Investment Management Regulatory Update

September 30, 2019

Rules and Regulations

SEC Issues Guidance Regarding Proxy Voting Responsibilities of Investment Advisers

On August 21, 2019, the Securities and Exchange Commission (the "**SEC**") issued guidance to assist investment advisers in fulfilling their proxy voting responsibilities (the "**Guidance**") and an interpretation that proxy voting advice provided by proxy advisory firms generally constitutes a "solicitation" subject to the federal proxy rules (the "**Interpretation**").

The Guidance:

- May disappoint some companies and investors by not stating generally that an investment adviser with voting authority need not vote in every instance;
- Articulated significant compliance and due diligence burdens that investment advisers will need to consider if they have authority to vote proxies on behalf of their clients, particularly if they utilize proxy advisory firms;
- Will generally require investment advisers with voting authority to review their policies and procedures in light of the positions set forth in the Guidance; and
- May cause investment advisers to consider whether they want to continue to have responsibility for voting proxies for clients or whether they would prefer to restructure their arrangements with clients to eliminate such responsibility or reduce their regulatory burden in this regard.

The Interpretation:

- Reiterated the SEC's long-held view that a proxy advisory firm's voting recommendations are proxy solicitations for purpose of the SEC's proxy solicitation rules; and
- Confirmed that, as such, a proxy advisory firm's voting recommendations are subject to the proxy solicitation rules' anti-fraud provisions

Davis Polk has published a client memorandum discussing the issuance of Guidance and the Interpretation, including key takeaways from the Guidance.

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

FDIC and OCC Approve Final Amendments to Volcker Rule Regulations

The Federal Deposit Insurance Corporation (the "**FDIC**") and the Office of the Comptroller of the Currency (the "**OCC**") approved final amendments to the original Volcker Rule regulations (the "**2019 Final Amendments**"), which were first adopted in December 2013. The Federal Reserve, SEC and Commodity Futures Trading Commission are expected to approve these same amendments in the coming days. The effective date of the 2019 Final Amendments is January 1, 2020, with compliance required by January 1, 2021.

Davis Polk has published a visual memorandum regarding the 2019 Final Amendments. The visual memorandum first discusses the background to the 2019 Final Amendments and the key changes contained in the 2019 Final Amendments. The visual memorandum also provides updated proprietary trading flowcharts, which graphically summarize the proprietary trading portion of the Volcker Rule regulations, as amended by the 2019 Final Amendments.

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

SEC Staff Releases Accounting and Disclosure Information Regarding Principal Risk Disclosures

On September 9, 2019, the staff of the Division of Investment Management of the SEC (the "**Staff**") released ADI 2019-08, entitled "Improving Principal Risks Disclosure" (the "**ADI**"), which is intended to assist registrants in preparing regulatory filings. The ADI focuses on the disclosure of principal risks contained in a mutual fund's summary prospectus. The ADI notes that "[p]rincipal risks include those risks that are reasonably likely to adversely affect the fund's net asset value, yield, and total return[,]" and that the principal risks will "depend on the fund's investment objective(s), holdings, investment strategies, and structure." The ADI further states that "while some funds provide clear and concise principal risk disclosures…others provide risk disclosures that are overly lengthy and technical."

According to the ADI, the following approaches have been observed by the Staff and may help improve these principal risk disclosures for investors:

1. *Ordering Risks by Importance.* The Staff strongly encourages funds to list their principal risks in order of importance, "with the most significant risks appearing first." The ADI states that "[f]unds that list their principal risks in alphabetical order could obscure the importance of key risks, especially when a fund includes many principal risks." The ADI further notes that in certain extreme cases, alphabetizing principal risks "could result in a fund's key risks being obscured to such an extent that it could render the disclosure potentially misleading." Additionally, the ADI states that the "relative importance of a risk can change with market conditions or with changes to a fund's investments[,]" and that funds are best positioned to make the necessary subjective determinations. Finally, the ADI notes that the Staff "would not generally expect to comment on a fund's ordering of risks by importance."

