# Investment Services Regulatory Update

May 2016

## In This Issue



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# New Rules, Proposed Rules and Guidance

## SEC Staff No-Action Letter Permits Index ETF to Exceed 1940 Act Limits on Investments in Insurance Companies and Securities-Related Issuers

On March 28, 2016, the staff of the SEC's Division of Investment Management issued a no-action letter to SPDR S&P Dividend ETF (the "Fund") permitting the Fund to acquire more than (i) 10% of the total outstanding voting stock of an insurance company notwithstanding Section 12(d)(2) of the 1940 Act and (ii) 5% of an outstanding class of equity securities of an issuer that, in its most recent fiscal year, derived more than 15% of its gross revenues from securities related activities (an "Equity Issuer") notwithstanding Rule 12d3-1(b)(1).

**The Fund**

The investment objective of the Fund is to seek to provide investment results that, before fees and expenses, correspond generally to the total return performance of the S&P High Yield Dividend Aristocrats Index (the "Index"), an index that tracks performance of publicly traded issuers that have historically followed a policy of making dividend payments, including insurance companies and financial services firms that derive a substantial portion of their revenues from securities-related activities. The index provider, which is not affiliated with the fund or its investment adviser (the "Adviser"), determines the composition of the Index, relative weightings of securities in the Index and publishes information regarding the market value of the Index. In managing the Fund, the Adviser may invest the Fund's assets in a subset of securities in the Index or may invest the Fund's assets in substantially all of the securities represented in the Index in approximately the same proportions as the Index.

**Section 12(d)(2)**

Section 12(d)(2) of the 1940 Act generally prohibits a fund from purchasing any security issued by an insurance company if, as a result of the purchase, the fund would own more than 10% of the total outstanding voting stock of the insurance company. The SEC historically has interpreted Section 12(d)(2) as "prohibiting control of an insurance company by an investment company but permitted acquisition of stock of an insurance company upon assurance that there would be no such control." Consequently, the staff stated that it would not be inconsistent with the intent of Section 12(d)(2) if the Fund exceeded the Section's investment limitations by purchasing or acquiring the outstanding voting stock of an insurance company in the approximate proportion that the insurance company's stock represents in the Index, based on the Fund's facts and representations. Such facts and representations include that the Fund has a non-fundamental investment policy to "not invest in the securities of a company for the purpose of exercising management or control, provided that the Trust may vote the investment securities owned by the Fund in accordance with its views." Notwithstanding the foregoing non-fundamental investment policy, the Fund represented that it will not exercise a controlling influence over the management or policies of the insurance company and will either: (a) vote its shares in the insurance company as directed by an independent third party, or (b) vote its shares in the insurance company in the same proportion as the vote of all other holders of the insurance company's shares.

### Section 12(d)(3) and Rule 12d3-1

Section 12(d)(3) of the 1940 Act generally prohibits a fund from purchasing any security issued by a broker, dealer, underwriter or registered investment adviser. Rule 12d3-1, however, exempts certain acquisitions from the prohibitions of Section 12(d)(3) but limits to 5% the amount that a fund may acquire of the outstanding securities of a particular class of equity securities of an issuer that engages in securities-related activities. The Fund noted for the SEC staff that as it increases in size it may be unable to comply with this 5% limitation, and consequently, may not be able to invest directly in Equity Issuers to the extent necessary for it to accurately track the Index.

In releases proposing amendments to Rule 12d3-1, the SEC identified two apparent Congressional purposes for prohibiting fund investments in securities-related issuers: (i) "to limit, at least to some extent, the exposure of [funds] to entrepreneurial risks peculiar to securities related businesses," and (ii) "to prevent potential conflicts of interest and reciprocal practices," such as directed brokerage. With respect to the former, the SEC staff agreed that the concern regarding entrepreneurial risks of securities-related issuers is adequately addressed by prohibiting the acquisition of general partnership interests in such issuers, adding that since virtually all securities firms are currently organized as corporations and not general partnerships, Congress's purpose in limiting the exposure of entrepreneurial risks to investment companies is theoretical.

To address concerns about conflicts of interest and reciprocal practices, the Fund represented that if it invests in an Equity Issuer it will not (i) use that Equity Issuer as the executing broker for any Fund transactions, and (ii) acquire the securities issued by that Equity Issuer in an amount exceeding the approximate proportion that the issuer represents in the Index. In addition, if the Fund owns more than 5% of the value of the outstanding securities issued by persons that engage in securities related activities (with the exception of Equity Issuers), the Fund will comply with the provisions of section 17(e) of the 1940 Act and Rule 17e-1 thereunder when using that issuer, or any affiliated person of that issuer as a broker for the purchase or sale of any security in the Fund's portfolio. Similarly, if the Fund uses any affiliated person of an Equity Issuer as the executing broker for any Fund transactions, the Fund will also comply with the provisions of section 17(e) of the 1940 Act and rule 17e-1 thereunder. The Fund contended, and the SEC staff agreed, that compliance with those provisions in such circumstances would provide adequate safeguards against the reciprocal practices and conflicts of interest that Section 12(d)(3) was intended to address.

