GODFREY & KAHN S.C.

Investment Management Focus

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Legal and Regulatory Update

LATEST DEVELOPMENTS

SEC Announces 2020 Examination Priorities

The SEC's Office of Compliance Inspections and Examinations (OCIE) has released its 2020 examination priorities. In its release, OCIE noted that it completed over 3,089 examinations in 2019 and issued over 2,000 deficiency letters relating thereto. Of the examinations completed, 2,180 examinations covered registered advisers, which represented approximately 15% of all registered advisers. In addition, examinations specific to investment companies increased by approximately 12%, covering over 150 examinations related primarily to sweep examinations addressing OCIE initiatives focused on mutual funds and ETFs.

OCIE noted its 2020 examination priorities cover certain practices, products and services that OCIE believes present heightened risks to investors or to the integrity of the U.S. capital markets. The 2020 priorities are grouped into the following categories:

1. Matters of importance to retail investors, including seniors and individuals saving for retirement;
2. Information security;
3. FinTech and innovation, including digital assets and electronic investment advice;
4. Focus areas relating to advisers, investment companies, broker-dealers and municipal advisers;
5. AML programs;
6. Market infrastructure; and
7. Select areas and programs of FINRA and the MSRB.

Several of these categories are described in more detail below. OCIE noted that while these priorities drive many of OCIE's examinations, the scope of any examination is determined through a risk-based approach that includes analysis of various factors, including the registrant's operations, products and services offered, prior examination observations and conduct, changes in firm leadership or other personnel, disciplinary history, and other factors.

Retail Investors, Including Seniors and Individuals Saving for Retirement

OCIE continues its focus on protecting retail investors, particularly seniors and individuals saving for retirement, and will focus on the following areas:

- *Fraud, Sales Practices and Conflicts.* OCIE will examine advisers' recommendations and advice provided to retail investors, with

a particular focus on seniors, including recommendations and advice made by individuals and entities targeting retirement communities, as well as teachers and military personnel. OCIE will also focus its exams on higher risk products, such as private placements and securities of issuers in new and emerging risk areas, including those that are non-transparent or complex, involve high fees and expenses or involve situations where the issuer is affiliated with or related to the firm making the investment recommendation. These exams will predominantly focus on the disclosures made by registered firms and their supervision of outside business activities of employees and associated persons and any conflicts that may arise from such activities. OCIE will also continue to focus on whether registered advisers, as fiduciaries, have satisfied their duties of loyalty and care. OCIE also noted that certain compensation-based conflicts of interest may arise that require adequate disclosure and mitigation.

- *Retail-Targeted Investments.* OCIE will continue to examine the services and products offered by advisers to seniors and those saving for retirement. Specifically, OCIE will focus on investments in mutual funds and ETFs, municipal securities and other fixed-income securities, as well as micro-cap securities. With respect to mutual funds and ETFs, OCIE will continue to focus on examining financial incentives provided to financial services firms and professionals that may influence the selection of certain mutual fund share classes. OCIE will also prioritize its review of mutual fund fee discounts or breakpoints.
- *Standards of Care.* In connection with the SEC's June 2019 adoption of Regulation Best Interest (Reg BI) and the publication of the "Interpretation Regarding Standard of Conduct for Investment Advisers" and the Form CRS Relationship Summary (which were discussed in our July 2019 update), OCIE intends to, prior to the June 30, 2020 compliance date, engage with registrants during their examinations on their progress toward implementing Reg BI and Form CRS, as applicable, and, following the June 30, 2020 compliance date, to assess implementation of Reg BI requirements, such as policies and procedures relating to conflicts of interest disclosures, as well as the content and delivery of Form CRS.

Information Security

OCIE believes information security protection is critical to the operation of the financial markets and will work with firms to identify and address information security risks, including cyber-related risks, and to encourage market participants to effectively and actively engage regulators and law enforcement in this effort. OCIE examinations will focus on proper configuration of network storage devices, and information security governance, as well as retail trading information security. OCIE will pay particular attention to the following areas: governance and risk management; access controls; data loss prevention; vendor management; training; and incident response and resiliency. OCIE will also focus on oversight practices of third-party service providers and network solutions, such as those using cloud-based solutions, and continue to conduct examinations to test compliance with Regulation S-P (privacy rules) and Regulation S-ID (identity theft prevention rules).

Additional Focus Areas Advisers and Investment Companies

OCIE will focus on these additional areas involving registered advisers and investment companies:

- *RIA Compliance Programs.* OCIE will continue to focus on reviewing compliance programs and will prioritize examinations of dual registrants and of advisers affiliated with broker-dealers or that have supervised persons that are registered representatives of an unaffiliated broker-dealer. OCIE's focus areas include effective compliance programs that properly address the following risk areas: fiduciary advice; disclosure of conflicts; best execution; and prohibited transactions. OCIE also noted that it will pay particular attention to advisers offering new or emerging investment strategies, such as those incorporating environmental, social and governance (ESG) criteria.
- *Never-Before or Not Recently-Examined Advisers.* OCIE will continue to examine certain advisers that have never been examined, including new registrants, and those that have not been examined

for a number of years and may have changed business models or have experienced substantial increases in assets under management.

