Published on *The National Law Review* https://natlawreview.com

Investment Services Regulatory Update - February 2018

Article By:

Financial Institutions Group

SEC Staff Issues Guidance on Cryptocurrency-related Holdings

On January 18, 2018, the staff of the SEC's Division of Investment Management issued a letter to representatives of the Investment Company Institute (ICI) and the Securities Industry and Financial Markets Association (SIFMA), raising questions concerning how funds holding substantial amounts of cryptocurrencies and related products would satisfy the requirements of the Investment Company Act of 1940. The letter follows the staff's recent requests to several fund sponsors to withdraw registration statements filed to register such products.

Noting the recent growth in cryptocurrencies and cryptocurrency-related products and the interest among fund sponsors in offering registered funds that would hold these products, the SEC staff emphasized its commitment to fostering innovation in investment products and stated its intention to engage in dialogue with sponsors regarding the potential development of these funds. However, as outlined in the letter, the staff maintained that there are many investor protection issues that must be adequately addressed before sponsors can offer these funds to retail investors. The staff raised several compliance concerns regarding valuation, liquidity and custody, as well as potential issues regarding ETF arbitrage and the potential for manipulation and fraud. The staff invited interested sponsors to engage with the staff to address these concerns.

The SEC staff's chief concerns are summarized below. The staff stated that until these concerns are adequately addressed by fund sponsors, it would not be appropriate for sponsors to initiate the registration of funds that invest substantially in cryptocurrencies and related products.

- Valuation. Given the requirement that mutual funds and ETFs value their assets every business day and the current volatility, fragmentation and lack of regulation of cryptocurrency markets, as well as the nascent state and low current trading volume in cryptocurrency futures markets, the SEC staff raised several concerns regarding valuation, including:
    - Availability of adequate information to value cryptocurrencies and related products;
    - How to develop fund policies and procedures to value such products;
    - How accounting and valuation policies would address significant events relevant to cryptocurrencies;
    - How to determine the eligibility and acceptability for investment of newly created cryptocurrencies; and
    - How to consider manipulation in the underlying cryptocurrency markets when

determining settlement prices of cryptocurrency futures contracts.

- Liquidity. Given the need for mutual funds and ETFs to maintain sufficiently liquid assets to satisfy redemptions, as well as considerations regarding Rule 22e-4, the SEC's new liquidity rule, the SEC staff noted various potential cryptocurrency-related issues relating to liquidity, including:
    - How to ensure that cryptocurrency funds have sufficient liquid assets to satisfy redemptions;
    - How to classify the liquidity of cryptocurrencies and related products for purposes of Rule 22e-4, including how funds would consider trading history, price volatility, trading volume, market depth and the fragmentation of cryptocurrency markets in determining cryptocurrency liquidity; and
    - How to prepare for the possibility that funds investing in cryptocurrency futures could grow to represent a substantial portion of the cryptocurrency futures markets, and how this development may impact portfolio management and liquidity.
- Custody. The 1940 Act imposes safeguards to ensure that funds maintain custody of their holdings, including standards regarding who may act as a custodian and the circumstances in which funds must verify their holdings. The SEC staff noted that it is not aware of a custodian that currently provides fund custodial services for cryptocurrencies. In light of this, the staff raised the following concerns:
    - How would a fund that plans to hold cryptocurrencies directly satisfy the custody requirements of the 1940 Act;
    - How to validate the existence, exclusive ownership and software functionality of private cryptocurrency keys and other ownership records; and
    - To what extent would cybersecurity threats or the potential for hacks on digital wallets impact the safekeeping of fund assets under the 1940 Act.

The SEC staff also raised concerns relating to the settlement of cryptocurrency futures contracts in the context of funds that may invest in cryptocurrency futures. Although bitcoin futures contracts are currently cash settled, the staff noted that in the future cryptocurrency futures contracts may provide for physical settlement, requiring funds that invest in cryptocurrency futures to hold cryptocurrencies directly under certain circumstances. This development would in turn raise custody-related concerns similar to those discussed above.

