Market Trends 2018/19: Investment Companies

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This market trends article reviews the Securities and Exchange Commission (SEC) regulatory agenda, releases, speeches, and statements for hints on how the SEC may regulate investment companies, as well as where regulations may be headed in the coming months. Rulemaking got off to a slow start in 2019, as the year opened in the midst of the government shutdown, which lasted from December 22, 2018 until January 25, 2019. Since then, the SEC has been playing catch up.

Reading the regulatory tea leaves, we are seeing a trend towards a regulatory approach that focuses more on principles-based regulations that are designed to reduce, or at least not increase, regulatory burdens on financial firms.

There also appears to be a continuing trend that the SEC may shift its enforcement efforts to focus on major fraud cases and place less emphasis on policing minor violations (known as the broken windows approach). In past years, many criticized the broken windows approach as a misplaced use of limited resources.

Legal and Regulatory Trends

The Office of Management and Budget's Spring 2019 Unified Agenda of Federal Regulatory and Deregulatory Actions (the Spring 2019 Agenda), which reports near and long-term regulatory actions, provides a window into the current thinking of certain administrative agencies, including the SEC. Here are some of the most relevant items on the SEC's regulatory agenda, as disclosed on the Spring 2019 Agency Rule List.

Pre-rule Stage

The staff of the SEC (the Staff) is considering recommending that the SEC seek public comment on ways to harmonize and streamline the SEC's rules for exempt offerings.

Proposed Rule Stage

The Staff is considering proposing to the SEC the following initiatives:

- **Custody rules for investment companies and investment advisers.** In what may be one of the SEC's most important and potentially controversial rules, the Division of Investment Management said that it is considering recommending that the SEC propose amendments to rules concerning custody under the Investment Company Act of 1940 (the 1940 Act) and the Investment Advisers Act of 1940 (the Advisers Act). We expect that the proposed amendments will address custody of digital assets, but this is by no means assured.
- **Use of derivatives by registered investment companies and business development companies.** The Division of Investment Management is considering recommending that the SEC re-propose a new rule designed to enhance regulation of the use of derivatives by registered investment companies and business development companies, as further discussed below.
- **Marketing rules under the Investment Advisers Act of 1940.** The Division of Investment Management is considering recommending that the SEC propose amendments to Rules 206(4)-1 and 206(4)-3 under the Advisers Act regarding marketing communications and practices by investment advisers.

- **Fund of funds arrangements.** On December 19, 2018, the SEC proposed new rules and amendments to allow funds to acquire shares of other funds (known as "fund of funds" arrangements), including arrangements involving exchange-traded funds (ETFs), without first obtaining exemptive orders from the SEC. The proposal drew more than 90 public comments, including some that questioned limitations on the amount of shares that a fund of funds could redeem of a portfolio fund that it holds.
- **Expedited application review process.** The Division of Investment Management is considering recommending that the SEC propose amendments to Rule 0-5 under the 1940 Act to establish an expedited review procedure for certain types of applications. This proposal would be a welcome step to reducing the time and cost associated with the process for applying for exemptive orders.
- **Volcker Rule.** On December 21, 2018, the SEC proposed revisions to the rules implementing Section 619 of the Dodd-Frank Act, known as the Volcker Rule, which restrict proprietary trading and certain relationships with covered funds (proposed jointly with other financial regulators).
- **Regulation S-X and Regulation S-K amendments.** The SEC staff is considering to recommend proposed amendments to certain disclosure requirements in Regulation S-X and Regulation S-K that have become redundant, duplicative, overlapping, outdated, or superseded in light of other accounting and disclosure requirements.

Final Rule Stage

Exchange-Traded Funds

On March 11, 2018, the SEC proposed rules and amendments to allow certain ETFs to operate without first obtaining exemptive orders from the SEC. If adopted as proposed, Rule 6c-11 would replace most individual exemptive orders issued to existing ETFs. One of the SEC's stated goals is to create a level playing field among all ETFs subject to the rule. Geared ETFs would be excluded from the exemptive rule, and would be required to obtain individual orders. (The SEC proposed similar ETF relief more than a decade ago without taking any further action on it.)

Regulation Best Interest

On June 5, 2019, the SEC approved Regulation Best Interest and related guidance and interpretations on responsibilities of investment professionals relating to standards of conduct to their retail customers, as further discussed below.

Investment Company Reporting Modernization

On June 5, 2018, the SEC adopted Rule 30e-3 under 1940 Act, which was originally proposed in May 2015 as part of the SEC's broader investment company reporting modernization proposal. Rule 30e-3 permits, but does not require, registered investment companies to deliver certain reports to shareholders electronically by making them accessible on their website.

