VedderPrice

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Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes New Fund-of-Funds Rule

On December 19, 2018, the SEC proposed new Rule 12d1-4 under the Investment Company Act of 1940, which, if adopted, would permit a fund to acquire shares of another fund in excess of the limits of Section 12(d)(1) of the 1940 Act without obtaining a separate exemptive order from the SEC and would expand the types of permissible fund-of-funds arrangements. In connection with the new rule, the SEC would rescind current Rule 12d1-2 under the 1940 Act and most existing fund-of-fund exemptive orders granted under Section 12(d)(1) and would make certain amendments to Rule 12d1-1 and Form N-CEN.

Section 12(d)(1) of the 1940 Act generally prohibits any registered fund (the acquiring fund) from (1) acquiring more than 3% of another fund's (the acquired fund's) outstanding voting securities (the 3% Limit); (2) investing more than 5% of its assets in any one fund; and (3) investing more than 10% of its total assets in funds generally. These limits apply to both registered and unregistered funds with respect to their investments in a registered fund, and to a registered fund with respect to its investment in an unregistered fund. At present, many funds have obtained separate exemptive orders under Section 12(d)(1) to enable investments beyond these limitations. Proposed Rule 12d1-4 would implement a consistent regulatory framework for funds-of-funds.

A fund relying on Rule 12d1-4 would be required to comply with certain conditions. These conditions would generally be similar to those under existing fund-of-funds exemptive orders:

- **Control and Voting.** An acquiring fund and its advisory group (i.e., the fund's investment adviser or sub-adviser and its controlling persons) would be prohibited from controlling, individually or in the aggregate, an acquired fund.

Once invested in an acquired fund above the 3% Limit, an acquiring fund would be required to either (1) seek voting instructions from its shareholders and vote proxies in accordance with their instructions (pass-through voting) or (2) vote the shares held by it in the same proportion as the vote of all other holders of the acquired fund (mirror voting).

- **Redemption Limits.** An acquiring fund that invests in an acquired fund's shares above the 3% Limit would be prohibited from redeeming more than 3% of the acquired fund's total outstanding shares in any 30-day period. This condition would replace the requirement under existing exemptive orders for fund boards to make certain findings and adopt procedures to prevent overreaching by the acquiring fund and its affiliates. This condition would also eliminate the need for participation agreements between acquiring funds and acquired funds.

- **Fees.** Before investing in an acquired fund and at least annually thereafter, an acquiring fund's adviser would be required to determine that the investment is in the acquiring fund's best interest, considering the complexity of and the aggregate fees associated with the resulting fund-of-funds structure. The adviser would be required to report its findings and the basis therefor to the acquiring fund's board.

- **Complexity of Arrangement.** Fund-of-funds arrangements would be limited to two-tiered structures (other than in limited circumstances). Accordingly, a fund relying on the proposed rule—or one that wants to preserve the flexibility to do so—would be required to disclose in its registration statement that it is (or may be) an acquiring fund for purposes of Rule 12d1-4.

Current Rule 12d1-2 provides additional flexibility to funds that invest in funds within the same fund group (in reliance on Section 12(d)(1)(G) of the 1940 Act) to invest in unaffiliated funds and other types of securities. In proposing Rule 12d1-4, the SEC proposed rescinding Rule 12d1-2 following a one-year grace period following the adoption of Rule 12d1-4. The SEC also proposed amending Rule 12d1-1 to enable funds relying on Section 12(d)(1)(G) to continue to invest in an unlimited amount of unaffiliated money market funds (e.g., cash sweep arrangements).

The SEC also proposed an amendment to Form N-CEN that would require funds to report that they relied on Rule 12d1-4 or the statutory exemption in Section 12(d)(1)(G) during the applicable reporting period.

Comments on the proposed rule and related amendments are due 90 days after publication of the proposing release in the Federal Register.

