April 6, 2017

Ropes & Gray's Investment Management Update: February 2017 – March 2017

The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

SEC Issues Guidance Update on Robo-Advisers

Recently, the SEC's Division of Investment Management published a Guidance Update, *Robo-Advisers*, (the "Guidance"), principally intended for automated advisers that provide services directly to clients over the Internet ("robo-advisers"). The Guidance states that robo-advisers are typically registered investment advisers that use technologies "to provide discretionary asset management services to their clients through online algorithmic-based programs."

The stated purpose of the Guidance is to remind robo-advisers of certain unique considerations that may apply to their business under the Advisers Act. The Guidance recognizes that robo-advisers' different business models may affect the applicability of the Guidance, providing suggestions about how robo-advisers can satisfy their Advisers Act obligations. The Guidance categorizes its suggestions into three categories:

1. The substance and presentation of disclosures to clients about the robo-adviser and the investment advisory services it offers;

2. The obligation to obtain information from clients to support the robo-adviser's duty to provide suitable advice; and

3. The adoption and implementation of effective compliance programs reasonably designed to address particular concerns relevant to providing automated advice.

The suggestions in the Guidance for each of these three categories are summarized below.

Substance and Presentation of Disclosures

Robo-advisers rely principally on algorithms and the Internet to provide advisory services with limited, if any, human interaction and, therefore, the Guidance recommends that robo-advisers consider the most effective way to communicate to their clients required disclosures regarding their advisory services. When designing disclosures, the Guidance recommends that it may be useful for a robo-adviser to consider how it explains its business model and the scope of the investment advisory services it provides, as well as how it presents material information to clients.

Explanation of Business Model

The Guidance states that, in addition to other required information, a robo-adviser should consider disclosing information regarding its particular business practices and related risks. The Guidance provides the following examples:

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- A statement that an algorithm is used to manage individual client accounts;
- A description of the algorithmic functions used to manage client accounts – *i.e.*, that an algorithm generates recommended portfolios, and that client accounts are invested and rebalanced by the algorithm;
- A description of the assumptions and limitations of the algorithm used by the adviser;
- A description of the particular risks arising from the use of an algorithm to manage client accounts (*e.g.*, rebalancing client accounts without regard to current market conditions);
- A description of circumstances that might cause the robo-adviser to override the algorithm used to manage client accounts (*e.g.*, the robo-adviser might halt trading or take other temporary defensive measures in stressed market conditions);
- A description of any conflicts of interest arising from a third party's involvement in the development, management, or ownership of the algorithm used to manage client accounts, including an explanation of any conflicts of interest the third party's involvement may create (*e.g.*, the algorithm directs clients into products from which the third party earns a fee);
- An explanation of fees a client will be charged directly by the robo-adviser, and of any other costs that the client may bear either directly or indirectly;
- An explanation of the degree of human involvement in the oversight and management of individual client accounts;
- A description of how the robo-adviser uses the information gathered from a client to generate a recommended portfolio and any limitations arising from the adviser's approach; and
- An explanation of how and when a client should update information he or she has provided to the robo-adviser.

Scope of Advisory Services

The Guidance cautions robo-advisers to use reasonable care to avoid creating a false implication about the scope of services they provide clients. The Guidance provides the following examples of potential false implications:

- The robo-adviser is providing a comprehensive financial plan if it is not, in fact, doing so;
- A tax-loss harvesting service also provides comprehensive tax advice; or
- Information other than that collected by the questionnaire is considered when generating investment recommendations if such information is not, in fact, considered.

Presentation of Disclosures

The Guidance notes that robo-advisers utilize a variety of practices in providing important information to their clients. Because of robo-advisers' reliance on online disclosures to provide such information, the Guidance states that unique issues arise in communicating important information to clients. Therefore, the Guidance reminds robo-advisers to consider the effectiveness of their written disclosures and, in particular, the Guidance lists these considerations:

- Whether key disclosures are presented prior to enrolling clients so that necessary information is available to clients before they make any investments with the robo-adviser;
- Whether key disclosures are specially emphasized;

- Whether some disclosures should be accompanied by interactive text or other means to provide additional details to clients who are seeking more information (*e.g.*, through FAQs); and
- Whether the presentation of disclosure made available on a mobile platform has been adapted for that platform.

