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# INVESTMENT MANAGEMENT UPDATE

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Covering legal developments and regulatory news for registered funds, their advisers and industry participants through June 30, 2019.

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## SEC AND SRO NEWS



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## RULEMAKING AND GUIDANCE

### *Auditor Independence With Respect to Certain Loans or Debtor-Creditor Relationships*

On June 18, 2019, the U.S. Securities and Exchange Commission (SEC) adopted amendments to the auditor independence rules relating to the analysis that must be conducted to determine whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client. The amendments are intended to more effectively identify debtor-creditor relationships that could impair an auditor's objectivity and impartiality, as opposed to certain more attenuated relationships that are unlikely to pose these concerns.

Rule 2-01(c)(1)(ii)(A) of Regulation S-X (Loan Provision) generally provides that an auditor is not independent if that auditor is in a lending relationship with its audit client. In its press release, the SEC states that the amendment is meant to address circumstances under which the existing Loan Provision "may not have been functioning as it was intended."

The amendments, among other things, (1) focus the analysis on beneficial ownership, rather than on both record and beneficial ownership; (2) replace the existing 10 percent bright-line shareholder ownership test with a significant influence test; (3) add a known-through-reasonable-inquiry standard with respect to identifying beneficial owners of the audit client's equity securities; and (4) exclude from the definition of audit client, for a fund under audit, any other funds that otherwise would be considered affiliates of the audit client under the rules for certain lending relationships.

The SEC's final rule is available at https://www.sec.gov/rules/final/2019/33-10648.pdf.

### *SEC Seeks Comment on Harmonizing Private Securities Exemptions*

On June 18, 2019, the SEC issued a concept release seeking public comment on ways to simplify, harmonize and improve the regulatory framework with respect to offerings exempt from the Securities Act of 1933, as amended (1933 Act) for the purpose of expanding investment opportunities, promoting capital formation and maintaining investor protections.

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The concept release includes a broad overview of the current exempt offering framework and seeks comment on several topics related to the framework, including whether it should be modified to provide greater consistency while addressing specific gaps and complexities. The concept release reviews certain concepts and requirements involved in the exempt offering framework, including the accredited investor definition; offerings under Regulation D, Regulation A and Regulation Crowdfunding; and intrastate offerings. Also included are discussions and requests for comment related to the integration offering doctrine, pooled investment funds and secondary trading.

In particular, the concept release and requests for comment focus on current limitations related to who may invest in certain exempt offerings, or the amount they can invest, and whether these limitations provide an appropriate level of investor protection or create an undue obstacle to capital formation or access to investment opportunities, particularly among retail investors. The concept release notes that, in 2018, approximately $2.9 trillion was raised in exempt offerings, while $1.4 trillion was raised in public offerings.

The comment period for the concept release will stay open until September 24, 2019.

The concept release is available at https://www.sec.gov/rules/concept/2019/33-10649.pdf.

### *Form CRS Relationship Summary and Amendments to Form ADV*

On June 5, 2019, the SEC adopted Form CRS as part of a package of rules and interpretive guidance designed to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers. In broad overview, Form CRS is intended to provide retail clients of investment advisers, broker-dealers and dual registrants with a concise and clear summary of the terms of the client's relationship with its financial professionals.

Form CRS will require investment advisers providing advice to retail clients to provide the clients with a brief summary of the scope and terms of the advisory relationship. Specifically, Form CRS requires (1) an introduction; (2) a description of the relationship and services; (3) a description of fees, costs, conflicts and standard of conduct; (4) a disciplinary history, if any; and (5) additional information. In addition to certain prescribed language, Form CRS will also provide "conversation starters" for clients throughout to help them elicit information that may be useful from investment advisers.

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Form CRS must be delivered to natural persons, or legal representatives of natural persons, who seek to receive the investment adviser's services primarily for personal, family or household purposes. The rule makes no distinction based on the client's assets under management or the net worth of the client. Regarding 401(k) plans and other workplace retirement plans, participants will not be considered to be retail investors for purposes of the Form CRS delivery obligation when making certain ordinary plan elections that do not involve selecting or retaining a firm to provide brokerage or advisory services. However, when a natural person seeks to select and retain a firm to provide brokerage or advisory services for his or her own retirement account, the Form CRS delivery obligation will apply.

Delivery and page-length requirements are generally as follows:

| | Timing of Initial Form CRS Delivery | Length (In Paper Format) |
|---|---|---|
| **Broker-Dealers** | Earliest of (1) a recommendation provided to a "retail investor" of a securities transaction, account type or investment strategy involving securities; (2) placing an order for the retail investor; or (3) opening a brokerage account for the retail investor. | May not exceed two pages. |
| **Investment Advisers** | Before or at the time of entering into an investment advisory contract with a retail investor (*i.e.*, the required timing of Form ADV Part 2 delivery). | May not exceed two pages. |
| **Dual Registrants** | Before or at the time of the earliest of any of the events in the above two sections. | Limited to four pages if brokerage and investment advisory services are covered in one Form CRS, or two pages each if covered in separate Forms CRS. |

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Additionally, Form CRS must be updated as information becomes materially inaccurate, and existing retail clients must be notified and provided with a summary of the changes. Form CRS must adhere to certain formatting requirements, be written in plain English, and take into account a retail investor's level of financial sophistication. Financial professionals are encouraged to use charts, graphs, tables and other graphics or text features to assist retail investors. Form CRS must include hyperlinks to other regulatory disclosure documents for ease of access.

Research continues to show that retail investors are confused about the services, fees, conflicts of interest and required standard of conduct for particular firms, as well as the differences between broker-dealers and investment advisers. Form CRS, as part of the SEC's layered disclosure approach, is designed to reduce retail investor confusion in the marketplace.

Firms that are registered, or investment advisers that have an application for registration pending, with the SEC before June 30, 2020 will have a period of time beginning on May 1, 2020 until June 30, 2020 to file their initial relationship summaries with the SEC. On and after June 30, 2020, newly registered broker-dealers will be required to file their relationship summary with the SEC by the date on which their registration with the SEC becomes effective, and the SEC will not accept any initial application for registration as an investment adviser that does not include a relationship summary that satisfies the requirements of Form CRS.

The text of the final rule, Form CRS Relationship Summary and Form ADV Amendments is available at https://www.sec.gov/rules/final/2019/34-86032.pdf.

### *Commission Interpretation — Standard of Conduct for Investment Advisers*

On June 5, 2019, the SEC released "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (Final Guidance), the primary purpose of which is to "reaffirm and in some cases clarify" certain aspects of the fiduciary duty that an investment adviser owes to its clients under section 206 of the Investment Advisers Act of 1940, as amended (Advisers Act). The Final Guidance generally follows the SEC's April 18, 2018 proposed guidance related to the standard of conduct for investment advisers under the Advisers Act (Proposed Guidance) but includes certain key modifications to address more than 150 comment letters it received following the Proposed Guidance.[1] The SEC opted for "guidance" and declined to propose any specific rule text, stating its belief that the principles-based approach to the relationship between an investment adviser and its clients, rooted in fiduciary principles, "should continue as it expresses broadly the standard to which investment advisers are held while allowing them flexibility to meet that standard in the context of their specific services."