The proposing release is available at: https://www.sec.gov/rules/proposed/2018/33-10590.pdf

SEC STAFF GUIDANCE AND ALERTS

SEC Staff Seeks Industry Engagement on Impact of MiFID II Research Provisions

On December 21, 2018, the SEC issued a statement encouraging continued industry engagement on the impact of recently implemented European Union rules relating to investment research that became effective on January 3, 2018. The EU's Markets in Financial Instruments Directive II (known as MiFID II) generally prohibits certain investment advisers from receiving or retaining "inducements" from a third party—such as commissions, fees or other monetary or non-monetary benefits, including, importantly, certain research from an executing broker-dealer—in connection with providing any investment or ancillary service to a client. Under MiFID II, an investment adviser can continue to receive research without violating the inducement prohibition if the investment adviser pays for that research: (1) directly out of the investment adviser's own resources; (2) with client approval, from a separate research payment account (RPA) controlled by the adviser, funded with client assets and subject to a research budget that is regularly assessed and agreed upon with the client; or (3) through a combination of (1) and (2). The practical effect of the foregoing is the required separation of bundled commission payments for research and brokerage services made by investment advisers subject to MiFID II, effectively prohibiting the use of "soft dollars" by advisers subject to MiFID II.

In October 2017, the staff of the SEC, following consultation with European authorities, issued three no-action letters to provide guidance to market participants seeking to comply with the requirements of MiFID II. One letter provided temporary no-action assurances under the Investment Advisers Act of 1940 to broker-dealers that receive payments in "hard dollars" or through MiFID II-compliant RPAs. These assurances are set to expire on July 3, 2020.

In its recent statement, the SEC encouraged public submission of data and other information relating to the effects of MiFID II's research provisions. The SEC said that comments "would be appreciated by Jan. 31, 2019 so that they can be of greatest value in the staff's evaluation of possible recommendations."

The statement is available at: https://www.sec.gov/news/press-release/2018-301

OCIE Announces 2019 Exam Priorities

On December 20, 2018, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced its 2019 examination priorities for regulated entities, including funds and investment advisers. The exam priorities are organized in six categories: (1) matters of importance to retail investors, including seniors and those saving for retirement; (2) compliance and risks in registrants responsible for critical market infrastructure; (3) select areas and programs of FINRA and the Municipal Securities Rulemaking Board (MSRB); (4) digital assets, including cryptocurrencies, coins and tokens; (5) cybersecurity; and (6) anti-money laundering programs. Within these groupings are several issues of potential interest to funds and their advisers, including the following:

- **Registered Investment Companies:** OCIE will continue to prioritize exams of funds and their advisers, along with the oversight practices of fund boards. OCIE will focus on the following risks: (1) index funds that track custom-built or bespoke indexes; (2) ETFs with little secondary market trading volume and smaller assets under management; (3) funds with higher allocations to certain securitized assets; (4) funds with aberrational underperformance relative to their peer groups; (5) funds managed by advisers that are relatively new to managing registered funds; and (6) advisers that provide advice to both registered funds and private funds with similar investment strategies.

- **Inadequately Disclosed Fees and Expenses:** OCIE will focus on firms with practices or business models that may create increased risk of inadequate disclosure regarding fees, expenses and other charges. OCIE will continue to focus on the financial incentives of advisers that influence the selection of mutual fund share classes for clients. In addition, OCIE will continue to focus on advisers that participate in wrap fee programs.

- **Use of Affiliated Service Providers:** In addition to certain other conflicts of interest, OCIE will focus on advisers that utilize the products or services of affiliates. Exams will focus on the adequacy of disclosure to clients of such arrangements.

- **Digital Assets:** Given the recent growth and the risks presented in the digital asset market, for advisers engaged in this market, OCIE will conduct exams focused on, among other things, portfolio management of digital assets, trading, safety of client funds and assets, pricing of client portfolios, compliance and internal controls.

