and offices. Moreover, from an enforcement perspective, the SEC's Cyber Unit is "dedicated to targeting cyber-related misconduct in our markets" and has focused on "alleged misconduct involving intrusions into retail brokerage accounts, the submission of false regulatory filings and hacking to obtain material non-public information." Clayton also mentioned the Office of Investor Education and Advocacy, which has worked to inform investors about cybersecurity and red flags of cyber fraud in order to prevent investors from becoming victims.

Conclusion

Clayton concluded by noting his satisfaction with the SEC's 2018 achievements and his dedication to the agency's new, ambitious agenda. In acknowledging the remaining challenges facing the agency, Clayton underscored the pragmatism of the agency's goals looking forward.

- **See a Transcript of the Speech**

Litigation

U.S. District Court of New Jersey Dismisses Excessive-Fee Lawsuit Against BlackRock

On February 8, 2019, a U.S. federal court dismissed a lawsuit against BlackRock Advisors, LLC, BlackRock Investment Management, LLC and BlackRock International Limited (collectively, "**BlackRock**"), which alleged the fund manager charged excessive advisory fees to certain of its clients.

The suit, *In re: BlackRock Mutual Funds Advisory Fee Litigation*, consolidated four claims against BlackRock, which was accused of overcharging investors in its affiliated Global Allocation Fund and Equity Dividend Fund in violation of Section 36(b) of the Investment Company Act of 1940, as amended. Section 36(b) establishes the fiduciary duty of an investment adviser to a registered investment company with respect to the receipt of compensation for services. The plaintiffs alleged that BlackRock charged investors in registered funds' that it advised more than double the advisory fees it charged to funds it sub-advised, though the services provided were the same. BlackRock argued that services provided to the advised and sub-advised funds were not comparable, and therefore, the higher fees for services provided to the advised funds was justifiable.

The suit was filed in 2014 and ultimately proceeded to an eight-day trial in August, 2018. In her order, Judge Freda Wolfson ordered that all claims be dismissed, though further information regarding the dismissal, including the legal grounds for the dismissal, will remain sealed until both sides can request redactions.

This is the third 36(b) advisory fee case to have gone to a trial in recent years. The investment advisers were victorious in each of these three cases. For a further discussion regarding *Sivolella v. AXA Equitable Life Insurance Company*, please see the September 28, 2016 **Investment Management Regulatory Update**.

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