On balance, no new fiduciary obligations were created in the Final Guidance, however, it does provide some useful examples of the application of an investment adviser's fiduciary duty obligations to its clients, and additional information as to the SEC's view of what constitutes full and fair disclosure by an investment adviser of its conflicts and informed consent to those conflicts by a client. All investment advisers subject to the Advisers Act, including private fund advisers, wealth managers and institutional and retail advisers, should take notice of the Final Guidance, as it seeks to consolidate the salient attributes of the federal fiduciary standard applicable to investment advisers.

***No Waiver of Fiduciary Duty.*** The Final Guidance discusses the long-established two-pronged fiduciary standard that includes a duty of care and a duty of loyalty, and clarifies the application of that fiduciary duty, as defined by the scope of a relationship between an investment adviser and its client. The Final Guidance makes a distinction between the obligations of an investment adviser providing "comprehensive, discretionary advice" in a retail client relationship and the obligations of an investment adviser to a registered investment company or private fund, where a negotiated contract defines the scope of services and limitations of authority. It also reaffirms that an investment adviser's fiduciary duty to its clients may not be waived, citing several examples of improper waivers of such duty, including any statement that the investment adviser will not act as a fiduciary, a blanket waiver of all conflicts of interest, and the waiver of any specific obligation under the Advisers Act.

***Hedge Clauses.*** The Final Guidance also withdraws prior no-action relief issued by the SEC that market professionals interpreted as an expansion of the ability of investment advisers to institutional investors to disclaim their fiduciary duties under state law and in the advisory agreement through inclusion of a "hedge clause." In 2007, the staff of the SEC (SEC Staff) issued a no-action letter to Heitman Capital Management, LLC (pub.

1 Investment Advisers Act Release No. 5248 (June 5, 2019), available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf. The Final Interpretation was first proposed in Investment Advisers Act Release No. 4889 (Apr. 18, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

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avail. Feb. 12, 2007), confirming that whether such a hedge clause would violate an investment adviser's fiduciary duty would depend on all the facts and consideration of the form and content in which the hedge clause was made. In the context of a retail client, the no-action letter described three factors to consider: (1) whether the hedge clause was written in plain English; (2) whether the hedge clause was highlighted and explained in person; and (3) whether the hedge clause disclosure explained when a client might still have a right of action notwithstanding language in the clause conveying the contrary. In the Final Guidance, however, the SEC, while acknowledging that the validity of a hedge clause is a facts-and-circumstances test, stated its view that such a clause is likely to mislead retail clients into not exercising their legal rights against an investment adviser for breach of its fiduciary duty in violation of the Advisers Act, and as such found "few (if any)" circumstances where it would be appropriate in a retail context. However, depending on the facts and circumstances of an investment adviser's relationship with an institutional client, the Final Guidance noted that an investment adviser may include hedge clauses in institutional advisory agreements, though it did not define the terms "retail client" or "institutional client" and did not indicate how investment advisers to pooled investment vehicles should apply the above principles.

***Duty of Care.*** As in the Proposed Guidance, the Final Guidance describes the duty of care as consisting of the following:

- *Duty to act and provide advice that is in the best interest of the client.* The duty to provide investment advice that is in the best interest of the client, based on a reasonable understanding of the client's investment objectives, includes a duty to provide advice that is suitable for the client. This obligation requires an investment adviser to not only engage in a reasonable inquiry to determine information pertinent to the client's objectives and risk tolerance, but also to conduct a reasonable investigation into the suitability of the investment itself.

- *Duty to seek best execution of the client's transactions.* The Final Guidance confirms investment advisers' existing obligations with respect to best execution that are set forth in existing SEC guidance. Generally, the investment adviser should seek to maximize value for each client under the particular circumstances occurring at the time of the transaction, and should "periodically and systematically" evaluate execution quality over time. The SEC clarifies in the Final Guidance that "maximizing value" encompasses more than simply minimizing costs. Investment advisers should consider the "full range and quality" of a broker's services, which may include the value

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of research provided, execution capability, commission rate, financial responsibility and responsiveness to the investment adviser. Accordingly, the determinative factor in deciding if the investment adviser has fulfilled its duty to seek best execution is not whether the client paid the lowest possible commission or other transaction cost, but "whether the transaction represents the best qualitative execution."

- *Duty to provide advice and monitoring.* An investment adviser must provide monitoring and advice at a frequency that is in the best interest of the client and consistent with the scope of services agreed to by the client and the investment adviser. When an investment adviser has an ongoing relationship and is compensated with a periodic "asset-based fee," then the duty to provide ongoing advice and monitoring will be extensive, consistent with the scope of the investment adviser's relationship with the client.

***Duty of Loyalty.*** The duty of loyalty requires that an investment adviser not subordinate its client's interests to its own. In describing its view on the duty of loyalty, the SEC seems to have relaxed certain notions from the Proposed Guidance. For example, the Proposed Guidance stated that "[d]isclosure of a conflict, alone, is not always sufficient to satisfy the investment adviser's duty of loyalty and Section 206 of the Advisers Act." In the Final Guidance, however, the SEC stated that "[w]e disagree that this Final [Guidance] includes a requirement to eliminate conflicts of interest. . . . [E]limination of a conflict is one method of addressing that conflict; when appropriate investment advisers may also address the conflict by providing full and fair disclosure such that a client can provide informed consent to the conflict." To meet the duty of loyalty, investment advisers must provide clients with full and fair disclosure of all material facts relating to the advisory relationship, including the capacity in which the firm is acting with respect to the advice provided. The Final Guidance provides additional guidance regarding the appropriate level of specificity and considerations for disclosure regarding conflicts as to allocation of investment opportunities.

- *Specificity.* Disclosure should "be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent." For example, the Final Guidance notes that it would be inadequate to disclose that the investment adviser has "other clients" without describing how the investment adviser will manage conflicts between clients or to disclose that

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the investment adviser has "conflicts" without further description. The use of the word "may" is not adequate in a disclosure when a conflict of interest actually exists. Similarly, using the word "may" is inappropriate when it precedes a list of all potential or possible conflicts, regardless of likelihood.

- *Allocation of Investment Opportunities.* In the Proposed Guidance, the SEC stated that "in allocating investment opportunities among eligible clients, an investment adviser must treat all clients fairly." However, noting that this language could lead to some misinterpretations that were inconsistent with the "full and fair disclosure" standard applicable to other conflicts, the SEC in the Final Guidance has removed the sentence and replaced it with a discussion consistent with the treatment of other conflicts. Instead, an investment adviser may consider the nature and objectives of a client and the scope of the advisory relationship when allocating investment opportunities. So long as a client provides informed consent, an investment adviser may agree with a client that certain opportunities will not be allocated or offered to the client.

In the Proposed Guidance, the SEC requested comment on: (1) licensing and continuing education requirements for personnel of SEC-registered investment advisers; (2) delivery of account statements to clients with investment advisory accounts; and (3) financial responsibility requirements for SEC-registered investment advisers along the lines of those that apply to broker-dealers. The Final Guidance notes that the SEC is continuing to evaluate the comments it received in response to these questions.

