Ballard Spahr LLP

Investment Management Update

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Below is a summary of recent investment management developments that affect registered investment companies, private equity funds, hedge funds, investment advisers, and others in the investment management industry.

REWARDS AND RISKS IN OPPORTUNITY ZONE FUNDS

H.R. 1—informally known as the Tax Cuts and Jobs Act—became law on December 22, 2017. Included in the Act is a new program intended to spur the reallocation of investments toward low-income areas called "Opportunity Zones." Designation of these areas was completed this summer and zones now exist in every state and Puerto Rico. Once a zone is designated, the Act makes investment available in the form of a "Qualified Opportunity Fund" or QO Fund.

The Act encourages investment in QO Funds by providing deferral and potential reduction of tax for investors. Broadly, the process is as follows:

- The taxpayer sells existing assets. Within 180 days after the sale, the taxpayer rolls the gain realized on the sale into a QO Fund. The taxpayer can make an election for the tax year in which the sale took place to defer recognition of the gain rolled into the QO Fund.
- If the taxpayer elects a deferral, regardless of how long the taxpayer holds the investment, recognition of the gain is deferred until the earlier of the taxpayer's disposition of the QO Fund investment or December 31, 2026. At that time, the taxpayer would include in their income the excess of the eligible gain the taxpayer rolled over or the fair market value of the investment, whichever is less, over the taxpayer's basis for the QO Fund investment.
- If the taxpayer waits at least five years to dispose of their QO Fund investment, their basis in the investment is increased by 10 percent. If the taxpayer waits at least seven years, their basis is increased by an additional five percent.
- If the taxpayer waits at least 10 years to dispose of their QO Fund investment, any gain attributable to appreciation in the value of the investment is permanently excluded from income.

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However, because opportunity zone designations will expire after 2028, IRS guidance is needed to determine how this benefit might or might not apply to an investment made in 2019 or later.

Even with some questions awaiting IRS guidance, there are potentially significant tax advantages to attract investors for entities that can qualify as a QO Fund. As a starting point, a QO Fund must establish that at least 90% of its assets constitute Qualified Opportunity Zone (QOZ) Property. QOZ Property can consist of stock in a U.S. corporation that is a Qualified Opportunity Zone Business; capital or profits interests in a U.S. partnership that is a QOZ Business; or tangible property used in a QOZ Business.

With respect to stock or partnership interests, the interest must be acquired for cash after 2017. The entity must either be a QOZ Business or being organized to be a QOZ Business when the applicable interests were issued. The corporation or partnership also must qualify as a QOZ Business during substantially all of the QO Fund's holding period for the interest.

A QOZ Business is a trade or business in which (i) substantially all tangible property is QOZ Business Property; (ii) at least 50 percent of gross income is derived from the active conduct of a trade or business in an Opportunity Zone; (iii) a substantial portion of any intangible property is used in the active conduct of the business; and (iv) less than five percent of the basis of the property of such business is attributable to "nonqualified financial property," including debt, stock, and annuities. Certain businesses cannot qualify as a QOZ Business, including country clubs, massage parlors, hot tub facilities, racetracks, health clubs, and liquor stores.

The requirement for tangible property to be QOZ Business Property imposes additional restrictions. The property must be purchased by the QOZ Business after 2017 and cannot be acquired from a related person. The QOZ Business must be the first person to use the property in the Opportunity Zone or it must substantially improve the property. The property also must be used in the Opportunity Zone during substantially all of the QOZ Business's holding period.

Several of these limitations drive home the point that QOZ Businesses are meant to be new enterprises attracting new investment in opportunity zones. However, there are potential issues that may hinder a QO Fund's ability to qualify for tax benefits by investing in a startup business. For example, the requirement that the business be a QOZ Business during substantially all of the QO Fund's holding period could preclude investment in businesses that take more than a few months to become operational. Also, the 50 percent gross income test may be particularly difficult to meet during a start-up period. If the QOZ Business fails to meet the provided qualifications, the QO Fund would in turn fail its requirements.

