Chapman and Cutler LLP

Chapman Client Alert

January 16, 2019 Current Issues Relevant to Our Clients

Annual Investment Adviser Compliance and Regulatory Review

The beginning of each year provides an opportunity for investment advisers to review compliance and regulatory matters, including issues related to private investment funds and commodity pools. A summary of the items that investment advisers might consider as part of their annual compliance and regulatory review is included in "Investment Adviser Compliance Obligations and Regulatory Filings" most recently published in October 2017 which is available here.

This alert briefly summarizes:

- Updates to certain sections of that publication based on recent regulatory and legislative activity;
- Selected new issues that arose since the publication that advisers should consider as part of their annual review process; and
- Selected items that investment advisers should watch for in 2019.

Updates to Selected Sections of "Investment Adviser Compliance Obligations and Regulatory Filings"

Updates to certain information included in "Investment Adviser Compliance Obligations and Regulatory Filings" is included below.

Cybersecurity (Section 24A:3.2.K)

Cybersecurity should continue to be a focus for firms in 2019. The Securities and Exchange Commission (the "SEC") announced in 2017 that it had formed a new Cyber Unit within its Enforcement Division. The Office of Compliance Inspections and Examinations ("OCIE") also published observations from its 2016 cybersecurity examinations available here. OCIE identified a number of issues, including that policies and procedures were not reasonably tailored and provided employees only with general guidance, policies did not reflect firms' actual practices and firms did not adequately conduct system maintenance. OCIE also provided a list of helpful practices for developing and implementing policies and procedures. Selected practices identified by OCIE include:

- Maintaining an inventory of all data, information and vendors, including a classification of related risks;
- Providing detailed cybersecurity-related instructions for penetration tests, security monitoring and system auditing, access rights and reporting;
- Maintaining of schedules and processes for testing data integrity and vulnerabilities;
- Establishing and enforcing controls to access data and systems;
- Mandating information security employee training; and
- Engaging senior management to vet and approve policies and procedures.

OCIE has also continued to prioritize cybersecurity in its examination priorities for 2019.

Hart-Scott-Rodino Filings (Section 24A:4.6)

Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"), parties to certain transactions (including purchases of publicly traded securities) that meet certain thresholds may be required to make certain filings. Federal law requires the Federal Trade Commission to adjust thresholds each year. The minimum HSR Act transaction threshold for 2019 will be released in late January and was $84.4 million in 2018.

Department of Labor Conflict of Interest Rule (Section 24A:6.7)

In April 2016, the Department of Labor ("DOL") released its final rule to define the term "fiduciary" and address conflicts of interest in providing investment advice to retirement accounts

along with related exemptions. The Fiduciary Rule and exemptions were to become applicable on April 9, 2017 but shortly after taking office, President Trump directed a new review of the Fiduciary Rule and the DOL issued a series of delays for full implementation and enforcement of the rule. On March 15, 2018, in a case challenging the DOL's authority to issue the Fiduciary Rule, the U.S. Court of Appeals for the Fifth Circuit issued a ruling and judgment vacating the Fiduciary Rule in its entirety. On June 21, 2018, the U.S. Court of Appeals for the Fifth Circuit confirmed its decision to vacate the rule.

The DOL's regulatory agenda indicates that it plans to issue a revised final fiduciary rule in September 2019. This is the same month that the SEC's regulatory agenda indicates that it will issue a final rule on its advice standards for broker-dealers and investment advisers (including Regulation Best Interest, Form CRS, amendments to Form ADV and certain other rule changes). This suggests a potentially more coordinated effort between the DOL and the SEC on this rulemaking.

Selected New Items

Tax Cuts and Jobs Act

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act impacts many types of taxpayers and could have significant implications for many in the investment management industry. Most of the provisions of the Tax Act became effective for taxable years beginning on or after January 1, 2018. Many, but not all, of the provisions of the Tax Act sunset after December 31, 2025.

Among other things, the Tax Act:

- Adjusts the top federal corporate income tax rate from 35% to 21%;
- Reduces the highest federal individual income tax rate;
- Imposes a three-year holding period for capital gains treatment for carried interest;
- Eliminates certain itemized deductions for individuals, trusts and estates;
- Creates a new deduction for certain pass-through income of non-corporate taxpayers;
- Limits the deduction of business interest;
- Imposes limitations on net operating loss; and
- Reduces the dividends received deduction.

Uncertainty remains in connection with certain provisions, and technical amendments and interpretive guidance from Congress and the Internal Revenue Service have followed since the adoption of the Tax Act. The Internal Revenue Service has issued Proposed Regulations on many of the issues, but the industry is largely waiting for the guidance to be finalized. For more information about selected provisions relating to individuals see our Client Alert available here.

