Investment Services Regulatory Update

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New Rules, Proposed Rules and Guidance

SEC's Rulemaking List Targets 2017 for Proposed Uniform Fiduciary Standard and Other Notable Proposals

The SEC's estimated timetable for issuing notices of proposed rulemaking concerning several areas of interest to advisers and funds is April 2017, according to the Spring 2016 Agency Rule List published by the Office of Information and Regulatory Affairs (OIRA) and the Office of Management and Budget (OMB).[1] The Agency Rule List, which is published semi-annually by OIRA and OMB, is a comprehensive list of rulemakings the SEC staff is working on that includes estimated dates or a particular month and year for proposed rule releases. Although there is no guarantee that the SEC staff will act on proposed rulemaking by the dates/months listed, the Agency Rule List offers an indication of key issues on the SEC's rulemaking agenda for the coming year. The issues subject to proposed rulemaking in 2017 include, among others: (1) a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers; (2) a rule that would require registered investment advisers to create and maintain transition plans; (3) new requirements for stress testing by large asset managers and large investment companies; (4) proposed additions and amendments to the current transfer agent rules in order to update the existing regulatory framework; (5) reproposed amendments to advertising rules to require target date retirement funds' marketing materials to provide investors enhanced information about those funds, including a glide path illustration; and (6) reproposed rules and rule amendments to provide exemptive relief for index-based and certain actively managed exchange-traded funds (ETFs) to enable these ETFs to begin operations without the need to obtain individual exemptive relief from the SEC.

The Spring 2016 Agency Rule List for the SEC is available at: http://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCd=3235&Image58.x=58&Image58.y=9.

FinCEN Adopts Customer Due Diligence Requirements for Covered Financial Institutions, Including Mutual Funds

On May 11, 2016, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued a final rule under the Bank Secrecy Act that enhances customer due diligence (CDD) requirements for "covered financial institutions," including mutual funds, banks, broker-dealers, introducing brokers in commodities and futures commission merchants. The final rule includes a new requirement for covered financial institutions to identify and verify the identity of beneficial owners of legal entity customers, subject to certain exclusions and exemptions, as well as a requirement to adopt risk-based supervisory procedures for anti-money laundering (AML) programs. The final rule follows the issuance by FinCEN of an Advance Notice of Proposed Rulemaking in March 2012 and a Notice of Proposed Rulemaking (NPRM) in August 2014. The effective date of the final rule is July 11, 2016 and the compliance date is May 11, 2018 (the Compliance Date).

[1] OIRA is part of the OMB within the Executive Office of the President. Among other things, OIRA reviews agency draft and proposed final regulatory actions and seeks to coordinate actions with other agencies to avoid inconsistent, incompatible, or duplicative policies.

In the preamble to the final rule, FinCEN identifies four key elements of CDD as constituting the "minimum standard of CDD," which FinCEN believes is fundamental to an effective AML program: (1) identifying and verifying the identity of customers; (2) identifying and verifying the identity of beneficial owners of legal entity customers (i.e., the natural persons who own or control legal entities); (3) understanding the nature and purpose of customer relationships to develop a customer risk profile; and (4) conducting ongoing monitoring for reporting suspicious transactions and, on a risk-basis, maintaining and updating customer information. Under FinCEN's existing rules, the first element of CDD is already satisfied by the existing customer identification program (CIP) requirements of financial institutions,[2] and the third and fourth elements are described by FinCEN as "already implicitly required for covered financial institutions to comply with their suspicious activity reporting requirements." However, the AML program requirements for covered financial institutions are being amended by the final rule in order to include the third and fourth elements as explicit requirements. Notably, the second element—beneficial ownership information for legal entity customers—is a new requirement.

<u>The New Requirement to Identify Beneficial Owners of Legal Entity Customers</u>

FinCEN will require, subject to certain exemptions and exclusions, covered financial institutions to establish and maintain written procedures that are reasonably designed to identify and verify the identity of the beneficial owners of any legal entity customers and to include such procedures in their AML compliance programs.