- **Cybersecurity:** OCIE will continue to prioritize cybersecurity in its examination program, with a focus on, among other things, proper configuration of network storage devices, information security governance and policies and procedures related to retail trading information security.

- **Never-Before-Examined Advisers:** OCIE will continue to conduct risk-based examinations of newly registered advisers and those that have been registered for several years but have never been examined. In addition, OCIE will prioritize advisers that have not been recently examined and that have undergone substantial growth or business model changes.

The examination priorities are available at: https://www.sec.gov/files/OCIE%202019%20Priorities.pdf

OCIE Issues Risk Alert on Electronic Messaging

The SEC's Office of Compliance Inspections and Examinations (OCIE) recently conducted a limited-scope examination initiative to gain a better understanding of the various forms of electronic messaging used by advisers and their personnel, the risks of such use and compliance with applicable provisions of the Investment Advisers Act of 1940, particularly the requirement to maintain certain books and records under Rule 204-2 (Books and Records Rule), and the requirement to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act under Rule 206(4)-7 (Compliance Rule). On December 14, 2018, OCIE published a risk alert to summarize its observations from the examination initiative and to provide guidance for advisers to improve their systems and compliance programs with respect to the use of electronic communications. Below is a summary of examples of the policies and practices observed by OCIE that it believes may assist advisers in meeting their obligations under the Books and Records Rule and the Compliance Rule.

- **Policies and Procedures.** Permitting only those forms of electronic communication for business purposes that can be used in compliance with the Advisers Act, and specifically prohibiting use of technologies that can be readily misused by enabling users to communicate anonymously or destroy messages. Where advisers permit employees to use personal devices for business purposes, implementing policies and procedures regarding employees' use of such devices with respect to texting, personal e-mail and information security. In addition, OCIE observed advisers that include a statement in their procedures that employees' violations of the procedures governing electronic communications may result in discipline or termination.

- **Employee Training and Attestations.** Requiring personnel to periodically complete training regarding the adviser's policies and procedures concerning electronic communications and providing attestations certifying compliance with such policies and procedures.

- **Supervisory Review.** Regularly reviewing popular social media sites to determine if personnel are using social media in any manner prohibited by the adviser's policies and procedures and implementing automated alerts to notify the adviser when the name of the adviser or its personnel appears on the Internet.

- **Control over Devices.** Requiring employees to obtain approval from the adviser before being provided access to e-mail or other business applications from personally owned devices and loading security software on devices prior to enabling them for use in connection with the advisory business.

OCIE shared its observations from the examination initiative to provide advisers an opportunity to consider enhancements to their own policies and practices concerning electronic communications.

The risk alert is available at: https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Electronic%20Messaging.pdf

Division of Trading and Markets Extends AML No-Action Letter Allowing Broker-Dealers to Rely on Investment Advisers

On December 12, 2018, the staff of the SEC's Division of Trading and Markets issued a no-action letter to SIFMA that extended existing no-action relief permitting a broker-dealer to rely on a registered investment adviser to perform some or all of its customer identification program (CIP) and customer due diligence rule obligations under federal anti-money laundering (AML) laws.

The latest relief effectively extends similar no-action relief issued by the Division in 2016, which was substantially similar to a previous no-action position first taken in 2004, and also applied the principles underlying that relief to the portion of the customer due diligence rule regarding beneficial ownership requirements for legal entity customers (the Beneficial Ownership Requirements).

