October 11, 2017

Ropes & Gray's Investment Management Update: August – September 2017

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

SEC Extends Relief Under Loan Rule No-Action Letter

On September 22, 2017, the staff of the SEC's Division of Investment Management published a no-action letter to the Fidelity Group that extends the temporary no-action assurance provided in a 2016 no-action letter with respect to the independence of a fund's auditor under the so-called "Loan Rule" (described below). There is no specified expiration date in the September letter, which instead provides that "this letter will be withdrawn upon the effectiveness of any amendments to the [Loan Rule] designed to address the concerns expressed in the [2016 no-action letter]."

In the 2016 Fidelity Group no-action letter (the "2016 Letter"), the SEC staff provided temporary no-action assurance to the Fidelity Group applicable to registered investment companies (each, a "Fund") and other entities (each, an "Entity") within the Fidelity Group whose financial statements are audited by a public accounting firm that is not "independent" from the Funds because of non-compliance with Rule 2-01(c)(1)(ii)(A) of Regulation S-X (the "Loan Rule"). The Letter stated that the SEC staff would not recommend enforcement action against any Fund or Entity that continues to rely on financial statement certifications from an accounting firm that is not in compliance with the Loan Rule in circumstances described in the 2016 Letter. The 2016 Letter was set to expire in eighteen months.

The extension of the 2016 Letter's no-action assurances resolves the legal uncertainty faced by the Fidelity Group and other similarly situated fund families. The additional statement in the September letter – that the extension will remain in place until the effective date of amendments to the Loan Rule designed to address the concerns expressed in the 2016 Letter – underscores that the SEC staff realizes that, at least as applied to fund complexes (and consistent with the industry's position), the Loan Rule is overbroad. In that vein, the SEC's current 2017 Regulatory Flexibility Agenda refers to rulemaking concerning the Loan Rule (available here).

Out-Sourced CCO Settles Allegations Regarding Form ADV Failures

Echoing a November 2015 Risk Alert from the SEC's Office of Compliance Inspections and Examinations ("OCIE") described below, on August 15, 2017, the SEC published a settlement order with David I. Osunkwo, formerly a principal with Strategic Consulting Advisors, LLC ("SC Consulting"), a provider of third-party compliance consulting and outsourced CCO services to investment advisers. The order concerned the Form ADV filings of two registered investment advisers under common control, Aegis Capital, LLC ("Aegis") and Circle One Wealth Management, LLC ("Circle One"). According to the order, (1) Aegis failed to file an annual update to its Form ADV for the 2010 fiscal year and (2) the annual amendment to Circle One's Form ADV in 2011, which purported to reflect the merger of Aegis and Circle One, materially overstated the assets under management ("AUM") and combined number of client accounts of the merged advisers. The order stated that the amended Form ADV identified the AUM of the combined entities as $182 million and number of client accounts as 1,289 advisory accounts, while the true AUM were $63 million and the number of client accounts was less than 300.

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According to the order, Mr. Osunkwo represented SC Consulting, which had contracted to provide certain compliance services to Aegis and Circle One and to designate Mr. Osunkwo as CCO for the two advisers. In preparing the 2011 amendment to the Form ADV, Mr. Osunkwo relied on an email from the Chief Investment Officer of Aegis and Circle One's parent company (the "CIO") for the faulty AUM and client-account numbers, which the CIO had labeled as estimates. Further, under time pressure to file the Form ADV, Mr. Osunkwo adopted these estimates without taking "sufficient steps to ascertain their accuracy," and listed the CIO as the signatory certifying the Form ADV without the CIO's consent, thereby causing the Form ADV to falsely represent that the CIO attested to the accuracy of that information.

The order concluded that that Mr. Osunkwo willfully violated Section 207 of the Investment Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission under Section 203, or 204…" Without admitting or denying the order's findings, Mr. Osunkwo agreed to pay a civil penalty of $30,000 and to be barred from association with any broker-dealer, investment adviser, registered investment company or transfer agent for a period of twelve months.

Prior Risk Alert. In November 2015, OCIE issued a Risk Alert (the "Alert") (not cited in the settlement order above, but described in Ropes & Gray's Update here) to raise awareness of potential compliance issues arising from the growing trend in the investment management industry of outsourcing compliance activities, including outsourcing the role of adviser or fund CCO. The Alert shared OCIE staff's observations from nearly 20 examinations of advisers and funds that outsourced their CCOs to unaffiliated third parties ("outsourced CCOs"). Among the Alert's general observations were (1) registrants relying on outsourced CCOs who have frequent and personal interaction with adviser and fund employees tend to have fewer inconsistencies between their compliance policies and procedures and their actual business practices and (2) more significant compliance issues were identified at registrants with an outsourced CCO who also served as outsourced CCO for multiple registrants and who did not appear to have adequate resources.