Because the penalty to a QO Fund for failing to meet the Act's requirements can be significant, it is hoped these practical issues for investors and businesses will be addressed by IRS guidance in the near future. In the meantime, investors and entities interested in pursuing QO Fund investment should proceed cautiously to preserve desired tax benefits.

Ballard Spahr's cross-disciplinary Qualified Opportunity Zone Team, including members of the Investment Management Group, will continue to monitor trends in this area.

SEC PROPOSES NEW ETF RULE AND FORM AMENDMENTS

On June 28, 2018, the U.S. Securities and Exchange Commission (SEC) voted to propose a new rule and form amendments intended to modernize the regulatory framework for Exchange-Traded Funds (ETFs).[1] The proposed Rule 6c-11 would permit ETFs that satisfy certain conditions to operate within the scope of the Investment Company Act of 1940, and come directly to market without the cost and delay of obtaining an exemptive order.[2] The SEC also is proposing to rescind certain exemptive orders that have been granted to ETFs

1 https://www.sec.gov/news/press-release/2018-118.

2 https://www.sec.gov/rules/proposed/2018/33-10515.pdf.

and their sponsors. Finally, the SEC is proposing certain disclosure amendments to Form N-1A and Form N-8B-2 to provide investors who purchase and sell ETF shares on the secondary market with additional information regarding ETF trading costs, regardless of whether such ETFs are structured as registered open-end management investment companies or unit investment trusts (UITs),[3] and certain amendments to Form N-CEN.[4]

I. Proposed Rule 6c-11

Proposed Rule 6c-11, which would be available only to ETFs that are organized as open-end funds, would provide certain exemptions from the Act, including permitting an ETF that meets the conditions of the rule to: (i) redeem shares only in creation unit aggregations; (ii) permit ETF shares to be purchased and sold at market prices rather than at NAV per share; (iii) engage in in-kind transactions with certain affiliates; and (iv) in certain limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days. However, these exemptions would be subject to the following conditions:

- **Transparency.** Under proposed Rule 6c-11, an ETF would be required to provide daily portfolio transparency on its website.
- **Custom basket policies and procedures.** An ETF relying on proposed Rule 6c-11 would be permitted to use baskets that do not reflect a pro-rata representation of the fund's portfolio or that differ from other baskets used in transactions on the same business day (custom baskets) if the ETF adopts written policies and procedures setting forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders. The proposed Rule 6c-11 also would require an ETF to comply with certain recordkeeping requirements.
- **Website disclosure.** The proposed Rule 6c-11 and form amendments would require ETFs to disclose certain information on their websites, including historical information regarding premiums, discounts, and bid-ask spread information. These disclosures are intended to inform investors about the efficiency of an ETF's arbitrage process. Additionally, the proposal would require an ETF to post on its website information regarding a published basket at the beginning of each business day.

II. Rescission of Certain ETF Exemptive Relief

The proposed rescission of orders would be specifically limited to the portions of an ETF's exemptive order that grant relief related to the formation and operation of an ETF and, with the exception of certain master-feeder relief, would not rescind the relief from Section 12(d)(1) and Sections 17(a)(1) and (a)(2) under the Act related to fund of funds arrangements involving ETFs.

III. Proposed Amendments to Form N-1A, Form N-8B-2, and Form N-CEN

The proposed amendments to Form N-1A[5] are designed to provide investors who purchase ETF shares in secondary market transactions with additional information regarding ETFs, including information regarding costs associated with an investment in ETFs. The proposal would eliminate certain disclosures that would be duplicative of the proposed amendments to Item 3 of Form N-1A regarding the exchange-traded nature of ETFs. Also, the SEC is requesting comment on whether it should create a new ETF-specific registration form. Similarly, the SEC is proposing to amend Form N-8B-2[6] to require UIT ETFs to provide disclosures that mirror certain of the proposed disclosure changes in Form N-1A.[7]

3 A UIT is an investment company organized under a trust indenture or similar instrument that issues redeemable securities, each of which represents an undivided interest in a unit of specified securities.

