February 8, 2019

Ropes & Gray's Investment Management Update – December 2018-January 2019

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

SEC Settles Pay-to-Play Matter with Adviser

On December 18, 2018, the SEC issued an order in an administrative proceeding against an investment adviser (the "Adviser") for its alleged violations of Rule 206(4)-5 under the Advisers Act. Rule 206(4)-5 is intended to stop abuses involving campaign contributions by investment advisers or their "covered associates" to elected officials or candidates who can influence the selection of such advisers to manage the assets of government entities and public pension plans. In general, the rule bars advisers from providing compensated advisory services to government clients for the two-year period following a prohibited campaign contribution. Violation of the rule does not require a showing of a *quid pro quo* or an actual intent to influence an elected official or candidate.

According to the SEC, covered associates of the Adviser made campaign contributions to candidates for the offices of governor of Ohio and treasurer of Ohio. The governor and treasurer each appoint at least one member of the board of the state public pension system (the "Pension System Board"), and the governor appoints all of the members of the state public university's board of trustees (the "University Board"). Members of the Pension System Board have the ability to influence the selection of investment advisers for the state public pension system, and the University Board has the ability to influence the selection of investment advisers for the assets of the state public university.

The SEC asserted that, during the two-year period following the campaign contributions, the Adviser continued to provide investment advisory services for compensation to the state public pension system and to the state public university, thereby violating Rule 206(4)-5.

Without admitting or denying the SEC's findings, the Adviser consented to being censured and agreed to pay a civil penalty of $100,000.

California Requires Women Board Members

California recently amended its Corporations Code to require any publicly held corporation incorporated under California law, and any publicly held corporation whose principal executive office – as stated in its "SEC 10-K form" – is located in California, to have at least one woman director by December 31, 2019. Thereafter, the required minimum number of women directors increases, depending on the size of the board, with compliance required by December 31, 2021. The term "publicly held corporation" is defined in the statute to mean "a corporation with outstanding shares listed on a major United States stock exchange." The statute permits California's secretary of state (the "Secretary") to impose fines in the amount of $100,000 for the first violation of the statute, and $300,000 for each subsequent violation.

The California statute is likely to be challenged in court on equal protection and Commerce Clause grounds, among other theories, and that litigation may take years. The application of the statute to ETFs and exchange-listed closed-end funds, which do not file annual reports on Form 10-K (they file on Form N-CSR), is uncertain because the statute permits the Secretary to adopt regulations to implement the statute, and the Secretary's regulations may attribute a broad intent to the statute's use of the term "SEC 10-K form" to include other SEC annual reports.

Regulatory Priorities Corner

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

OCIE Announces 2019 Exam Initiatives and Priorities

On November 8, 2018, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert announcing OCIE's risk-based examination initiatives of mutual funds (including ETFs) and their advisers that fall within one or more of six categories:

1. Index funds that track custom-built indexes;
2. Smaller ETFs and/or ETFs with little secondary market trading volume;
3. Mutual funds with higher allocations to certain securitized assets;
4. Funds with aberrational underperformance relative to their peer groups;
5. Advisers relatively new to managing mutual funds; and
6. Advisers who provide advice to both mutual funds and private funds that have similar strategies and/or are managed by the same portfolio managers.

With the exception of the last category (side-by-side management), all of the Risk Alert's examination initiatives appeared in OCIE's *Examination Priorities for 2018* (published in February 2018). The Risk Alert describes OCIE's rationale for focusing on funds and advisers within each examination initiative category, as well as the types of information sought by OCIE from funds and advisers within each category.

On December 20, 2018, OCIE published its 2019 Examination Priorities. With respect to mutual funds and ETFs, OCIE stated it will continue to prioritize examinations of retail funds, the activities of their advisers and the oversight practices of fund boards. In particular, OCIE stated it will focus on funds and advisers that fall within the six categories identified in the November Risk Alert, described above.