Provision of Suitable Advice

This portion of the Guidance focuses on the information relied upon by a robo-adviser to support its reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives.

Reliance on Questionnaires to Gather Client Information

Robo-advisers may provide investment advice based primarily, if not solely, on client responses to online questionnaires, which vary from adviser to adviser. The Guidance recommends that, given the limited interaction a robo-adviser has with a client, a robo-adviser should consider the following factors:

- Whether the questions elicit sufficient information to allow the robo-adviser to conclude that its recommendations and ongoing advice are suitable and appropriate for each client;
- Whether the questions are sufficiently clear, including whether the questionnaire seeks clarification or provides examples to clients when necessary; and
- Whether steps are taken to address inconsistent client responses.

Client-Directed Changes in Investment Strategy

Robo-advisers may provide clients with the ability to deviate from a recommended portfolio, without consultation with investment advisory personnel. The Guidance recommends that a robo-adviser consider providing commentary about why it believes the recommended portfolio may be more appropriate in light of a given investment objective and risk profile, including pop-up boxes or other design features that could alert a client to an inconsistency between a stated investment objective and the chosen investment portfolio.

Effective Compliance Programs

The final portion of the Guidance reminds a robo-adviser to be mindful of the unique aspects of its business model in designing its compliance program required by Rule 206(4)-7 under the Advisers Act. In particular, the Guidance recommends that robo-advisers should consider whether to adopt and implement written policies and procedures that address the following areas:

- The development, testing, and backtesting of its algorithm code and post-implementation monitoring of its performance;
- The disclosure to clients of any changes to the adviser's algorithm code that may have a material effect on their portfolios;
- The oversight of any third party that develops or manages the algorithm or software modules utilized by the robo-adviser;
- The prevention and detection of, and response to, cybersecurity threats;
- The use of social/electronic media to market its advisory services; and

- The protection of client accounts and key advisory systems to assure business continuity.

SEC Provides Guidance Regarding Rule 3a-2 and Holding Companies

The SEC's Division of Investment Management recently issued a Guidance Update, *Holding Companies and the Application of Rule 3a-2 Under the Investment Company Act* (the "IM Guidance") to make Rule 3a-2 – the transient investment company exclusion – more available to holding companies that are engaged in various operating businesses through wholly-owned and majority-owned subsidiaries ("Holding Companies") that experience an "extraordinary event."[1]

Background. Rule 3a-2 provides a one-year safe harbor exclusion from the definitions of investment company within Sections 3(a)(1)(A) and (C) of the 1940 Act. Rule 3a-2's one-year exclusion begins to run upon the earlier of:

i. the date on which an issuer owns securities and/or cash having a value exceeding 50% of the value of such issuer's total assets on either a consolidated or unconsolidated basis ("50% Threshold"), or

ii. the date on which an issuer owns *investment securities* having a value exceeding 40% of the value of such issuer's total assets (excluding government securities and cash items) on an unconsolidated basis ("40% Threshold").

The Problem. Holding Companies, by their nature, frequently cross the 50% Threshold without the occurrence of an extraordinary event. In contrast, as the IM Guidance notes, the occurrence of an extraordinary event may result in a Holding Company's owning a significant amount of securities issued by entities that are not majority-owned subsidiaries of the Holding Company (*i.e.*, securities that are "investment securities") and holding investment securities in excess of the 40% Threshold. If, at the time of such an event, the Holding Company were to look to Rule 3a-2's one-year safe-harbor, the Holding Company, because it may have already crossed the 50% Threshold, could be deemed to have "run out the clock on its one-year period before ever needing to rely upon [R]ule 3a-2."