- ETF Arbitrage. Given the price volatility, fragmentation and low trading volumes in cryptocurrency markets, the SEC staff raised certain concerns regarding the functioning of the arbitrage mechanism for ETFs that may invest in cryptocurrencies, including how such ETFs would comply with the requirement of exemptive orders that the ETF's market price not deviate materially from net asset value. The staff also asked whether funds have engaged with market makers and authorized participants to understand the feasibility of an effective arbitrage mechanism for cryptocurrency ETFs and how volatility-based trading halts in cryptocurrency futures markets or the shutdown of a cryptocurrency exchange may affect the arbitrage mechanism.
- Potential Manipulation and Other Risks. The SEC staff referenced concerns voiced by SEC Chairman Jay Clayton, among others, and highlighted by recent media reports that cryptocurrency markets provide substantially lower levels of investor protections than traditional securities markets, with correspondingly greater opportunities for fraud and manipulation. In this regard, the staff raised concerns regarding: how the potential for fraud and manipulation may affect considerations of valuation- and liquidity-related issues discussed above; and whether these risks would impact the appropriateness of a cryptocurrency fund for retail investors, suitability determinations and the ability of an adviser

to satisfy its fiduciary obligations when investing in cryptocurrency funds on behalf of retail clients.

The SEC staff's letter is available at: https://www.sec.gov/divisions/investment/noaction/2018cryptocurrency-011818.htm

SEC Staff Issues Liquidity Risk Management Program FAQs

On January 10, 2018, the staff of the SEC's Division of Investment Management issued guidance in the form of frequently asked questions (FAQs) relating to the liquidity risk management (LRM) program requirements of Rule 22e-4, which was adopted in October 2016. The FAQs generally address two categories of questions: (i) the delegation of LRM program administrative duties to sub-advisers and (ii) the definition and applicability of Rule 22e-4 to "In-Kind ETFs." The following is a summary of the issues addressed in the FAQs.

Sub-Advised Funds

- The staff clarified that a board may designate a sub-adviser as LRM program administrator under Rule 22e-4. The staff additionally stated that a program administrator may delegate specific responsibilities (e.g., providing liquidity classifications for the fund's investments) to a sub-adviser or other appropriate third party and, further, that entities with delegated responsibilities may sub-delegate to others, provided there is appropriate supervision. The staff noted that the fund retains ultimate responsibility for complying with Rule 22e-4. Accordingly, the staff recommended that a fund implement policies and procedures governing the scope and conditions of delegating LRM program responsibilities.
- Because Rule 22e-4 requires funds—and not advisers—to adopt LRM programs, an investment adviser (including a sub-adviser) has no independent obligation to adopt and implement its own LRM program.
- The staff recognized that certain investment advisers (or sub-advisers) may provide advisory services to multiple funds in multiple fund complexes that have differing practices, including different LRM programs with unique policies and procedures (including different LRM programs for funds in the same complex). The FAQs clarified that an entity administering multiple LRM programs that differ from one another is under no obligation to reconcile those programs, the programs' methodologies or the programs' outputs (e.g., different liquidity classifications of certain investments). The staff further clarified that each fund's board-approved LRM program will control how an adviser or sub-adviser carries out any of its responsibilities under Rule 22e-4 to that particular fund.
- Further to the previous bullet point, an investment adviser, sub-adviser or other LRM program administrator, or its delegate, may classify the same investment differently across multiple funds based on the funds' differing LRM programs. The staff noted that, under Rule 22e-4, "a fund must take into account 'relevant market, trading, and investment-specific characteristics' in classifying its portfolio investments' liquidity," and that different funds (even funds within the same complex) are permitted to arrive at different conclusions.
- Pursuant to an LRM program administrator's ability to delegate, an LRM program administrator may adopt an approach whereby multiple entities (e.g., the investment adviser and a sub-adviser) may have input as to the liquidity classification of particular investments. In such instances, the staff believes a fund may consider addressing in its LRM policies and procedures how to treat a circumstance in which the adviser and sub-adviser reach a different conclusion regarding the liquidity classification of a particular investment. The staff noted certain possible solutions, including allowing a specified party's determination to control,

employing a factor analysis or hierarchy or using the most conservative determination. However, the staff clarified that other methodologies could be used