The Final Guidance is available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

The Proposed Guidance is available at https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

### *SEC Adopts Regulation Best Interest and Broker-Dealer Standard of Conduct*

On June 5, 2019, after years of consideration, commentary, rulemaking and guidance, the SEC adopted Regulation Best Interest (Rule 15l-1 under the Securities Exchange Act of 1934, as amended (1934 Act)). This new rule applies to broker-dealers' (and their affiliates') relationships with retail customers and requires them to act in the best interest of those retail customers when making a recommendation. As part of this enhanced standard, broker-dealers must maintain and enforce policies and procedures designed to identify and disclose material facts about conflicts of interest. The regulation also enacted another rule that adds additional disclosure obligations, Form CRS Relationship Summary, which requires registered investment advisers and broker-dealers to provide retail investors with a plain English summary of their relationship with retail investors and the standards of conduct they are held to (See Rule 17a-14 and Form CRS under the 1934 Act. Form CRS amends Form ADV by adding this requirement to a new Part 3.) The new rules and forms will be effective 60 days after publication in the *Federal Register*, and firms must transition into compliance with Regulation Best Interest by June 30, 2020.

The obligation to act in the best interests of retail clients means broker-dealers must not place their financial or other interests ahead of the retail customer when making a recommendation. This enhanced standard is referred to by the regulation as the "General Obligation." The SEC did not define "best interest" in the new rule, but elaborated that it comprises four components. These four components are (1) the Disclosure Obligation, (2) the Care Obligation, (3) the Conflict of Interest Obligation and (4) the Compliance Obligation. Compliance with these four components is necessary to comply with the General Obligation — a failure to comply with one of them is a violation of the General Obligation, but compliance with each of the four obligations does not create a safe harbor.

The Disclosure Obligation requires broker-dealers to provide retail customers with written disclosures that identify the details of the scope and terms of the relationship with the retail customer and material facts about conflicts of interest associated with a broker-dealer's recommendation. The Care Obligation requires a broker-dealer to exercise reasonable diligence, care and skill to understand the basis for a recommendation and the risks, rewards and costs associated with it. The Conflict of Interest Obligation mandates that broker-dealers establish and enforce written policies and procedures designed to disclose or eliminate conflicts of interest that are associated with a recommendation. Finally, the Compliance Obligation requires broker-dealers to establish and enforce written policies and procedures designed to achieve compliance with Regulation Best Interest.

The new Form CRS Relationship Summary is an amendment to Form ADV that requires investment advisers and broker-dealers to prepare a summary of their relationship with retail investors in a new Part 3 to Form ADV. It is designed to be in a short and accessible question-and-answer format. The SEC's intention is that it will allow retail investors to use the new Form CRS to compare information about various firms' advisory or brokerage capabilities.

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The text of the final rule, Regulation Best Interest, is available at https://www.sec.gov/rules/final/2019/34-86031.pdf.

The text of the final rule, Form CRS Relationship Summary and Form ADV Amendments is available at https://www.sec.gov/rules/final/2019/34-86032.pdf.

### *Commission Interpretation — Broker-Dealer Exclusion*

On June 5, 2019, the SEC voted to approve several rulemakings and interpretations, including an interpretation under the Advisers Act, in an attempt to clarify the SEC's position regarding when a broker-dealer is outside the "broker-dealer exclusion" of section 202(a)(11)(C) of the Advisers Act (Interpretation). Although the measures adopted by the SEC are intended primarily to address the protection of retail investors, the new Interpretation has implications for all broker-dealers, including those that serve only institutional investors.

Section 202(a)(11)(C) of the Advisers Act excludes from the definition of "investment adviser," brokers or dealers "whose performance of such advisory services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor" (Exemption). Without the Exemption, brokers or dealers may otherwise be subject to the Advisers Act. In its Interpretation, the SEC stated that advice is "consistent with the solely incidental prong if the advice is provided in connection with and is reasonably related to the broker-dealer's primary business of effecting securities transactions."[2] The determination will hinge on the facts and circumstances, including the broker-dealer's business, its services offered and the broker-dealer's relationship with its customer. The SEC stated, "if a broker-dealer's primary business is giving advice as to the value and characteristics of securities or the advisability of transacting in securities, or if the advisory services are not offered in connection with or are not reasonably related to the broker-dealer's business of effecting securities transactions,"[3] then the broker-dealer's advisory services are not solely incidental to the broker-dealer's business as a broker-dealer.

2 Commission Interpretation Regarding the Solely Incidental Prong of the Broker-Dealer Exclusion from the Definition of Investment Adviser. Release No. IA-5249 (June 5, 2019).

3 *Id.* at 12-13.

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When analyzing a broker-dealer's activities and whether or not it can avail itself of the Exemption, the analysis does not need to consider the amount of advice or the significance of the advice. From the SEC's perspective, "[a]dvice need not be trivial, inconsequential or infrequent to be consistent with the solely incidental prong." As discussed below, the SEC provided additional guidance on how to apply the application of the Interpretation to (1) exercising investment discretion over customer accounts and (2) account monitoring.

***Investment Discretion.*** The SEC reiterated its position that. when a broker-dealer exercises investment discretion, it is not providing advice to customers that is in connection with and reasonably related to effecting securities transactions; rather, the broker-dealer is making investment decisions relating to the purchase or sale of securities on behalf of customers. This type of activity does not fall within the meaning of the Exemption. When a broker-dealer is granted discretion on a limited or temporary basis, whether the broker-dealer is within the scope of the Exemption depends on the facts and circumstances. The SEC indicated, however, that there are situations where a broker-dealer may exercise temporary or limited discretion in a way that is not indicative of a relationship that is primarily advisory in nature. Generally, these are situations where the discretion is limited in time, scope or other manner, and lacks the comprehensive and continuous character of investment discretion that would suggest that the relationship is primarily advisory.

The SEC provided certain examples that illustrate temporary or limited discretion that would typically fall within the protection of the Exemption:

- discretion as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount or quantity of a specified security

- discretion on an isolated or infrequent basis to purchase or sell a security or type of security when a customer is unavailable for a limited period of time

- discretion as to cash management, such as to exchange a position in a money market fund for another money market fund or cash equivalent

- discretion to purchase or sell securities to satisfy margin requirements, or other customer obligations that the customer has specified

- discretion to sell specific securities and purchase similar securities in order to permit a customer to realize a tax loss on the original position

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- discretion to purchase a bond with a specified credit rating and maturity
- discretion to purchase or sell a security or type of security limited by specific parameters established by the customer.