- *Mutual Funds and ETFs.* OCIE will continue to focus on: advisers that use third-party administrators to sponsor mutual funds that they advise or are affiliated with; mutual funds or ETFs that have not previously been examined; and advisers that provide advice to both private funds and registered funds with similar investment strategies.
- *RIAs to Private Funds.* OCIE's examinations will continue to prioritize advisers to private funds that have a larger impact on retail investors, including firms that advise separately managed accounts side-by-side with private funds. OCIE will focus on the compliance risks of such advisers, including controls to prevent the misuse of material, non-public information and conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses, and the use of RIA affiliates to provide services to clients.

AML Programs

OCIE will continue to focus on investment company and broker-dealer AML programs to ensure such programs include, among other things, policies and procedures reasonably designed to identify and verify the identity of customers and beneficial owners of legal entity customers, monitor suspicious activity, perform customer due diligence, and, if applicable, file suspicious activity reports with FinCEN.

The SEC's press release relating to OCIE's 2020 examination priorities noted that these published priorities are not exhaustive and will not be the only issues OCIE addresses in its examinations.

Sources: SEC Office of Compliance Inspections and Examinations Announces 2020 Examination Priorities (Jan. 7, 2020), available here; 2020 Examination Priorities, Office of Compliance Inspections and Examinations (Jan. 7, 2020), available here.

LATEST DEVELOPMENTS: FUNDS

OCIE Issues Risk Alert Regarding Compliance Topics Observed in Investment Company Examinations

OCIE issued a Risk Alert highlighting the most often cited deficiencies and weaknesses that its staff observed in recent examinations of registered investment companies (funds). The observations resulted from approximately 300 fund examinations conducted over a two-year period. OCIE indicated that the most often cited deficiencies and weaknesses related to the fund compliance rule (Rule 38a-1), disclosures to investors, the Section 15(c) approval process and the fund code of ethics rule (Rule 17j-1).

Deficiencies Related to the Fund Compliance Rule

Rule 38a-1 under the 1940 Act requires a fund to adopt and implement, and review at least annually, written policies and procedures reasonably designed to prevent violations of the federal securities laws and which provide for compliance oversight of the fund's investment adviser(s), principal underwriter, administrator and transfer agent (collectively, "service providers"). Deficiencies observed included:

- **Compliance programs that did not take into account fund-specific business activities or risks.** For example, funds lacked:
  - Policies and procedures reasonably designed to prevent the funds from violating their own investment limitations and guidelines.
  - Procedures to review the appropriateness and accuracy of the methods used to price securities.
  - Procedures to ensure the accuracy of disclosures made in advertisements or other sales literature.

- **Policies and procedures not followed or enforced.** Funds did not follow or enforce their own compliance policies and procedures, including instances where board approval or ratification was required but not obtained.
- **Inadequate service provider oversight.** For example:
  - Fund policies and procedures did not provide for ongoing monitoring or due diligence of service provider services relating to pricing of portfolio securities and fund shares.
  - Funds failed to obtain board approval of subadvisers' policies and procedures.
- **Annual reviews were not performed or did not address the adequacy of fund policies and procedures.** For example:
  - Funds failed to perform or adequately document annual reviews of their policies and procedures.
  - Annual reviews were conducted but did not address the adequacy of fund policies and procedures and the effectiveness of their implementation.

Deficiencies Related to Investor Disclosures

Under federal securities laws, it is unlawful to make untrue statements of material fact or omit material information necessary to make other statements not misleading in registration statements or other documents filed with the SEC or provided to investors. OCIE observed funds providing incomplete or potentially misleading information in registration statements or shareholder reports when compared to actual fund activities. For example, funds:

- Omitted disclosure regarding the payment of fees to service providers or a change to an investment strategy.
- Identified strategies as principal investment strategies even though the funds had not implemented (or did not expect to implement) these strategies.

Deficiencies Related to the Section 15(c) Approval Process

Section 15(c) of the 1940 Act requires a majority of a fund's independent directors to initially approve and to approve any renewals of advisory agreements. As part of this approval process, fund boards have a duty to request and evaluate information that may be reasonably necessary for the board to consider the terms of the agreements, and to preserve records relating to the review and approval process. Deficiencies observed included:

- **Reasonably necessary information not requested or considered.** Boards did not request or consider information reasonably necessary to evaluate the fund's advisory agreement. For example, boards:
  - Did not appear to consider relevant information related to the profitability of the fund to the adviser, economies of scale, or peer group comparisons for the advisory fee.
  - Received incomplete materials but did not request the omitted information, such as performance data for the fund and other accounts managed by the adviser and profitability reports.
- **Inadequate discussion forming the basis of board approval.**
  - Fund shareholder reports did not adequately discuss the material factors and conclusions that formed the basis for the board's approval of an advisory contract.

- Funds did not retain copies of written materials considered by the board in approving advisory contracts.
- Funds failed to maintain a clear record of the information requested or considered by the board as part of the advisory contract approval process due to, for example, inadequate board minutes.

Deficiencies Related to the Fund Code of Ethics Rule

Rule 17j-1 under the 1940 Act requires funds to adopt a written code of ethics containing provisions reasonably necessary to prevent "access persons" from engaging in any fraudulent, deceptive, or manipulative acts in connection with the purchase and sale of securities held or to be acquired by the fund. The rule also generally requires access persons to report certain personal securities holdings and transactions. Deficiencies observed included:

- **Failure to implement code of ethics or related procedures.** For example, funds:
    - Adopted codes of ethics lacking procedures adequate to prevent access persons from misusing material non-public information or procedures for determining and documenting that an access person was eligible for an exception.
    - Failed to designate the proper individuals as access persons.
- **Failure to follow or enforce code of ethics.** For example, funds did not collect or review personal securities holdings and transactions reports of their access persons or did not enforce the pre-clearance and holdings period restrictions contained in their codes of ethics.
- **Code of ethics approval and reporting.** Funds failed to comply with the approval and reporting obligations of Rule 17j-1. For example, funds:
    - Failed to obtain initial approval of the code of ethics by the board.
    - Did not provide, or provided inaccurate, required annual reports to the board regarding code of ethics violations and sanctions.

