# Investment Management Regulatory Update

October 30, 2020

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## COVID-19 Update

Please refer to Davis Polk's "**Coronavirus Updates**" webpage for content related to the outbreak.

## Rules and Regulations

### SEC Adopts Updated Regulatory Framework for Fund of Funds Arrangements

On October 7, 2020, the Securities and Exchange Commission ("**SEC**") adopted a new rule and related amendments "designed to put in place a comprehensive regulatory framework for fund of funds arrangements." Among other things, the rule: (i) created new Rule 12d1-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), which permits registered investment companies or business development companies to acquire the securities of other registered investment companies or business development companies beyond the limits contained in Section 12(d)(1) of the Investment Company Act, provided certain conditions have been met; (ii) rescinded Rule 12d1-2 under the Investment Company Act, as well as most exemptive orders granting relief from Sections 12(d)(1)(A), (B), (C) and (G) of the Investment Company Act; and (iii) amended Rule 12d1-1 under the Investment Company Act which allowed funds that primarily invest in funds within the same group to invest in unaffiliated money market funds; and (iv) amended Form N-CEN to include a requirement that funds report whether they have relied on new Rule 12d1-4 or the statutory exemption contained in Section 12(d)(1)(G) of the Investment Company Act during the reporting period. Davis Polk is currently preparing a client memorandum that will more fully describe the final rule and related amendments.

- See a copy of the Press Release
- See a copy of the Final Rule

### SEC Adopts Modernized Regulatory Framework for Derivatives Use by Registered Funds and Business Development Companies

On October 28, 2020, the SEC adopted Rule 18f-4 under the Investment Company Act. According to the adopting release, proposed Rule 18f-4 would apply to registered investment companies (other than money market funds and UITs) and business development companies, and is designed to reflect the broad product innovation and investor choice available in today's markets, while still addressing the investor protection concerns underlying Section 18 of the Investment Company Act. Notably, the SEC did not adopt, as originally proposed, certain exceptions for leveraged/inverse investment vehicles from the fund leverage risk limit under Rule 18f-4, or the proposed new sales practices rules under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") and the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), with respect to the purchase and sale of leveraged/inverse investment vehicles for retail investor accounts. In adopting Rule 18f-4, the SEC is rescinding prior guidance provided in Release 10666[1] regarding the application of Section 18 to the use of derivatives and financial commitment transactions by registered funds. Davis Polk is currently preparing a client memorandum that will more fully describe the final rule and related amendments.

- See a copy of the Press Release
- See a copy of the Final Rule

### SEC Proposes to Exempt Certain "Finders" from Broker-Dealer Registration Requirements

A divided SEC voted last week to issue a **Proposed Exemptive Order** (the "**Proposal**") that would, if adopted, permit natural person "finders" to engage in certain private capital-raising activities, including in connection with private funds, without registering as a broker-dealer. The extent to which finders are subject to broker-dealer registration has long been uncertain. The question of whether a finders exemption already exists has long been debated, recognized in a very limited form by historical SEC staff no-action letters and more recent case law, but never explicitly adopted by the SEC. The Proposal, if adopted, would provide legal certainty to issuers and finders that previously operated under a legal shadow. The timing and politically divided views on the Proposal, however, raise the question of whether it ultimately will be adopted, should the administration, and thus the political makeup of the SEC, change in January. For further information, please see Davis Polk's **Client Memorandum** outlining the Proposal.

## Industry Update

### Dalia Blass Keynote Address at the Investment Company Institute 2020 Virtual Securities Law Developments Conference: Regulating with Our Eyes on the Future

On September 24, 2020, Dalia Blass, Director of the SEC's Division of Investment Management (the "**Division**"), delivered the keynote address at the Investment Company Institute 2020 Virtual Securities Law Developments Conference. She noted that while past events impacting the asset management industry, such as the 2008 financial crisis and the 2020 pandemic, have led to significant regulatory

[1] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10,666, 44 Fed. Reg. 25, 128 (Apr. 27, 1979).

changes, it is "critically important to avoid regulating the past." Blass spoke of the Division's philosophy of seeking forward-looking solutions in its recommendations for change in the regulatory framework, and its focus on "regulations that will balance flexibility to accommodate future changes with promoting resiliency to future crises." She illustrated her comments through the industry's recent experiences with money market funds and ETFs.