A copy of the no-action letter is available at: https://www.sec.gov/divisions/investment/noaction/2016/spdr-sp-dividend-etf-032816-12d2.htm.

## 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.

# 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:

**<u>On Operational Risk:</u>**

**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.

[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.

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# 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.

# Other News and Developments

## ICI Issues Memo Regarding the Adequacy of Fund Policies, Procedures and Disclosures In Light of Unanticipated Events on Securities Trading Venues

On April 12, 2016, the Investment Company Institute (ICI) issued a memorandum to member firms regarding fund policies and procedures for valuing portfolio assets and pricing, issuing and redeeming fund shares, as well as related disclosure, in light of unanticipated events on securities trading venues. The ICI memo states that unanticipated disruptions in the functions of securities exchanges or other trading venues raise various legal and operational considerations for open-end funds, including issues such as trade execution, valuation of portfolio assets, pricing of fund shares and processing transactions in fund shares. Citing the midday suspension of trading on the New York Stock Exchange (NYSE) on July 8, 2015, the ICI notes that, in that case, the NYSE resumed trading before the 4:00 pm (Eastern Time) market close and therefore, funds were able to price their shares in accordance with standard operating procedures and policies. Nonetheless, the memo explains, many fund complexes have been evaluating relevant policies, procedures and disclosure in anticipation of future potential trading venue disruptions. In this connection, the ICI identifies several matters that member firms may wish to consider as they conduct such evaluations.

*Valuation Policies and Procedures:* Noting that funds often look primarily to a security's closing price on its primary listing market or exchange in valuing that security, the memo advises funds to review their current valuation policies to determine whether they provide for the use of additional sources of pricing data or information when prices from the primary listing market are unavailable, or are earlier and less representative of current market value. In this regard, the ICI notes that in the event of an unexpected close of the primary listing market, a security may continue to trade in one or more other markets, and the price as reflected in those other trading venues may be more reflective of the security's value than an earlier price from the primary listing market (which had closed unexpectedly).

*Consideration of a Fund's Time for Pricing Fund Shares and Accepting Orders:* The ICI recommends that funds take into account valuation and operational factors in adopting policies with respect to when and how often fund shares will be priced. For instance, the memo notes that funds may consider the capabilities of service providers such as pricing vendors (e.g., whether they can provide reliable values for securities at unanticipated times of the day) and intermediaries (e.g., whether they can apply an unanticipated fund cut-off time and sort purchase and redemption orders accordingly). On this matter, the memo explains that Rule 22c-1 under the Investment Company Act provides funds with flexibility regarding when and how often they must price their shares and, as a result, fund policies vary with respect to the time when they price fund shares and stop accepting purchase and redemption orders (the "cut-off time"). Some funds stipulate a fixed cut-off time (e.g., 4:00 pm Eastern Time); others stipulate that their cut-off time will coincide with the close of trading on the NYSE. The ICI explains that this difference in policies may yield different results in the event that trading is suspended on the NYSE and "closed" as of a time that is not 4:00 pm Eastern Time.

*Enhancing Fund Policies and Related Disclosure:* Whichever general option a fund adopts, funds should consider ways of elaborating on Rule 22c-1 policies and related disclosure to describe steps to be taken in response to unanticipated market events. The objectives, according to the ICI, should be to improve funds' ability to accommodate these events while still providing shareholders a clear sense of likely outcomes from the application of these policies. For instance, a fund preferring to tie its daily cut-off time to that of the NYSE might specify that the relevant time would be the time as of which the NYSE determines official closing prices. Thus, in the event that the NYSE were to close early unexpectedly but determine prices for its securities at a later time, this later time would control for purposes of the fund's cut-off time.

In addition to the foregoing, the memo advises that the fund board should review and approve any material changes to the fund's valuation policies and procedures regarding when the fund will price its shares. The ICI also recommends that a fund effectively communicate to its intermediaries any changes to the fund's policies and procedures or its cut-off time to ensure prompt and proper application of the fund's new policies and the proper cut-off time when sorting purchase and redemption orders following an unanticipated exchange event. Finally, as to disclosure, the memo states that a fund must provide shareholders with disclosure about its procedures for valuing portfolio assets and pricing, issuing and redeeming fund shares in its prospectus and SAI. Therefore, any changes to such policies and procedures may require conforming changes to the fund's prospectus and SAI.

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## Investment Services Group

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