The Auditor Loan Rule

On June 18, 2019, the SEC adopted rules governing auditor independence with respect to certain loans or debt-credit relationships. Under the prior rule, an auditor that has obtained a loan from an entity that is the beneficial owner of more than 10% of the outstanding securities of a fund may find its independence in question with respect to that fund and other funds in the complex. The rule replaces the 10% bright-line test with a **significant influence** test. The new rule becomes effective 90 days after the date of publication in the Federal Register.

Long-Term Actions

In the Spring 2019 Agenda, the SEC published its list of back-burner (Long-Term Action) status regulatory initiatives. These include:

- Rules to improve and modernize the current disclosure framework of funds under the 1940 Act to improve the investor experience
- Rules and form amendments to improve and modernize the current disclosure framework for investment company fees under the 1940 Act
- The listing and trading of exchange-traded products (ETPs), other than ETFs
- Requirements to disclose in proxy statements information about the diversity of board members and nominees
- Rules implementing Section 953(a) of the Dodd-Frank Act, to require issuers to disclose information that shows the relationship between executive compensation actually paid and the financial performance of the issuer
- Rules that would (1) amend the net capital rule to require broker-dealers to conduct regular liquidity stress testing and maintenance requirements, (2) add additional notification requirements for broker-dealers concerning their financial condition, and (3) amend certain broker-dealer recordkeeping requirements concerning transfer of customer accounts to another carrying broker-dealer

Investment Company Use of Derivatives and Leverage

For more than 30 years, the SEC and its staff have been improvising on how, and to what extent, investment companies can use derivatives. When Congress adopted the 1940 Act, derivatives, as we know them today, had not yet been invented. As these instruments grew in popularity, regulatory bodies and fund managers struggled to find a way to properly regulate fund use derivatives to hedge, create leverage and new strategies within the 1940 Act's legal parameters.

Beginning in 1979, with Release No. IC-10666 (known as Release Ten-Triple-Six), the SEC and Staff paved the way for the use of derivatives, including allowing certain trading practices. This interpretation led to a patchwork of guidelines and interpretations that sought to both permit innovation and protect investors.

The 2008 financial crisis increased the focus on derivatives and leverage, which led to the SEC proposing Rule 18f-4 to address fund use of derivatives in 2015. This controversial proposed rule would have codified many existing interpretations of the law and would have imposed substantive limits on derivatives use and required funds to segregate qualifying coverage assets (generally consisting of cash or cash equivalents) to cover potential liabilities and establish specific policies and procedures designed to monitor compliance. Moreover, the proposed rule would have required fund directors to actively oversee fund use of derivatives with a degree of substantive detail not previously seen.

This initiative came to a grinding halt immediately after the 2016 presidential election. The rule's adoption fell victim to a stalemate at the SEC, which may not have been able to muster a quorum to vote on a final rule. While the SEC pushed this rule to the back burner in the Fall 2017 Agenda, the initiative was revived in the Spring 2018 Agenda, when the SEC said that the Staff is considering recommending to the SEC a revised proposal.

Liquidity Risk Management

Beginning June 1, 2019, large fund groups must comply with the SEC's liquidity risk management rules, which the SEC adopted with great fanfare in 2016. The new rules require funds to adopt specific liquidity risk management programs, comply with substantive limits on investments in illiquid securities, and categorize and report liquidity levels. Funds were originally supposed to comply with the new requirements starting in 2018, which for many fund advisers will involve substantial and costly enhancement in systems and compliance personnel. The SEC estimated that the onetime cost for funds to comply ranges from $800,000 to $10.2 million, with an average cost per fund complex of $1 million, and an aggregate industry cost of approximately $855 million.

In February 2018, the SEC postponed the compliance dates for certain provisions of the Liquidity Rules until June 1, 2019 (from December 1, 2018), for larger entities, and December 1, 2019 (from June 1, 2019), for smaller entities. The postponement applies to Rule 22e-4 for classification, highly liquid investment minimum, and board approval, as well as certain reporting requirements and liquidity disclosures on Forms N-LIQUID and N-PORT. All other compliance dates remain the same.

Fiduciary Rule / Standard of Conduct for Investment Advisers and Broker-Dealers

On June 5, 2019, the SEC adopted Regulation Best Interest, as well as interpretations and guidance designed to enhance and clarify the standards of care that apply to broker-dealers when dealing with retail customers/clients, and the fiduciary obligations of investment advisers when dealing with clients. The proposals, published in April 2018, for investment advisers under the Advisers Act and broker-dealers under the Exchange Act are interlocking and complementary but are not uniform.