Blass highlighted the 2010 and 2014 amendments to money market fund regulation under rule 2a-7 under the Investment Company Act. The amendments addressed issues that arose during the 2008 financial crisis by, for example, reducing the risks of money market fund portfolios and permitting non-government funds to use liquidity fees or gates. She noted that the COVID-19 pandemic tested these reforms, with money market funds experiencing even higher levels of redemptions than in September 2008. She noted the importance of analyzing whether the rule 2a-7 framework contributed to, or alleviated, the stress experienced by money market funds during the pandemic. For example, did the possibility of gates being triggered influence market behavior, or did the risk limits imposed by rule 2a-7 allow money market funds to have the liquidity needed to meet heightened redemptions? However, Blass also noted that analysis of past market dislocations should not be the only drivers of regulatory change and stressed the Division's focus "on how to create a flexible framework that will interact smoothly with future market innovations, different market conditions, and investor reactions that we may not have already experienced."

Blass noted that in March, when the COVID-19 pandemic was beginning to affect the markets, ETF secondary market trading spiked to historic levels, and many ETFs saw a significant difference between their net asset value and their market price. Blass asserted that it is too early to determine why this happened but notes that future analyses of these events should recall that ETFs were able to meet redemptions, even with high market volatility. She also asserted that any analyses of how funds fared in March and April should not be beholden to a one-size-fits-all approach, as ETFs are structurally different from other types of funds. Blass also noted that the Division continues to support healthy innovation in the ETF industry, and seeks forward-looking solutions rather than solely reacting to past events.

**Pathways to Aid the Effective Regulation for a Resilient Industry**

More generally, Blass suggested three ways to structure regulations so as to be flexible enough to permit innovation in the industry while also providing appropriate protections and oversight, i.e., data-driven regulatory tools, risk management, and international engagement.

Blass believes that structural resiliency depends on data-driven regulatory tools such as risk guidelines, standardized limits, and reporting, and noted that the recently proposed derivatives rulemaking is an illustrative example of these tools in action. (For further information on the proposed rule on derivatives use by registered funds, please see Davis Polk's **Client Memo dated January 14, 2020**.) Blass highlighted that data-driven regulatory frameworks such as the proposed derivatives rule "seek to balance flexible requirements that can be tailored to a particular fund's risks with minimum standards and tools to promote resilience, strong oversight and informed market monitoring."

Blass believes that such data-driven regulatory tools must be developed in the context of a larger conversation about risk management. She believes that it is important to consider what risks are appropriate or can be tolerated and what risks should be addressed and how. This weighing is important to accomplish the SEC's three equal goals of protecting investors, maintaining fair and efficient markets, and facilitating capital formation.

Blass also observed that the asset management industry is fundamentally interconnected with the broader U.S. economy and operates on a global basis. For example, the European Union's unbundling of payment for research impacts U.S. asset managers because of their global presence. Accordingly, any industry regulation must recognize this interconnectedness, and Blass emphasized the importance of engagement with international regulators to learn about the consequences of different regulatory approaches, and help address potential operational complexities and obstacles to financial innovation, as well as avoid higher compliance costs.