The Risk Alert also included observations from examination initiatives focusing on money market funds and target date funds in connection with OCIE's assessment of market-wide risks and matters of importance to retail investors and investors saving for retirement.

Source: OCIE Risk Alert: Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives (November 7, 2019); available here.

SEC Proposes New Rules Governing the Use of Derivatives by Registered Investment Companies and Financial Intermediary Sales Practices

On November 25, 2019, the SEC re-proposed a rule, originally proposed in 2015, regarding the use of derivatives and financial commitment transactions by registered investment companies (including mutual funds, ETFs and closed-end funds) and business development companies. Proposed Rule 18f-4 under the 1940 Act is designed to promote funds' ability to use derivatives in a variety of ways while addressing the speculation and asset sufficiency concerns underlying the restrictions in Section 18 of the 1940 Act regarding senior securities and borrowing. In addition, the SEC believes the rule will help promote a modern and comprehensive framework for derivatives and other transactions. The proposed rule would limit funds' use of derivatives and require them to adopt written derivatives risk management programs. Unlike the 2015 proposal, the current proposal does not include a specific asset segregation requirement, although the SEC is requesting comment on this approach.

As part of the proposal, the SEC is also proposing to rescind Release IC-10666, a 1979 release that many funds currently rely on to engage in certain securities trading practices, including reverse repurchase, firm

commitment and standby commitment agreements that otherwise may raise concerns under Section 18 of the 1940 Act. The staff of the Division of Investment Management (IM Division) is reviewing certain of its no-action letters and other guidance addressing derivatives transactions to determine which letters and other staff guidance should be withdrawn in connection with any adoption of the proposed new rule. The release states that the SEC expects to provide funds a one-year transition period before Release IC-10666 is withdrawn.

Under the proposed rule, funds that enter into derivatives transactions (except funds that only engage in a limited amount of derivatives transactions) must establish a formalized derivatives risk management program and must comply with an outer limit on fund leverage risk based on a "value-at-risk" (VaR) test. A limited derivatives user, defined as a fund that either limits its derivatives exposure to 10% of its net assets or uses derivatives only to hedge certain currency risks, would not be required to comply with the risk management program or VaR-based risk limit requirements, provided that such funds adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks.

The rule proposal would also require new reporting by funds on Form N-PORT, N-LIQUID and Form N-CEN. The SEC also issued proposed sales practice rules that would require a broker-dealer or adviser to exercise due diligence in approving a retail investor's account to invest in leveraged or inverse funds. The rule proposal also addresses funds' use of reverse repurchase agreements and unfunded commitment agreements separately from funds' use of derivatives.

Definition of Derivatives Transactions

The proposed rule would permit funds to enter into derivatives transactions, subject to the rule's conditions. "Derivatives transaction" is proposed to be defined as: (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument, under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; and (2) any short sale borrowing. The release notes that the first prong of the proposed definition is designed to describe those derivatives transactions that involve the issuance of a senior security, because they involve a contractual future payment obligation, and is intended to include derivatives that may be developed in the future. As discussed below, because the proposal addresses funds' use of reverse repurchase agreements and unfunded commitment agreements separately, they are not included in the proposed definition.

Risk Management Program and Board Oversight

Funds that are not limited users of derivatives would be required to adopt and implement a formalized derivatives risk management program and designate a fund adviser's officer or officers to serve as the fund's derivatives risk manager. The following elements would be required in the program:

1. **Risk Identification and Assessment.** A fund would be required to identify and assess its derivatives risks, taking into account the fund's other investments as well as its derivatives transactions.
2. **Risks Guidelines.** A fund would be required to establish, maintain and enforce investment, risk management or related guidelines that provide for quantitative or other measurable criteria, metrics, or thresholds of the fund's derivative risks.
3. **Stress Testing.** A fund would be required to provide for stress testing to evaluate potential losses to the fund's portfolio under stressed conditions.
4. **Backtesting.** A fund would be required to backtest the results of the VaR calculation model used by the fund.
5. **Internal Reporting and Escalation.** The program would have to identify the circumstances under which a fund must communicate with its portfolio management about the fund's derivatives

risk management, including the program's operation. The derivatives risk manager is also required to communicate material risks to the fund's portfolio management and, as appropriate, its board.

6. **Periodic Review.** A fund's derivatives risk manager would be required to review and update the derivatives risk management program at least annually.

The derivatives risk manager would be responsible for the day-to-day administration of the fund's program, subject to board oversight. The fund's board must approve the designation of the derivatives risk manager, taking into account the derivatives risk manager's relevant experience, and the derivatives risk manager must have a direct reporting line to the board. The proposal also provides that funds should reasonably segregate derivatives risk management functions from portfolio management (i.e., the derivatives risk manager cannot solely consist of a fund's portfolio manager(s)). The derivatives risk manager must provide a written report on the effectiveness of the program at least annually and also provide regular written reports at a frequency determined by the board.

