June 5, 2019

Ropes & Gray's Investment Management Update – April-May 2019

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

Actions at the SEC's June 5, 2019 Meeting

As we prepared this Update for distribution, at its June 5 meeting, the SEC finalized or published the following items. These items will be the subject of separate Ropes & Gray Alerts in the near future.

1. ***Regulation Best Interest*** – Standard of Conduct for Broker-Dealers, applicable when a broker-dealer and its associated persons make a recommendation to a retail customer of any securities transaction or investment strategy involving securities.

2. ***Form CRS Relationship Summary***, requiring registered investment advisers and registered broker-dealers to provide a brief relationship summary to retail investors.

3. ***Standard of Conduct for Investment Advisers***, an SEC interpretation of the standard of conduct for investment advisers.

4. ***Interpretation of "Solely Incidental"*** – An SEC interpretation of the solely incidental prong of Section 202(a)(11)(C) of the Investment Advisers Act.

SEC Issues Exemptive Order for Precidian Actively Managed, Non-Transparent ETFs

On May 20, 2019, the SEC issued an exemptive order (the "Order") permitting registered open-end investment companies that are actively managed ETFs advised by Precidian Funds LLC (each an "ActiveShares ETF"), to operate without being subject to the daily portfolio transparency condition of existing actively managed ETF exemptive orders. The Order also contains conditions, not present in prior ETF orders, designed to assure the efficient operation of the arbitrage mechanism and minimize risks associated with the unique structure. The principal conditions are as follows:

1. An ActiveShares ETF must publish a verified intraday indicative value (VIIV), reflecting the value of its portfolio holdings, calculated every second (instead of every 15 seconds for existing ETFs), at the mid-point of the national best bid and offer (NBBO) of the securities in the portfolio at the prior day's close.

2. An Authorized Participant (an "AP") purchases and redeems shares through an AP representative ("APR"), a broker-dealer that is unaffiliated with the AP and that (i) knows, and must keep confidential, the composition of each ActiveShares ETF's creation basket and (ii) effects purchases and redemptions in an ActiveShares ETF's shares upon an AP's instructions without disclosing the identity and weighting of the ActiveShares ETF's holdings to the AP. Thus, in the case of a creation, an AP delivers to its APR the cash necessary to purchase the basket of securities to be exchanged for the shares of the ActiveShares ETF. In the case of a redemption, the ActiveShares ETF delivers a basket of securities to the APR, which, in turn, sells the securities in exchange for cash on behalf of the AP.

3. An ActiveShares ETF may only hold securities that trade on a U.S. or foreign exchange contemporaneously with the ActiveShares ETF's shares (*e.g.*, ETFs, exchange-traded notes, common stocks, American depositary receipts (ADRs), exchange-traded preferred stocks, real estate investment trusts (REITs), commodity pools,

metal trusts, currency trusts and futures). An ActiveShares ETF may not hold short positions, which may affect its ability to engage in certain hedging activities, and an ActiveShares ETF may not acquire illiquid investments or borrow for investment purposes.

4. Except in limited circumstances where purchases or redemptions may include cash, the creation and redemption baskets must be a *pro rata* representation of the portfolio holdings used to calculate an ActiveShares ETF's NAV that day. No intra-day changes to these baskets are permitted, except to correct errors.

5. An ActiveShares ETF must make prescribed disclosures, which are intended to draw an investor's attention to differences between the ActiveShares ETF and traditional ETFs.

In the application underlying the Order, the applicants stated that Precidian Funds LLC intends to enter into license agreements with other investment advisers that seek to launch new series operating as additional ActiveShares ETFs. These investment advisers will apply separately for exemptive relief from the SEC using a short-form application incorporating the terms and conditions of the Precidian application.

Note that other applications for exemptive relief for actively managed, non-transparent ETFs are currently under consideration by the SEC and may be granted in the future. In a separate Ropes & Gray Alert, we discuss why this structure may be attractive to many active managers, and that active equity managers may seek to offer their strategies as ETFs, including potentially through the conversion of an existing open-end fund into an ETF. The separate Alert provides a high-level overview of key considerations in converting an existing traditional open-end fund into an ETF.

SEC Staff Issues Statement on the Review of Rule 485(a) Filings

On April 3, 2019, the SEC's Division of Investment Management's Disclosure Review and Accounting Office ("DRAO") published a guidance document, ADI 2019-07 – Review of Certain Filings Under Automatic Effectiveness Rules (the "Guidance"), presenting DRAO's views regarding the operation of Rule 485(a) under the Securities Act. Rule 485(a) provides for the automatic effectiveness, without SEC staff action, of a post-effective amendment (a "PEA"), containing material changes to a registration statement of an existing open-end fund or unit investment trust, as early as 60 days after the PEA is filed. Rule 485(a) also provides for the automatic effectiveness of a PEA, filed by a registered open-end investment company to add a new series, as early as 75 days after the PEA is filed.