### Staff Statements

Blass noted that as part of the Division's focus on being forward-looking to account for evolution in the industry, the staff continues to review past no-action letters to determine whether they are still relevant and consistent with the SEC's overall regulatory approach. She noted that reconsideration of prior staff statements would continue to be a priority of the Division. Accordingly, the Division has withdrawn or modified some past staff statements, including no-action letters that addressed investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms; the intersection between state control share acquisition statutes and the Investment Company Act's voting requirements for closed-end funds; and those relating to amended rules or newly adopted rules. Blass highlighted the Division's new webpage (**https://www.sec.gov/divisions/investment/im-modified-withdrawn-staff-statements**) that lists no-action letters that have been modified or withdrawn, but noted that such list is not exhaustive. Blass encouraged the audience to consider, when looking at a staff no-action letter, whether markets have changed significantly since issuance or the SEC has spoken recently on the issue. If the impact of developments on a prior staff no-action letter is unclear, Blass encouraged the audience to call Division staff.

### Conclusion

Blass stated that the Division plans to make recommendations to the SEC for next steps on all of the outstanding proposals in its area, including fund of funds arrangements, funds' use of derivatives, fund valuation practices, and investment adviser advertising and solicitation. Blass also noted that the Division is exploring ideas for updating the SEC's guidance on e-delivery and virtual board meetings beyond the recent temporary relief related to COVID-19. As it does so, it will strive both to look back and understand what happened and why, as well as to look forward on regulatory solutions that are flexible enough to build a more resilient framework going forward.

- **See a copy of the Keynote Address**

## Joint Statement on New FAQs for Form CRS

On October 8, 2020, Chairman Jay Clayton; Director of the Division of Investment Management, Dalia Blass, and Director of the Division of Trading Markets, Brett Redfearn, delivered a joint statement notifying the public of the new "frequently asked questions" ("**FAQs**") that were published in response to improper completion of the disciplinary history section of Form CRS.

### Background on Form CRS

Form CRS is a brief relationship summary which is designed to help retail investors make informed choices about which type of relationship best suits his/her needs and circumstances. Broker-dealers and investment advisers are required to provide the relationship summary to retail investors.

The instructions require that a firm include in its relationship summary the heading: "Do you or your financial professionals have legal or disciplinary history?" and must answer "Yes" or "No" depending upon whether the firm or any of its financial professionals has had a triggering event. Also, a firm must report disciplinary history if that history is required to be reported on other forms. There is no discretion to leave the answer blank or omit reportable history, and firms cannot use descriptive or other qualitative or quantitative language when describing their disciplinary history, as such language could minimize the extent of the wrongdoing.

In its review of Form CRS filings, the staff of the Standards of Conduct Implementation Committee has observed numerous examples of firms incorrectly completing the form. For example, some firms did not provide any response in the disciplinary history section, some were missing the heading, and others lacked key information. Because of this, on October 8, 2020, the Division of Investment Management and the Division of Trading and Markets published four new FAQs which addressed questions regarding the disciplinary section of Form CRS including:

- Whether or not a firm can omit the heading and any response in Item 4.C, because there is no reportable disciplinary history.
    - The SEC staff's response stated that the heading ""Do you or your financial professionals have legal or disciplinary history?" and a "Yes" or "No" response is required in all cases, even if there is no reportable history. The staff emphasized that the presence or absence of any legal or disciplinary history of a firm is important information for retail investors to have and thus, it cannot simply be omitted.
- Whether or not a firm may modify the heading in Item 4 to make it applicable to only the firm or only the firm's financial professionals.
    - The SEC staff's response stated that the heading applied to both the firm and its financial professionals and cannot be modified to apply to only one or the other. The response must be inclusive of both parties' histories.
- Whether or not two responses can be provided; one for the firm and one for the firm's financial professionals.
    - The SEC staff's response stated that two separate answers may be used. The staff suggested that they would approve a response similar to "No for our firm. Yes for the Financial professionals" or "Firm—no; Financial professionals—yes." However, the staff made it clear that qualitative, descriptive and/or quantitative language could not be used.
- Whether or not additional information may be included in the relationship summary to explain a "Yes" response.
    - The SEC staff's response stated that additional information may not be included in the form. However, the form does not preclude a firm or its financial professionals from providing separate copies of additional regulatory disclosures, such as Form ADV Part 2B brochure supplements or a printout of the IAPD or BrokerCheck "Disclosures" section for the particular firm or financial professional.
- **See a copy of the FAQs**
- **See a copy of the statement**