The SEC's proposed rules evolved out of a 2011 Staff study required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) (111 P.L. 203, 124 Stat. 1376). See Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (January 2011). Section 913 required the staff of the SEC to evaluate regulatory standards of care. The Staff report made several recommendations addressing retail customer confusion about differing standards of care that apply to broker-dealers and investment advisers. Among other things, the 2011 study addressed the need to establish uniform fiduciary standards that would apply to both broker-dealers and investment advisers.

The SEC's new rules follow an attempt by the Department of Labor (DOL) to fashion its own fiduciary rule (Fiduciary Rule), which would have expanded fiduciary status to various financial service providers under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and effectively would have imposed a fiduciary status on financial firms that provided services to retail customers, including those who invest in individual retirement accounts, which are not covered by ERISA.

While it would not have applied directly to registered investment companies, the Fiduciary Rule would have affected them because financial intermediaries may have required registered funds to change fund fee structures to accommodate their compliance requirements.

The Fiduciary Rule compliance date was originally delayed until July 1, 2019. On March 15, 2018, the Fifth Circuit Court of Appeals vacated the Fiduciary Rule in its entirety. See Chamber of Commerce of the United States v. United States DOL, 885 F.3d 360 (5th Cir. 2018). The DOL did not appeal this decision.

On May 7, 2018, the DOL announced a temporary enforcement policy, the Field Assistance Bulletin 2018-02 (the FAB), to address the uncertainty about fiduciary obligations and the scope of exemptive relief under ERISA, the Internal Revenue Code of 1986, as amended, and associated prohibited transaction exemptions in light of the Fifth Circuit's ruling. The FAB states that pending further action, the DOL will not pursue prohibited transaction claims against investment fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards that would have been exempted by the Fiduciary Rule. The DOL said that it is evaluating what further regulatory relief would be appropriate. Thus, for the time being, the fate of the Fiduciary Rule is uncertain.

The SEC's rules and interpretations applying to the standard of care for broker-dealers and investment advisers when dealing with retail clients include the following:

Form CRS. Form CRS requires broker-dealers and SEC-registered investment advisers to provide a simple point of entry for retail investors to understand their relationship with their investment professional. The form addresses, among other things, the nature of the services offered, the applicable standard of care, information about fees, disclosure of material conflicts of interest, and other relevant information.

Use of titles. The SEC's original proposal would have restricted broker-dealers and their associated persons (unless they were registered as, or supervised persons of, an investment adviser), when communicating with a retail investor, from using the term adviser or advisor as part of a name or title. In light of the disclosure requirements of Regulation Best Interest, the SEC decided that a separate rule restricting the use of the title was not necessary. In particular, Regulation Best Interest includes an obligation for a broker-dealer to disclose the capacity in which it provides services to a customer/client. A broker-dealer or its supervised person that is not also registered as an investment adviser or an associated person that is not also a supervised person of an investment adviser that uses that title violate the capacity disclosure requirements of Regulation Best Interest.

Regulation Best Interest. Historically, broker-dealers were held to a suitability standard, which means that they can recommend an investment as long as it is suitable for a client.

Regulation Best Interest, adopted under the Exchange Act, would create a principles-based standard that requires brokers, dealers, or their associated persons to act in the best interest of a retail customer, without placing their financial or other interests ahead of the customer, when recommending a securities transaction or investment strategy involving securities. The final rule also applies to recommendations of account types and rollovers or transfers of assets and also covers implicit hold recommendations resulting from agreed-upon account monitoring.

Broker-dealers satisfy this obligation if they comply with separate disclosure, care, and conflicts of interest requirements. While it moves the ball forward, Regulation Best Interest stops short of creating a uniform fiduciary obligation that applies to both broker-dealers and investment advisers.

The disclosure obligation in Regulation Best Interest requires broker-dealers (and their associated persons), before recommending a securities transaction or investment strategy to a retail customer, to reasonably disclose in writing the material facts relating to the relationship with the retail investor, including conflicts of interest. Among other things, the SEC considers the following to be examples of material facts relating to the scope and terms of the relationship with the retail customer:

- That the broker-dealer is acting in a broker-dealer capacity with respect to the recommendations
- Fees and charges that would apply to the retail customer's transactions, holdings, and accounts –and–
- Type and scope of services provided by the broker-dealer, including, for example, monitoring the performance of the retail customer's accounts

The care obligation closely tracks existing suitability standards of Rule 2111 of the Financial Industry Regulatory Authority, Inc. (FINRA), which requires a broker-dealer or an associated person to exercise reasonable diligence, care, skill, and prudence to:

- Understand the risks of a recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail investors

- Have a reasonable basis to believe that the recommendation is in the best interest of the particular retail investor
- Have a reasonable basis to conclude that a series of recommendations, when viewed together, is not excessive and in the retail investor's best interest

Regulation Best Interest also requires broker-dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and, at a minimum, disclose or eliminate all material conflicts of interest associated with a recommendation, and to mitigate or eliminate material conflicts of interest that arise from financial incentives associated with a recommendation.

