Investment Services Regulatory Update

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New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Guidance on Fund Disclosure Reflecting Risks Related to Current Market Conditions

On March 9, 2016, the staff of the SEC's Division of Investment Management issued a Guidance Update advising funds to review risk disclosures on an ongoing basis and consider their adequacy and completeness in light of changing market conditions. Noting the importance to investors of full and accurate information about fund risks and that "different risks may be heightened or lessened at different points in time," the staff explained that its guidance is intended to address the changes in a fund's susceptibility to risk that may result from market developments and the need for funds to review and assess risk disclosures in light of changing market conditions. To this end, the staff identified certain steps that funds and their advisers should consider to help provide "robust" risk disclosures to investors. In addition, the staff recommends that a fund's adviser should consider reporting to the board on its process for evaluating fund risk disclosures and whether changes to risk disclosure are appropriate.

In the guidance, the staff suggests that funds: actively monitor market conditions and assess their impact on fund risks, "as a normal part of day-to-day operations"; determine whether material fund risks have been adequately communicated to investors in existing disclosures; and communicate any material risks to investors that are not adequately communicated in current disclosure materials. Unless a particular method of communication (such as a prospectus supplement) is required by the federal securities laws, the Guidance Update indicates that funds should consider the appropriate means of communicating updated risk considerations to investors, including through the prospectus or shareholder reports, as well as less formal methods, such as website disclosure and letters to investors.

As to the type of market developments that the staff views as potentially warranting updated disclosures, the Guidance Update states that in reviewing fund disclosures the staff observed a number of instances where funds have updated disclosures to address current market conditions. In this regard, the staff cites as examples: (i) disclosures by fixed income funds regarding interest rate risk, liquidity risk and duration risk in connection with potential increases in interest rates by the Federal Reserve; and (ii) disclosures by funds with investments in Puerto Rico debt securities in light of the Commonwealth's significant financial difficulties, including budget deficits and ratings downgrades.

The Guidance Update is available at: https://www.sec.gov/investment/im-guidance-2016-02.pdf.

Division of Investment Management Issues Guidance on Oversight of Distribution Fees and Intermediary Payments

On January 6, 2016, the staff of the SEC's Division of Investment Management issued a Guidance Update outlining the staff's views and recommendations regarding oversight of mutual fund distribution

fees and the payment of fees to financial intermediaries characterized as non-distribution related to sub-transfer agent, administrative, sub-accounting and other shareholder servicing fees (collectively, sub-accounting fees).

The Guidance Update follows sweep examinations conducted by the SEC's Office of Compliance Inspections and Examinations to assess whether mutual fund payments to financial intermediaries constitute "distribution-in-guise." That is, whether some or all of the payments characterized as sub-accounting fees were, in fact, for distribution-related services, paid out of fund assets, but not pursuant to a Rule 12b-1 plan and thus, impermissible under the 1940 Act. Rule 12b-1 prohibits mutual funds from engaging, directly or indirectly, in the financing of any activity which is primarily intended to result in the sale of fund shares except pursuant to a written plan that meets the requirements of Rule 12b-1.

In the Guidance Update, the staff's broad recommendations include the following:

- whether or not a fund has a 12b-1 plan, the fund's board should have a process in place reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution;
- as part of this process, advisers and other relevant service providers should provide sufficient information to inform the board of the "overall picture" of the fund's distribution and servicing arrangements, including how the level of sub-accounting fees may affect other payment flows (such as 12b-1 fees and revenue sharing) that are intended for distribution; and
- advisers and other relevant service providers should inform boards if certain activities that are potentially distribution-related exist in connection with sub-accounting fee arrangements, and if they do, boards should evaluate the appropriateness and character of those payments with heightened attention.

In addressing how a board may seek to appropriately characterize fees, the staff cites the 1998 letter from the SEC staff to the Investment Company Institute regarding mutual fund supermarket fees (commonly referred to as the "supermarket letter"), noting that the same types of factors and analysis described in the supermarket letter may serve as a useful framework for the board's process. In addition, the staff noted that boards might generally consider also requesting relevant additional information from the adviser and other service providers, including:

i. information about the specific services provided under the mutual fund's sub-accounting agreements;
ii. the amounts being paid;
iii. if the adviser and other service providers are recommending any changes to the fee structure or if any of the services provided have materially changed;
iv. whether any of the services could have direct or indirect distribution benefits;
v. how the adviser and other service providers ensure that the fees are reasonable; and
vi. how the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so).