## Litigation

### SEC Settles with a State-Charted Trust Company for Failing to Register Trust Funds Under the Investment Company Act and the Securities Act

On September 30, 2020, the SEC issued an order (the "**Great Plains Order**") instituting and settling cease-and-desist proceedings against Great Plains Trust Company, Inc. ("**Great Plains**"), a state-chartered trust company that offered and sold investment units in two categories of trust funds, Collective Pension Trust Funds and Common Personal Trust Funds (collectively, the "**Funds**"), for allegedly failing to register the Funds as investment companies under the Investment Company Act, and never registering the offer and sale of securities in the Funds under the Securities Act of 1933 (the "**Securities Act**").

According to the Great Plains Order, when Great Plains organized the Funds in 1990, it did not register them as investment companies, nor did it register the offer and sale of securities in the Funds, relying on the exclusion from the definition of "investment company" under Sections 3(c)(11) and 3(c)(3). In certain situations, trust funds offered by a bank are excluded from the definition of "investment company" under the provisions of the Investment Company Act and are exempt from the registration provisions of the Investment Company Act and the Securities Act. However, in this case, from 2015 to 2019, Great Plains did not satisfy the statutory requirements necessary to qualify for the exclusions—according to the SEC—

one of which being that the Funds must be “maintained” by a bank. The SEC alleged that the Funds failed to satisfy the “maintained” by a bank requirement because Great Plains did not exercise substantial investment responsibility over the Funds. Instead, Great Plains allegedly provided only “minimal” oversight over the advisory firm that Great Plaints hired to manage the Funds, and failed to exercise its own substantial investment responsibility over the Funds.

As a result, the SEC alleged that Great Plains caused the Funds to violate Section 7(a) of the Investment Company Act and Sections 5(a) and 5(c) of the Securities Act. Great Plains agreed to terminate and liquidate the Common Trust Funds by October 30, 2020, to cease and desist from any further violations, and to pay a civil monetary penalty in the amount of $300,000.

The Great Plains Order is notable for a dissent by SEC Commissioner Hester M. Peirce. Commissioner Peirce’s dissent, published on October 2, 2020, noted that she believed that the SEC has not provided guidance on the question of what it means for the Funds to be “maintained by” Great Plains, particularly because “the only interpretive guidance derives from a rather unconventional forty-year old release summarizing the views of the [SEC]’s staff.” Commissioner Peirce further explained that the SEC was, in her view, “using an enforcement action” to provide guidance, which she believes to be “an inappropriate way for a regulator to communicate its interpretation of the law.” Commissioner Peirce further stated that she is “particularly concerned about using an enforcement action to disentangle overlapping regulatory regimes” and that the SEC “ought to be particularly wary of using enforcement actions to communicate with entities [they] do not directly regulate.” Lastly, Commissioner Peirce noted that the SEC’s construction of the scope of the exclusion for trusts “maintained by a bank” would benefit from “consultations with their bank regulatory colleagues,” and that together they could have “defined the scope of the exclusion in a manner to ensure that all funds operate within an appropriate regulatory structure.”

This dissent is consistent with Commissioner Peirce’s oft-stated concerns that “rulemaking by enforcement” implicates “due process principles,” [2] and that other regulatory tools may be better suited to promulgating a new rule or offering guidance on implementation of existing rules.[3]

- See a copy of the **Great Plains Order**
- See a copy of **Commissioner Peirce's Dissent**

## Blockchain Lending Company Settles SEC Charges Arising from Unregistered ICO

On September 30, 2020, the SEC announced that it had settled charges against Salt Blockchain Inc. ("**Salt**") for conducting an unregistered initial coin offering ("**ICO**") of digital tokens.