Political Information – SEC Settles with Adviser Lacking Adequate Controls to Prevent Insider Trading

On August 21, 2017, the SEC published a settlement order with Deerfield Management Company, L.P. ("Deerfield"), a registered investment adviser to several private funds, regarding allegations that Deerfield had failed to establish and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.

According to the order, from 2012 to 2014, Deerfield retained research firms, particularly those specializing in political intelligence. During this period, a political intelligence analyst at one of the retained firms provided Deerfield analysts material, nonpublic information regarding three confidential decisions by the Centers for Medicare and Medicaid Services before the decisions were publicly announced. Deerfield analysts made trading recommendations based on the information, resulting in Deerfield making trades that resulted in profits of more than $3.9 million for the private funds that it advised.

The order noted that Deerfield's compliance manual described the risk regarding the misuse of material, nonpublic information by the firm or its employees. The manual also established procedures for the use of "experts" and "expert networks" but, according to the order, Deerfield did not apply these procedures to a broad category of "research firms," including those that employed political intelligence analysts.

The order concluded that Deerfield had willfully violated Section 204A of the Investment Advisers Act, which requires investment advisers to establish and enforce written policies and procedures reasonably designed "to prevent the misuse . . . of material nonpublic information by such investment adviser or any person associated with such investment adviser." Without admitting or denying the order's findings, Deerfield agreed to disgorge more than $800,000 including interest, and to pay a civil money penalty of $3.9 million.

The Deerfield matter highlights that political information concerning pending regulatory actions that will affect issuers may be treated by the SEC staff as material, nonpublic information about a specific issuer. Compliance policies and procedures may be expected to capture political information and, more generally, should be reviewed and updated to capture all routes by which information flows into an adviser firm.

REGULATORY PRIORITIES CORNER

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

SEC Gives ETFs Three-Month Extension to Comply with Continued Listing Standards

In 2016, Bats BZX Exchange, Inc., The NASDAQ Stock Market LLC, and NYSE Arca, Inc. (each an "Exchange" and, collectively, the "Exchanges") each proposed rule changes concerning (1) continued listing standards for exchange-traded products ("ETPS"), including ETFs, and (2) procedures that the Exchanges would follow when an ETP no longer complied with the relevant Exchange's continued listing standards. The proposed rules required, for the first time, *continued* listing standards on ETFs identical to the ETFs' *initial* listing standards. The proposed rules were requested from the Exchanges by the staff of the SEC's Office of Trading and Markets, which cited concerns regarding potential manipulation of ETPs. The rule changes were to go into effect on October 1, 2017.

On September 29, 2017, each Exchange filed with the SEC a proposal to extend the compliance date for the rule changes to January 1, 2018. In their proposals, each Exchange cited the comments received from sponsors of ETPs, industry advocacy groups and index providers to the effect that additional time was required to design and implement new compliance systems. In addition, issuers stated that they required time to complete discussions with third parties that provide and track data needed to assure compliance with the rule changes.

OCIE Risk Alert – Advertising Rule Issues Identified in Adviser Examinations

On September 14, 2017, OCIE issued a Risk Alert (the "Alert") listing the compliance issues relating to Rule 206(4)-1 (the "Advertising Rule") under the Investment Advisers Act that OCIE most frequently identified in deficiency letters sent to registered investment advisers. The stated purpose of the Alert is to assist advisers in adopting and implementing effective compliance programs.

The following are the deficiencies most frequently observed by OCIE staff in connection with advisers' failure to comply with the Advertising Rule:

1. ***Misleading Performance Results***. Advertisements that (1) present performance results without deducting advisory fees, (2) compare results to a benchmark without disclosing the limitations of such comparisons or (3) contain hypothetical and back-tested performance results without an explanation of how the results were derived and did not include other potentially material information regarding the performance results.

2. ***Misleading One-on-One Presentations***. Advertisements in one-on-one presentations that (1) advertise performance results (gross of fees) without including relevant disclosures (e.g., the fact that advisory fees are described in Part II of the adviser's Form ADV or a chart or table showing the effect an investment advisory fee, over a period of years, can have on the value of a portfolio) or (2) do not disclose that the advertised performance results do not reflect the deduction of advisory fees, which would reduce client returns.

3. ***Cherry-Picked Profitable Stock Selections***. Advertisements that include only an adviser's profitable stock selections or recommendations in presentations, client newsletters or adviser websites.