Regardless of the specific process employed to make an evaluation of fees, the SEC staff recommends that boards have a process in place reasonably designed to provide them enough information that they can make an informed judgment as to whether fund-paid fees are being used to pay directly or indirectly for distribution, noting that there are “a number of reasonable approaches” but, “in the absence of any such process, it is unclear how a board might make an informed judgment” regarding the fund’s compliance with Rule 12b-1. Notably, the SEC staff suggested that funds should have “explicit policies and procedures as part of their Rule 38a-1 compliance programs designed to prevent violations of Section 12(b) and Rule 12b-1.” In this regard, the Guidance Update states that, as part of the distribution-in-guise sweep exams, the staff observed that many funds did not have such “explicit policies and procedures.”

Other staff observations from the sweep exams are noted in the Guidance Update as indicia that may raise concerns that a payment, though ostensibly not for distribution-related activities, may in fact be (at least in part) a payment for such services. These situations or arrangements include:

- distribution-related activity is conditioned on the payment of a sub-accounting fee;
- a fund has not adopted a 12b-1 plan and does not impose sales loads;
- a fund uses a tiered payment structure for a number of services in which intermediaries are paid first from Rule 12b-1 fees, then fund-paid sub-accounting fees and finally any balance is paid by the adviser or an affiliate from revenue sharing, raising the question of what services the fund is actually paying for and whether any fund-paid fees reduce or subsidize fees that the adviser or other service provider might otherwise be responsible for;
- there is a lack of specificity of services provided by an intermediary or payments for both sub-accounting and distribution have been bundled into a single contract. As to this particular circumstance, the staff noted that, in some cases, boards have evaluated whether the overall payment for a bundled set of services or activities is a payment that is primarily for distribution-related services, an approach that is, in the staff’s view, “inconsistent with the requirements of Rule 12b-1, which explicitly requires that any activity which is primarily intended to result in the sale of mutual fund shares be paid for through a 12b-1 plan, if paid from mutual fund assets.”
- the adviser and other service providers take into account distribution and sales benefits when recommending, instituting or raising sub-accounting fees;
- there are large disparities in the sub-accounting fee rates to intermediaries providing substantially the same set of services to the fund; and
- intermediaries sell additional “strategic sales data” to funds, their advisers or other service providers, providing information about fund investor demographics and other information about top sales partners and channels.

Recognizing that boards are typically not involved in the negotiation of agreements with intermediaries, the SEC staff maintains that boards should be able to rely on the adviser and other service providers “to affirmatively provide information about the existence of any of these activities or arrangements, as well as summary data about expenses and activities related to distribution-related activities.” In addition,

the SEC staff notes its expectation that fund directors can receive and rely on the assistance of outside counsel, the fund's chief compliance officer, or personnel of the adviser or relevant service providers, as appropriate, to assist them in evaluating payments to intermediaries. In the staff's view, the board's role should "focus on understanding the overall distribution process as a whole to inform its reasonable business judgment about whether sub-accounting and other mutual fund-paid fees represent payments for distribution, in whole or in part."

The Guidance Update is available at: https://www.sec.gov/investment/im-guidance-2016-01.pdf.

Public Statements, Press Releases and Testimony

SEC Chair Mary Jo White Addresses Several Topics Regarding Mutual Fund Directors, Including Enforcement Actions and Oversight of Operational, Liquidity and Cybersecurity Risks

On March 29, 2016, SEC Chair Mary Jo White delivered the keynote address at the Mutual Fund Directors Forum 2016 Policy Conference. In her remarks, Chair White shared her views on how directors should approach their role in 2016 and emphasized the important role that directors play in protecting investors. Chair White also noted certain questions and considerations that she expected mutual fund directors to be thinking about in the course of exercising their responsibilities. Some of the questions and considerations that Chair White recommended are as follows:

On Operational Risk:

Directors should consider and ask questions about:

- how a fund's—and its service providers'—compliance policies and procedures, business continuity plans and back-up systems address recent market and industry events (e.g., the SunGard U.S. InvestOne System outage that affected BNY Mellon's fund accounting services; the suspension of redemptions by the Third Avenue Focused Credit Fund);
- whether similar events could happen at their fund, how to prevent them from happening and how to respond promptly and effectively if they do occur;
- the back-up systems and redundancies of the critical service providers that value the fund, keep track of fund holdings and transactions, and strike NAVs; and
- whether fund management has considered specific alternate systems or work-arounds that may be necessary to continue operations or manage through potential business disruptions.

On Liquidity Risk:

Directors should consider and ask questions about:

- whether a fund's investments are appropriately aligned with their anticipated liquidity needs and redemption obligations;

- the quality of the information that management provides to the board on liquidity, the frequency with which management reports to the board on liquidity and how management monitors and manages liquidity risk;
- whether the directors understand any links that may exist between liquidity and valuation with respect to funds they oversee and whether directors are appropriately focused on funds with strategies that may be more likely to face liquidity challenges; and
- whether an open-end fund's investments and investment strategy are appropriate for a fund offering daily redemptions.

On Cybersecurity:

Directors should consider:

- the range of risks posed to a fund's computer networks, noting that it is incumbent upon funds and their advisers to employ robust, state-of-the-art prevention, detection, and response plans, and incumbent on independent directors to consider whether funds, advisers and other key service providers are taking the appropriate steps to do so; and
- recent SEC staff guidance on cybersecurity, which encourages funds to assess their ability to prevent, detect and respond to cyberattacks, and details a number of measures funds may wish to consider.

On Board Composition and Diligence:

Noting that boards "should also think more broadly about the emerging problems of tomorrow and what issues they may be missing," Chair White also advised directors to consider:

- whether the current composition of their boards includes individuals with the necessary skills, experience and expertise and whether to hire subject matter experts as consultants to the board; and
- a fund's risks and to ask the difficult questions, not only in cases of something suspicious or problematic, but also when directors simply do not understand the information they have received.

Oversight vs. Day-to-Day Management:

Notwithstanding the foregoing recommendations to directors and emphasis on their critical role in representing the interests of investors, Chair White acknowledged that regulators must "avoid completely overloading directors with additional responsibilities, or confusing strong oversight with the management of a fund." In this regard, she noted that the role of the board is to provide independent oversight of the administration of fund compliance policies and procedures and other critical functions and to approve compliance policies and procedures, but not to perform them. However, Chair White also acknowledged that recent rule proposals for the fund industry and regulatory focus areas, including with respect to liquidity risk management reforms, the use of derivatives and distribution-in-guise, include several

requirements for or expectations of a fund's board. On this point, Chair White stated that the board's oversight function and how directors can best serve as gatekeepers will remain a key focus for the SEC, adding that she welcomes director input to help the SEC "strike an appropriate balance for the board's oversight role."

Enforcement Perspective on Fund Directors:

Chair White emphasized that directors' judgments made in good faith based on responsibly performing their duties will not be second guessed by the SEC. In contrast, directors who fail to perform their duties "should expect action to punish and deter such conduct." Chair White cited two enforcement actions to illustrate instances in which directors fell short:

- In the first enforcement action, directors did not, as required, approve any fair valuation methodology or continuously review the application of an approved methodology. Instead, the directors delegated this responsibility to a valuation committee of the investment adviser to the funds without setting any parameters or reviewing the committee's work; and[1]
- In the second enforcement action, directors did not receive certain materials they had specifically requested from the adviser in connection with contract review, failed to follow up, and did not seek to clarify the incomplete, unclear and inaccurate information that they did receive. The directors nevertheless acted without this critical information and approved the advisory contracts, thereby breaching their obligations to shareholders and the funds.[2]

Chair White's takeaway from these cases is that directors should carefully review the materials they receive, ask questions instead of rubber-stamping management recommendations, investigate potential inaccuracies, and follow up on unfulfilled requests.