Legal Entity Customer

"Legal entity customer" generally means a "corporation, limited liability company, or other entity that is created by the filing of a public document with a Secretary of State or similar office, a general partnership, and any similar entity formed under the laws of a foreign jurisdiction that opens an account." The final rule provides a specific list of several entities that are excluded from the definition of "legal entity customer" since beneficial ownership information for these entities is generally accessible from other sources. Thus, the definition of "legal entity customer" excludes, among others: a financial institution regulated by a federal functional regulator or a bank regulated by a state bank regulator; entities whose common stock or equity interests are listed on a stock exchange; certain issuers of securities registered with the SEC under the Securities Exchange Act of 1934 (the Exchange Act); exchanges, clearing agencies or any other entity registered with the SEC under the Exchange Act; CFTC-registered entities; public accounting firms registered under the Sarbanes-Oxley Act; insurance companies regulated by a state; investment companies registered under the Investment Company Act of 1940 (the 1940 Act); investment advisers registered under the Investment Advisers Act of 1940; and certain pooled investment vehicles. Covered financial institutions do not need to collect beneficial owner information for the excluded entities.

Beneficial Owners

A "beneficial owner" is defined to include:

- each individual, if any, who directly or indirectly, through any contract, arrangement, understanding, relationship, or other means, owns 25% or more of the equity interests of a legal entity customer (the ownership prong); and
- any individual with significant responsibility to control, manage, or direct a legal entity customer,

[2] Section 326 of the USA PATRIOT Act of 2001 grants authority to FinCEN to prescribe minimum standards for covered financial institutions in identifying and verifying customer information when customers open accounts. In 2003, FinCEN issued a rule establishing requirements for a customer identification program (CIP). The CIP requirements focused on the individual or entity opening an account and did not require covered financial institutions to identify and verify information regarding the beneficial owners of legal entity customers.

including an executive officer, senior manager, or any other individual who performs similar functions (the control prong).

The preamble to the final rule states that the number of beneficial owners identified for each legal entity customer will vary due to the ownership prong—there could be as few as zero (i.e., if no individual meets the 25% threshold) and as many as four individuals who satisfy this prong. However, all legal entities would be required to identify at least one beneficial owner under the control prong.[3] In cases in which an individual owns 25% or more of a legal entity and also meets the definition for control, that same individual could be identified as a beneficial owner under both prongs. Alternatively, a covered financial institution may voluntarily choose to identify additional individuals or use a lower threshold than 25% if it deems appropriate on the basis of risk.

Identification and Verification of Beneficial Owners

A covered financial institution must identify the beneficial owner(s) of each legal entity customer at the time a new account (i.e., each account opened at a financial institution by a legal entity customer on or after the Compliance Date) is opened (unless the customer is otherwise excluded or the account is exempted). Covered financial institutions may comply either by obtaining the required information on a standard certification form[4] or by any other method that complies with the substantive requirements of the obligation. The final rule requires that covered financial institutions verify the identity of each beneficial owner by using risk-based procedures "to the extent reasonable and practicable." At a minimum, these verification procedures must contain the elements required under the existing CIP. Therefore, the procedures for beneficial owners will be similar to those for individual customers under a CIP, except that for beneficial owners, financial institutions are entitled to rely on customer representations regarding the individual or individuals with ownership and/or control; provided that the financial institution has "no knowledge of facts that would reasonably call into question the reliability of the information." Consequently, financial institutions, in general, do not need to verify whether individuals identified on certification forms (or by another method) as beneficial owners in fact hold the requisite ownership interest or exert significant control over the entity.

FinCEN permits covered financial institutions to rely on another financial institution's (including an affiliate's) performance of the beneficial owner identification and verification process so long as, among other things, the other financial institution enters into a contract requiring it to certify annually to the covered financial institution that it has implemented its AML program, and that it will perform (or its agent will perform) the specified requirements of the covered financial institution's procedures to comply with the beneficial owner identification and verification requirements. In addition, covered financial institutions will be required to maintain records of the beneficial ownership information obtained, but may also assign this duty to another financial institution (including affiliates) under the same conditions as those set forth in the CIP rules.

Intermediated Account Relationships

In the 2014 NPRM, FinCEN proposed that if an intermediary is the legal entity customer and a covered financial institution has no CIP obligation with respect to the intermediary's underlying clients pursuant to existing guidance, the covered financial institution should treat the intermediary, and not the intermediary's underlying clients, as its legal entity customer. In the preamble to the final rule, FinCEN confirms that the foregoing principle

[3] The preamble to the final rule indicates that the control prong is designed to ensure that the covered financial institution has a record of at least one natural person associated with the legal entity customer.