MiFID II

MiFID is the Markets in Financial Instruments Directive. The original MiFID has been applicable across the European Union ("EU") since November 2007 and is the foundation of the EU's regulation of financial markets. MiFID II became effective on January 3, 2018 and revised the original MiFID package to take into account developments in the trading environment since the original implementation in 2007 and to make financial markets more efficient, resilient and transparent in light of the financial crisis.

While MiFID II generally does not apply directly to non-EU broker-dealers and investment advisers that do not have any EU place of business, many non-EU firms will likely encounter indirect impacts as a result of doing business with EU firms or their affiliates. Some non-EU firms may see an impact as a result of new requirements sought by EU firms, such as an executing broker-dealer being asked to receive separate payments for brokerage and research services rather than a single bundled commission. In other cases, EU firms may seek to contractually impose MiFID II or equivalent requirements on non-EU firms as a means of satisfying their own direct MiFID II requirements through delegation of obligations to the non-EU firm. A key indirect impact to U.S. broker-dealers, investment advisers and registered investment companies relates to MiFID II's requirements related to payments for research services by EU investment managers. These issues also impact EU investment managers that provide services to registered investment companies in the U.S. or that are registered in the U.S. under the Investment Advisers Act of 1940 (the "Advisers Act").

MiFID II will generally prohibit certain EU investment managers from receiving certain "inducements" from a third party in connection with providing investment services. Among other things, "research" is a prohibited inducement unless an investment manager pays for the research (1) directly out of its own money, (2) from a research payment account (an "RPA") funded with a client's own money and with client approval or (3) a combination of the two. The research payment also may not be linked to the volume or value of transactions executed on behalf of a client. As a result, MiFID II effectively requires that payments for research not be bundled into single payments for other services, such as trade execution. In the

U.S., investment managers often use client commission arrangements to obtain brokerage and research services from a broker-dealer using a single, bundled commission that is separated after execution to pay for order execution and research. The MiFID II unbundling of research payments from commissions paid for trade execution creates several regulatory issues for U.S. broker-dealers, investment advisers and investment companies.

In October 2017, the SEC issued three no-action letters designed to assist broker-dealers and investment advisers in addressing issues related to the MiFID II. The no-action positions provide the following:

- Investment Adviser Registration/Regulation—temporary relief from registration and regulation under the Advisers Act for broker-dealers that receive separate payments for providing research to EU investment managers in connection with trade execution;
- Soft Dollar Safe Harbor—relief allowing investment advisers to rely on the soft dollar safe harbor in Section 28(e) of the Securities Exchange Act of 1934 even if they separately pay for research through RPAs; and
- Joint Transactions—relief from Investment Company Act of 1940 Section 17(d) and Rule 17d-1 and Advisers Act Section 206 for investment advisers that aggregate trade orders that accommodate differing research payment arrangements for different client accounts as required under MiFID II.

For more information about MiFID II and these no-action letters, see our Client Alert available here. The SEC staff is seeking comments until January 31, 2019 related to the effects of MiFID II's research provisions.

Bureau of Economic Analysis (BEA) Filing Updates

Entities or individuals that make investments in foreign entities and firms that are owned, in whole or in part, by foreign entities or individuals may be required to make certain filings with the Bureau of Economic Analysis (BEA) of the Department of Commerce. The most common triggers for the filing requirements are a U.S. person or entity owning 10 percent or more of the voting securities of a foreign entity and a U.S. entity having 10 percent or more of its voting securities being owned by a foreign person or entity.

BEA report information is generally confidential and not subject to Freedom of Information Act disclosure. The most typical required BEA filings are:

- *Form BE-10 (Benchmark Survey of U.S. Direct Investment Abroad):* required to be filed every five years by entities or individuals meeting a filing threshold. 2020 is the next Form BE-10 filing year.
- *Form BE-11 (Annual Survey of Direct Investment Abroad):* annual report due only if specifically requested by the BEA.
- *Form BE-12 (Benchmark Survey of Foreign Direct Investment in the United States):* required to be filed every five years by entities or individuals meeting a filing threshold. 2023 is the next Form BE-12 filing year.
- *Form BE-13 (Survey of New Foreign Direct Investment in the United States):* required to be filed by any U.S. business enterprise within 45 days of certain foreign direct or indirect investments meeting a filing threshold.
- *Form BE-15 (Annual Survey of Foreign Direct Investment in the United States):* annual report due only if specifically requested by the BEA.
- *Form BE-577 (Quarterly Survey of U.S. Direct Investment Abroad):* quarterly report due only if specifically requested by the BEA.
- *Form BE-605 (Quarterly Survey of Foreign Direct Investment in the United States):* quarterly report due only if specifically requested by the BEA.

Exemptions and exclusions may be available for certain filings. Where an exemption is available from one of the filing requirements a Claim for Exemption must be filed. Firms should review the specific thresholds and requirements associated with these filings and consider whether they are required to make a filing.