The Guidance. The IM Guidance states that it is the staff's view that, when adopting Rule 3a-2, the SEC did not intend to treat Holding Companies differently from other issuers. Accordingly, the IM Guidance, in effect, removes for Holding Companies the 50% Threshold as an event that triggers the clock running on the one-year safe harbor. Instead, in the case of a Holding Company, the IM Guidance provides that Rule 3a-2's one-year safe harbor does not begin until the occurrence of an extraordinary event.

REGULATORY PRIORITIES CORNER

The following brief updates exemplify trends and areas of current focus of relevant regulatory authorities:

SEC Publishes a List of the Top Five Compliance Deficiencies

On February 7, 2017, the SEC's Office of Compliance Inspections and Examinations published a risk alert, *The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers* (the "Alert"). The Alert categorizes the compliance deficiencies in five categories and, within each category provides examples, as summarized below:

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[1] The IM Guidance provides the following examples of extraordinary events, which the IM Guidance states "may help to facilitate capital formation" – investing its offering proceeds in securities while arranging to acquire a new majority-owned subsidiary; selling a large operating division and investing the proceeds in securities pending acquisition of a new majority-owned subsidiary; and making a tender offer to stockholders of a non-investment company and failing to obtain a majority of the target company's stock.

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Compliance Rule, including (i) compliance manuals that are not reasonably tailored to the adviser's business practices, (ii) failure to conduct annual reviews of the adviser's written policies and procedures, as required by Rule 206(4)-7 under the Advisers Act, (iii) among advisers that conducted annual reviews, failure to address the adequacy of the advisers' policies and procedures and the effectiveness of their implementation or to address problems identified in the review, (iv) advisers not following their own compliance policies and procedures and (v) policies and procedures that are not kept current.

Regulatory Filings, including advisers (i) making inaccurate disclosures in their Form ADVs or not promptly amending their Form ADVs when certain information became inaccurate; (ii) filing Form PFs that were incomplete or inaccurate or not filed on time and (iii) filing Form Ds that were incomplete or inaccurate and not filed on time.

Custody Rule, including advisers (i) not recognizing that they may have custody due to online access to client accounts, (ii) with surprise examinations (for advisers with custody) that do not meet the requirements of Rule 206(4)-2 under the Advisers Act and (iii) not recognizing that they may have custody as a result of certain authority over client accounts.

Code of Ethics under Rule 204A-1, including (i) codes that did not identify access persons or failed to specify required information, (ii) codes that did not specify review of the holdings and transactions reports or did not identify the specific submission timeframes, as required by the rule, (iii) access persons submitting transactions and holdings less frequently than required by the rule and (iv) advisers not describing their codes in their Part 2A of Form ADVs and not indicating that their code was available to any client or prospective client upon request.

Required Books and Records Rule, including advisers' (i) failures to maintain all required records, (ii) failures to maintain books and records that are accurate and updated and (iii) maintaining contradictory information in separate sets of records.

SEC Issues Information Update on Obtaining Letters to Support Tax Claims in Foreign Jurisdictions

Recently, the SEC's Division of Investment Management published an Information Update, *Information Letters to Support Foreign Tax Claims* (the "Information Update"), to assist registered funds in obtaining foreign tax refunds. The Information Update reports that, since late 2015, the Division has been providing U.S.-registered funds with letters addressed to foreign jurisdictions to assist such funds in obtaining refunds of any foreign taxes that were inappropriately withheld.

The purpose of the Information Update is to provide U.S.-registered funds with a framework for making requests for such letters from the Division. The Information Update requests, for funds that may have similar outstanding tax claims seeking a letter from the Division, that draft letters should be submitted to the Division. The Information Update specifies the recommended contents of the draft letters and the supporting documentation that should accompany the draft letters. Finally, the Information Update provides a special SEC email address to which the draft letters and supporting documentation should be submitted.

OTHER DEVELOPMENTS

Since the last issue of our Investment Management Update, we have also published the following separate Alerts of interest to the investment management industry:

Department of Labor Delays Fiduciary Rule for 60 Days

April 5, 2017

On April 4, 2017, the U.S. Department of Labor issued a final rule delaying the applicability date of its fiduciary rule from April 10, 2017 to June 9, 2017 – the 60-day delay it proposed at the end of February. The rule also delays to June 9, 2017 certain transitional requirements under the Best Interest Contract Exemption (the "BIC") and other new or revised prohibited transaction exemptions; however, it does not delay the compliance date for the "full" BIC, which remains January 1, 2018.