4 https://www.sec.gov/rules/proposed/2018/33-10515.pdf.

5 Form N-1A is the registration form used by open-end funds to register under the Act and to offer their securities under the Securities Act of 1933.

6 Form N-8B-2 is the registration form under the Act for UITs which are currently issuing securities and is used for registration of ETFs organized as UITs.

7 Although the SEC is not proposing to include UITs within the scope of proposed Rule 6c-11, the SEC nonetheless is proposing amendments to Form N-8B-2 as it believes that "it is important for investors to receive consistent disclosures for ETF investments, regardless of the ETF's form of organization."

The SEC also is proposing to add to Form N-CEN[8] a requirement that ETFs report if they are relying on Rule 6c-11. The SEC is changing the definition of "authorized participant" in Form N-CEN to exclude the specific reference to an authorized participant's participation in the Depository Trust Company in order to obviate the need for future amendments if additional clearing agencies become registered with the SEC. Revised Form N-CEN would define the term as "a member or participant of a clearing agency registered with the SEC, which has a written agreement with the Exchange-Traded Fund or Exchange-Traded Managed Fund or one of its service providers that allows the authorized participant to place orders for the purchase and redemption of creation units."[9]

PROPOSED RULE 139(B) WOULD CREATE A SAFE HARBOR TO ALLOW NON-AFFILIATED BROKER-DEALERS TO PUBLISH RESEARCH ON INVESTMENT COMPANIES AND PARTICIPATE IN THE DISTRIBUTION OF FUND SHARES

In 2017, the Fair Access to Investment Research Act (FAIR Act) was signed by President Trump. Among its provisions, the FAIR Act directed the SEC to establish a safe harbor under the Securities Act of 1933 (the Securities Act) to permit broker-dealers unaffiliated with a registered investment company to publish research reports on the investment company' securities, even if the broker-dealer participates in the distribution of the fund's securities. Pursuant to that legislative direction, the SEC recently proposed Rule 139(b) to the Securities Act and related new proposed Rule 24(b)-4 of the Investment Company Act of 1940 (ICA) rules and related proposed amendments to Regulation M.

Rule 139(a) of the Securities Act Safe Harbor Currently

Under current Rule 139(a) of the Securities Act, broker-dealers can publish issuer-specific or industry-general investment research reports on operating companies while such companies are in the process of offering securities to the public, and the broker-dealer may be participating in the offering if the broker-dealer satisfies the conditions of the safe harbor. Generally, for issuer-specific reports, the broker-dealer can only write on issuers whose value of public equity held by non-affiliates exceeds $75 million and if such issuers have filed all required SEC reports in the last 12 months. For industry-wide reports, broker-dealers can only write on certain size issuers, and the broker-dealer must comply with presentation and regular course of business requirements.

Proposed Rule 139(b) Applies to Mutual Funds and Other Public Investment Funds

In proposed Rule 139(b), the SEC, following Congressional direction, proposes an equivalent safe harbor for broker-dealers writing research on public investment companies similar, but not identical to, the safe harbor under current Rule 139(a).

Under proposed Rule 139(b), broker-dealers not affiliated with an investment company could write and publish research reports on the investment company and participate in the distribution of the investment company's securities, and the broker-dealer's research report would not be considered an offer under the Securities Act requiring statutory prospectus delivery if the conditions of the safe harbor were satisfied.

Conditions to the Safe Harbor

As in the current version of Rule 139(a), the SEC proposed conditions applicable to investment company issuer-specific research reports and investment company industry-wide research reports.

- **Issuer-Specific Conditions.** A broker-dealer writing research while participating in an investment company's distribution of securities can only write and publish research on issuers:

8 Form N-CEN is a structured form that requires registered funds to provide census-type information to the SEC annually.

9 See proposed amendment to Instruction to Item E.2 of Form N-CEN.

- that have been subject to the reporting requirements of the ICA for at least 12 months;
- that have timely made all required filings under the ICA and the Securities Act in the last 12 months; and
- when the value of the investment company's public equity of non-affiliates exceeds $75 million.