***Account Monitoring.*** The Interpretation discusses account monitoring and account review practices by broker-dealers of retail customer accounts. The SEC disagreed with some commenters who asserted that *any* monitoring of customer accounts would not be consistent with the "solely incidental" prong, noting that a broker-dealer that agrees to monitor a retail customer's account on a periodic basis for purposes of providing buy, sell or hold recommendations may still be considered to provide advice in connection with and reasonably related to effecting securities transactions, thus not triggering investment adviser registration. This monitoring, the SEC noted, results in a recommendation to purchase, sell or hold a security each time the agreed-to monitoring occurs, and those recommendations are subject to Regulation Best Interest. On the other hand, when a broker-dealer, on its own initiative and without any agreement with the customer, reviews the holdings in a retail customer's account for the purposes of determining whether to provide a recommendation to the customer — and, if applicable, contacts that customer to provide a recommendation based on that voluntary review — the broker-dealer's actions are in connection with and reasonably related to the broker-dealer's primary business of effecting securities transactions. Absent an agreement with the customer (which would be required to be disclosed pursuant to Regulation Best Interest), the SEC would not consider this voluntary review to be "account monitoring."

The SEC concluded by recommending that broker-dealers consider adopting policies and procedures that, if followed, would help demonstrate that any agreed-upon monitoring is in connection with and reasonably related to the broker-dealer's primary business of effecting securities transactions. For example, broker-dealers may include in their policies and procedures that a registered representative may agree to monitor a customer's account at specific time frames (*e.g.*, quarterly) for the purpose of determining whether to provide a buy, sell or hold recommendation to the customer. However, these policies and procedures should not permit a broker-dealer to agree to monitor a customer account in a manner that, in effect, results in the provision of advisory services that are not in connection with or reasonably related to the broker-dealer's primary business of effecting securities transactions, such as providing continuous monitoring.

The SEC release is available at https://www.sec.gov/rules/interp/2019/ia-5249.pdf.

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## *FINRA Proposes Rule 4111 to Target Firms With History of Misconduct*

In its Notice to Members 19-17, FINRA announced on May 2, 2019 that it is requesting comment on proposed new Rule 4111 (Restricted Firm Obligations), which would impose tailored obligations, including financial requirements, on designated member firms that cross specified numeric disclosure-event thresholds. FINRA expects the number of member firms that could be subject to these obligations to be small, but states that these firms present a “heightened risk of harm to investors and their activities may undermine confidence in the securities markets as a whole.” FINRA notes further that the proposal is intended to give it another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards.

FINRA is requesting comment on:

- proposed new Rule 4111 (Restricted Firm Obligations), which would authorize FINRA to require “Restricted Firms,” identified by a multistep process involving threshold calculations, to make deposits of cash or qualified securities that could not be withdrawn without FINRA’s prior written consent, adhere to other conditions or restrictions on the member’s operations that are necessary or appropriate for the protection of investors and in the public interest, or be subject to some combination of those obligations

- proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111) (new Rule 9559) and amendments to existing Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) to be renumbered as Rule 9560 (Rule 9560 or the Hearing Procedures Rule) to create an expedited proceeding that allows a prompt review of the determinations under the Restricted Firm Obligations Rule and grants a member a right to challenge any obligations imposed.

Proposed new Rule 4111 targets firms that have a concentration of individuals with a history of misconduct and firms that consistently hire these individuals and fail to reasonably supervise their activities. FINRA points to studies that have indicated that “past disciplinary and other regulatory events associated with a firm or individual can be predictive of similar future events.” According to FINRA, individuals and firms with a history of misconduct can pose a particular challenge for FINRA’s existing examination and enforcement programs. In particular, it states that FINRA examinations can identify compliance failures — or imminent failures — and prescribe remedies to be taken, but examiners are not empowered to require a firm to change or limit its business operations in a particular manner. Enforcement actions can only be brought after a rule has been violated — and any resulting customer harm has already occurred — and by the time intervention is practical, the firm may have exited the industry and/or failed to pay arbitration awards, thereby limiting FINRA's jurisdiction over the misconduct.

Under its proposed new Rule 9559, firms may appeal adverse Rule 4111 decisions through an expedited process, resulting in final FINRA action, which can then be appealed to the SEC, and then to federal court in the event of an adverse decision, pursuant to section 19 of the 1934 Act.

FINRA's Notice to Members 19-17 is available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-17.pdf.

### *First Exemptive Relief for Nontransparent Active ETFs*

On May 20, 2019, the SEC issued an order granting exemptive relief to allow Precidian Investments to launch actively managed exchange-traded funds (ETFs) that do not provide daily disclosure of portfolio holdings to the general public. Precidian refers to this new type of ETF as "ActiveShares" and is also seeking a patent for them. This order marks the first time the SEC has permitted an ETF to operate without daily portfolio disclosure. It is a significant step toward allowing new and competitive nontransparent ETFs to develop.

ETFs are different from traditional open-end mutual funds, in part because they do not offer a daily right of redemption and because their shares trade on the secondary markets rather than at daily net asset value per share (NAV). Yet like open-end mutual funds, they are permitted to offer unlimited shares to investors. Because ETFs do not fit neatly into the regulatory framework for traditional open-end or closed-end investment companies, they require exemptive relief from the SEC under the 1933 Act, 1934 Act and Investment Company Act of 1940, as amended (1940 Act). The SEC has allowed ETFs to operate since the early 1990s through individual exemptive orders when applicants can demonstrate a mechanism to ensure that ETF shares will trade on an exchange at or close to NAV. Because ETFs are not subject to daily redemption but instead trade on the secondary markets, the SEC has viewed this mechanism as essential to protecting investors.

Until the Precidian order, the mechanism the SEC has settled on to ensure shares trade at or close to NAV is daily portfolio transparency. The SEC has been comfortable with daily portfolio transparency as an appropriate mechanism because it allows for the

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creation of an efficient arbitrage mechanism among market participants. However, many investment advisers hesitate to offer actively managed ETFs because they do not want to provide daily portfolio transparency. Doing so can be detrimental to an adviser's competitive edge because it provides a public window into the adviser's specific investments and trading strategies, which could be copied by others.

Precidian originally sought an exemption from the daily portfolio disclosure requirement in 2013. The SEC was hesitant to permit an alternative process to achieve efficient arbitrage, and Precidian withdrew its original application and filed a new one on December 22, 2014, proposing a different method. Precidian amended the application seven times, culminating in the amended application that was filed on April 4, 2019.

Precidian's successful application proposed two structural features that it contended would supply the requisite mechanism for efficient arbitrage. First, Precidian proposed a "Verified Intraday Indicative Value" or "VIIV" for each ActiveShares ETF, which would display the value of its portfolio holdings. This would be calculated each second during the trading day and be subject to certain parameters. As part of this feature, each ActiveShares ETF subject to exemptive relief would commit to investing only in securities trading on a U.S. exchange.

Second, to avoid disclosing the portfolios of ActiveShares ETFs, each ETF would sell and redeem creation units with authorized participants (APs) through unaffiliated broker-dealers, using confidential brokerage accounts and acting as agents for the APs. The broker-dealer would be provided with a basket representing a pro rata slice of the portfolio, which would be used to create or redeem shares of the ActiveShares ETF. The broker-dealers would be contractually prevented from disclosing the portfolio holdings to anyone, including the APs.