Separately Managed Accounts – SEC Provides Guidance on "Inadvertent" Custody and Reliance on Standing Letters of Authorization

April 5, 2017

The SEC's Division of Investment Management recently published a three-page Guidance Update, *Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority* (the "Guidance"). The purpose of the Guidance is to caution registered investment advisers that, for purposes of Rule 206(4)-2 under the Advisers Act (the "Custody Rule"), an adviser may have custody of a client's funds or securities when a custody agreement between a client and a custodian grants an adviser greater access to the client's funds or securities than the adviser's agreement with the client. The Guidance calls this situation "inadvertent custody" and notes that inadvertent custody subjects an adviser to the Custody Rule's surprise examination requirements. Inadvertent custody is most likely to arise with respect to a separately managed account because the custodian of a separately managed account is typically hired by the client.

SEC Approves U.S. Master Fund/Foreign Feeder Fund Arrangement – Section 12(d)(1)(E)

April 4, 2017

On March 8, 2017, the SEC staff issued a no-action letter (the "Letter") providing assurance with respect to a plan for foreign-regulated investment companies ("Foreign Feeder Fund") to invest exclusively in corresponding SEC-registered open-end master funds ("U.S. Master Fund"). The no-action assurance was conditioned upon compliance with the requirements of Section 12(d)(1)(E) of the 1940 Act, as modified by the Letter.

2017 ICI Mutual Funds and Investment Management Conference

April 3, 2017

Ropes & Gray's memorandum summarizing the 2017 ICI Mutual Funds and Investment Management Conference sponsored by the ICI and the FBA is available at the hyperlink, above. The Conference included sessions that discussed the following regulatory developments, among others:

- The changing legislative and regulatory landscape in light of the new presidential administration and new Congress, including a discussion of how changes in legislative and regulatory priorities may affect the regulated fund industry and fund investors.

- The SEC's examination and enforcement focus areas over the past year, and expected focus areas in the coming year.
- The preparations needed for the SEC's liquidity risk management rule.
- Dodd-Frank Act derivatives reform rulemaking, including congressional efforts to amend the Dodd-Frank Act, potential regulatory changes, and effects on the global derivatives markets.
- The Department of Labor's fiduciary rule, its implications for financial services providers, and the prospect for changes under the new administration.

SEC's Information Update for Advisers Relying on the Unibanco No-Action Letters

March 24, 2017

The SEC's Division of Investment Management published a four-page Information Update for Advisers Relying on the Unibanco No-Action Letters (the "Update"). The stated purpose of the Update is to inform multi-national financial firms that rely on the Unibanco letters about what information, if any, should be submitted to the SEC to address the representations and undertakings required by the Unibanco letters.

Department of Labor Adopts Temporary Non-Enforcement Policy for Fiduciary Rule

March 13, 2017

On March 10, 2017, the U.S. Department of Labor (the "DOL") issued Field Assistance Bulletin No. 2017-01, announcing a temporary non-enforcement policy for non-compliance with its fiduciary rule. This Alert discusses the DOL's non-enforcement policy.

Another Court Rejects Excessive Fee Claims Following Trial on Mutual Fund "Manager of Managers" Theory

March 7, 2017

On February 28, 2017, Judge Renée Bumb of the New Jersey federal district court entered judgment in favor of Hartford Funds Management Group, Inc. ("Hartford") following last November's four-day bench trial relating to plaintiffs' allegations of excessive fees under Section 36(b) of the Investment Company Act of 1940. The Hartford case is the second to proceed to trial after the Supreme Court's 2010 decision in *Jones v. Harris Associates L.P.*, which established the standard by which courts assess allegations that investment advisers charge mutual fund investors excessive fees. Although the court had declined to grant summary judgment in Hartford's favor, Judge Bumb's trial decision embraces several helpful principles – including its recognition of the adviser's right to earn a reasonable profit, the various risks borne by sponsoring investment advisers, and the legitimacy of Lipper comparisons.