2. *Tailoring Risk Disclosures.* The ADI states that while "standardized disclosures across funds may be appropriate for certain risks, the Staff encourages funds to tailor other risk disclosures to how the particular fund operates." Further, the ADI criticizes the inclusion of principal risk disclosures describing investments that are not discussed in the funds' principal investment strategies.

3. *Disclosing that a Fund is Not Appropriate for Certain Investors*. Next, the ADI notes that a fund may "describe the types of investors the fund is intended for or the types of investment goals that may be consistent with an investment in the fund." According to the ADI, the Staff "encourages funds to consider disclosing that a fund *is not* appropriate for certain investors given the fund's characteristics."

4. *Other Disclosure Considerations.* Finally, the Staff also noted the following additional measures that funds can take to "improve their risk disclosure so as to provide investors clear, concise, relevant, and timely information":

    a. Limit summary prospectuses to a "concise summary of key information[,]" with more detailed information about principal risks presented elsewhere in the prospectus.

    b. "[D]isclose non-principal risks (and non-principal investment strategies) in the fund's statement of additional information[,]" as disclosing in the prospectus may "overwhelm other important information."

    c. "[P]eriodically review their risk disclosures… and consider whether the disclosures remain adequate in light of the fund's characteristics and market conditions."

- **See a copy of the ADI**

SEC Adopts Rule to Modernize ETF Regulation

On September 26, 2019, the SEC adopted new rule 6c-11 (the "**Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), as well as form amendments designed to "modernize the regulation of exchange-traded funds ("**ETFs**"), by establishing a clear and consistent framework for the vast majority of ETFs operating today." Additionally, the SEC voted to issue an exemptive order intended to further harmonize related relief for broker-dealers.

According to the SEC's press release, the Rule will "permit ETFs that satisfy certain conditions to operate within the scope of the [Investment Company Act] and come directly to market without the cost and delay of obtaining an exemptive order[,]" which, "should facilitate greater competition and innovation in the ETF marketplace by lowering barriers to entry."

These conditions include requirements that: (i) ETFs provide daily portfolio transparency on their website; (ii) ETFs that use "custom baskets" (i.e., baskets that do not reflect a pro-rata representation of the fund's portfolio or that differ from the initial basket used in transactions on the same business day) adopt written policies and procedures that set forth the parameters for constructing and accepting such custom baskets; and (iii) ETFs disclose certain information on their website.

Additionally, one year following the effective date of the Rule, the SEC will rescind exemptive relief previously granted to ETFs permitted to rely on the Rule, as well as exemptive relief permitting ETF master-feeder structures, though it will not rescind exemptive relief permitting ETF fund of funds arrangements.

Davis Polk has published a Client Alert discussing the adoption of the Rule and will publish a full Client Memorandum discussing the Rule shortly.

- **See a copy of the Press Release**
- **See a copy of the Rule**
- **See a copy of the Exemptive Order**

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

SEC Expands "Testing the Waters" Communications

On September 26, 2019, the SEC announced a welcome, broad expansion of "testing the waters" flexibility for all companies. Under new Rule 163B, all companies, and persons authorized to act on their behalf (such as underwriters), will be able to gauge market interest in a possible offering with qualified institutional buyers and institutional accredited investors prior to or after the filing of a registration statement. The new rule is welcome relief for all non-emerging growth companies and for companies without a registration statement on file.

Davis Polk has published a Client Memorandum discussing the new rule, including its applicability to registered investment companies and business development companies.

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

Industry Update

OCIE Issues Risk Alert Regarding Principal and Agency Cross Trading Compliance Issues

On September 4, 2019, the Office of Compliance Inspections and Examinations ("**OCIE**") of the SEC issued a risk alert (the "**Risk Alert**") to provide investment advisers with information regarding common deficiencies identified in recent examinations related to principal trading and agency cross transactions under Section 206(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**") and Rule 206(3)-2 thereunder.