- The staff clarified that in a multi-manager fund in which the various sub-advisers of distinct sleeves are responsible for designating the liquidity classification of portfolio investments, each sub-adviser is permitted to classify the same investment differently even within the same fund, and that none of the fund, the LRM program administrator or the adviser or sub-adviser has any obligation to reconcile these differences for compliance purposes (e.g., monitoring compliance with the fund's highly liquid investment minimum, if applicable, or the 15% limit on illiquid investments).
- The staff noted that, notwithstanding the foregoing bullet point, Form N-PORT does not permit a fund to report more than one liquidity classification for a single investment. Accordingly, an LRM program's policies and procedures should include a methodology for selecting a single liquidity classification for Form N-PORT reporting purposes in circumstances in which different sub-advisers classify the same investment differently for compliance purposes. For illustrative purposes only, the staff noted that a fund may choose to report the classification of the sub-adviser with the largest position in the asset, calculate a weighted average and round to the nearest liquidity classification or report the most conservative (i.e., the lowest) liquidity classification. The staff encouraged a fund with diverging liquidity classifications to report these policies and procedures in the explanatory notes section of Form N-PORT.

In-Kind ETFs

Under Rule 22e-4, ETFs that satisfy redemptions through in-kind transfers of securities positions and assets, other than a de minimis amount of cash, and that publish portfolio holdings on a daily basis are "In-Kind ETFs" that are exempt from certain LRM program requirements. The FAQs address the following considerations with respect to InKind ETFs under the Rule:

- For purposes of determining an ETF's status as an In-Kind ETF, Rule 22e-4 permits each ETF to determine what constitutes a de minimis amount of cash in its policies and procedures; the Rule does not establish a precise methodology. Rather, an ETF may take "a variety of reasonable approaches," provided the approach is applied consistently. The staff stated that it would not object to an approach that includes testing each individual redemption transaction or testing redemption transactions in the aggregate over a reasonable period of time to ensure that the cash amounts used are de minimis. For determining what is a "reasonable period of time," the staff suggested a day or a week for an ETF with frequent redemption basket activity or a month for an ETF with less frequent redemption basket activity. However, the staff stated that in no event would a period in excess of one month be deemed reasonable.
- Although de minimis amounts may differ depending on the facts and circumstances of each ETF, the staff believes that it would be reasonable to determine that overall redemption proceeds paid in cash not exceeding 5% would be de minimis, but that it would be unreasonable to determine that redemption proceeds paid in cash exceeding 10% (subject to permissible exclusions, e.g., the amount of uninvested cash in the ETF's investment portfolio) are de minimis. An ETF should evaluate its particular facts and circumstances to determine whether an amount of cash in excess of 5% (subject to permissible exclusions) is de minimis, including whether such cash redemptions would give rise to liquidity risks substantially similar to those applicable to mutual funds.
- The staff clarified that an ETF may exclude the cash portion of redemption proceeds that is proportionate to the uninvested cash in the ETF's investment portfolio for purposes of defining and testing compliance with the de minimis standard.

- Noting the practical considerations that would prevent an ETF that loses its status as an In-Kind ETF from coming into immediate compliance with the provisions of Rule 22e-4 from which In-Kind ETFs are exempt, the staff stated that it would not recommend enforcement against an ETF that loses its In-Kind ETF designation so long as the ETF comes into compliance with the Rule "as soon as reasonably practicable" after the In-Kind ETF designation is lost.
- A new ETF with little or no operating history may use a forward-looking analysis of its policies and procedures and expected redemption practices to determine that it is an In-Kind ETF. The staff stated, more generally, that backwards-looking redemption history is not by itself dispositive, and that an ETF with an operating history may consider making material changes to its policies and procedures and redemption practices to qualify as an In-Kind ETF

The SEC expects to update the FAQs from time to time to include responses to additional questions.