SEC Staff Highlighted Investment Adviser Fee Compliance Issues

On April 12, 2018, OCIE published a Risk Alert that highlighted frequently identified investment adviser fee and expense compliance issues. The Risk Alert identified the fee and expense compliance issues most frequently identified in deficiency letters from over 1,500 investment adviser examinations. In particular OCIE identified issues associated with:

- Incorrect account valuations;
- Improper timing or frequency;
- Incorrect fee rate;

- Incorrect or omitted discounts and rebates;
- Disclosure issues; and
- Improper expense allocations to private and registered funds.

The Risk Alert is available here and is described in our Client Alert available here.

Proposed SEC Broker-Dealer and Investment Adviser Standards of Conduct

On April 18, 2018, the SEC proposed new and amended rules relating to registered investment advisers' and broker-dealers' conduct. The SEC released a proposed interpretive guidance of the standard of conduct for investment advisers which reaffirms and clarifies duties owed by investment advisers to their clients under Section 206 of the Advisers Act and is not intended to create new or different obligations already imposed on investment advisers. The full text of the proposed interpretive guidance is available here and is described in our Client Alert available here.

Simultaneously, the SEC released proposed new rule Regulation Best Interest which, if adopted, would establish a best interest standard for broker-dealers and natural persons who are associated persons of a broker-dealer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. The full text of the proposed rule is available here and is described in our Client Alert available here.

Proposed Form CRS Relationship Summary

On April 18, 2018, the SEC proposed new Form CRS to require registered investment advisers and broker-dealers to provide a brief relationship summary to retail investors regarding their offered services, the standard of conduct and fees associated with the services. For registered investment advisers, initial delivery of Form CRS would be required before or at the time the investment adviser enters in an investment advisory agreement with the retail investor. The full text of the proposal is available here and is described in our Client Alert available here.

SEC Staff Identified Most Common Best Execution Deficiencies

On July 11, 2018, OCIE issued a Risk Alert that highlighted many of the most common deficiencies that the staff has cited in recent examinations of registered investment advisers' best execution practices. In particular OCIE identified issues associated with:

- Not performing best execution reviews;
- Not considering materially relevant factors during best execution review;
- Not seeking comparisons from other broker-dealers;
- Not fully disclosing best execution practices;
- Not disclosing soft dollar arrangements;
- Not properly administering mixed use allocations;
- Inadequate policies and procedures related to best execution; and
- Not following best execution policies and procedures.

The Risk Alert is available here and is described in our Client Alert available here.

Guidance on Investment Adviser Electronic Messaging Practices

OCIE issued a Risk Alert reminding investment advisers of their recordkeeping obligations with respect to electronic messaging and summarizing their related observations from recent examinations. The staff's recent limited-scope examinations discussed in the Risk Alert were designed to obtain an understanding of the various forms of electronic messaging used by advisers and their personnel, the risks of such use and the challenges in complying with the related provisions of the Advisers Act and rules thereunder. The Risk Alert includes guidance on:

- Policies and procedures that have helped firms with monitoring and risk management around electronic communications;
- Employee training and mandated attestations;
- Supervisory review practices; and
- Firm control over devices.

A copy of the Risk Alert is available here and is described in our Client Alert available here.

Items to Watch for in 2019

Updated SEC Agenda

In late 2018, the SEC published its updated Regulatory Flexibility Act Agenda. The agenda included a near-term

agenda for proposed and final rulemaking available here. The near-term agenda items include:

- Proposed rules for exchange-traded funds;
- Proposed rules for use of derivatives by registered investment companies and business development companies;
- Final rules on investment advice standards of conduct for investment professionals (discussed further above); and
- Final rules to amend the whistleblower rules.

The long-term agenda is available here and includes:

- Rulemaking relating to amendments to the custody rules for investment companies and investment advisers;
- Rulemaking relating to amendments to the advertising rules to require target date retirement funds' marketing materials to provide enhanced information;
- Requirements for stress testing by large asset managers and large investment companies;
- Rulemaking relating to investment company liquidity risk management programs;
- Rulemaking to mandate that certain applications of orders and requests be submitted electronically; and
- Evaluation of the listing and trading of exchange-traded products in the marketplace for consistency with the Securities Exchange Act of 1934.

SEC Examination Priorities for 2019

Firms should consider OCIE's exam priorities as they review their policies, procedures and business activities. The examination priorities for 2019 is available here and is described in our Client Alert available here.

FINRA Examinations Priorities for 2019

Firms that are also registered as broker-dealers should consider FINRA's regulatory and examinations priorities letter. FINRA typically releases its regulatory and examination priorities letter in early January. As of the date of this Client Alert, FINRA has not yet released these examination priorities for 2019. Firms should watch for the release of the FINRA priorities and consider them as they review their policies, procedures and business activities. The regulatory and examination priorities letter will be available here once released, along with prior year FINRA priorities letters.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®