VaR-Based Limit on Fund Leverage Risk

A fund relying on the proposed rule would generally have to comply with a VaR limit. This limit would be based on a relative VaR test that compares the fund's VaR to the VaR of a "designated reference index" for that fund. The fund's VaR would not be permitted to exceed 150% of the VaR of the fund's designated reference index. If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed 15% of the value of the fund's net assets. The release notes that VaR is a commonly-known and widely-used industry metric and is designed to address leverage risk for a variety of fund strategies.

Proposed Sales Practice Rules

Proposed Rule 15l-2 under the Exchange Act and Rule 211(h)-1 under the Advisers Act would require a broker-dealer or SEC-registered adviser to exercise due diligence in approving a retail customer or client's account to buy or sell shares of leveraged/inverse funds. A broker-dealer or adviser may only approve the purchase if it has a reasonable basis to believe that the customer or client is capable of evaluating the risks associated with these products. Because these rules would create a more comprehensive regulatory framework applicable to the sale of leveraged and inverse funds, the SEC also proposed to amend the recently adopted ETF rule, Rule 6c-11, to remove the provision excluding such funds from the scope of the rule one year following its adoption. The proposed rules would rescind the exemptive orders previously issued to leveraged and inverse funds. A "leveraged/inverse investment vehicle" is defined as a registered investment company or listed commodity pool that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.

Reverse Repurchase Agreements and Unfunded Commitments

The SEC also proposed that a fund may engage in reverse repurchase agreements and similar financing transactions so long as they meet the asset coverage requirements of Section 18 of the 1940 Act, like a bank borrowing or other borrowing. Reverse repurchase agreements and similar financing transactions would not be included in calculating a fund's derivatives exposure under the limited user exception to the proposed rule. However, any portfolio leveraging effect would be included and restricted through the proposed VaR-based limit on funds that are not eligible for the limited user exception. The SEC would not consider a fund's obligation to return collateral received as part of a securities lending transaction to be a similar financing transaction as long as the fund reinvests cash collateral in highly liquid, short term investments, such as money market funds or other cash or cash equivalents, and does not sell or otherwise use non-cash collateral to leverage the fund's portfolio.

Unfunded commitments, such as capital commitments to a private fund, would not be derivatives instruments under the proposed rule. The proposed rule, however, would prescribe certain factors that a fund must take

into account when entering into an unfunded commitment agreement and would require a fund to comply with the asset coverage requirements under the 1940 Act with respect to any borrowings made to meet its obligations under unfunded commitment agreements.

Comments on the proposed rules are due February 26, 2020.

Sources: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles, Release No. IC-33704, File No. S7-24-15 (November 25, 2019), available here; SEC Proposes to Modernize Regulation of the Use of Derivatives by Registered Funds and Business Development Companies, Press Release No. 2019-242 (November 25, 2019), available here.

SEC Proposes Rule for Expedited 1940 Act Exemptive Relief

On October 18, 2019, the SEC issued a release proposing amendments to Rule 0-5 under the 1940 Act that establish an expedited review process for applications requesting exemptive relief that are substantially identical to recent applications that have been granted exemptive relief by the SEC (Routine Applications). The proposed amendments also establish an internal timeframe for the IM Division staff to review applications outside of the expedited review process, namely those "applications that seek novel, largely unprecedented relief or relief for which some [SEC] precedent exists but raises additional questions of fact, law, or policy" (Non-Routine Applications).

Expedited Review Process for Routine Applications

Under proposed Rule 0-5(d)(1), an applicant may request expedited review if the application is substantially identical to two other applications granted the requested relief by the SEC within two years of the application's initial filing. "Substantially identical" applications are applications that "reques[t] relief from the same sections of the 1940 Act and rules thereunder, containing identical terms and conditions, and differing only with respect to factual differences that are not material to the relief requested."

Applications for expedited review would be required to include:

- A notation prominently stating "EXPEDITED REVIEW REQUESTED UNDER 17 CFR 270.0-5(d)" on the application's cover page; and
- Exhibits with marked copies of the application showing changes from the final versions of the two precedent/substantially identical applications.

Under proposed Rule 0-5(f), notice for a Routine Application would be issued no later than 45 days from the date of filing unless the applicant is notified that the application does not meet the eligibility criteria for expedited review or additional time is necessary for appropriate consideration of the application.

The 45-day review period would restart upon the filing of any amendment not solicited by the Commission or the staff; however, if the unsolicited amendment relates only to factual differences immaterial to the requested relief or a minor change, the staff could take action before the end of the additional 45-day period. The 45-day period would be paused upon the issuance of any staff comment on the application and resumed 14 days after the applicant files an amended application that addresses the staff's comments.

If an applicant fails to file an amendment to its Routine Application within 30 days of receiving the staff's comments or requests for modification, the application would be deemed withdrawn.

Standard Review Process and SEC Internal Timeframe for Non-Routine Applications

The SEC also proposed a new timeframe for the standard review process for Non-Routine Applications under Rule 0-5. Under the proposed rule, the SEC would take action on a Non-Routine Application within 90 days of the initial filing and any amendments to the application. Action on an application or amendment would consist of issuing a notice of application, providing an applicant with comments, or informing the applicant that the application will be forwarded to the Commission. If the staff does not support the requested relief, the staff would notify the applicant of its recommendation that the Commission deny the application and provide the applicant the opportunity to withdraw its application before the staff makes such recommendation to the Commission.

Public Dissemination of Staff Comments

The SEC intends to publicly disseminate staff comments on applications and responses to staff comments no later than 120 days after the SEC has issued an order granting or denying the requested relief or the application has been withdrawn.