The FAQs are available at: https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq

Public Statements, Press Releases and Testimony

OCIE Announces 2018 Exam Priorities

On February 7, 2018, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced its 2018 examination priorities for regulated entities, including funds and investment advisers. The examination priorities are organized in five categories: (1) matters of importance to retail investors; (2) compliance and risks in critical market infrastructure; (3) Financial Industry Regulatory Authority (FINRA) and Municipal Securities Rulemaking Board (MSRB); (4) cybersecurity; and (5) anti-money laundering programs. Within these groupings are several issues of potential interest to funds and their investment advisers, including the following:

Mutual Funds: OCIE will focus on mutual funds "(i) that have experienced poor performance or liquidity in terms of their subscriptions and redemptions relative to their peer groups, (ii) that are managed by advisers with little experience managing registered investment companies, or (iii) that hold securities which are potentially difficult to value during times of market stress, including securitized auto, student, or consumer loans, or collateralized mortgage-backed securities."

ETFs: OCIE will focus on ETFs that have "little secondary market trading volume and that face the risk of being delisted from an exchange and having to liquidate assets." OCIE noted that it will analyze whether investment risks are adequately disclosed to investors.

Index Funds: OCIE noted that it will focus on ETFs and mutual funds that are designed to track custom-built indexes and will focus on the potential for conflicts between the adviser and index provider, including "the adviser's role with respect to the selection and weighting of index components."

Cybersecurity: OCIE will continue to prioritize cybersecurity in its exam programs, with a focus on "governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response," among other things.

Inadequately Disclosed Fees, Expenses or Other Charges: OCIE will be on the lookout for instances in which an adviser is incentivized to recommend that "investors invest, or remain invested, in particular share classes of mutual funds that are subject to higher sales loads or distribution fees and the conflict of interest may not be disclosed to investors."

Electronic Investment Advice: OCIE will continue to examine advisers and broker-dealers that offer investment advice through automated or digital platforms, including "robo-advisers." Examinations will focus on "compliance programs, including the oversight of computer program algorithms that generate recommendations, marketing materials, investor data protection, and disclosure of conflicts of interest."

Wrap Fee Programs: OCIE will continue to examine investment advisers and broker-dealers in connection with wrap fee programs. Examinations will likely focus on "whether investment advisers are acting in a manner consistent with their fiduciary duty and whether they are meeting their contractual obligations to clients." Other areas of particular focus will be wrap account suitability, the disclosure of conflicts of interest and whether advisers are obtaining best execution and disclosing the costs of executing through another broker-dealer.

Never-Before-Examined Investment Advisers: OCIE stated that it will continue to make "risk-based assessments and select those investment advisers for examination that have elevated risk profiles."

This list of examination priorities is not exhaustive. OCIE states that it "remains flexible in order to cover emerging and exigent risks to investors and the marketplace as they arise," adding that "[r]apid institutional and technological change in the market landscape demands a responsive approach."

The examination priorities are available at: https://www.sec.gov/about/offices/ocie/national-examination-programpriorities-2018.pdf

Litigation and Enforcement Actions

SEC ENFORCEMENT ACTIONS

SEC Settles with Mutual Fund Administrator in Connection with Calculation of Inflated Net Asset Value

Pursuant to an order dated January 22, 2018 (the Order), the SEC assessed a civil monetary penalty of $400,000, in addition to other penalties, against Gemini Fund Services, LLC (Gemini), administrator to the GL Beyond Income Fund (the Fund), in settlement of allegations that Gemini struck an inflated net asset value (NAV) for the Fund under circumstances in which Gemini did not have adequate proof of the existence of certain Fund assets. The administrative proceeding concerning Gemini follows a separate civil securities fraud action by the SEC against the Fund's investment adviser, GL Capital Partners, LLC (GL Capital), and its principal, Daniel Thibeault, for the creation of fictitious loans that were included as assets of the Fund when Gemini struck the Fund's NAV. From January 2012 through December 2014, Gemini was responsible for calculating the Fund's NAV, transmitting the NAV to Nasdaq and performing data reconciliation with the Fund's custodian.