Precidian agreed with the SEC to be bound by several other conditions. These included a commitment to provide the public with enhanced disclosures informing investors how ActiveShares ETFs differ from traditional ETFs, including the fact that they do not provide portfolio transparency and that, as a result, trading in ActiveShares ETFs could be more expensive. In addition, Precidian agreed that its ActiveShares ETFs would comply with Regulation Fair Disclosure, even though ordinary ETFs are not subject to that regulation. Precidian also agreed to provide the SEC with periodic reports on the functionality of its ActiveShares mechanism and to take certain remedial actions if the ActiveShares do not function as anticipated.

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The ActiveShares exemptive relief marks an important evolution in the development of ETFs and opens a door to increased competition among investment advisers that wish to protect their trading strategies. While Precidian seeks a patent for the mechanism behind ActiveShares, it offers licenses to other investment advisers to use their methodology and seek their own SEC exemptive relief by incorporating the terms of Precidian's successful exemptive application by reference. Yet interested investment advisers should closely consider whether the limitations on ActiveShares fit with their investment strategies. For example, an adviser that wishes to invest in foreign markets or securities would be unable to execute that strategy with an ActiveShares ETF because of the requirement that these ETFs invest in securities traded on a U.S. exchange. There are other applications for innovative exemptive relief that are currently pending with the SEC and that present alternative methods besides daily portfolio transparency to ensure efficient arbitrage. Whether the SEC will grant these applications is unknown.

The SEC's notice of Precidian's application is available at https://www.sec.gov/rules/ic/2019/ic-33440.pdf, and the accompanying order is available at https://www.sec.gov/rules/ic/2019/ic-33477.pdf.

### *Amendments to Financial Disclosures About Acquired and Disposed Businesses*

On May 3, 2019, the SEC voted to propose rule amendments to improve the information that investors receive regarding the acquisition and disposition of businesses. The proposed amendments are also intended to facilitate more timely access to capital and reduce the complexity and cost to prepare the required disclosure.

The amendments being proposed impact the financial disclosure requirements in Rules 3-05 and 3-14 (applicable to a real estate operation) and Article 11 of Regulation S-X, as well as related rules and forms, for financial statements of businesses acquired or to be acquired and for business dispositions. The SEC also proposed new Rule 6-11 of Regulation S-X and amendments to Form N-14 for financial reporting of acquisitions involving investment companies.

Rule 3-05 applies to registrants, other than a real estate operation, but including registered investment companies and business development companies. When a registrant acquires a significant business, Rule 3-05 generally requires a registrant to provide separate audited annual and unaudited interim pre-acquisition financial statements of

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that business. Investment company registrants differ from noninvestment company registrants in that they principally invest for returns from capital appreciation and/or investment income, are required to recognize changes in value to their portfolio investments each reporting period, and generally do not consolidate entities they control or use equity method accounting. Due to the nature of investment companies, under the current rules, it is often unclear how to apply these reporting requirements to acquired funds. Article 11 of Regulation S-X also requires registrants to file unaudited pro forma financial information relating to the acquisition or disposition.

Among other items, the changes proposed include:

- changes to significance tests
- reducing the number of years of audited financial statements required
- permitting the omission of financial statements for businesses included in a registrant’s financial statements for a full fiscal year
- amended disclosure regarding acquisitions of a component of an entity
- amended pro forma financial information requirements and certain clarifications
- expanded permitted use of IFRS-IASB
- other proposed amendments for specific industries.

Currently, investment company registrants, including business development companies, apply the general provisions of Regulation S-X, unless subject to the special rules set forth in Article 6. The proposed amendments specific to investment companies would tailor the financial reporting requirements for investment companies with respect to acquisitions of investment companies and other types of funds. The proposed amendments would add a definition of “significant subsidiary” in Regulation S-X that is specifically tailored for investment companies. Proposed new Rule 6-11, which is modeled after proposed Rules 3-05 and 3-14, addresses the financial reporting of fund acquisitions that would apply to the acquisition of another investment company, including a business development company, a private fund and any private account managed by an investment

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adviser. The proposed amendments would eliminate the pro forma financial information requirement for investment company registrants in connection with fund acquisitions, and instead require investment companies to provide supplemental financial information that the SEC believes will be more relevant to investors.

The SEC's proposed rule is available at https://www.sec.gov/rules/proposed/2019/33-10635.pdf.

### *Framework for 'Investment Contract' Analysis of Digital Assets*

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 (Framework). Although not binding on the SEC, the Framework is nonetheless useful as an analytical tool to help market participants assess whether the federal securities laws apply to the offer, sale or resale of a particular digital asset.

The seminal case in analyzing whether an instrument is an investment contract is *SEC v. W.J. Howey Co.* There, the Supreme Court held that an investment contract exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. The focus of the analysis is not only on the terms of the instrument itself, but also on the circumstances surrounding the instrument and the manner in which it is offered, sold or resold.

With this in mind, the Framework breaks down the *Howey*-test into its constituent parts: (1) the investment of money, (2) common enterprise, and (3) reasonable expectation of profits derived from the efforts of others. The Framework focuses on the third prong and provides useful guideposts for analysis as to whether there may be a reasonable expectation of profits as a result of the efforts of others.

In determining whether the purchaser is relying on the efforts of others, the analysis focuses on (1) whether the purchaser reasonably expects to rely on the efforts of the active participants in the offering and (2) whether those efforts are undeniably significant in effecting the failure or success of the enterprise or whether they are merely ministerial. In determining whether there is a reasonable expectation of profits, the analysis asks whether the asset entitles the holder to a share of future profits and whether there is a secondary market for the asset, among other questions. Other relevant considerations to

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the analysis include whether the distributed ledger network and digital asset are fully developed and operational and whether the holder of the digital asset is able to immediately use the digital asset for its intended functionality.

At the same time as FinHub released the Framework, the SEC Staff granted no-action relief to TurnKey Jet, Inc. (TKJ) for its offering of nonregistered tokens. The no-action relief dovetails with the Framework in that it explicitly references a number of factors included in the Framework as underpinning its conclusion, including:

- TKJ will not use any funds from token sales to develop the TKJ platform, network or app, and each of these will be fully developed and operational at the time any tokens are sold.

- The tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold.

- TKJ will restrict transfers of tokens to TKJ wallets only, and not to wallets external to the platform.

- TKJ will sell tokens at a price of $1 per token throughout the life of the program, and each token will represent a TKJ obligation to supply air charter services at a value of $1 per token.

- If TKJ offers to repurchase tokens, it will only do so at a discount to the face value of the tokens ($1 per token) that the holder seeks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the tokens.

- The token will be marketed in a manner that emphasizes the functionality of the token, and not the potential for an increase in the market value of the token.

Together, the Framework and the TKJ no-action letter represent an important development in the regulation of digital assets, and a clear pronouncement of the current contours of law. Although the regulation of digital assets will surely develop in the future, the Framework and the TKJ no-action letter will likely serve as important guideposts for the foreseeable future.

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The SEC's Framework is available at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

The TKJ no-action letter is available at https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.