Section 206(3) makes it unlawful for any investment adviser acting as a principal for his or her own account to knowingly "sell any security to or purchase any security from a client" (a "**principal trade**") without disclosing to such client in writing before the completion of such transaction the capacity in which the adviser is acting and obtaining the client's consent to such transaction. Additionally, advisers must obtain client consent for principal trades on a transaction-by-transaction basis—blanket disclosure and consent are not permitted. Section 206(3) also prohibits an adviser from knowingly effecting a sale or purchase of a security for a client where the adviser is, directly or indirectly, acting as a broker for a person other than the advisory client (an "**agency cross transaction**") without disclosing its capacity to the client and obtaining client consent. Rule 206(3)-2 provides that transaction-by-transaction disclosure and consent is not required for agency cross transactions, and blanket consent can be obtained if, among other things: (1) the client has executed a written consent prospectively authorizing agency cross transactions after receiving full written disclosure of the conflicts involved (and other information described in the rule); (2) the adviser provides a written confirmation to the client at or before the completion of each transaction disclosing, among other things, the source and amount of any remuneration received by the adviser; (3) the adviser provides a written disclosure, including a summary of all agency cross transactions during the period, on at least an annual basis; and (4) the written disclosure documents and confirmations conspicuously disclose that consent may be revoked at any time.

According to the Risk Alert, OCIE staff identified four common investment adviser compliance issues related to principal and agency cross trading under Section 206(3) and Rule 206(3)-2 during examinations over the past three years:

- OCIE *staff observed advisers that did not follow the specific requirements of Section 206(3)*. For example, some advisers did not recognize that they were effecting principal trades subject to Section 206(3). Other advisers recognized that they were engaging in principal trades, but failed to obtain appropriate client consents or failed to provide sufficient disclosure regarding potential conflicts of interest. OCIE staff also observed advisers that had obtained consent *after* the completion of the transaction.

- OCIE *staff observed advisers that engaged in transactions involving pooled investment vehicle clients where the advisers involved did not follow the requirements of Section 206(3)*. OCIE staff observed advisers that failed to recognize that their significant ownership interest in pooled investment vehicles would cause the transaction to be subject to Section 206(3) and then failed to obtain effective consent from pooled investment vehicle clients prior to completing the transaction.
- OCIE *staff observed advisers' practices that gave rise to compliance issues in connection with agency cross transactions*. OCIE staff observed advisers engaging in agency cross transactions after disclosing to clients that they would not do so, or effecting such transactions relying on Rule 206(3)-2 without producing any documentation that they had complied with the consent, confirmation or disclosure requirements of the rule.
- OCIE *staff observed advisers that did not have policies and procedures relating to Section 206(3) (or failed to follow such policies) even though the advisers engaged in principal trades and agency cross transactions*.

The OCIE staff encourages advisers to review their written policies and procedures and their implementation to ensure that they are compliant with the principal trading and agency cross transaction provisions of the Advisers Act and the rules thereunder.

- **See a copy of the Risk Alert**

Litigation

Raymond James Settles with SEC for Approximately $15 Million

On September 17, 2019, the SEC issued an order (the "**Order**") instituting and settling cease-and-desist proceedings against Raymond James & Associates, Inc. ("**RJA**"), Raymond James Financial Services, Inc. ("**RJFS**") and Raymond James Financial Services Advisors, Inc. ("**RJFSA**") relating to their: (i) failure to conduct suitability reviews for certain advisory accounts; (ii) failure to adopt policies and procedures reasonably designed to "prevent violations concerning the suitability of fee-based advisory accounts"; (iii) overvaluation of certain assets resulting in the receipt of excess advisory fees; (iv) failure to have a "reasonable basis for recommending certain unit investment trust ("**UIT**") transactions to brokerage customers"; and (v) failure to disclose the conflict of interest "associated with earning greater compensation when recommending certain securities without providing applicable sales-load discounts to brokerage customers." According to the Order, the above conduct occurred at various times between January 2013 through May 2018 and "involved products sold and services provided to retail investors."

According to the Order, despite disclosure in their brochures and policies and procedures requiring the review of client accounts "to determine, among other things, if keeping a client in an advisory account was suitable or if the client should consider moving to a brokerage account[,]" both RJA and RJFSA failed to "adequately and timely conduct a suitability review for certain accounts." The Order noted that following the beginning of the SEC's investigation, RJA and RJFSA conducted suitability reviews and "determined that 1,703 [accounts] were unsuitable for a fee-based advisory arrangement and converted those to brokerage accounts, and closed an additional 2,112 [accounts]." The Order further stated that RJA and RJFSA failed to "adopt and implement reasonably designed policies and procedures concerning inactive advisory account monitoring and review consistent with their representations to their clients."