The Guidance states that automatic effectiveness under Rule 485(a) can present problems for the SEC staff when a filing raises complex issues for which there are no precedents. The Guidance notes that such filings typically involve novel investment strategies, fee structures or operational policies that may require additional review and interaction between disclosure reviewers and registrants. Therefore, the Guidance "urges" registrants that are planning to make a Rule 485(a) filing that "may raise material questions of first impression – or that address issues in a manner inconsistent with" precedent to contact the SEC staff before making their filings. The Guidance also requests, as a general matter, that registrants respond to SEC staff comments regarding a Rule 485(a) filing no later than five business days before the filing is scheduled to become effective automatically.

A footnote to the Guidance contains an additional noteworthy DRAO request. Specifically, if a registrant is unable to respond to SEC staff comments regarding a Rule 485(a) filing at least five business days before a PEA will become effective automatically, the Guidance requests that the registrant file an amendment under Rule 485(b)(1)(iii) to delay the date a PEA becomes effective automatically. The Guidance states that the purpose of this request is to provide additional time to resolve SEC staff comments.

Registrants are not required to accede to the Guidance's requests, which are at odds with the plain language of Rule 485(a). Nevertheless, for a variety of reasons, registrants may choose to accede to these requests.

Regulatory Priorities Corner

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

Changes to the SEC's Regulatory Agenda

In May, the federal Office of Information and Regulatory Affairs published the *Spring 2019 Unified Agenda of Regulatory and Deregulatory Actions* (available here), which includes the SEC's Current Agency Agenda (the "Agenda") and the SEC's Current Long Term Actions (the "Long-Term Actions"). Both the Agenda and the Long-Term Actions were last updated in November 2018, and the following items are changes to the Agenda and the Long-Term Actions of interest to the mutual fund/investment management industry. The items listed below reflect only the priorities of SEC Chairman Clayton and do not necessarily reflect the view and priorities of any other Commissioner.

New items on the Current Agenda

- *Amendments to the Custody Rules for Investment Companies and Investment Advisers*. The Division of Investment Management (the "Division") is considering recommending that the SEC propose amendments to rules concerning custody under the 1940 Act and the Advisers Act. This was a Long-Term Actions item in November 2018.

- *Amendments to Procedures for Applications Under the 1940 Act*. The Division is considering recommending that the SEC propose amendments to Rule 0-5 under the 1940 Act to establish an expedited review procedure for certain applications.

New item in the Long-Term Actions

- *Investment Company Summary Shareholder Report*. The Division is considering recommending that the SEC propose a new summary shareholder report under the 1940 Act.

Items dropped from the November 2018 Long-Term Actions

- *Investment Company Advertising, Target Date Retirement Fund Name and Marketing*. The Division was considering recommending that the SEC re-propose amendments to its advertising rules to require target date retirement funds' marketing materials to provide investors enhanced information about those funds.

- *Mandatory Electronic Submissions for Orders Under the Advisers Act and Confidential Treatment Requests Made on Form 13F*. The Division was considering recommending that the SEC propose to require electronic filing for applications of orders under any section of the Advisers Act and of confidential treatment requests for filings made under Section 13(f) of the Exchange Act. The Division also was considering a recommendation to permit an alternate format for submitting an application for orders under any section of the 1940 Act.

OCIE Issues Risk Alerts Regarding Regulation S-P Deficiencies and Storage of Customer Information in the Cloud or on Third-Party Networks

Regulation S-P Risk Alert. On April 16, 2019, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert titled, *Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies*. Regulation S-P is the principal SEC rule concerning consumer information privacy notices and privacy safeguarding policies for investment advisers and broker-dealers ("Registrants"). Among other things, Regulation S-P governs the timing and content of privacy notices to customers and the policies and procedures that Registrants are required to have in place to safeguard the privacy of customer records and information. The Risk Alert described Regulation S-P compliance issues that OCIE staff observed in recent examinations of Registrants, including the following:

1. *Privacy and opt-out notices*. Failures to provide initial privacy notices, annual privacy notices and opt-out notices to customers, as well as privacy notices that did not inform customers of their right to opt out of a Registrant's sharing customer personal information with unaffiliated third parties.

2. *Policies and procedures*. Some Registrants did not have written policies and procedures reasonably designed to safeguard customer records and information. OCIE staff observed Registrants with documents that merely restated the safeguard requirements without policies and procedures concerning the administrative, technical and physical safeguards employed.