The text of Chair White's speech is available at: https://www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html.

OCIE Announces 2016 Exam Priorities

On January 11, 2016, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced its 2016 examination priorities for regulated entities, including registered funds and investment advisers. The examination priorities are organized into the same three broad categories as last year: (1) matters of importance to retail investors, including investors saving for retirement; (2) issues related to market-wide risks; and (3) use of data analytics to identify potential illegal activities. Within these groupings are several issues of potential interest to registered funds and their investment advisers, including the following:

ETFs: OCIE will examine ETFs for compliance with applicable exemptive relief granted under the Exchange Act and the 1940 Act and with other regulatory requirements, as well as review the ETFs' unit creation and redemption process. OCIE also stated its intent to evaluate ETF sales strategies, trading practices and disclosures, including "excessive portfolio concentration, primary and secondary market trading risks, adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs."

1 In the Matter of J. Kenneth Alderman, et al., Release No. IC-30557 (Jun. 13, 2013), available at https://www.sec.gov/litigation/admin/2013/ic-30557.pdf.

2 In the Matter of Commonwealth Capital Management, LLC, et al., Release No. IC-31678 (June 17, 2015), available at https://www.sec.gov litigation/admin/2015/ic-31678.pdf.

Cybersecurity: Noting its recent initiatives to examine cybersecurity compliance and controls, OCIE will continue these efforts by testing and assessing firms' implementation of cybersecurity procedures and controls. Throughout the past year, the SEC has devoted a significant amount of attention to identifying risks in the area of cybersecurity, including releasing cybersecurity guidance and publishing summary observations of findings from a series of cybersecurity examinations.

Liquidity Controls: In light of changes in fixed income markets over the past several years, OCIE will examine investment advisers to mutual funds, ETFs and private funds that have exposure to potentially illiquid fixed income securities and evaluate, among other things, risk management, valuation, liquidity management and trading activity.

Never-Before-Examined Investment Advisers and Investment Companies: OCIE will continue conducting "focused, risk-based examinations" of investment advisers and fund complexes that have not yet been examined.

This list of examination priorities is not exhaustive and OCIE may adjust the priorities in light of market conditions, industry developments and ongoing risk assessment activities.

The examination priorities are available at: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

Litigation and Enforcement Actions

SEC Settles Charges Against AIG Affiliates for Mutual Fund Sales Conflicts

On March 14, 2016, the SEC announced settled administrative proceedings against Royal Alliance Associates, Inc., SagePoint Financial, Inc. and FSC Securities Corporation, each a dual-registered broker-dealer and investment adviser indirectly owned by American International Group, Inc. (collectively, the "Firms"), for breaches of fiduciary duty and compliance failures resulting from investing advisory clients in higher-fee mutual fund share classes instead of lower-fee share classes of the same funds.

According to the order, from 2012 to 2014, the Firms invested certain of their clients in the Firms' largest fee-based advisory service in share classes that charged 12b-1 fees (for marketing and distribution expenses) when lower-fee share classes of the same funds without 12b-1 fees were available in many instances. As a result, the SEC found that, in their capacity as broker-dealers, the Firms received approximately $2 million in 12b-1 fees that they would not have collected had they invested those clients in available lower-fee share classes. The SEC also found that the Firms did not disclose in their Forms ADV or otherwise that they had a conflict of interest with respect to selecting mutual fund share classes due to a financial incentive to place advisory clients in higher-fee share classes over lower-fee share classes of the same fund. Consequently, the order states that the Firms breached their fiduciary duties to those clients that were invested in the higher-fee

share classes. In addition, the SEC found that the Firms failed to adopt any written compliance policies or procedures governing mutual fund share class selection.