Offering Reforms for BDCs and Closed-End Funds

In March 2019, the SEC proposed rule and form amendments to implement provisions of the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act, which Congress passed in 2018. The proposed rules would allow business development companies (BDCs) and closed-end funds to use the registration offering and communications reforms that the SEC adopted for operating companies in 2005. The proposals also include other amendments designed to help implement congressionally mandated amendments by further harmonizing the disclosure and regulatory framework for BDCs and closed-end funds.

Among other things, the rules would allow BDCs and closed-end funds to:

- Engage in a more streamlined registration process to sell securities off-the-shelf
- Qualify for Well-Known Seasoned Issuer (WKSI) status, which allow for more flexibility in the registration process and communications with the market
- Use many communication rules currently available to operating companies
- Incorporate by reference previously filed materials when providing purchasers with information

Division of Investment Management Outlook

In March 2019, Dalia Blass, in a speech to the Investment Company Institute's (ICI) Mutual Fund and Investment Management Conference the Director of the SEC's Division of Investment Management, discussed the division's goals and outlook for 2019. Among other things, she noted that the division's top priorities include recommendations on Regulation Best Interest, Form CRS, and the fiduciary duty interpretation, which the SEC adopted in June 2019, and exploring options for a summary shareholder report and ways to improve fee and risk disclosures. She also said that finalizing the proposed ETF rule and fund of funds rule would be priorities of the division.

Director Blass said that the division will continue to build on the foundations laid the previous year to focus on improving investor experience. On June 5, 2018, the SEC asked for public comment from individual investors and other interested parties on enhancing disclosures by mutual funds, ETFs, and other types of investment funds to improve the investor experience and to help investors make more informed investment decisions. Among other things, the SEC asks for investors' views on how they rely on electronic media for information about their investments and whether they prefer to receive electronic or paper copies of prospectuses and other fund documents. The SEC also asks about the form and design of disclosures and how they can be more user-friendly. After the SEC receives and digests the public comments it receives, it would not be surprising to see the SEC consider innovative approaches to disclosures and how to communicate information efficiently to a new generation of investors that rely on mobile devices.

Perhaps most significantly, the Division Director said that she anticipates that the next milestone will be recommending updates to the SEC's valuation guidance for investment companies. This long-awaited guidance likely would be welcomed by funds and their independent directors.

Other hot regulatory buttons in the division is the role of proxy advisory firms and international policies. With respect to the latter item, the division likely will address how U.S. advisory firms can pay for research in light of the European Union's (EU) Markets in Financial Instruments Directive (MiFID) II restrictions, which generally prohibit soft dollar payments for research in the EU.

Examinations and Enforcement

The SEC's Division of Enforcement issued its 2018 Annual Report discussing enforcement-related accomplishments and key initiatives for the coming year. The report cautioned that the raw number of cases filed or the amounts of fines and penalties assessed during an arbitrary period do not adequately measure the effectiveness of an enforcement program. Rather, the report says, the division evaluates the effectiveness of its program by measuring the nature, quality, and effects of the SEC's enforcement actions.

The Enforcement Division articulated five core principles that would drive its enforcement decision-making process:

- Focus on the main street investor

- Focus on individual accountability
- Keep pace with technological change
- Impose sanctions that most effectively further enforcement goals
- Constantly assess the allocation of our resources

It is too early to tell how the Enforcement Division's enumerated core principles will affect the number and scope of enforcement proceedings, and how they will differ from the actions commenced in the past.

Although the SEC mentioned the limits of raw quantitative metrics, it said that fiscal year 2018 reflected a high level of activity by the Division of Enforcement, representing an improvement over the previous year. During the fiscal year, the SEC brought 821 actions and obtained judgments and orders totaling more than $3.9 billion in disgorgement and penalties, and returned $794 million to harmed investors. As of the close of fiscal year 2018, the SEC brought more than 12 stand-alone enforcement actions involving digital assets and initial coin offerings (ICOs), some involving fraud, and others designed to ensure compliance with registration requirements of the federal securities laws.