3. *Policies not implemented or not reasonably designed to safeguard customer records and information*. OCIE staff observed Registrants with written policies and procedures that did not appear reasonably designed to (i) assure the safeguarding of customer information, (ii) protect customer information against likely threats and (iii) protect against unauthorized access to customer information. The Risk Alert cited these observed deficiencies:

    a. Registrant employees storing customer information on their personal devices, where the Registrant's policies and procedures did not address how these devices were to be configured to safeguard the customer information.

    b. Registrants without policies and procedures to prevent employees from sending unencrypted emails to customers containing personally identifiable information ("PII").

    c. Registrants that required customer information to be encrypted, password-protected and transmitted using only approved methods, where the Registrants did not provide employees with adequate training on these practices and/or failed to monitor employees to ensure that these practices were followed.

    d. Registrants with policies and procedures that did not prohibit employees from sending customers' PII to unsecure locations outside of the Registrant network.

    e. Failures to identify all systems on which the Registrant maintained customers' PII.

    f. Failures to follow existing policies and procedures regarding outside vendors (*e.g.*, not requiring third-party vendors by contract to keep customers' PII confidential, despite this practice being mandated by the Registrant's policies and procedures).

    g. Registrants with written incident response plans that failed to cover important areas, such as role assignments for implementing the plan, actions required to address a cybersecurity incident and to assess system vulnerabilities.

    h. Customers' PII stored in unsecure physical locations, such as in unlocked file cabinets in open offices.

    i. Customer login credentials disseminated to a larger group of Registrant employees than permitted under policies and procedures.

    j. Former employees retaining access rights after their separation from a Registrant.

The Network Storage Risk Alert. On May 23, 2019, OCIE published a separate Risk Alert titled, *Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features*. This Risk Alert is targeted at security risks arising from the electronic storage of customer information by Registrants in network storage systems, including cloud-based storage systems. These security risks raise compliance issues under Regulation S-P, as well as

Regulation S-ID's Identity Theft Red Flags Rule, which requires each Registrant to maintain a written identity theft prevention program.

The Risk Alert describes the following compliance issues and "Examples of Effective Practices" observed by the OCIE staff during examinations:

1. ***Compliance Issues***

   - Misconfigured network storage solutions, including Registrants that have not configured the security settings on their network storage system to prevent unauthorized access (some Registrants lack policies and procedures addressing their security configuration).
   - Registrants that did not ensure, through policies, procedures, contractual provisions or otherwise, that the security settings on vendor-provided network storage solutions were configured in a manner consistent with the Registrant's standards.
   - Registrants with policies and procedures that do not inventory the types of data stored and the controls applicable for each type of data.

2. ***Examples of Effective Practices***

   - Policies and procedures that support the initial installation, maintenance and periodic review of a Registrant's network storage systems.
   - Guidelines for security controls and baseline configurations to ensure that a Registrant's network storage systems are properly configured.
   - Vendor management policies and procedures that, at a minimum, include regular installation of software patches and hardware updates, followed by Registrant review to assure that the patches and updates do not unintentionally weaken or alter the desired security configuration.

Other Developments

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

Converting Traditional Open-End Funds into ETFs
May 23, 2019
The SEC recently issued exemptive relief to Precidian ETFs Trust that permits an actively managed exchange-traded fund ("ETF") to operate without being subject to the daily portfolio transparency condition included in past active ETF orders. We anticipate that this structure may be attractive to many active managers who may seek to offer their strategies as ETFs, including potentially through the conversion of an existing open-end fund into an ETF.

Podcast: International Finance Corporation (IFC) Impact Investing Standards
May 22, 2019
In this podcast, Isabel Dische and Melissa Bender discuss the recent impact investing standards published by the International Finance Corporation, an arm of the World Bank. This discussion provides a high-level overview of the IFC impact investing framework and related considerations for asset owners and managers.

UK's Information Commissioner's Office Invites Enquiries from Organisations Considering Developing a GDPR Certification Scheme

May 17, 2019
The UK Information Commissioner's Office ("ICO") is welcoming enquiries from organisations that are considering developing a General Data Protection Regulation ("GDPR") certification scheme. The announcement comes alongside updated ICO guidance on certification under the GDPR, as the European Data Protection Board ("EDPB") completes a round of consultations with a view to adopting a full set of guidelines and annexes on certification, identifying certification criteria and the accreditation of certification bodies. Member States and supervisory authorities such as the ICO, along with the EDPB and the European Commission, are required to encourage the use of certification mechanisms as a means to enhance transparency and compliance with the GDPR. The submission process for certification schemes will open once the EDPB guidelines are finalised.

