Investment Services Regulatory Update

September 2019

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New Rules, Proposed Rules, Guidance and Alerts

GUIDANCE AND ALERTS

SEC Staff Issues Guidance on Improving Fund Principal Risks Disclosure

On September 9, 2019, the Disclosure Review and Accounting Office staff in the SEC's Division of Investment Management issued recommendations to mutual funds regarding certain disclosure practices intended to improve principal risk disclosures for the benefit of fund investors. The staff's guidance was issued as Accounting and Disclosure Information (ADI) 2019-08 – Improving Principal Risks Disclosure.

The ADI includes three primary recommendations:

- **Order Risks by Importance.** To better highlight for investors the fund risks that they should consider most carefully, the staff "strongly encourage[s]" all funds to list their principal risks in order of importance, rather than alphabetically. In the staff's view, an alphabetical listing of risk disclosures could obscure the importance of key risks and, "[i]n some extreme cases," could render the disclosure potentially misleading. The staff acknowledged that ordering risks based on importance requires subjective determinations that funds are best positioned to make. Importantly, the staff said that it "would not generally expect to comment on a fund's ordering of risks by importance."
- **Tailor Risk Disclosures for Each Fund.** Although the staff noted that standardized disclosures across funds may be appropriate for certain risks, it encouraged funds to tailor risk disclosures to how the particular fund operates. The staff also observed that certain principal risk disclosures described investments not discussed in the fund's principal investment strategies, and it encouraged funds to tailor risk disclosures to align with the principal risks associated with an investment in that particular fund.
- **Disclose that a Fund Is Not Appropriate for Certain Investors.** The staff encouraged funds to consider disclosing that a fund is not appropriate for certain investors given the fund's characteristics.

In addition to the foregoing, the staff also reminded funds that the intent of the summary prospectus is to provide investors a concise summary of key information, and that more detailed information about principal risks should be presented elsewhere in the prospectus. The staff also encouraged funds to (1) disclose non-principal risks (and non-principal investment strategies) in the fund's statement of additional information and (2) periodically review their risk disclosures, including their order, and consider the adequacy of such disclosures in light of the fund's characteristics and market conditions.

The ADI is available here.

SEC Staff Announces Rule 14a-8 No-Action Request Process Changes

On September 6, 2019, the staff of the Division of Corporation Finance announced changes to the process for no-action requests pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, the rule governing inclusion of shareholder proposals in a company's proxy materials. Specifically, starting with the 2019–2020 shareholder proxy season, when informing a proponent and the company of the SEC staff's position—i.e., whether the staff concurs, disagrees or declines to state a view regarding the company's asserted basis for excluding the shareholder proposal—the staff may respond orally instead of in writing to some no-action requests. Written responses generally will be limited to circumstances in which the staff believes its response provides broader value regarding Rule 14a-8 guidance.

The announcement clarifies that if the staff declines to state a view on any particular Rule 14a-8 no-action request, interested parties should not interpret that position as indicating that the proposal must be included. Instead, it means the staff is declining to take a position on the argument's merits, and the company may have a valid legal basis to exclude the proposal under Rule 14a-8. The announcement reminds parties that binding adjudication on the merits of the issue may be sought in court.

The SEC's announcement can be found here.

OCIE Releases Risk Alert Relating to Principal Transaction and Agency Cross Trade Compliance Issues

On September 4, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert identifying common principal trading and agency cross trading compliance issues observed by OCIE staff in adviser examinations during the past three years. Principal trades and agency cross trades when acting as a broker are governed by Section 206(3) of the Investment Advisers Act of 1940.