Additionally, the Order noted that certain registered representatives of RJA and RJFS recommended that brokerage clients "liquidate a UIT position in their accounts 100 days or more before the UIT's maturity date, and then purchase a newly-issued UIT within 30 days after the disposition of the previous UIT position." The Order stated that those recommendations "accelerated the frequency of UIT transactions for affected brokerage customers, thereby increasing the cost over time of investing in UITs." Further, the Order noted that "[d]espite the costs of [these] short-hold transactions, certain [RJA and RJFS registered representatives] did not reasonably investigate or understand these costs." As a result, the Order stated that the recommendations were made without a "reasonable basis to believe that such transactions were suitable for their brokerage customers, particularly in light of the significant costs."

Further, the Order stated that despite the availability of sales charge discounts for certain UIT rollover transactions, RJA and RJFS "failed to properly monitor how rollover discounts were applied to certain eligible brokerage customers." As a result, the third-party software application on which RJA and RJFS relied on to apply the discounts, failed to apply certain discounts, and according to the Order, RJA and RJFS received additional compensation from certain brokerage clients "because they did not provide the disclosed rollover discount." The Order further stated that RJA and RJFS failed to disclose the related conflict of interest.

Finally, the Order noted that UIT investments held in advisory accounts "have distinct CUSIPs that reflect the absence of sales charges compared to those held in brokerage accounts of the same UIT." The Order states that "[d]uring the first few months following the issuance of a UIT, the pricing of the CUSIPs in brokerage accounts diverge from the CUSIPs in advisory accounts despite the fact that each hold the same assets. In particular, for the first few months, the brokerage CUSIP shows a higher unit value than the advisory CUSIP because the impact of the sales charges are reflected on a deferred basis." Accordingly, the Order stated that RJA and RJFSA "incorrectly priced certain UIT positions held by advisory clients, overcharging advisory fees associated with those clients who purchased UITs." According to the Order, RJA and RJFSA valued the UIT investments as if they were held in brokerage accounts and not in advisory accounts. The Order further stated that the inaccurate valuation was reflected in advisory clients' statements and was used to determine advisory fees, leading to the overcharging of advisory fees to clients.

As a result of the conduct described above, the SEC found that RJA and RJFS willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, which prohibit "any person in the offer or sale of securities from obtaining money or property by means of any untrue statement of material fact or any omission to state a material fact necessary in order to make statements made not misleading, and from engaging in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser." In addition, the Order further noted that the SEC found that RJA and RJFSA violated Section 206(2) of the Advisers Act, which makes it unlawful for an adviser to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Finally, the SEC also found that RJA and RJFSA willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require registered investment advisers to, among other things, "[a]dopt and implement written policies and procedures reasonably designed to prevent violation" of the Advisers Act and its rules.

RJA, RJFS and RJFSA agreed to pay disgorgement of $11,098,349.01, prejudgment interest of $1,072,764.80 and a civil monetary penalty of $3,000,000. The Order noted the remedial efforts taken by RJA, RJFS and RJFSA, as well as their cooperation with the SEC's investigation, including the self-reporting of certain violations which were uncovered by a compliance consultant voluntarily retained by the respondents. RJA, RJFS and RJFSA also consented to the entry of the Order and agreed to cease and desist from future violations.

- **See a copy of the Order**

Second Circuit Concludes Investment Company Act Creates an Implied Private Right of Action

On August 5, 2019, the United States Court of Appeals for the Second Circuit ruled that section 47(b) of the Investment Company Act creates an implied private right of action allowing parties to sue for rescission of a contract that allegedly violates the Investment Company Act. The Second Circuit's decision creates a circuit split, raising the prospect of Supreme Court review, as the Third Circuit and several district courts had previously concluded that the Investment Company Act does not create an implied private right of action.