The SEC order states that Salt, a privately held Delaware corporation with a principal place of business in Colorado, developed a lending business in 2016 to allow borrowers to obtain United States dollar-denominated loans collateralized by digital assets such as Bitcoin or Ether. From June to December of 2017, Salt held a "membership token sale" in which it offered and sold "Salt Tokens" issued on a blockchain. Salt explained in its offering documents that Salt Tokens would increase in value based on Salt's efforts to develop the lending business. The offering documents allegedly stated that Salt's technology would "automatically manage blockchain-backed credit agreements between borrowers and lenders" with several key functions, including secure storage of blockchain assets held as collateral, monitoring the value of the blockchain assets held as collateral, and liquidating those assets as needed. Investors purchased Salt Tokens using other digital assets, specifically Bitcoin and Ether, as well as U.S.

[2] Commissioner Hester M. Peirce. May 8, 2019 speech at Rutgers Law School, entitled “**Reasonableness Pants**.”

[3] Commissioner Hester M. Peirce, remarks before the 51st Annual Institute on Securities Regulation, entitled “**Broken Windows**.”

dollars. Salt raised approximately $47 million from these sales. Following the ICO, Salt offered loans secured by blockchain assets on a limited basis to the public and continued to sell Salt Tokens to the public.

The SEC order states that pursuant to the test laid out in *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), the Salt Tokens were sold as investment contracts, and therefore constitute securities, because purchasers would have had a reasonable expectation of obtaining a future profit based upon Salt's efforts. The SEC order states that Salt Token purchasers could reasonably expect profits from their investment in the Salt enterprise because Salt told investors that Salt would take various steps to increase the price of Salt Tokens, including limiting the number of Salt Tokens created and sold, managing the price at which Salt continued to sell the Salt Token, and managing the value at which Salt allowed the Salt Token to be redeemed for various benefits. Additionally, the SEC order alleges that Salt made promotional statements online and in other materials directed at digital token investors encouraging speculative purchases with the earliest purchasers receiving the greatest discounts and the opportunity to profit by selling Salt Tokens on the secondary market. For example, Salt allegedly referred to the fact that tokens sold in the ICO were being sold at a "discount" to the $10 price per token at the conclusion of the ICO and that purchasers who did not use all of their Salt Tokens on the platform could sell the tokens at full price on their own.

The SEC order states that through this conduct, Salt violated Sections 5(a) and 5(c) of the Securities Act, which require issuers to register non-exempt securities with the SEC. Without admitting or denying the SEC's findings, Salt agreed to cease and desist from committing or causing any violations of the charged provisions, to engage in a claims process to return funds to investors who purchased tokens, and to pay a civil penalty of $250,000. The company also agreed to register its tokens as securities and file required periodic reports with the SEC.

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

## SEC Settles with Private Equity Fund Manager Regarding Alleged Fee Overcharges

On October 22, 2020, the SEC issued an order (the "**EDG Management Order**") instituting and settling cease-and-desist proceedings against EDG Management Company, LLC ("**EDG**"), a private equity fund adviser, for allegedly failing to adjust management fees due from a managed fund, the EDG Partners Fund II, L.P. (the "**Fund**"), to account for write downs of assets held by the Fund.

According to the EDG Management Order, the Fund's limited partnership agreement provided that EDG would charge the fund a management fee of 1.5% per annum, that the management fee would be determined and payable quarterly, and that the management fee would be reduced upon the occurrence of certain events, including the write down of portfolio securities. The SEC alleged that from January 2016 through October 2019, five different portfolio securities held by the Fund were subject to write downs, but that EDG did not incorporate the effects of these write downs into management fee calculations on thirteen management fee payment dates. According to the EDG Management Order, EDG's failure to account for the write downs caused the Fund to overpay a total of $901,760.91 in management fees.

The SEC alleged that, on account of the conduct described above, EDG violated sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder. EDG agreed to cease and desist from further violations, to be censured, to pay a total of $1,026,642.02, made up of $901,760.91 in disgorgement and $124,881.11 in prejudgment interest, and to pay a civil money penalty of $175,000.

- See a copy of the **EDG Management 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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