The risk alert categorized the compliance deficiencies as follows:

- **Failure to meet specific requirements of Section 206(3).** Advisers, acting as principal for their own accounts, purchased or sold securities in transactions with individual clients without recognizing that such principal trades were subject to Section 206(3) of the Advisers Act and therefore did not make the required written disclosures to clients or obtain the required client consents. Other advisers recognized that they had engaged in principal trades but failed to meet all of the requirements of Section 206(3) by: (1) failing to obtain appropriate prior client consent for each principal trade; or (2) failing to provide sufficient disclosure regarding the potential conflict of interests and transaction terms. OCIE also observed advisers that obtained client consent to a principal trade after completion of the transaction.
- **Failure to identify principal transactions relating to pooled investment vehicles.** Advisers effected trades between advisory clients and an affiliated pooled investment vehicle, but failed to recognize that the advisers' significant ownership interests in the pooled investment vehicle (typically greater than 25%) would cause the transaction to be subject to Section 206(3). Advisers also effected principal trades between themselves and pooled investment vehicles, but did not obtain effective consent from the pooled investment vehicle prior to completing the transactions.
- **Agency cross trade activity despite contrary disclosures to clients.** Advisers engaged in agency cross trades in reliance on Rule 206(3)-2 despite having disclosed to clients that they would not engage in such transactions.
- **Agency cross trade activity without documentation.** Advisers effected agency cross trades purportedly in reliance on Rule 206(3)-2 but could not produce any documentation substantiating their compliance with the written consent, confirmation or disclosure requirements of the rule.
- **Failure to institute policies and procedures.** OCIE observed advisers that either did not have policies and procedures relating to Section 206(3) or failed to follow them.

The risk alert encourages advisers to review their written policies and procedures and the implementation of those policies and procedures to ensure that they are compliant with the principal trading and agency cross transaction provisions of the Advisers Act and the rules thereunder.

OCIE's announcement and a link to the risk alert is available here.

SEC Issues Proxy Voting Guidance

On August 21, 2019, the SEC issued two releases that set forth new guidance on various matters relating to proxy voting. Specifically, the SEC issued a policy release concerning the proxy voting responsibilities of investment advisers and an interpretive release and related guidance regarding the applicability of the proxy rules under the Securities Exchange Act of 1934 to voting recommendations provided by proxy advisory firms. The releases are part of a long-term review of the proxy process and a re-examination of relevant guidance being conducted by the SEC, and the SEC noted that it may propose amendments to the proxy rules or issue additional guidance in the future.

Proxy Voting Responsibilities of Investment Advisers

The policy release provides a non-exhaustive list of questions and answers discussing how an investment adviser's fiduciary duties of care and loyalty to its clients, as well as its obligations under Rule 206(4)-6 under the Investment Advisers Act of 1940, can be met when the adviser votes proxies on behalf of clients, particularly when proxy advisory firms are used. The policy release recommends the following:

- The scope of an adviser's authority to vote proxies on behalf of a client should be agreed upon pursuant to full and fair disclosure and informed consent.
- An adviser can demonstrate that voting determinations are made in its clients' best interest and in accordance with its proxy voting policies and procedures by analyzing matters on which the adviser votes, considering whether uniform or separate voting policies would be in the best interest of its clients (e.g., because of different investment objectives), identifying factors for determining whether certain types of matters to be voted on require more detailed analysis, and sampling proxy votes cast to evaluate compliance.
- In evaluating proxy advisory firms, advisers should consider a firm's capacity and competency to adequately analyze the matters on which the adviser is voting, whether the proxy advisory firm has adequately disclosed the reasons for making a voting recommendation, and the firm's policies and procedures for identifying and addressing various conflicts of interest.
- An adviser's proxy voting policies and procedures should be reasonably designed to evaluate third parties (e.g., proxy advisory firms) on an ongoing basis for changes in their business, conflicts of interest and methodologies, and to ensure that the adviser's voting determinations are not based on materially inaccurate or incomplete information. In this regard, an adviser should consider the proxy advisory firm's policies and procedures to assure that recommendations are made based on current and accurate information and that the firm has a process in place to cure deficiencies in its analysis.
- If an adviser has assumed voting authority on behalf of a client, the adviser is not required to exercise voting authority (1) subject to conditions set forth in the client agreement and (2) in cases in which the adviser determines it is in the client's best interest to refrain from voting.