In addition, only broker-dealers that regularly publish research reports in the regular course of business can rely on the safe harbor. This is to avoid market conditioning.

Conditions for Industry-Wide Investment Company Research Reports

Broker-dealers can only write about investment companies that are registered under the ICA. Broker-dealers must publish investment company industry research as a regular part of the broker-dealer's business. Industry research also is subject to content and presentation conditions. If a broker-dealer is writing on a type of fund, it must cover all of the funds with a similar strategy, and no one fund can receive more prominence than another.

Broker-Dealers Writing Research Reports under the Safe Harbor Will Not Be Subject to Rule 482 and Rule 34-b-1 Advertising Rules

Under Rule 482 of the Securities Act and Rule 34-b-1 of the ICA, investment company advertising has specific disclosure requirements regarding risks, performance data, and fees, among other things. Under proposed Rule 139(b), broker-dealers publishing research on investment companies that comply with the safe harbor will not be subject to Rule 482 and Rule 34-b-1.

Self-Regulatory Organizations (SRO) Must Allow Unaffiliated Broker-Dealers to Publish Investment Company Research and Participate in Fund Distribution

As directed by Congress under the FAIR Act, Rule 139(b) would prohibit SROs, such as the Financial Industry Regulatory Authority (FINRA), from enforcing or maintaining any rule that would prohibit a non-affiliated broker-dealer from publishing or distributing a research report under the safe harbor solely because the broker-dealer is participating in the distribution of the investment company's securities. FINRA also would be precluded from prohibiting a non-affiliated broker-dealer from participating in a distribution of an investment company's securities solely because the unaffiliated broker-dealer published or distributed a research report on the investment company under the safe harbor.

Copies of Research Reports under the Safe Harbor Need Not Be Filed under Section 24(b) of the ICA

Section 24(b) of the ICA requires that advertising related to publicly offered investment company securities be filed with the SEC. In connection with the new safe harbor under Rule 139(b), the SEC has proposed new Rule 24b-4 under the ICA that would exempt investment fund research reports under safe harbor from the filing requirements of Section 24(b), so long as the broker-dealer also complies with FINRA requirements.

SEC PROPOSES AMENDMENTS TO THE WHISTLEBLOWER RULES

On June 28, 2018, the SEC voted to propose amendments to the rules governing its whistleblower program.[10] Section 21F of the Securities Exchange Act of 1934 (Exchange Act) provides, among other things, that the SEC shall pay an award—under regulations prescribed by the SEC and subject to certain limitations—to eligible whistleblowers who voluntarily provide the SEC with original information about a violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action or a related action. On May 25, 2011, the SEC adopted a comprehensive set of rules to implement the whistleblower program. The proposed rules would make certain changes and clarifications to the existing rules, as well as several technical amendments.

10 https://www.sec.gov/news/press-release/2018-120.

The SEC is proposing substantive amendments to the whistleblower rules.[11]

- Awards based on deferred prosecution agreements and non-prosecution agreements entered into by the U.S. Department of Justice or a state attorney general in a criminal case, or a settlement agreement entered into by the SEC outside of the context of a judicial or administrative proceeding to address violations of the securities laws, would be allowed. The SEC is proposing an amendment that would expressly allow for the payment of awards based on money collected under these types of arrangements.
- Potential double recovery under the current definition of related action would be eliminated. The SEC is proposing an amendment to clarify that a law enforcement action would not qualify as a related action if the SEC determines that there is a separate whistleblower award scheme that more appropriately applies to the enforcement action.
- There are additional considerations for small and exceedingly large awards. In the context of potential awards that could yield a payout of $2 million or less to a whistleblower, the proposed rules would authorize the SEC to adjust the award percentage upward under certain circumstances (subject to the 30 percent statutory maximum) to an amount that the SEC determines more appropriately achieves the program's objectives of rewarding meritorious whistleblowers and sufficiently incentivizes future whistleblowers who might otherwise be concerned about the low dollar amount of a potential award.