In order for a broker-dealer to treat an investment adviser as if it were subject to an AML program rule for purposes of the CIP obligations or the Beneficial Ownership Requirements, the following conditions must be satisfied:

- The broker-dealer's reliance on the investment adviser must be reasonable under the circumstances;
- The investment adviser must be a U.S. investment adviser registered with the SEC; and
- The adviser must enter into a contract with the broker-dealer in which the adviser agrees to:
  - implement its own AML program and update it as necessary to implement changes in applicable laws and guidance;
  - perform the specified requirements of the broker-dealer's CIP or Beneficial Ownership Requirements in a manner consistent with the relevant laws;
  - promptly disclose to the broker-dealer potentially suspicious or unusual activity detected as part of the CIP or Beneficial Ownership Requirements being performed on the broker-dealer's behalf in order to enable the broker-dealer to file a Suspicious Activity Report (SAR), as appropriate based on the broker-dealer's judgment;
  - certify annually that the representations in the reliance agreement remain accurate and that it is in compliance with such representations; and
  - promptly provide its books and records relating to the foregoing to the SEC, a self-regulatory organization that has jurisdiction over the broker-dealer (e.g., FINRA) or to authorized law enforcement agencies, either directly or through the broker-dealer.

A broker-dealer may decide not to rely on the no-action relief and still contractually delegate the implementation and operation of its CIP and beneficial ownership procedures to an investment adviser. However, under such circumstances the broker-dealer will remain solely responsible for assuring compliance with the CIP rule and the Beneficial Ownership Requirements, and therefore it must actively monitor the operation of its CIP and beneficial ownership procedures and assess their effectiveness.

The effectiveness of the latest no-action relief will continue until the earlier of (1) the date upon which an AML program rule for investment advisers becomes effective or (2) two years from the date of the letter (i.e., December 12, 2020).

The no-action letter is available at: https://www.sec.gov/divisions/marketreg/mr-noaction/2018/sifma-120718-17a8.pdf

Litigation and Enforcement Actions and Initiatives

ENFORCEMENT MATTERS

SEC Settles Administrative Proceedings against Two Robo-Advisers for Allegedly False Disclosures

On December 21, 2018, the SEC announced that it has settled enforcement actions against two robo-advisers—Wealthfront Advisers, LLC and Hedgeable, Inc.—in connection with making allegedly false statements regarding investment products and publishing allegedly misleading advertising material. These settlements represent the SEC's first enforcement actions against "robo-advisers," which provide algorithmic investment advice typically through low-cost, online platforms.

With respect to Wealthfront, the SEC alleged that the adviser made false statements regarding a tax-loss harvesting strategy that Wealthfront claimed would be monitored to identify potential wash sales. The SEC alleged that Wealthfront failed to effectively monitor this strategy and that wash sales took place in at least 31% of accounts that were enrolled in the strategy. The SEC also alleged that Wealthfront engaged in a number of improper social media practices, including improperly retweeting client testimonials and using paid bloggers for client referrals without appropriate disclosure and documentation. The SEC also alleged that Wealthfront failed to implement a compliance program reasonably designed to prevent violations of applicable provisions of the Investment Advisers Act of 1940. Without admitting or denying the allegations, Wealthfront agreed to be censured, to cease and desist from violating relevant provisions of the Advisers Act and to pay a civil penalty of $250,000.

With respect to Hedgeable, the SEC alleged that the adviser made various misleading statements regarding the investment performance of its customers. According to the order, Hedgeable disclosed on its website and on social media comparisons of its customers' performance to the performance of two other robo-advisers. However, the SEC alleged that the information for Hedgeable represented less than 4% of its customers' accounts—accounts that experienced above-average returns during the relevant period—and that both the performance information for Hedgeable's customers and the comparison to robo-advisers were improperly calculated. The SEC also alleged that Hedgeable failed to maintain necessary documentation regarding reported performance and failed to implement a compliance program reasonably designed to prevent violations of applicable provisions of the Advisers Act. Without admitting or denying the allegations, Hedgeable agreed to be censured, to cease and desist from violating relevant provisions of the Advisers Act and to pay a civil monetary penalty of $80,000.

The order for Wealthfront is available at: https://www.sec.gov/litigation/admin/2018/ia-5086.pdf

The order for Hedgeable is available at: https://www.sec.gov/litigation/admin/2018/ia-5087.pdf

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Investment Services Group

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