Applicability of Proxy Rules to Voting Recommendations Provided by Proxy Advisory Firms

The interpretive release set forth the SEC's view that a proxy voting recommendation provided by a proxy advisory firm generally constitutes a "solicitation" that is subject to the federal proxy rules. In this regard, the SEC noted that Rule 14a-1 under the Exchange Act broadly defines the term "solicitation," and that this term has been construed by courts to include any communication to security holders "reasonably calculated to result in the procurement, withholding or revocation of a proxy," whether or not the person making the solicitation is soliciting on its own behalf, is seeking authorization to act as a proxy or is interested in the outcome of the vote. The SEC found that because proxy advisory firms market their expertise in, and receive fees for, researching and analyzing matters submitted to a shareholder vote and providing voting recommendations, those recommendations are reasonably calculated to influence votes and should be considered a solicitation regardless of whether the recommendations are followed. The SEC also found that voting recommendations based on tailored, client-mandated voting guidelines are solicitations, provided that the proxy advisory firm is not merely performing administrative or ministerial services. The SEC stated that this interpretation is not intended to restrict or limit reliance on applicable exemptions from the information and filing requirements under the proxy rules.

The SEC also provided its view that proxy voting recommendations deemed solicitations are subject to the anti-fraud provisions of Rule 14a-9 under the Exchange Act, which provides that a solicitation may not contain a material misstatement or omission. In this regard, the SEC stated that a proxy advisory firm may need to explain the methodology used to reach a voting recommendation (including material deviations from its standard methodologies) and disclose any third-party information used in its analysis, as well as any material conflicts of interest that could be relevant to a voting recommendation, in order to avoid a potential anti-fraud violation.

The SEC's Guidance regarding Proxy Voting Responsibilities of Investment Advisers is available here.

The SEC's Interpretation and Guidance regarding Applicability of Proxy Rules to Voting Recommendations is available here.

Litigation and Enforcement Matters

LITIGATION MATTERS

SEC Charges Two Advisers with Fiduciary Duty Breaches for Failing to Disclose Conflicts of Interest relating to the Receipt of Compensation from Client Investments in Mutual Funds

In August 2019, the SEC filed complaints in federal district court against two registered investment advisers alleging fiduciary duty breaches resulting from the failure to disclose conflicts of interest relating to the receipt of compensation from client investments in mutual funds.

SEC v. Cetera Advisors, LLC

On August 29, 2019, the SEC filed a complaint in the U.S. District Court for the District of Colorado alleging that Cetera Advisors, LLC, a dual-registered broker-dealer and investment adviser, breached its fiduciary duties to clients by, among other things, failing to adequately disclose conflicts of interest relating to Cetera's receipt of certain types of compensation and investing or holding client assets in high-fee mutual fund share classes when lower-cost share classes of the same funds were available. The SEC alleged that Cetera's violations resulted in the collection of more than $10 million in improper fees over a six-year period.

The SEC alleged that Cetera, though its registered representatives, invested or held client assets in mutual fund share classes from which Cetera received ongoing 12b-1 fees even though lower-cost share classes of the same mutual funds were available without such fees. The SEC also alleged that Cetera entered into a revenue-sharing arrangement with its clearing broker pursuant to which Cetera received compensation for investing or holding client funds in certain mutual funds. The SEC further alleged that Cetera directed its clearing broker to markup certain fees that Cetera then received indirectly from its clients.

In its complaint, the SEC alleged Cetera failed to implement its written policies and procedures to disclose material conflicts of interest in its Form ADV Part 2A brochure—disclosure that would have given client a basis for understanding the fee arrangements described above and the potential conflicts of interest created by such arrangements.