In *Oxford University Bank v. Lansuppe Feeder, Inc.*, a private fund issuer claimed an exemption from registration as an "investment company" under the Investment Company Act, relying on section 3(c)(7), which exempts issuers whose securities are owned exclusively by "qualified purchasers" or "knowledgeable employees." Holders of a class of junior notes of the issuer alleged that the exemption had been violated because certain notes had been resold to non-qualified purchasers.

Section 47(b) of the Investment Company Act provides, that "(1) a contract that is made, or whose performance involves, a violation of [the Investment Company Act] is unenforceable" and that "[t]o the extent that a contract described in paragraph (1) has been performed, a court may not deny rescission at the instance of any party unless such court finds that under the circumstances the denial of rescission would produce a more equitable result . . . ." Plaintiff-intervenors argued that the indenture under which the notes were issued was a contract that violates the Investment Company Act, and sued for rescission of the indenture and their purchases of notes under section 47(b) of the Investment Company Act. The district court concluded that no private right of action exists under section 47(b) because (i) the Investment Company Act provides for SEC enforcement of the provision declaring contracts in violation of the Investment Company Act void; (ii) the Investment Company Act expressly provides for private enforcement under section 36(b), and (iii) there was "no implication of an intent to confer rights" on entities such as the plaintiff.

On appeal, the Second Circuit affirmed the District Court's grant of summary judgment, but on different grounds. The Second Circuit held that the text of section 47(b) stating that "a court may not deny rescission at the instance of any party" presupposes that a party may seek rescission by filing suit, and "is thus effectively equivalent to providing an express cause of action." Similarly, the panel concluded that parties to contracts violating the Investment Company Act are exactly the "class of persons" that section 47(b) aims to protect through the creation of a private right of action, and that both the legislative history and congressional intent behind section 47(b), which was added to the Investment Company Act by a 1980 amendment, supported this interpretation. In reaching its decision, the Second Circuit considered, but ultimately disagreed with, the Third Circuit's contrary decision in *Santomenno ex rel. John Hancock Trust v. John Hancock Life Ins. Co.*, 677 F.3d 178 (3d Cir. 2012), in which the Third Circuit concluded that section 47(b) did *not* create a private right of action.

The Second Circuit nonetheless affirmed the district court's decision to dismiss plaintiff-intervenors' claims on the ground that the plaintiff-intervenors had not demonstrated that the indenture under which the notes were issued was a contract "made, or whose performance involves, a violation" of the Investment Company Act, and that the relief they sought was not rescission, but "a restructuring of its terms to give junior notes a priority status equal to that of senior notes[,]" which is not contemplated by the statute.

One consequence of the Second Circuit's decision—and of the split with the Third Circuit—is that the issue may be more likely to be reviewed by the Supreme Court. The creation of a new implied private right of action also opens the door to additional litigation by parties to contracts subject to the Investment Company Act, and to litigation aimed at increasing the scope of this right of action.

- **See a copy of the Second Circuit Opinion**

Broker-Dealer Settles with SEC for Failure to Supervise Trader Involved in Premium Point Fund Fraud

As reported in our prior updates of **May 2018** and **July 2019**, in 2018 the SEC sued Premium Point Investments, LP ("**Premium Point**") a registered investment adviser, its CEO, a portfolio manager, and a trader, for allegedly inflating the performance of Premium Point's managed fund by, among other things, asking "friendly" brokers to obtain specific marks on bonds held by Premium Point, in exchange for directing trades to those brokers. In July 2019, a jury found Premium Point's CEO and a trader guilty of securities fraud, wire fraud, conspiracy to commit securities fraud and conspiracy to commit wire fraud. One of the "friendly" brokers involved in the scheme, Frank Dinucci Jr. ("**Dinucci**"), pleaded guilty to several criminal counts including securities fraud.

On August 20, 2019, the SEC brought and settled an enforcement action against Mosaic Capital, LLC, formerly known as AOC Securities, LLC ("**AOC**"), for failing to reasonably supervise Dinucci. The SEC alleged that AOC and its executive officer did not establish policies and procedures reasonably designed to prevent and detect Dinucci's violations. AOC agreed to be censured and to pay a civil money penalty of $250,000. AOC had also withdrawn from registration as a broker dealer as of December 2018.

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

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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