Source: Amendments to Procedures with Respect to Applications under the Investment Company Act of 1940, SEC Release IC-33658 (Oct. 18, 2019), available here.

LATEST DEVELOPMENTS: ADVISERS

SEC Proposes Amendments to the "Accredited Investor" Definition

On December 18, 2019, the SEC issued a proposal to change the definition of "accredited investor," which is a key component for several exemptions from SEC registration, such as Rules 506(b) and 506(c) under Regulation D of the Securities Act. The proposed changes would expand the definition to include new categories of qualifying natural persons and other entities and make other updates to the current definition, which would have a meaningful impact because these persons or entities would be able to participate in investment opportunities that are currently not available to them, such as offerings by certain hedge funds, private equity funds and venture capital funds, as well as investments in private companies.

SEC Chairman Jay Clayton stated that "[t]he current test for individual accredited investor status takes a binary approach to who does and does not qualify based only on a person's income or net worth," and that "[m]odernization of this approach … would add additional means for individuals to qualify to participate in our private capital markets based on established, clear measures of financial sophistication."

In particular, the proposed amendments to the definition of "accredited investor" under Rule 501(a) of Regulation D would:

- Add new categories for natural persons to qualify as accredited investors based on certain professional certifications and designations, such as actively holding Series 7, 65 and 82 licenses, or other credentials meeting the SEC's proposed criteria.
- Add a new category for natural persons to qualify as accredited investors based on such person's status as a "knowledgeable employee" of a private fund. "Knowledgeable employee" would be defined based on the 1940 Act definition in Rule 3c-5(a)(4).
- With respect to calculating "joint net worth" for purposes of the asset test, or "joint income" for the income test, add a note that natural persons will be able to include income from/assets of "spousal equivalents" rather than just spouses so that spousal equivalents may pool their finances for purposes of qualifying as accredited investors. "Spousal equivalent" would be defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.
- Expand the types of entities that qualify as accredited, such as limited liability companies that meet the criteria currently applicable to corporations, registered advisers and rural business investment companies.
- Add a broader "catch-all" category of "any entity owning investments in excess of $5 million that is not formed for the specific purposes of acquiring the securities being offered."
- Add a note to the current accredited investor category where an entity may qualify under the definition if all of its equity owners are accredited investors that would permit an entity to look through various forms of equity ownership to natural persons because, in some instances, an equity owner of an entity is another entity and not a natural person.

- Add a new category for family offices and its family clients (each as defined under the Advisers Act) to the definition of accredited investor, subject to the following criteria: (i) the family office has at least $5 million of assets under management and (ii) the family office or family client was not formed for the specific purposes of acquiring the securities being offered and whose purchases are directed by a person with such knowledge and experience in financial and business matters that is able to evaluate the risks and merits of such investment.

Notably, the SEC is not proposing, at this time, to amend the financial thresholds in the accredited investor definition, even though those thresholds have been in place since 1982 and have not been adjusted for inflation. However, the proposal requested feedback on potential adjustments to the financial thresholds.

In its proposal, the SEC is also proposing amendments to the "qualified institutional buyer" (QIB) definition in Rule 144A under the Securities Act, which would add limited liability companies and rural business investment companies to the types of entities that are eligible to qualify as a QIB so long as they meet the $100 million in securities owned and investment threshold tests in Rule 144A's definition. The proposal would also add a "catch-all" category, which would allow institutional accredited investors under Rule 501(a) of any entity type not currently included in the QIB definition to qualify as a QIB when they satisfy the required $100 million threshold.

Comments on the proposal are due within 60 days after publication in the Federal Register. As of the date of this Update, the rule proposal has not been published in the Federal Register.

Sources: SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments, Press Release No. 2019-265 (Dec. 18, 2019), available here; Amending the "Accredited Investor" Definition, Release No. 33-10734, File No. S7-25-19, available here.

SEC Proposes Rules Regarding Proxy Voting Advice and Shareholder Approvals; ISS Sues SEC

On November 5, 2019, the SEC published rule proposals that, if adopted, would amend the proxy voting rules related to proxy voting advice and shareholder proposals. These two proposed amendments, along with the other actions taken by the SEC and described in our October 2019 and October 2018 Updates, further signal the SEC's enhanced scrutiny on proxy voting, which has not been met with open arms by proxy advisory firms. In fact, Institutional Shareholder Services, Inc. (ISS) filed a complaint in the U.S. District Court of the District of Columbia against the SEC to block the enforcement of the SEC's proxy-voting guidance, which was published in August and described in our October 2019 Update, arguing that the SEC made a "seismic shift in the regulatory landscape" by issuing guidance that would treat proxy advice as a form of proxy solicitation. The complaint alleges that this guidance was unlawful because it: (i) exceeds the SEC's statutory authority in Section 14(a) of the Exchange Act and is contrary to the plain language of the statute; (ii) is procedurally improper because ISS views it as a substantive rule and, therefore, the SEC failed to go through the proper notice-and-comment procedures under the Administrative Procedure Act; and (iii) is arbitrary and capricious because the SEC denies that this guidance changes its current position, whereas ISS alleges that it makes substantive changes to the rules related to proxy-voting advice.