FCA Issues Press Releases On Best Execution and Dealing Commission

March 7, 2017

The UK's Financial Conduct Authority issued two important press releases on March 3, 2017, outlining its findings from its recent supervisory work on firms' use of dealing commission and firms ensuring effective oversight of best execution.

Department of Labor Proposes 60-day Delay of Fiduciary Rule

March 3, 2017

On March 1, 2017, the U.S. Department of Labor (the "DOL") published a proposed rule that would delay the applicability date of its fiduciary rule from April 10, 2017 to June 9, 2017 (a 60-day delay). The proposed rule calls for a 15-day comment period on the proposed 60-day delay, including on the appropriate length of the delay and on whether the entire rule should be delayed or whether the delay should apply only to certain aspects of the rule, such as notice and disclosure provisions. During this 15-day comment period, uncertainty will remain regarding whether compliance will be required on April 10, 2017, and any delay will not be official until less than one month before the current compliance date. Individual institutions and advisers will need to decide whether to move forward with their compliance plans in light of this uncertainty or to stop working on compliance in anticipation of a potential delay. Adding to this uncertainty, it is also possible that the DOL may seek to delay the compliance date further in the future.

CFTC Proposes Updated Recordkeeping Rules

March 3, 2017

The Commodity Futures Trading Commission (the "CFTC") recently proposed certain amendments to Regulation 1.31 ("§1.31"), which sets forth requirements for records required to be kept under the Commodity Exchange Act and CFTC regulations. The proposed amendments would affect all persons required to maintain records under CFTC rules, including asset managers registered as commodity pool operators and commodity trading advisors, as well as certain other persons who trade commodity interests on U.S. markets. The proposal grants welcome relief from outdated requirements of the current rule and aims to make recordkeeping requirements technology-neutral in order to accommodate future advances. The CFTC requested comments on many issues. Comments are due by March 20, 2017.

UK Treasury Confirms Change to the Regulated Activities Order

February 28, 2017

The UK Treasury confirmed today that it will amend Article 53 of the Regulated Activities Order (covering the regulated activity of "advising on investments") to bring it into line with the definition of "giving investment advice" under the EU Markets in Financial Instruments Directive ("MiFID"). This means that, once the change is in effect, a firm will only be providing investment advice under Article 53 of the Regulated Activities Order when it gives a "personal recommendation" that is presented as suitable for the person to whom it is made or that is based on an investor's circumstances. This will replace the broader definition of advising on investments, which did not depend on the advice amounting to a personal recommendation or being based on an investor's circumstances.

CPOs of Registered Investment Companies Granted Limited Relief from CFTC Liquidation Audit Requirements

February 22, 2017

The U.S. Commodity Futures Trading Commission (the "CFTC") Division of Swap Dealer and Intermediary Oversight (the "Division") recently issued Letter 17-04 (the "Letter"), which grants relief from certain financial disclosure obligations to a registered commodity pool operator ("CPO") of an investment company registered under the Investment Company Act of 1940 ("RIC"). Specifically, where not all series of a RIC are liquidating, the Letter exempts the CPO of a liquidating series from the investor waiver provisions of CFTC Rule 4.22(c)(7), such that the

CPO may provide to investors and the National Futures Association unaudited liquidation financial statements in accordance with CFTC Rule 4.22(c)(7).

CFTC Extends Deadline for Notice Filings under Amended Position-Limit Aggregation Rules

February 7, 2017

On February 6, 2017, the Division of Market Oversight of the U.S. Commodity Futures Trading Commission (the "CFTC") issued temporary no-action relief from the notice filing requirements applicable to persons who rely on certain exemptions from aggregation for position-limit purposes. The relief extends the compliance date for notice filings under CFTC Rule 150.4 from February 14, 2017 to August 14, 2017.

If you would like to learn more about the developments discussed in this Update, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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