The SEC alleged that Cetera violated Sections 206(2) and 206(4) of and Rule 206(4)-7 under the Advisers Act and is seeking an injunction against Cetera, as well as disgorgement and a civil penalty.

SEC v. Commonwealth Equity Services, LLC

The litigation against Cetera followed a similar complaint the SEC filed on August 1, 2019 in the U.S. District Court for the District of Massachusetts that set forth claims against Commonwealth Equity Services, LLC, a dual-registered broker-dealer and investment adviser, related to allegations concerning Commonwealth's receipt of compensation pursuant to a revenue-sharing arrangement, and Commonwealth's failure to disclose to clients the nature of such compensation or the conflicts of interest arising from such payments. The SEC alleged that Commonwealth's violations resulted in the collection of over $100 million in improper payments over a four-year period.

The SEC alleged that Commonwealth entered into a revenue-sharing agreement with its clearing broker pursuant to which Commonwealth would receive payments for investing or holding client assets in certain share classes of "no transaction fee" and "transaction fee" mutual funds. The SEC alleged that this arrangement created a conflict of interest that resulted in Commonwealth, through its registered representatives, investing or holding client assets in higher-cost mutual fund classes for which Commonwealth received revenue-sharing payments when lower-cost share classes of the same mutual funds were available.

In the complaint, the SEC alleged that Commonwealth failed to disclose to its clients that Commonwealth received revenue-sharing payments under the broker's transaction fee program, that there were available mutual fund share classes that were less expensive than those that resulted in the revenue-sharing payments to Commonwealth and that there were mutual fund investments that did not provide for any revenue-sharing payments to Commonwealth.

In addition, the SEC alleged that Commonwealth failed to adopt policies and procedures reasonably designed to identify material conflicts of interest that arose from the revenue-sharing arrangement.

The SEC alleged that Commonwealth violated Sections 206(2) and 206(4) of and Rule 206(4)-7 under the Advisers Act and is seeking an injunction against Commonwealth, as well as disgorgement and a civil penalty.

The foregoing enforcement actions follow the conclusion of the SEC's Share Class Selection Disclosure Initiative and the recent adoption of Regulation Best Interest.

The SEC's complaint against Cetera is available here.

The SEC's complaint against Commonwealth is available here.

Investment Services Group Members

Chicago

Cathy G. O'Kelly, *Co-Chair*	+1 (312) 609 7657
Juan M. Arciniegas	+1 (312) 609 7655
James A. Arpaia	+1 (312) 609 7618
Deborah B. Eades	+1 (312) 609 7661
Renee M. Hardt	+1 (312) 609 7616
Joseph M. Mannon	+1 (312) 609 7883
John S. Marten, *Editor*	+1 (312) 609 7753
Maureen A. Miller	+1 (312) 609 7699
S. Jay Novatney	+1 (312) 609 7609
Jacob C. Tiedt, *Editor*	+1 (312) 609 7697
Junaid A. Zubairi	+1 (312) 609 7720
Heidemarie Gregoriev	+1 (312) 609 7817
Nathaniel Segal, *Editor*	+1 (312) 609 7747
Adam S. Goldman	+1 (312) 609 7731
Cody L. Lipke	+1 (312) 609 7669
Kelly Pendergast	+1 (312) 609 7719
Mark Quade	+1 (312) 609 7515
David W. Soden	+1 (312) 609 7793
Cody J. Vitello	+1 (312) 609 7816
Jeff VonDruska	+1 (312) 609 7563
Jake W. Wiesen	+1 (312) 609 7838

New York

Joel S. Forman	+1 (212) 407 7775
Luisa M. Lewis	+1 (212) 407 7795

Washington, DC

Bruce A. Rosenblum, *Co-Chair*	+1 (202) 312 3379
W. Thomas Conner	+1 (202) 312-3331
Amy Ward Pershkow	+1 (202) 312 3360
John M. Sanders	+1 (202) 312 3332

London

Sam Tyfield.	+44 (0)20 3667 2940

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