The SEC also is proposing to modify Exchange Act Rule 21F-2. The amendments are in response to the Supreme Court of the United States' recent decision in *Digital Realty Trust, Inc. v. Somers*.[12] In that decision, the Court held that Section 21F(a)(6) of the Exchange Act unambiguously requires that an individual report a possible securities law violation to the SEC in order to qualify for employment retaliation protection and that the SEC's rule interpreting the anti-retaliation protections in Section 21F(h)(1) more broadly was therefore not entitled to deference. The SEC is proposing to modify Rule 21F-2 so that it comports with the Court's holding by, among other things, promulgating a uniform definition of "whistleblower" that would apply to all aspects of Exchange Act Section 21F.

In addition to the amendments mentioned above, the SEC is proposing the following amendments that are intended to clarify and enhance certain policies, practices, and procedures in implementing the program:

- The SEC is proposing to revise Exchange Act Rule 21F-4(e) to clarify the definition of "monetary sanctions" so that it codifies the agency's current understanding and application of that term.
- The SEC is proposing to revise Exchange Act Rule 21F-9 to provide the SEC with additional flexibility to modify the manner in which individuals may submit Form TCR (Tip, Complaint, or Referral).
- The SEC is proposing to revise Exchange Act Rule 21F-8 to provide the SEC with additional flexibility regarding the forms used in connection with the whistleblower program.
- The SEC is proposing an amendment to Exchange Act Rule 21F-12 to clarify the list of materials that the SEC may rely upon in making an award determination.
- The SEC is proposing an amendment to Rule 21F-13 to clarify the materials that may comprise the administrative record for purposes of judicial review.
- The SEC is proposing to add paragraph (e) to Exchange Act Rule 21F-8 to clarify the SEC's ability to bar individuals from submitting whistleblower award applications where they are found to have submitted false information in violation of Exchange Act Section 21F(i) and Rule 8(c)(7) thereunder, as well as to afford the SEC the ability to bar individuals who repeatedly make frivolous award claims in SEC actions.
- The SEC is proposing to add new Exchange Act Rule 21F-18 to afford the SEC with a summary disposition procedure for certain types of likely denials, such as untimely award applications and those applications that involve a tip that was not provided to the SEC in the form and manner that the SEC's rules require.
- The SEC is proposing a technical correction to Exchange Act Rule 21F-4(c)(2) to modify an erroneous internal cross-reference, as well as several

11 https://www.sec.gov/rules/proposed/2018/34-83557.pdf.

12 138 S. Ct. 767 (2018).

technical modifications to Exchange Act Rules 21F-9, 10, 11, and 12 to accommodate certain of the substantive and procedural changes described above.

The SEC also is including proposed interpretive guidance to help clarify the meaning of "independent analysis" as that term is defined in Exchange Act Rule 21F-4 and utilized in the definition of "original information."

OCIE ISSUES RISK ALERT RELATED TO BEST EXECUTION, WARNS ADVISERS OF MANY DEFICIENCIES FOUND IN EXAMINATION OF ADVISERS' POLICIES RELATED TO BEST EXECUTION

In July, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert from its national examination program, warning investment advisers of the most common compliance deficiencies that the OCIE had found in recent examinations of advisers related to best execution obligations under the Investment Advisers Act of 1940. As most compliance professionals know, a risk alert is often a precursor to aggressive enforcement action in a particular area, and it allows the SEC to tell advisers that they have been warned. Paying close attention to a risk alert is prudent.

An adviser has an obligation to seek best execution of client trades. This does not mean that the client has to get the lowest cost execution, but the adviser must consider the full range and quality of a broker-dealer's services including, among other things, the value of research provided to the adviser, execution capability, commission rate, financial responsibility, and broker-dealer responsiveness. An adviser should consider all of these qualitative factors in selecting a broker-dealer to execute client trades.