Robare v. SEC: The D.C. Circuit "May" Have Punted on Key Disclosure Question, but Takes Clear Stand on "Willful" Conduct
May 14, 2019
On April 30, 2019, the U.S. Court of Appeals for the D.C. Circuit issued a long-awaited decision in *Robare Group, LTD. v. SEC*, providing valuable insight for investment advisers as to the level of detail courts expect to see in disclosures—both to clients and the Commission—with respect to conflicts of interest. The *Robare* court also concluded that the SEC cannot sustain a charge of "willfulness" with merely negligent conduct. This distinction—which runs in conflict with the SEC's historical position on what constitutes "willful" conduct—may impact the SEC's charging decisions in the months and years to come, and may limit its ability to seek certain remedies in settlements under the Advisers Act and possibly other securities laws.

For the First Time CFTC Publishes Enforcement Manual
May 13, 2019
On May 8, 2019, the Commodity Futures Trading Commission's ("CFTC") Division of Enforcement issued its Enforcement Manual ("Manual") to the general public for the first time. Although the Manual does not create any rights or announce any new policies, it is the first time the CFTC has published its procedures for investigating potential violations of the Commodity Exchange Act, the CFTC Regulations and bringing enforcement actions in one comprehensive manual. It will serve as a valuable resource going forward for compliance officers, entities, and individuals subject to the CFTC's regulation of the U.S. derivative markets. As CFTC Director of Enforcement James McDonald stated, the Manual "aims to increase the level of clarity and transparency" in CFTC enforcement policies, which "should promote fairness, increase predictability, and enhance respect for the rule of law." In that sense, the Manual resembles the enforcement manual promulgated by the Securities and Exchange Commission, which addresses many of the same policy considerations.

Podcast: ERISA Plan Sponsors, ESG and the April 2019 Executive Order on Promoting Energy Infrastructure
May 10, 2019
In this podcast, Isabel Dische and Josh Lichtenstein discuss President Trump's April 10, 2019 Executive Order on Promoting Energy Infrastructure and Economic Growth and its possible implications for Department of Labor guidance with respect to ERISA plan fiduciaries' consideration of environmental, social and governance ("ESG") risks and opportunities as part of their investment processes and related proxy activities.

Podcast – Credit Funds: 1940 Act Interval Funds
May 1, 2019
In this podcast, Sarah Clinton and David Sullivan discuss interval funds registered under the Investment Company Act of 1940, an increasingly common vehicle for credit strategies. As interval funds have risen in popularity recently, with the number of interval funds and amount of AUM having essentially doubled in the past two years, credit fund managers may be considering using this alternative strategy for the first time. This podcast explains what interval funds are and outlines advantages and challenges to these funds to provide credit fund managers a quick view into why they may want to consider registered interval funds.

SEC Publishes Framework for Investment Contract Analysis of Digital Assets and Issues First No-Action Letter for a Token Sale

April 30, 2019

On April 3, 2019, the SEC's Strategic Hub for Innovation and Financial Technology ("FinHub") published a framework for analyzing whether a digital asset is offered and sold as an investment contract and, therefore, is a security (the "Framework"). At the same time, the Division of Corporation Finance issued a no-action response to an aviation company in connection with its proposed offer and sale of blockchain-based digital assets in the form of "tokenized" jet cards without registration under the U.S. federal securities laws (the "TKJ Letter"). The Framework and the TKJ Letter provide the latest guidance to market participants to help them assess whether a particular digital asset is a "security" and, therefore, its offer and sale must be registered under the federal securities laws or qualify for an exemption. Taken together, they confirm that the "not a security" path for most digital assets will be a very steep one.

Congressional Review Act: OMB Memo Would Make SEC, CFTC and Other Independent Agency's "Major Rule" Analyses Subject to Executive Branch Review

April 29, 2019

The Congressional Review Act (the "CRA") is an oversight tool that Congress may use to overturn a rule issued by a federal department or an agency, including rules issued by independent regulatory agencies, such as the SEC and CFTC. On April 11, 2019, the Office of Management and Budget ("OMB") issued a memorandum to the heads of all federal departments and agencies titled, "Guidance on Compliance with the [CRA]." This Alert describes the OMB memorandum and its potential ramifications with respect to future SEC and CFTC rulemakings.

Federal Reserve Board Proposes Changes in Control Analysis

April 26, 2019

On April 23, 2019, the Federal Reserve Board released for public comment proposed changes to its longstanding positions on the exercise of controlling influence under the Bank Holding Company Act of 1956, as amended (the "Proposal"). The Proposal holds promise for simplification of structures and promoting investment activity in the financial services, asset management and fintech sectors.

SEC Proposes Extending Securities Offering Reforms to Closed-End Funds and Business Development Companies

April 15, 2019

On March 20, 2019, the SEC issued a release containing proposals intended to streamline the registration, communications and offering practices for business development companies ("BDCs") and registered closed-end investment companies ("registered CEFs"). The release's proposed rule and form amendments would permit BDCs and registered CEFs to use the securities offering and proxy rules that are already available to operating companies.

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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