No-Action Letter Harmonizes Regulation M Exemptions for ETFs

Background. The Exchange Act's Regulation M, consisting of Rules 100 – 105, operates around the time of a public distribution of securities, and is intended to protect the market from manipulation by persons who have an interest in the distribution (*e.g.*, underwriters, issuers and selling security holders). In particular, Rule 101 and Rule 102 regulate the activities of any "distribution participant," the issuer and selling shareholders (and their respective "affiliated purchasers") in a securities distribution.

Rule 101 and Rule 102 exempt redeemable securities issued by an open-end registered fund from their respective prohibitions. However, the SEC has historically taken the position that the exemptions do not apply to ETFs organized as open-end funds because ETF shares are not individually a "redeemable security" for purposes of Section 2(a)(32) of the 1940 Act (*i.e.*, only authorized participants may redeem ETF shares). Consequently, index-based ETFs have relied on class relief letters[1] to be excepted from Rules 101 and 102, thereby permitting (i) persons participating in the continuous distribution of shares of an ETF, including authorized participants and their affiliated purchasers, to bid for and purchase the ETF's shares and (ii) such persons to purchase the ETF's shares for investment purposes and to redeem shares (collectively, the persons in (i) and (ii), "Exempt Persons").

[1] *See, e.g.*, Letter from James A. Brigagliano, Acting Assoc. Dir., Div. of Mkt. Regulation, to Stuart M. Strauss, Esq., Clifford Chance US LLP (Oct. 24, 2006), available here.

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The class relief letters did not extend to *actively managed* ETFs. Therefore, actively managed ETFs instead rely on guidance issued in 2010 by the staff of the SEC Division of Trading and Markets (the "DTM") providing that an actively managed ETF and its Exempt Persons are exempt from Rules 101 and 102, provided the actively managed ETF satisfies certain conditions. This left a small gap, arising from minor differences between the conditions within the class relief letters (applicable to index-based ETFs) and conditions in the DTM's 2010 guidance (applicable to actively managed ETFs).

No-Action Letter. In a December 3, 2018 no-action letter, the DTM staff agreed that it would not recommend enforcement action under Rules 101 and 102 of Regulation M with respect to the index-based ETFs in the no-action letter and their respective Exempt Persons, provided the ETFs and their Exempt Persons satisfied the conditions applicable to actively managed ETFs, as set out in the DTM's 2010 guidance. Thus, the no-action letter levels the playing field under Regulation M for index-based and actively managed ETFs.

The no-action letter could become moot in the near future. Under the SEC's proposed ETF Rule, discussed in this Ropes & Gray Alert, each ETF share is defined as a "redeemable security" within the meaning of Section 2(a)(32). As noted above, redeemable securities issued by open-end registered funds are expressly exempt from Rules 101 and 102 of Regulation M.

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:

Podcast: Keeping Up with Recent Changes and Trends in Private Fund Regulation
January 17, 2019
This Ropes & Gray podcast series, which we expect to update periodically, highlights developments in Washington, D.C. that affect private funds and their legal, regulatory and compliance obligations. In the first episode of the series, hedge fund partner Joel Wattenbarger is joined by investment management counsel David Tittsworth to discuss relevant SEC rulemakings, enforcement and inspection issues, as well as developments on Capitol Hill, including impacts of the partial government shutdown.

SEC Provides Custody Rule No-Action Letter Concerning Adviser's Administrative Services Loan Syndication Business
January 9, 2019
On December 20, 2018, the SEC staff issued a no-action letter to Madison Capital Funding LLC ("Madison"), a registered investment adviser, concerning the administrative agent services Madison performs for its loan syndication business, which includes commingling advisory client assets with non-client assets in a single account (the "Agency Account"). The SEC staff agreed not to recommend enforcement action under Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder (the "Custody Rule"), notwithstanding the facts that Madison's use of the Agency Account did not comply with Custody Rule provisions 206(4)-2(a)(1) and 206(4)-2(a)(3). However, the no-action position required that Madison satisfy various conditions set forth in the no-action letter.