According to the Order, Thibeault began misappropriating money from the Fund's investors in February 2013 by creating fictitious loans, using the names and personal information of family and friends as purported borrowers. The Order states that Thibeault caused the Fund's custodian to disburse the proceeds of the fake loans, which were diverted to his personal and business bank accounts.

The Order also states that although Gemini did not know that the loans were fake when it struck the Fund's NAV, Gemini personnel allegedly knew—through the performance of contractually required reconciliation processes with the Fund's custodian—that "for extended periods of time," the Fund's custodian did not have adequate proof of the loans' existence. The Order notes that the custodian was not counting the loans as Fund assets during the time that Gemini was striking a NAV that included those same assets, and that the Fund's claimed assets exceeded the assets reflected in the custodian's records by as a much as $6.8 million. According to the Order, Gemini neither notified the investing public or the Fund's board that the custodian did not have proof of the validity of the assets nor reduced the Fund's NAV to reflect the problem.

The Order states that Gemini "was a cause of Thibeault's and GL Capital's violations" of Section 206(1) of the Investment Advisers Act of 1940, which prohibits any investment adviser from employing any device, scheme or artifice to defraud any client or prospective client, and Section 206(2) of the Advisers Act, which prohibits any investment adviser from engaging in any transaction, practice or course of business that operates as a fraud or deceit upon any client or prospective client.

In addition to the $400,000 civil monetary penalty, the SEC ordered Gemini to pay $147,334 in disgorgement and $14,072 in prejudgment interest, enjoined Gemini from committing or causing any future violations and required Gemini to retain an independent compliance consultant and adhere to the recommendations and findings of the consultant's report.

The Order is available at: https://www.sec.gov/litigation/admin/2018/ia-4847.pdf

Legislative Developments

House Passes Expanding Investment Opportunities Act, Which Would Ease Regulatory Requirements Applicable to Closed-End Fund Offerings

On January 17, 2018, the U.S. House of Representatives passed a bill, referred to as the Expanding Investment Opportunities Act, that would require the SEC to adopt rules permitting closed-end funds to use offering and proxy rules currently available only to non-investment companies for increased flexibility to register and offer additional shares, in an effort to reduce filing requirements and restrictions for closed-end funds and save on reporting costs for communications with investors in certain circumstances. Such rules would, among other things, allow closedend funds to offer shares more quickly through "automatic shelf registrations" and would remove requirements that closed-end funds file post-effective amendments to their registration statements to make material revisions, including to update financial statements. The bill will next go to the U.S. Senate for consideration.

The text of the Expanding Investment Opportunities Act is available at:
https://www.congress.gov/bill/115thcongress/house-bill/4279/text

House Committee Passes Mutual Fund Litigation Reform Act, Which Would Heighten Standards for Litigation Under Section 36(b)

On January 8, 2018, the U.S. House of Representatives Financial Services Committee voted in favor of introducing a bill, referred to as the Mutual Fund Litigation Reform Act, that would increase the requirements for plaintiffs bringing excessive fee cases against mutual fund firms under Section 36(b) of the Investment Company Act of 1940. If adopted, the Act would amend Section 36(b) to require that excessive fee complaints “state with particularity all facts establishing a breach of fiduciary duty” and, if such alleged facts will be based on information and belief, also “state with particularity all facts on which that belief is formed.” In addition, it would set a new standard at trial for excessive fee claims, requiring plaintiffs to prove a breach of fiduciary duty “by clear and convincing evidence.” The Mutual Fund Litigation Reform Act will next go to the full House for consideration.

The text of the Mutual Fund Litigation Reform Act is available at: https://www.congress.gov/bill/115th-congress/housebill/4738/text

National Law Review, Volume VIII, Number 50