Chapman and Cutler LLP

Chapman Client Alert

January 31, 2018 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 in 2017 that advisers should consider as part of their annual review process; and
- Selected items that investment advisers should watch for in 2018.

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 2018. 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 best practices for developing and implementing policies and procedures. Selected best 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.

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 2018 is $84.4 million (up from $80.8 million for 2017).

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 rule and certain parts of its related prohibited transaction exemptions took effect on June 9, 2017 but the DOL delayed the more onerous requirements of certain exemptions, including the Best Interest Contract

exemption, until January 1, 2018. The DOL subsequently proposed a further delay of these requirements until July 1, 2019, and published a notice implementing this delay on November 29, 2017. A copy of the notice is available here. In addition, the DOL's notice also announced that the temporary enforcement policy described in Field Assistance Bulletin 2017-02 will continue to apply during the 18-month transition period. Therefore, until July 1, 2019, the DOL and Internal Revenue Service will not pursue claims against fiduciaries working diligently and in good faith to comply with the fiduciary duty rule and exemptions, or treat those fiduciaries as being in violation of the fiduciary duty rule and exemptions.

Selected New Items from 2017

Tax Cuts and Jobs Act

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act will impact 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 may require technical amendments or interpretive guidance from Congress and the Internal Revenue Service.

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 revises 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 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 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 Investment Advisers Act of 1940 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 Investment Advisers Act of 1940 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.

SEC Staff Highlighted Investment Adviser Advertising Compliance Issues

In September 2017, OCIE published a Risk Alert that highlighted frequently identified investment adviser advertising compliance issues. The Risk Alert identified the advertising compliance issues most frequently identified in deficiency letters from over 1,000 investment adviser examinations. The Risk Alert is available here and is described in our Client Alert available here. In particular OCIE identified issues associated with:

- Misleading performance results;
- Misleading one-on-one presentations;
- Misleading Claims of Compliance with Global Investment Performance Standards ("GIPS");
- Past specific investment recommendations issues; and
- Deficiencies with compliance policies and procedures.

OCIE also summarized its findings from its "Touting Initiative" where it identified issues with disclosures that advisers provided to clients when touting awards, promoting ranking lists and/or identifying professional designations.

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. 2018 is a 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.

Items to Watch for in 2018

Updated SEC Agenda

In late 2017, the SEC published its updated its Regulatory Flexibility Act Agenda for 2018. 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 (discussed further below);
- Proposed rules on investment advice standards of conduct for investment professionals (discussed further below);
- Proposed rules to amend the whistleblower rules; and
- Final rules and forms to modernize the reporting and disclosure of information by registered investment companies.

The long-term agenda is available here and includes:

- Rulemaking relating to the use of derivatives by registered investment companies and business development companies (which had previously been on the near-term agenda and had a rule proposal issued in 2015);
- 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 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.

Among other things, the long-term agenda no longer includes rulemaking relating to registered investment adviser business continuity plans.

New ETF Rule

The SEC noted in its Regulatory Flexibility Act Agenda for 2017 that it is considering new rules and rule amendments to allow certain exchange-traded funds to operate without first obtaining exemptive orders from the SEC. Currently, exchange-traded funds must receive exemptive relief prior to being offered to the public. Rule proposals to streamline this process and eliminate the need for exemptive relief for at least some exchange-traded funds are expected in the first half of 2018.

Broker-Dealer and Investment Adviser Standards of Conduct

In June 2017, the SEC requested comments from retail investors and other interested parties on the standards of conduct applicable for broker-dealers and investment advisers, which is described in our Client Alert available here. This follows years of review of these standards of conduct by the SEC. Throughout the DOL's rulemaking process on its own fiduciary rule, there were many calls for the SEC to take the lead on establishing the appropriate conduct standards for broker-dealers and investment advisers rather than having the DOL create a separate standard applicable to advisers who provide advice to ERISA retirement plans and IRAs.

SEC Chairman Clayton has noted that a range of potential regulatory actions have been suggested to and considered by the SEC including:

- maintaining the existing regulatory structure;
- requiring enhanced disclosures intended to mitigate reported investor confusion;
- the development of a best interests standard of conduct for broker-dealers; and
- pursuing a single standard of conduct combined with a harmonization of other rules and regulations applicable to both investment advisers and broker-dealers when they provide advice to retail investors.

It is expected that the SEC will propose rules on investment advice standards of conduct for investment professionals in 2018 and the SEC included this item on its Regulatory Flexibility Act Agenda for 2018.

SEC Examination Priorities for 2018

The SEC's OCIE typically releases its examination priorities in early January. As of the date of this Client Alert, OCIE has not yet released these examination priorities. Firms should watch

for the release of the OCIE priorities and consider them as they review their policies, procedures and business activities. The examination priorities memo will be available here once released, along with prior year OCIE priorities memos.

FINRA Examinations Priorities for 2018

Firms that are also registered as broker-dealers should consider FINRA's 2018 regulatory and examinations priorities letter which is available here. For more information about FINRA's 2018 examination priorities see our Client Alert available here. Firms should consider those priorities as they review their policies, procedures and business activities.

For More Information

If you would like further information concerning the matters discussed in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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