Proxy-Voting Advice

The proposed amendments to Rules 14a-1, 14a-2 and 14a-9 under the Exchange Act relating to proxy voting advice follow the SEC's August 2019 guidance that was intended to clarify the applicability of federal proxy voting rules to proxy-voting advice and proxy voting responsibilities of advisers. The proposed amendments would amend the definition of "solicitation" to include proxy-voting advice provided by proxy advisory firms, such as ISS and Glass Lewis, therefore codifying the SEC's August 2019 guidance, and would continue to exempt proxy-voting advice provided by advisers and broker-dealers from that definition. Therefore, the proposed amendments would eliminate a proxy advisory firm's exemption from the proxy rules' filing and information requirements for certain types of solicitations and require enhanced disclosure of material

conflicts of interest in their proxy voting advice, as well as policies and procedures to identify and properly manage any such conflicts. In addition, the proposed amendments would give registrants and certain other soliciting persons time to review and provide feedback on proxy voting advice before it is issued and allow registrants and certain other soliciting persons to include in a proxy advisory firm's voting advice a link or similar electronic medium directing the recipient of the advice to a written statement representing the registrant's or other soliciting person's views on such proxy voting advice. Finally, the proposal would also amend the antifraud provisions in the federal proxy rules to include failure to disclose information relating to conflicts of interests and related policies and procedures. Based on the foregoing, it is understandable why proxy advisory firms do not like these proposed rules; however, if adopted in their current form, these rules would provide registrants, such as investment companies, the opportunity to counter or supplement proxy advice published by such firms.

Shareholder Proposals

The proposal relating to shareholder proposals is intended to modernize this rule and would amend Rule 14a-8 under the Exchange Act to change the criteria for shareholders' ability to propose or resubmit proposals under Rule 14a-8(b), provide for a one-proposal limit by person (rather than by shareholder) under Rule 14a-8(c) and increase the percentages of the resubmission thresholds under Rule 14a-8(i)(12). Comments on both proposals are due by February 3, 2020.

Sources: Institutional Shareholder Services Inc. v. Securities and Exchange Commission, et al, Case 1:19-cv-03275 (D.C. Oct. 2019), available here; ISS Files Suit Over August SEC Guidance, Litigation to Prevent the Chill of Proxy Advisers' Protected Speech, ISS Press Release (Oct. 31, 2019), available here; Beagan Wilcox Volz, ISS Sues SEC Over 'Seismic' Regulatory Shift in Proxy-Voting Guidance, IGNITES (Nov. 1, 2019); SEC Proposes Rule Amendments to Improve Accuracy and Transparency of Proxy Voting Advice, SEC Press Release 2019-231 (Nov. 5, 2019), available here; Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Release No. 34-87457, File No. S7-22-19, available here; SEC Proposes Amendments to Modernize Shareholder Proposal Rule, SEC Press Release 2019-232 (Nov. 5, 2019), available here; Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, Release No. 34-87458, File No. S7-23-19, available here.

SEC Proposes Amendments to Modernize Advertising and Cash Solicitation Rules

On November 4, 2019, the SEC published rule proposals that, if adopted, would significantly change the advertising and cash solicitation rules applicable to advisers by replacing the current constraints with "principles-based provisions." The proposals are intended to modernize these rules to reflect the expectations of investors seeking investment advisory services, changes in technology and the evolution of industry practices. For example, Rule 206(4)-1 under the Advisers Act (the Advertising Rule) predates the Internet and thus fails to address implications associated with social media, such as whether or not the "like" button on Facebook and LinkedIn or the endorsement feature on LinkedIn are banned under the testimonials prohibition.

The Advertising Rule

The proposed amendments to the Advertising Rule update the definition of "advertisement" to include "any communication, disseminated by any means, by or on behalf of an adviser, that offers or promotes advisory services," and excludes live oral communications that are not broadcast, responses to unsolicited requests for specified information, advertisements or other sales materials regarding a registered investment company that are within the scope of other SEC rules, and information required to be contained in a statutory or regulatory notice, filing or other communication (such as the information required by Part 2 of Form ADV and Form CRS). The revised definition is intended to be more flexible so that it accounts for future technology advances and evolving industry practices.

The proposed amendments to the Advertising Rule would also permit certain endorsements and testimonials, provided that certain disclosures are made, such as whether the person giving the testimonial or endorsement is a client and whether compensation has been provided by or on behalf of the adviser. In addition, the proposed amendments would allow third-party ratings, subject to certain criteria pertaining to the preparation of the rating and specified disclosures, and would add new conditions regarding the presentation of performance-related information provided to retail customers, such as requiring that net performance data be presented adjacent to gross performance data and requiring the presentation of performance results of any portfolio or composite across one-, five- and ten-year periods.

The Solicitation Rule

The proposed amendments to Rule 206(4)-3 under the Advisers Act (the Solicitation Rule) largely cover requirements for written agreements and disclosures. Among other things, the current Solicitation Rule prohibits advisers from paying a cash fee to any unaffiliated third party that solicits on its behalf, unless the cash payment is pursuant to a written agreement. The proposed amendments to the rule would continue to require a written agreement between an adviser and an unaffiliated solicitor, but would apply to both cash and non cash compensation arrangements. In addition, the proposed rule would expand the scope of the rule and apply to the solicitation of current and prospective investors in private funds, rather than only to the solicitation of current and prospective clients (i.e., the private funds themselves) of the adviser.

The proposal requires the written agreement to include: a description of the compensation to be paid and the solicitation activities to be performed; a provision that requires the solicitor to perform its activities in accordance with certain provisions of the Advisers Act; and a provision that obligates the solicitor to deliver a solicitor disclosure statement to each person solicited. Under the proposal, solicitors would no longer be required to deliver the adviser's Form ADV firm brochure, which is currently required under the Solicitation Rule. The proposed rule would also require the solicitor disclosure to continue to highlight the solicitor's financial interest in the client's choice of an adviser and would revise the current solicitor disclosure requirements to include additional information about conflicts of interest. The rule proposal also eliminates the current requirement that an adviser obtain acknowledgement of receipt of such disclosures from each of its clients who has been the subject of solicitation. Comments on the two new rule proposals are due by February 10, 2020.