### *ADI 2019-07 — Review of Certain Filings Under Automatic Effectiveness Rules*

On April 2, 2019, the SEC's Division of Investment Management issued ADI 2019-07 regarding the SEC Staff's review of certain filings under Rule 485(a) of the 1933 Act. Rule 485(a) provides for automatic effectiveness within prescribed time periods for certain investment company registration statement amendments. Under the Rule, a new open-end fund that is organized as a new series of an existing registrant can file a post-effective amendment to an existing registration statement and automatically become effective in as early as 75 days. In addition, a post-effective amendment containing material changes to the registration statement of an existing open-end fund or unit investment trust can become effective in as early as 60 days. SEC Staff action is not required to bring about effectiveness in either case.

The ADI states that, on occasion, seeking automatic effectiveness can complicate efforts by the SEC Staff in the Division of Investment Management's Disclosure Review and Accounting Office to effectively address investor protection interests, particularly in cases where filings raise complex issues not easily resolved because of a lack of precedent. The ADI provides, by way of example, "issues requiring additional review and interaction between disclosure reviewers and registrants typically involving novel investment strategies, fee structures, and/or operational policies (*e.g.*, significant changes to policies related to purchases and redemptions by investors)."

While the ADI notes that most filings that seek automatic effectiveness under Rule 485(a) do not raise these types of unique or novel issues, the SEC Staff urges registrants planning filings under Rule 485(a) that may raise material questions of first impression — or that address issues in a manner inconsistent with previous precedent — to contact the SEC Staff to discuss these issues before making a Rule 485(a) filing. In addition, the SEC Staff urges registrants to respond to SEC Staff comments on a Rule 485(a) filing as a general matter no later than five business days before the filing is scheduled to become effective automatically.

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The SEC's ADI is available at https://www.sec.gov/investment/accounting-and-disclosure-information/adi-2019-07-review-certain-filings-under-automatic.

### *SEC Proposes Securities Offering Reform for Closed-End Funds and Business Development Companies*

On March 20, 2019, the SEC proposed amendments to certain rules and forms that would, if adopted, allow certain business development companies and other closed-end funds (Affected Funds) to use securities offering rules that are currently available to operating companies. The proposed rules would accomplish this by streamlining the registration process for Affected Funds, including the process for shelf registration; reforming the ongoing reporting and disclosure obligations of Affected Funds; and reforming rules around communications by Affected Funds. The proposed rules include a number of other reforms as well.

Significant proposals include:

- *Streamlining Registration.* The proposed amendments would allow eligible Affected Funds to use a new short-form version of Form N-2 to conduct offerings of securities "off the shelf" more quickly and efficiently.

- *Reform Reporting and Disclosure Obligations.* The proposed amendments would supplement the new short-form registration statement on Form N-2 by requiring additional ongoing disclosure and the disclosure of certain events on Form 8-K by all Affected Funds.

- *Reform Issuer Communication Rules.* The proposed amendments would increase the ability of Affected Funds to communicate with the investing public without running afoul of the "gun-jumping" rules.

The SEC adopted securities offering reforms applicable to operating companies in 2005. The 2005 reforms were intended to modernize the securities offering and communication processes, but expressly excluded investment companies. In 2018, the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act directed the SEC to extend the 2005 modernization amendments to Affected Funds. The proposed rule is in keeping with this legislative mandate.

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The comment period ended on June 10, 2019.

The SEC's proposed rule is available at https://www.sec.gov/rules/proposed/2019/33-10619.pdf.

### *SEC Seeks Comment on Custody Rule: Non-DVP Trades, Digital Assets*

The SEC Staff has invited industry engagement and sought information regarding products and transactions that do not settle on a delivery versus payment (Non-DVP) basis, blockchain/distributed ledger technology (DLT) and digital assets, particularly in the context of Rule 206(4)-2 under the Advisers Act (Custody Rule). The SEC Staff cites issues raised following its February 2017 Guidance Update on inadvertent custody, as well as growth in the variety and complexity of the types of securities and other assets that settle on a Non-DVP basis as the drivers for this request.

The SEC Staff is seeking input on the following:

- What types of instruments trade on a Non-DVP basis? How do these instruments trade?

- What are the risks of misappropriation or loss associated with various types of Non-DVP trading? What controls do investment advisers have in place to address the risks of misappropriation related to such trading? What types of independent checks, other than a surprise examination, do investment advisers use currently to test these controls?

- Are there particular types of securities transactions settled on a Non-DVP basis that present greater or lesser risk of misappropriation or loss?

- What role do custodians play in the settlement process of Non-DVP trading? What role do they play in mitigating risks of misappropriation or loss arising from such trading?

- For investment advisers that currently obtain surprise examinations, what is the marginal cost of adding accounts that trade on a Non-DVP basis to the list of client accounts provided to the accountant performing the surprise examination of a sample of client accounts?

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- What challenges do investment advisers have in obtaining surprise examinations regarding Non-DVP traded securities? How do investment advisers to unaudited private funds that are subject to surprise examinations address these challenges?

- Are there types of external checks that could be more effective and less costly than surprise examinations with respect to Non-DVP traded securities?

- To what extent do Non-DVP assets appear on client account statements from qualified custodians? To what extent does an investment adviser have any influence over, or input into, whether and how these assets appear on account statements? Are there any assets that trade on a Non-DVP basis that would not appear on a qualified custodian's account statements?

- To what extent could evolving technologies, such as DLT, provide enhanced or diminished client protection in the context of Non-DVP trading?

The SEC Staff expects to utilize what it learns in any future recommendations to the SEC with respect to any regulatory action that may be necessary or appropriate. There is no deadline for comments, which can be submitted to a dedicated email address (IMOCC@sec.gov) and will be made public.

The SEC Staff request for comments is available at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.

The February 2017 guidance is available at https://www.sec.gov/investment/im-guidance-2017-01.pdf.

### *SEC Staff Eases Certain 'In-Person' Board Approval Requirements*

On February 28, 2019, the SEC Staff in the Division of Investment Management issued a no-action letter providing relief with respect to certain in-person voting requirements for fund boards for actions including the renewal or approval of investment advisory agreements or underwriting agreements, the approval of interim advisory agreements, the selection of an independent public accountant, or the renewal or approval of a fund's Rule 12b-1 plan. Specifically, the SEC Staff agreed not to pursue enforcement action under sections 12(b), 15(c) and 32(a) and Rules 12b-1 and 15a-4 of the 1940 Act if, in limited circumstances, fund boards do not follow certain in-person voting specifications.

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The no-action letter set forth two specific scenarios in which board action outlined above may be taken via telephone, video conference or other means by which all participating directors can participate and communicate simultaneously, rather than in person. The first scenario includes instances where the directors needed for board action cannot meet in person due to unforeseen or emergency circumstances, provided that no material changes to the relevant contract, plan and/or arrangement are proposed to be approved at the meeting and the directors ratify the applicable approval at the next in-person board meeting (Scenario 1). The second scenario includes instances where the directors needed for board action had previously fully discussed and considered all material aspects of the proposed matter at an in-person meeting, but did not vote on the matter at that time, provided that no director requests another in-person meeting (Scenario 2). The no-action letter notes that the applicability of Scenario 1 is limited to instances in which a fund board is renewing an existing advisory or underwriting agreement or 12b-1 plan or approving the independent public accountant selected in the immediately preceding fiscal year. Board action under Scenario 2, on the other hand, would include instances in which a fund board is renewing or approving an advisory or underwriting agreement or 12b-1 plan, approving an interim advisory agreement, or approving the independent public accountant (which is not required to be the same accountant as in the preceding fiscal year).