The New Year Rings in New Requirements for NFA Member Asset Managers
January 9, 2019
In the final weeks of 2018, the National Futures Association ("NFA") issued new requirements applicable to asset managers who are members of the NFA that will take effect in 2019. First, the NFA amended its Interpretive Notice 9070, "NFA Compliance Rules 2-9, 2-36 and 2-49: Information Systems Security Programs" (the "Cybersecurity Notice"). The amended Cybersecurity Notice adds an NFA notification obligation, employee training requirements, and specific approval procedures to the written information systems security program ("ISSP") required of each NFA member firm (a "firm") under the original Cybersecurity Notice issued in 2016. In addition, Interpretive Notice "NFA Compliance Rule 2-9: CPO Internal Controls System" (the "Internal Controls Notice") requires commodity pool operator ("CPO") members to establish a system of internal controls and provides guidance on designing and implementing such

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controls. The Cybersecurity Notice will become effective on April 1, 2019, and we expect the Internal Controls Notice to be effective on April 1 or soon thereafter.

SEC Proposes Changes for Fund of Funds Arrangements
January 3, 2019
On December 19, 2018, the SEC issued a release (the "Release") proposing new Rule 12d1-4 and related amendments under the 1940 Act intended to enhance and streamline the regulation of funds that invest in other funds ("fund of funds arrangements"). The Release noted that the current combination of statutory exemptions, SEC rules and exemptive orders has created a regime in which substantially similar fund of funds arrangements are subject to different conditions. The Release's proposals are intended to replace the existing regime in order "to create a more consistent and efficient regulatory framework for fund of funds arrangements." Nonetheless, if Rule 12d1-4 is adopted as proposed, we expect that many existing fund of funds arrangements would need to be restructured.

Happy New Year: Proposed Volcker Rule Regulation Would Ease Hedge Fund and Private Equity Fund Name-Sharing Restrictions
January 2, 2019
The Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"), enacted on May 24, 2018, amended section 13 of the Bank Holding Company Act ("BHC Act") (a section of the BHC Act commonly known as the "Volcker Rule") by modifying the definition of "banking entity," to exclude certain small banks from the Volcker Rule's restrictions and by permitting a banking entity to share a name with a hedge fund or private equity fund that it organizes and offers under certain circumstances. On December 21, hours before the federal government shut down, the Department of Treasury, Federal Reserve System, OCC, FDIC, SEC, and CFTC (the "Agencies") proposed to amend their respective Volcker Rule regulation's definition of banking entity to conform to the provisions of the EGRRCPA.

SEC Issues Risk Alert on Adviser Personnel's Use of Electronic Messaging
December 18, 2018
On December 14, 2018, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert to share its observations from a recent exam initiative that focused on investment adviser personnel's use of electronic messaging for business purposes. OCIE's examination initiative specifically highlighted whether and to what extent advisers complied with the relevant rules – including Rule 204-2 (the "Books and Records Rule") and Rule 204-2(a)(11) (the "Advertisements Recordkeeping Rule") – and whether advisers had adopted and implemented relevant policies and procedures to comply with their obligations under the Books and Records Rule and the Advertisements Recordkeeping Rule.

U.K. Financial Regulator Flags Deficiencies in Firms' Cyber Practices
December 13, 2018
A review of the U.K. asset management and wholesale banking sectors by the Financial Conduct Authority ("FCA") has found that regulated firms struggle to identify and respond to the specific cyber risks facing their businesses. In a report released on Monday, December 10 (the "Report"), the FCA detailed the findings of a multi-firm review it conducted in late 2017 and early 2018 of 20 firms varying in size, structure and business model. The firms surveyed had assets under management ranging from £15 billion to £500 billion and services ranging from boutique offerings to full-service models. The aim of the review was to help assess how firms oversaw and managed risk in this area, how they identified and mitigated risk and their capability to respond and recover from attacks.

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