Sources: Investment Adviser Advertisements; Compensation for Solicitations, Release No. IA-5407, File No. S7-21-19, available here; SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers, SEC Press Release No. 2019-230 (Nov. 4, 2019), available here.

Update on the California Consumer Privacy Act: Important Exemptions for Financial Services Companies

The California Consumer Privacy Act (the CCPA), a privacy law that regulates the collection, use, disclosure and security of personal information, became effective on January 1, 2020. Generally, companies are subject to the CCPA if they conduct business in California and either (1) have gross revenues in excess of $25 million, or (2) collect the personal information of more than 50,000 California individuals, households or devices. The CCPA regulates a company's use of personal information of a California resident, such as an email address, IP address, or written communications.

Many financial services companies are struggling to identify what information is exempt from the CCPA. Financial services companies are primarily relying on two major exemptions from the law: (1) Nonpublic Personal Information under the Gramm Leach Bliley Act (GLBA) and (2) personal information used or provided under the Fair Credit Reporting Act (FCRA).

The GLBA exemption applies to Nonpublic Personal Information of a consumer, including: (1) information provided by a consumer to obtain a financial product or service from a financial institution; (2) transactional information related to a financial product or service; and (3) information the financial institution received in connection with providing a financial product or service to the consumer. A consumer under GLBA is an individual who obtains financial products or services from a financial institution for personal, family, or household purposes. For financial services companies, this generally means that most existing customer information is exempt under GLBA. For example, information generated from consumer accounts and financial services transactions is not subject to the CCPA. However, marketing information and information about prospective customers are not covered by the exemption. For example, general advertising and website marketing information of non-customers is subject to the CCPA.

The FCRA exemption applies to personal information related to a consumer's creditworthiness that is used in accordance with FCRA. This typically involves information from a consumer credit report or information provided for a consumer credit report.

The CCPA also exempts information subject to other federal laws, such as the Health Insurance Portability

and Accountability Act (HIPAA). Until 2021, personal information exchanged in the context of business to business transactions is also exempt. As companies subject to the CCPA move forward with analyzing compliance requirements, a best practice is to document what personal information is and is not subject to the CCPA. More information about the CCPA can be found in our October 2018 update.

Sources: CA Assembly Bill No. 375 (June 28, 2018), available here; CA Senate Bill No. 1121 (Sept. 23, 2018), available here; CA Assembly Bill No. 25 (Oct. 14, 2019), available here.

SEC Issues FAQs on Disclosure of Certain Financial Conflicts Related to Compensation

On October 18, 2019, the IM Division staff issued FAQs providing guidance relating to certain compensation arrangements (such as Rule 12b-1 fees and revenue sharing) and related disclosure requirements stemming from an adviser's fiduciary duty and Form ADV disclosure requirements. The staff noted that certain compensation arrangements might create a conflict of interest between an adviser and its clients, where an adviser may have a financial incentive to recommend certain types of investments that benefit the adviser, which contravenes such adviser's fiduciary duty to place its clients' interests ahead of its own interests. The FAQs heavily cite the SEC's June 2019 release, "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," which is discussed in greater detail in our July 2019 regulatory update.

The guidance provides that, when considering requirements relating to the disclosure of conflicts of interest related to compensation that an adviser receives in connection with investments it recommends, the adviser must consider its general disclosure requirements as a fiduciary and Form ADV's disclosure obligations. Specifically, the adviser must (1) make full and fair disclosure to its clients of all material facts relating to the advisory relationship and (2) eliminate or at least expose through full and fair disclosure all conflicts of interest that might incline it (consciously or unconsciously) to render advice that is not disinterested.

In addition to re-emphasizing an adviser's fiduciary duty, the guidance also reiterates certain key disclosure obligations contained in the instructions to and text of Form ADV, including the following:

- In order to allow clients to understand the adviser's conflicts and business practices and give informed consent or reject them, disclosure must include "sufficiently specific facts" that may require disclosure of "information not specifically required by" Form ADV or "more detail than the Form otherwise requires." For example, if a conflict actually exists, disclosure that an adviser "may" have a conflict is inadequate.
- Advisers are required to disclose if they or their supervised persons accept sales compensation, including asset-based sales charges or service fees, and include how those advisers address the conflict and whether the advisers' compensation is offset by their advisory fees.
- Advisers are required to disclose their supervised persons' other business activities, such as whether they receive commissions, bonuses or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative, and including distribution and/or servicing fees from the sale of mutual fund shares.

In light of the foregoing, an adviser must disclose in a concise and direct manner in Form ADV the conflict of interest resulting from compensation it receives (either directly or indirectly) in connection with recommended investments, and, if a conflict exists, how the adviser addresses such conflicts.

The FAQs provide examples of material facts an adviser should disclose to its clients regarding the adviser's practices related to recommending investments or services with different compensation characteristics, such as mutual fund share classes. The FAQs also clarify that advisers are required to disclose if someone who is not a client provides an economic benefit to an adviser for providing investment advice or other advisory services to its clients (i.e., a "revenue-sharing" arrangement), explain the conflict of interest and describe how the adviser addresses the conflict. The FAQs note that advisers are required to disclose material facts about their practices related to revenue-sharing arrangements, such as the existence of any incentives provided to the adviser or shared between the adviser and others, such as clearing brokers, custodians, fund advisers or

other service providers.