The SEC also found that the Firms failed to implement compliance policies and procedures requiring monitoring for "reverse churning." Reverse churning generally refers to the practice where a client is charged an inclusive wrap fee that covers all advisory services and trading costs even though the client trades infrequently. As the order explains, a wrap fee account may not be in the best interest of a client with minimal or no trading activity as compared to a non-wrap fee account or brokerage account where the client would otherwise pay trading costs as incurred but a lower fee in a non-wrap account or no advisory fee in a brokerage account. The Firms were required under their advisory compliance policies and procedures to review "inactive" wrap fee accounts to ensure that such accounts remained in the best interest of advisory clients with minimal trading activity. However, the order states that during the course of examinations conducted by the SEC's Office of Compliance Inspections and Examinations it was discovered that there had been several periods, ranging from 3 months to 18 months, when there was a lapse in inactive account reviews.

As a result of the foregoing conduct, the SEC found that the Firms violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any fraud or deceit upon any client or prospective client. The SEC also found that the Firms violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires a registered investment adviser to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder. In addition, as a result of the inadequate disclosure concerning mutual fund share class selection and the related conflict of interest, the SEC found that the Firms violated Section 207 of the Advisers Act, which makes it unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the SEC or willfully to omit to state in any such application or report any material fact which is required to be stated therein.

The Firms consented to the SEC's order without admitting or denying the findings that they violated Sections 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-7 thereunder. Pursuant to the terms of the order, the Firms agreed to retain an independent compliance consultant to conduct a comprehensive review of their policies and procedures. The Firms also agreed to pay disgorgement and prejudgment interest of slightly more than $2 million, as well as a civil monetary penalty of $7.5 million.

The SEC order is available at: https://www.sec.gov/litigation/admin/2016/34-77362.pdf.

U.S. District Court Rules in Favor of Defendants on Remaining Claims in Schwab Case Relating to Violation of Fundamental Investment Policies

On February 23, 2016, the U.S. District Court for the Northern District of California issued an order denying the plaintiffs' motion for reconsideration and granting the defendant's motion for judgment on the pleadings in the shareholder class action originally brought in August 2008 by Northstar

Financial Advisors, Inc. (Northstar), on behalf of its clients, against Schwab Investments (the Trust), a Massachusetts business trust, the Board of Trustees of the Trust (the Board) and Charles Schwab Investment Management, Inc. (CSIM). In doing so, the District Court has now ruled against the plaintiffs on all claims in this case, having determined that all such claims are precluded by the Securities Litigation Uniform Standards Act of 1998 (SLUSA). Northstar, on behalf of its clients, had filed a shareholder class action lawsuit in August 2008 against the Trust, the Board and CSIM, setting forth a number of claims based on allegations that the Schwab Total Bond Market Fund (the Fund), a series of the Trust for which CSIM serves as investment adviser, deviated from its fundamental investment policies. The case was on remand to the District Court after the U.S. Court of Appeals for the Ninth Circuit reversed the District Court's dismissal of several claims and ruled, among other things, that Northstar (1) could bring state law claims for breach of fiduciary duty against the Board directly, rather than derivatively, (2) could assert a claim against the Fund itself for breach of a purported contract between Fund shareholders and the Trust based on "the mailing of the proxy statement and the adoption of the two fundamental investment policies after shareholders voted to approve them, and the annual representations by the Fund that it would follow these policies" and the shareholders' acceptance of the terms set forth in the proxy statement and prospectuses by means of their investment in the Fund, and (3) could bring a claim against CSIM under the theory that shareholders should be considered third-party beneficiaries of the Fund's investment advisory contract with CSIM.

SLUSA generally bars class action lawsuits if the action is based on state law claims and alleges either a material misrepresentation or omission or the use of manipulation or deception in connection with the purchase or sale of a "covered security," which includes shares of mutual funds. The District Court found that "the gravamen of Northstar's allegations" is that the defendants misrepresented or omitted a material fact in their management of the Fund: "If, as Northstar alleges, Defendants did deviate from the Fund's investment objectives, then Defendants committed a misrepresentation or omission of material fact. Specifically, Defendants promised to manage the Fund one way, but ended up managing the Fund in a different way." Thus, the District Court determined that Northstar's allegations are subject to SLUSA preclusion.

The case is Northstar Financial Advisors, Inc. v. Schwab Investments, et al., case number 5:08-cv-04119 in the U.S. District Court for the Northern District of California. Northstar filed a notice of appeal to the U.S. Court of Appeals for the Ninth Circuit on February 25, 2016.

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