The no-action letter provides a further discussion of instances in which board action taken in response to Scenario 1 and Scenario 2 would be appropriate. With respect to Scenario 1, the no-action letter notes that action may be appropriate in certain unforeseen or emergency circumstances in which directors' in-person meeting attendance would be impossible. Such unforeseen or emergency circumstances may include any circumstances that, in the board's determination, could not have been reasonably foreseen or prevented and would make it impossible or impracticable for the directors to attend a meeting in person, such as illness or death, including of family members; weather events or natural disasters; acts of terrorism; and disruptions in travel. With respect to Scenario 2, the no-action letter indicates that board action may be appropriate in instances where the directors had previously met in person and fully discussed and considered all material matters related to the action. According to the no-action letter, these scenarios could include: (i) the directors preferring to wait to vote until the completion of a contingent event; (ii) the selection of an independent public accountant for certain funds in a fund complex and the subsequent selection of the same independent public accountant at a later date for other funds in the same fund complex that have different fiscal years when no additional information is needed from the independent public accountant; or (iii) if directors

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wish to wait to vote on a matter until further requested information is provided or previously provided information is confirmed, and they determine at the in-person meeting that the nature of the information to be provided or confirmed would not be likely to change the vote of any director needed for the board action.

The no-action letter indicates that the relief provided is part of the SEC Staff's continuing effort to review existing director responsibilities and to consider whether they are appropriate and are carried out in a manner that serves the shareholders' best interests in light of market, regulatory and technological developments.

The no-action letter is available at https://www.sec.gov/divisions/investment/noaction/2019/independent-directors-council-022819.

### *SEC Proposes New Rule 163B to Expand 'Testing the Waters' Communications to All Issuers*

On February 19, 2019, the SEC voted to propose a new rule and related amendments that would expand the permissible use of "test the waters" communications with certain institutional investors regarding a contemplated registered securities offering prior to, or following, the filing of a registration statement related to the offering. Sections 5(c) and 5(b)(1) of the 1933 Act generally prohibit oral and written offers of securities before the issuer files a registration statement, and written offers of securities after the filing of a registration statement must meet the requirements for a statutory prospectus. In 2012, Congress passed the Jumpstart Our Business Startups Act (JOBS Act), which created section 5(d) of the 1933 Act, under which "test the waters" communications are permitted, but only for emerging-growth companies (EGCs). This accommodation is not currently available to non-EGCs, investment company issuers or business development companies. Proposed Rule 163B would make test-the-waters communications exempt, for all issuers, from restrictions imposed by section 5 of the 1933 Act on written and oral offers prior to or after filing a registration statement. However, these communications would be limited to potential investors that are, or are reasonably believed to be, qualified institutional buyers (QIBs), as defined in Rule 144A under the 1933 Act, and institutional accredited investors (IAIs), as defined in Regulation D under the 1933 Act. The proposed rule would be nonexclusive, and an issuer could rely on other 1933 Act communications rules or exemptions when determining how, when and what to communicate in connection with a contemplated securities offering. According to the SEC in its press release, the expanded test-the-waters provisions of proposed Rule 163B are intended to provide all

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issuers with appropriate flexibility in determining when to proceed with a registered public offering while maintaining investor protections, to provide a cost-effective means for evaluating market interest before incurring the costs associated with such an offering, and to thereby encourage more issuers to consider entering the public equity markets.

Under the proposed new rule:

- Issuers would not be required to verify investor status. Section 5(d) will be expanded to include a “reasonable belief” standard that an investor is a QIB or IAI.

- Testing-the-waters communications would not need to be filed with the SEC or be required to include any specific legend. The SEC also proposes to amend the definition of “free writing prospectus” to exclude communications made under the proposed rule.

- Test-the-waters communications may not conflict with material information in the related registration statement.

- Issuers, including closed-end investment companies, with a class of securities registered under section 12 of the 1934 Act, or required to file reports under section 15(b) of the 1934 Act, will need to ensure compliance with the applicable requirements under Regulation FD.

The comment period for the proposed rule closed on April 29, 2019.

The SEC’s proposed rule is available at https://www.sec.gov/rules/proposed/2019/33-10607.pdf.

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## LITIGATION AND ENFORCEMENT

### *Hedge Fund Adviser to Pay $5 Million for Compliance Failures Related to Valuation*

On June 4, 2019, the SEC announced that Deer Park Road Management Company, LP (DP), a registered investment adviser principally to private funds investing in mortgage-backed securities, agreed to pay $5 million to settle charges of willful violation of section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder (Compliance Rule) by failing to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the federal securities laws in connection with the valuation of client assets.

The SEC found that, from at least October 2012 through December 2015 (Period), DP's policies failed to address sufficiently how to conform DP's valuations with Generally Accepted Accounting Principles or GAAP. The SEC asserted that DP's policies were not reasonably designed for its business practices given DP's use of valuation models and pricing vendors and the potential conflict of interest arising from DP's traders' ability to determine the fair-value assessment of a portion of the positions they manage.

The SEC asserted that during the Period, DP did not sufficiently prevent its traders from providing erroneous information to a pricing vendor and then used the prices DP received to value bonds in one of its funds. While DP did have a valuation committee that oversaw its valuation process, the committee lacked expertise in bond valuation and its chief investment officer approved valuations that included explanations to markup values gradually rather than to market. This practice was in violation of the accounting principles required by DP's policies.

In sum, the SEC noted that the valuation of client assets is critically important for investment advisers. Failure to properly value assets can impact key areas of fund operations and also potentially lead to inappropriate payments of withdrawal proceeds, incorrect calculation of fees and inaccurate performance reporting. As the SEC continues to focus on valuation issues and the practices of investment advisers, a firm's policies and procedures concerning valuation should be reviewed regularly to ensure that the policies and procedures are being properly implemented and to confirm that the policies and procedures are tailored to the specific business of the investment adviser.

The SEC's order is available at https://www.sec.gov/litigation/admin/2019/ia-5245.pdf.

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## *SEC Risk Alert: Customer Data and Third-Party Cloud Storage Platforms*

On May 23, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert, "Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features," in which OCIE "identified security risks associated with the storage of electronic customer records and information by broker-dealers and investment advisers in various network storage solutions, including those leveraging cloud-based storage." In particular, OCIE has observed that many firms are not making use of available security features offered by network storage providers. The Risk Alert highlighted the following:

- *Misconfigured network storage solutions.* Firms failed to adequately configure the security settings on their network storage solution to protect against unauthorized access or develop policies and procedures addressing the security configuration of their network storage solution.

- *Inadequate oversight of vendor-provided network storage solutions.* Firms failed to ensure, through policies, procedures, contractual provisions or otherwise, that security settings on network storage solutions offered by third-party vendors were configured to the firms' standards.