Source: Frequently Asked Questions Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation (October 18, 2019); available here.

Form CRS: Upcoming Deadline and FAQs

SEC-registered advisers must file the Form CRS Relationship Summary (the Summary) electronically as Form ADV Part 3 via the IARD system beginning on May 1, 2020 and no later than June 30, 2020 as either (1) an other-than annual amendment or (2) part of an initial application or annual updating amendment. Advisers must deliver the Summary to all existing clients who are retail investors within 30 days of electronically filing the Summary via the IARD system. Advisers must deliver a Summary to new and prospective clients who are retail investors before or at the time the adviser enters into an investment advisory agreement with the retail investor.

The IM Division and the SEC's Division of Trading and Markets staff recently released FAQs relating to the format and delivery requirements for the Summary. With respect to the format of the Summary, the staff stated that where an adviser offers multiple types of services to retail investors, the adviser must prepare a single Summary that summarizes all of the principal relationships and services the adviser offers to retail investors. If an adviser is dually-registered as both an adviser and a broker-dealer and chooses to prepare a single Summary rather than two separate Summaries, the adviser must summarize all of the principal brokerage and investment advisory relationships and services the adviser offers to retail investors.

With respect to delivery requirements for the Summary, the staff indicated that an adviser may satisfy its delivery obligation by delivering the Summary separately, in bulk delivery to clients, or as part of the delivery of information the adviser already provides, such as quarterly account statements, an annual Form ADV update, or other periodic reports. If the Summary is delivered in paper format as part of a package of documents, the adviser must ensure the Summary is the first among any documents delivered at that time. If the Summary is delivered electronically, it must be presented prominently in the electronic medium, such as a direct hyperlink or in the body of an email, and must be easily accessible for retail investors. The staff also indicated that pooled investment vehicles, such as hedge funds, private equity funds and venture capital funds, do not meet the definition of "retail investor" and therefore advisers are not required to deliver a Summary to those clients.

Source: Frequently Asked Questions on Form CRS (Nov. 26, 2019), available here; Form CRS, available here.

COMPLIANCE DATES FOR FINAL RULES

<table>
<tr><th>Final Rule</th><th>Compliance Date(s)</th></tr>
<tr><td>Amendments to Form N-CEN Associated with Liquidity Rule</td><td>Fund complexes with $1 billion or more in net assets:
first filing date is no later than 75 days following the first fiscal year ending after December 1, 2018, based on fiscal year end data

Fund complexes with less than $1 billion in net assets:
first filing date is no later than 75 days following the first fiscal year ending after June 1, 2019, based on fiscal year end data</td></tr>
<tr><td>Amendments to the Certification Requirements of Form N-CSR
(each certifying officer must state that such officer has disclosed in the report any change in internal control over financial reporting that occurred during the most recent fiscal half-year, rather than most recent fiscal quarter)</td><td>Fund complexes with $1 billion or more in net assets:
compliance date has passed

Fund complexes with less than $1 billion in net assets:
March 1, 2020</td></tr>
<tr><td>Investment Company Reporting Modernization: New Form N-PORT (As Amended)</td><td>Fund complexes with $1 billion or more in net assets:
compliance date has passed

Fund complexes with less than $1 billion in net assets:
first filing date is June 1, 2020, based on March 2020 data. The actual filing date depends on a fund's fiscal quarter end.

<table>
<tr><th>Fiscal Quarter End</th><th>Deadline for First Form N-PORT</th><th>Required Monthly Data</th></tr>
<tr><td>March 31, 2020</td><td>June 1, 2020</td><td>March 2020</td></tr>
<tr><td>April 30, 2020</td><td>June 29, 2020</td><td>March, April 2020</td></tr>
<tr><td>May 31, 2020</td><td>July 30, 2020</td><td>March, April, May 2020</td></tr>
</table>

Once funds are required to file reports on Form N-PORT, they must maintain in their records the information that is required to be included on Form N-PORT within 30 days of each month end and file reports on Form N-PORT for each fiscal quarter within 60 days of such quarter end.</td></tr>
</table>

Final Rule	Compliance Date(s)
Rescission of Form N-Q (funds are required to continue filing Form N-Qs until they begin filing Form N-PORTs)	Fund complexes with $1 billion or more in net assets: compliance date has passed Fund complexes with less than $1 billion in net assets: May 1, 2020 (a fund's last Form N-Q reporting period will be the fiscal quarter ending December 31, 2019, January 31, 2020 or February 28, 2020, as applicable)
Form N-1A (narrative disclosure regarding operation of a fund's liquidity risk management program in new subsection of the applicable shareholder report)	Fund complexes with $1 billion or more in net assets: December 1, 2019 Fund complexes with less than $1 billion in net assets: June 1, 2020
FAST Act Amendments Impacting Registration Statement and N-CSR Filings	All investment company registration statement and Form N-CSR filings made on or after April 1, 2020 must be made in HTML format and include a hyperlink to each exhibit identified in the filing's exhibit index, whether the exhibit is included in the filing or incorporated by reference.
Form CRS, Client Relationship Summary	Form CRS must be filed by June 30, 2020. Initial delivery of Form CRS to all of an investment adviser's and broker-dealer's existing customers/clients who are retail investors due by July 30, 2020.