Registered Investment Advisers Must Do Best Execution Reviews and Document Processes

The OCIE found that many advisers could not demonstrate that they were periodically and systematically evaluating the execution performance of broker-dealers used to execute transactions. Advisers cannot select a broker-dealer and keep that decision on auto pilot, never revisiting the performance of the broker-dealer.

Registered Investment Advisers Must Look at Qualitative Factors in Selecting a Broker-Dealer

Another key deficiency that the OCIE found concerned advisers not considering materially relevant factors during best execution reviews. When advisers do an evaluation of a broker-dealer's services, they must consider qualitative factors, such as the broker-dealer's execution capability, financial responsibility, and responsiveness to the adviser. Advisers should solicit and document input from their traders and portfolio managers regarding these factors and a broker-dealer's performance.

Registered Investment Advisers Should Comparison Shop

The OCIE warns that advisers should not simply remain with one broker-dealer without comparing services provided by competitors. In addition, advisers cannot rely solely on perfunctory summaries of a broker-dealer's services and should document their efforts to compare the prices and services of competitor broker-dealers.

Registered Investment Advisers Must Fully Disclose Best Execution Practices

Form ADV requires full disclosure of an adviser's best execution practices. The OCIE's risk alert warns that its staff found that advisers did not fully disclose that certain types of client accounts may trade the same securities after other client accounts and failed to disclose how this type of trading could affect best execution pricing. The OCIE is also concerned about advisers who claim that they review trades to ensure that prices obtained fell within an acceptable range, when in fact no such review occurred or was documented.

Soft Dollar Issues

Soft dollars arise when an adviser receives research products and services from a broker-dealer that are "paid

for" by the adviser directing trades to the broker-dealer and receiving credits from the trading costs that are then used to pay for the research products and services.

Section 28(e) of the Exchange Act provides a safe harbor for an adviser to pay more than the lowest possible commission rate for brokerage services and to receive research services from a broker-dealer without breaching fiduciary duties, so long as the adviser determines in good faith that the commission payments are reasonable in light of the value of the research and brokerage services provided.

Through interpretative guidance and rulemaking, the SEC has advised that brokerage and research services can include computer software and hardware used to make investment decisions, quotation systems, and research seminars. Some research products and services are mixed-use, meaning that these items could fall under the 28(e) safe harbor, but serve other functions not related to the making of investment decisions. One example of mixed-use products is computer hardware and software that is used for general office administration and investment decision-making. These mixed-use products are supposed to be allocated to their functions, and the adviser must maintain records to show how their use is allocated. In its recent risk alert, the OCIE found a number of deficiencies related to soft dollars.

Non-Disclosure of Soft Dollar Arrangements

Item 12.A.1 of Part 2A of Form ADV requires disclosure of policies and practices for any adviser receiving products and services paid for through soft dollars. The OCIE found that advisers were not providing full and adequate disclosure on Form ADV. Advisers were not describing how soft dollars were being used, that certain clients may be bearing more of the cost of soft dollar arrangements than other clients, and that advisers were not properly disclosing that some products and services provided by broker-dealers were not eligible for the safe harbor.

Mixed-Use Issues

The OCIE warned that advisers were not making a reasonable allocation of the costs of a product or service that had a mixed use. This allocation must be made, it must be reasonable, and it must be documented.

Best Execution Compliance Policies Generally

Finally, the OCIE observed that its examination found that advisers did not have adequate compliance policies regarding best execution generally. Advisers did not have good controls in place to monitor broker-dealer performance. Even when best execution policies had been adopted, the OCIE found that advisers often did not follow them. Failures included not continually reviewing broker-dealer performance and neglecting to allocate soft-dollar expenses in accordance with policies.

What to Do Now

Advisers should review their best execution practices and policies in light of the risk alert. As we mentioned previously, these types of alerts very often are precursors to enforcement actions.

CONTACTS

The above articles address the relevant investment management issues at a high level. Please consult members of the Ballard Spahr Investment Management Group for further discussion.

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