- *Insufficient data classification policies and procedures.* Firms' policies and procedures failed to identify the different types of electronic data stored and the appropriate controls for different types of data.

OCIE, perhaps intentionally, referred to a very broad definition of "cloud-based storage solution" by way of example as "the electronic storage of information on infrastructure owned and operated by a hosting company or service provider."[4] If you are using one or more of these solutions and have not performed holistic assessments of the usage, gaps may exist that leave you exposed to both cyber and regulatory risk. In light of the concerns regarding the security of network storage solutions identified by OCIE, firms should review the adequacy and effectiveness of their practices, policies and procedures

4 Risk Alert at p.1, citing the NIST Definition of Cloud Computing, Recommendations of the National Institute of Standards and Technology, NIST Special Publication 800-145 (Sept. 2011) (NIST Publication).

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with respect to the storage of electronic customer information and oversight of vendors providing network storage solutions. Further, firms should implement controls in the cloud, and then assess the controls to ensure they are working as intended. Finally, firms should perform appropriate levels of monitoring and review to ensure compliance with your policies and procedures.

The Risk Alert is available at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Network%20Storage.pdf.

The NIST Publication is available at https://nvlpubs.nist.gov/nistpubs/Legacy/SP/nistspecialpublication800-145.pdf.

### *SEC Risk Alert: Regulation S-P, Privacy, Safeguarding and Registrant Compliance*

On April 16, 2019, the OCIE issued a Risk Alert summarizing numerous issues it found in its recent examinations of registered investment advisers' and broker-dealers' privacy practices. Some of the most common deficiencies cited were firms' failure to give their customers initial or annual privacy notifications or to notify them that they could opt out of sharing their nonpublic personal information with nonaffiliated third parties.

Regulation S-P, the primary SEC rule regarding privacy notices and safeguard policies of investment advisers and broker-dealers, requires that entities provide to customers a clear and conspicuous notice of their privacy practices, including the customer's right to opt out of some sharing of the customer's personal information to nonaffiliated third parties. Customers must receive notice when the entity-customer relationship is established and every year thereafter for so long as the relationship continues, unless an exception to the annual requirement exists.

In addition, Regulation S-P requires entities to develop and implement administrative, technical and physical safeguards for the protection of customer information. In OCIE's recent investigations, not only were firms found to have not been providing their customers with the required notice, but many firms also lacked internal policies and procedures for administrative, technical and physical information safeguards. For some that had the requisite policies and procedures in place, they either had not been implemented or they were not sufficient to reasonably safeguard customer records and information.

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The Risk Alert also suggested that firms should maintain an inventory of customer information, which would identify all systems where customer information is used or stored and the categories of personal information kept. Though the Risk Alert does not provide guidance as to the specificity of the inventory, it appears to require that firms develop better policies and procedures to protect customer information. The Risk Alert further validates the SEC's ongoing focus on enforcing privacy regulations. Registered investment advisers and broker-dealers should review their written policies and procedures regularly to ensure they are in compliance with Regulation S-P and have a monitoring program in place to ensure compliance with internal policies and procedures as well as Regulation S-P.

The Risk Alert is available at https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Regulation%20S-P.pdf.

## SEC AND SRO NEWS

### *Marshall Gandy Named Co-Head of SEC's Investment Adviser/Investment Company Examination Program*

On June 4, 2019, the SEC announced that Marshall Gandy was named co-national associate director of the investment adviser/investment company examination program in the OCIE. He joins co-national associate director Kristin Snyder, who has led the program since August 10, 2016 and was named OCIE's deputy director on July 25, 2018. Together, Snyder and Gandy will oversee more than 630 lawyers, accountants, and examiners responsible for inspections of SEC-registered investment advisers and investment companies. Gandy has been the associate regional director for examinations in the SEC's Fort Worth office since March 2012 and will continue in that role while also assuming this shared leadership position in the national investment adviser/investment company program. He joined the SEC in 1999 and spent eight years as a trial counsel and enforcement attorney in the Fort Worth office's enforcement program before taking the role of senior regional counsel at FINRA's Dallas District Office.

The SEC's press release on Gandy is available at https://www.sec.gov/news/press-release/2019-88.

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### *Wesley Bricker, Chief Accountant, Leaves SEC*

The SEC previously announced that Wesley R. Bricker, chief accountant, will leave the agency after more than six years of distinguished service. Bricker was appointed acting chief accountant in the SEC's Office of the Chief Accountant in July 2016. He was named to the position permanently in November 2016. Bricker has been replaced by Sagar Teotia, who has been named as acting chief accountant following Bricker's departure. Teotia has served as the SEC's deputy chief accountant since 2017 and previously served as a partner in Deloitte LLP's national office. As acting chief accountant, he will assist the SEC in its oversight of the Financial Accounting Standards Board and Public Company Accounting Oversight Board.

The SEC's press release on Bricker is available at https://www.sec.gov/news/press-release/2019-79.

The SEC's press release on Teotia is available at https://www.sec.gov/news/press-release/2019-80.

### *Adam S. Aderton Named Co-Chief of Asset Management Unit*

On May 2, 2019, the SEC announced that Adam S. Aderton was named co-chief of the Division of Enforcement's Asset Management Unit, a national specialized unit that focuses on misconduct by investment advisers, investment companies and private funds. Aderton joined the SEC in 2008 as a staff attorney in the Division of Enforcement. He joined the Asset Management Unit in 2010 and was promoted to assistant director in 2013. At the SEC, Aderton has brought or supervised enforcement actions that addressed a wide range of misconduct and investor harm across the asset management industry.

The SEC's press release on Aderton is available at https://www.sec.gov/news/press-release/2019-64.

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### *Sara Cortes and David Bartels Named Deputy Chief Counsels of the Division of Investment Management*

On April 15, 2019, the SEC announced that Sara Cortes and David P. Bartels were named deputy chief counsels of the Division of Investment Management. They will join a team that handles a wide range of legal and policy issues, including providing legal and policy guidance, evaluating applications for exemptive relief, and running the division's enforcement liaison program. Cortes will oversee the exemptive applications program, and Bartels will oversee the enforcement liaison program. Both Cortes and Bartels have a history of service with the SEC and with the Division of Investment Management before their appointments as deputy chief counsels. Cortes has been a member of the Rulemaking Office since 2013, and she previously served as counsel and senior advisor to chair Elisse Walter. Bartels most recently served as senior policy advisor to Dalia Blass, the current director of the Investment Management Division. He has worked in a variety of capacities in the Division of Investment Management and in the broader SEC, including as counsel to Commissioner Kara M. Stein.

The SEC's press release on Cortes and Bartels is available at https://www.sec.gov/news/press-release/2019-56.

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Pepper Hamilton LLP
Attorneys at Law

Pepper Hamilton's Financial Services Practice Group includes more than 45 lawyers and other professionals who focus their practices on issues affecting the financial services industry. Our Investment Management Group serves a wide range of businesses in the investment management community. Our practice involves three general areas: representation of registered investment companies and registered investment advisers, representation of alternative investment funds and investors in alternative products, and counseling regarding securities regulation, enforcement and litigation.

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