4. ***Misleading Selection of Recommendations***. Advertisements illustrating a particular investment strategy that disclose past specific investment recommendations that include only some, but not all, recommendations, and that do not satisfy the representations upon which the staff of the SEC's Division of Investment

Management based no-action assurances in *The TCW Group*, SEC No-Action Letter (pub. avail Nov. 7, 2008) or *Franklin Management, Inc.*, SEC No-Action Letter (pub. avail. Dec. 10, 1998).

a. *The TCW Group* no-action letter allowed an adviser to advertise the five (or more) best performing holdings along with an equal number of worst performing holdings, subject to certain representations in the no-action letter. (*e.g.*, maintaining records that evidence the criteria used to select the specific securities listed in each best/worst-performers chart). OCIE staff observed advertisements that appear inconsistent with the these representations, including the use of advertisements that include the best performers, without including the same number of the worst performers.

b. The *Franklin Management* no-action letter allowed an adviser to advertise past specific recommendations that were selected using consistently applied, objective, non-performance-based selection criteria, subject to additional representations. OCIE staff observed advertisements that appear inconsistent with these representations, including failures to disclose that the advertised specific recommendations do not include all securities recommended to clients during the relevant period, and discussing (contrary to the *Franklin Management* no-action letter's representations) the amount of profit or loss from any particular security identified in the advertisement.

5. ***Compliance Policies and Procedures***. Advisers that lack compliance policies and procedures reasonably designed to prevent deficient advertising practices. For example, advisers that do not have, or do not implement, policies and procedures (1) covering a process for review and approval of advertising materials, (2) for advertisements showing composite performance, determining which accounts were included or excluded from performance calculations or (3) confirming the accuracy of advertised performance results.

Separately, the Alert discussed the results of OCIE's 2016 "Touting Initiative," which examined the adequacy of disclosures provided by advisers to their clients in advertisements containing awards and ranking lists, or identifying professional designations. The Alert summarized the deficiencies observed by OCIE staff during the Touting Initiative:

1. ***Misleading Use of Third-Party Rankings or Awards***. Advisers that publish misleading advertisements that contain references to third-party awards or rankings but omit material facts about the awards or rankings:

    a. The awards or rankings were obtained by submitting false or misleading information in the applications for the awards and rankings.

    b. The rankings were stale (*e.g.*, issued by publications several years earlier, and the rankings were no longer applicable).

    c. The selection criteria for the awards or rankings, who created and conducted the survey or the fact that advisers pay to participate in or distribute the results of the survey.

2. ***Misleading Use of Professional Designations***. Advertisements and disclosures made in advisers' Form ADV Part 2B Brochure Supplements that contain misleading references to employee professional designations (*e.g.*, lapsed professional designations or designations without an explanation of the minimum qualifications required to attain the professional designations).

3. ***Prohibited Testimonials***. Advisers that publish statements of clients attesting to their services or otherwise endorsing the adviser.

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:

New Disclosure Requirements Applying to EU Fund Distribution in 2018

September 21, 2017

Asset managers located inside and outside the European Union ("EU") must comply with the new "point of sale" disclosure requirements that will apply when they distribute financial products, and investment services, to EU investors and clients. These requirements derive from the next iteration of the Markets in Financial Instruments Directive ("MiFID II") (effective January 3, 2018) and the EU Packaged Retail Investment and Insurance Products Regulation (effective December 31, 2017) (the "PRIIPs Regulation"). This Alert provides an overview of the impact on the new requirements that relate to fund distribution in the EU. The precise application of the rules will depend on the types of funds distributed in the EU, the distribution channels used, and the types of investors targeted.

Newly Adopted Fed Rules Will Limit Buy-Side Remedies in a Financial Institution Failure

September 13, 2017

The Board of Governors of the Federal Reserve System (the "Board") has adopted final rules that represent a significant shift in the terms of over-the-counter derivatives, repurchase and reverse repurchase transactions and securities lending transactions. These rules will require buy-side firms to relinquish certain termination rights that have long been part of bankruptcy "safe harbors" for these types of contracts under bankruptcy and insolvency regimes in many jurisdictions in order to continue trading with large financial institutions. The new rules will impact institutional investors, hedge funds, mutual funds, sovereign wealth funds and other buy-side market participants who enter into over-the-counter derivatives, repurchase and reverse repurchase transactions and securities lending transactions with large financial institutions.

Department of Labor Proposes 18-Month Delay in Applicability Date for Portions of Fiduciary Rule

September 1, 2017

On August 31, 2017, the U.S. Department of Labor (the "DOL") published proposed amendments to the Best Interest Contract Exemption and other exemptions that would delay the applicability date of many of the requirements for fiduciaries to comply with the fiduciary rule from January 1, 2018 until July 1, 2019. In the release, the DOL stated that the delay is primarily intended to give it more time to consider possible changes or alternatives to the rule and exemptions, and to coordinate with the SEC on any changes. The proposal also indicates that the DOL plans to release, in the near future, a new, "more streamlined" exemption based on new developments in the financial services industry. Comments are requested on the length and format of the delay (comments are due within 15 days of publication).

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