A notable trend is the increase in enforcement activity involving cyber-related misconduct, and on issues relating to ICOs and digital assets.

In February 2019, the Office of Compliance Inspections and Examinations (OCIE) published its 2019 examination priorities, which emphasize:

- Retail investors, including seniors and people saving for retirement
- Compliance and risks in critical market infrastructure
- Focus on FINRA and the Municipal Securities Rulemaking Board (MSRB)
- Digital assets
- Cybersecurity
- Anti-money laundering programs

The addition of digital assets to OCIE's list of its not exhaustive examination priorities is a recognition that this growing area is now on its regulatory radar screen.

Blockchain and Digital Assets

The blockchain frenzy is creating a new and swiftly evolving paradigm for investment managers and regulators alike as they grapple with a variety of issues, including whether digital assets are securities for purposes of federal law and whether to allow registered investment companies to invest substantially all of their assets in these new instruments.

The SEC's Division of Investment Management waded into this thicket in January 2018 when Division Director Dalia Blass cautioned digital asset proponents to proceed with caution. In a letter to the mutual fund industry, the Staff raised questions about how funds that hold substantial amounts of digital assets and related products would satisfy the requirements of the 1940 Act and its rules. Among other things, the Staff raised questions about valuation of assets, liquidity, custody, the ability of ETFs that invest in digital assets to maintain adequate arbitrage, potential manipulation, and other risks.

In a letter dated March 12, 2019, the Division of Investment Management sought public comment to help it understand how investment advisers that invest in digital assets can comply with Rule 206(4)-2 under the Investment Advisers Act of 1940, the so-called Custody Rule. The Custody Rule, which was designed to prevent misappropriation of assets, stops short of prescribing requirements for actual custody of assets. The letter suggests that the SEC and its staff are attempting to determine how, and to what extent, it should regulate custody of digital assets. Indeed, as indicated above, the SEC has indicated that it is considering recommending that the SEC adopt new rules addressing custody requirements for investment companies and investment advisers.

Other issues that have raised concerns with respect to blockchain also extend to investment advisers of investment companies and private funds, including personal trading practices, cybersecurity, and disclosure issues, among others.

Pooled investment vehicles that invest heavily in digital assets must be concerned not only with the scope of the SEC's regulation but also must be mindful that they may be subject to regulation by the Commodity Futures Trading Commission, FINRA, the Financial Crimes Enforcement Network, and various state regulators. This rapidly growing area is likely to continue to attract more and more attention from the SEC and other regulators.

Other Key Market Trends

The Investment Company Institute, in its 2019 Fact Book, reported that U.S. registered investment company assets of $21.4 trillion at the end of 2018, a decline of $1.1 trillion from the end of 2017.

According to the ICI data, there were 1,988 U.S. ETFs at the end of 2018, with total assets of $3.37 trillion. These numbers represent a small increase in the number of ETFs from a year ago, as well as a slight dip in total net assets from a year ago.

Market Outlook

We expect that while the pace of new regulations may remain steady in coming months, the SEC will enter into a balancing act, as it emphasizes regulations and enforcement designed to protect main street investors while at the same time encourage a principles-based approach away from a rule-based regulatory approach. We expect that the role of fund directors will continue to grow as the SEC adopts more principles-based regulations. Moreover, we believe that the SEC and its staff will begin to formulate policies and rules that address the growing interest in digital asset investments..

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Jay G. Baris is a partner in the Investment Funds practice and has practiced in the asset management area for more than 35 years.

Jay is widely recognized for his breadth of experience representing registered funds, investment advisers, financial institutions, broker-dealers and independent directors on the full spectrum of financial services regulation, transactions and governance matters. Jay's work with registered funds spans mutual funds, closed-end funds, exchange-traded funds (ETFs) and business development companies (BDCs). He has extensive experience advising on the regulatory aspects of fund and investment advisory operations, and has represented numerous clients on mergers and acquisitions, reorganizations, compliance, exemptive applications and compliance issues. He also advises operating companies on "status" issues that arise under the Investment Company Act of 1940. More recently, he has been advising FinTech clients on cryptocurrency issues.

An active speaker and writer on issues concerning investment management and the regulation of financial institutions, Jay has been published in a variety of trade and general interest publications, Insights: The Corporate & Securities Law Advisor, The New York Times, The Wall Street Journal, The Review of Securities & Commodities Regulation, Fund Action, The Review of Banking & Financial Services, Fund Directions and Fund Board Views.

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