[4] FinCEN attached a form, "Certification Regarding Beneficial Owners of Legal Entity Customers," as an appendix to the adopting release.

will apply: " To the extent that existing guidance provides that, for purposes of the CIP rules, a financial institution shall treat an intermediary (and not the intermediary's customers) as its customer, the financial institution should treat the intermediary as its customer for purposes of this final rule." Under existing guidance,[5] if a broker-dealer or other financial institution purchases mutual fund shares on behalf of its customers by opening an account for the intermediary through the Fund/SERV system, the customers of the intermediary are not treated as customers of the mutual fund. Under the mutual fund CIP rule, a "customer" of a mutual fund includes a "person that opens a new account" and the intermediary is deemed to be such person.

Use of Beneficial Ownership Information

Beneficial ownership information should be used in a similar manner as information that is collected through CIP, including for compliance with Office of Foreign Assets Control regulations.

Risk-Based Procedures for Ongoing Due Diligence

As noted above, in addition to the requirement to identify and verify the beneficial owner(s) of certain legal entities that open new accounts, the final rule formalizes the requirement that covered financial institutions incorporate "appropriate risk-based procedures for conducting ongoing customer due diligence" in their AML compliance programs. Specifically, these procedures must include, but are not limited to:

- understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and
- conducting ongoing monitoring to identify and report suspicious transactions, and to maintain and update customer information (which includes information regarding the beneficial owners of legal entity customers).

FinCEN explained that the "customer risk profile refers to the information gathered about a customer at account opening used to develop a baseline against which customer activity is assessed for suspicious activity reporting" and may include "self-evident information" such as the type of customer or type of account, service or product. As to the requirement to update customer information, the preamble to the final rule indicates this is not intended to impose a categorical requirement to update customer information on a continuous or ongoing basis. Rather, this requirement is "event-driven" and triggered by information that arises in the normal course of monitoring.

AML Program Requirements for Mutual Funds

In the preamble to the final rule, FinCEN acknowledges that a relatively small proportion of a mutual fund's underlying customers purchase their shares directly from the fund and instead, "the great majority of mutual fund investors purchase shares through an intermediary, such as a securities broker-dealer, and therefore the mutual fund has no direct relationship with them." FinCEN further notes that of all the legal entity customers of a mutual fund, "a significant number are typically financial intermediaries (e.g., securities broker-dealers), most of which are regulated" and "any legal entities that are direct customers of a fund, and not any type of intermediary, would comprise a relatively small portion of its direct customers." Nonetheless, both intermediary and non-intermediary customers are subject to a mutual fund's AML program, which requires the application of

[5] See Guidance from the Staffs of the Department of the Treasury and the U.S. Securities and Exchange Commission, Questions and Answers Regarding the Mutual Fund Customer Identification Rule, August 11, 2003.

risk-based due diligence. In this regard, FinCEN expects that non-intermediary legal entity customers of mutual funds would be subject to a different risk assessment than intermediary customers for due diligence purposes.

Notably, FinCEN states that the incorporation of explicit risk-based supervisory procedures for mutual funds' AML programs "serves only to articulate current practice consistent with existing regulatory and supervisory expectations." For instance, understanding the nature and purpose of customer relationships "encapsulates practices already generally undertaken by mutual funds to know and understand their customers." FinCEN notes that many mutual funds use customer information during the course of an investigation into suspicious activity triggered by transaction monitoring and, in this connection, FinCEN "would not generally expect such firms to change their practices in order to comply with [the formalized requirement for ongoing monitoring]." As to customer risk profiles, FinCEN states that "we expect mutual funds to utilize the customer risk profile as necessary or appropriate during the course of complying with their [suspicious activity reporting] requirements—as we understand is consistent with the general current practice—in order to determine whether a particular transaction is suspicious."

The Federal Register publication of the preamble and the final rule is available at: https://www.fincen.gov/redirect.html?url=https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf.

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 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 the 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 SEC 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 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 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 SEC staff views as potentially warranting updated disclosures, the Guidance Update states that in reviewing fund disclosures the staff observed a number of instances in which 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.

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Public Statements Press Releases and Testimony

SEC Chair Discusses Future Regulatory Initiatives and Emerging Industry Challenges at ICI 2016 General Meeting

On May 20, 2016, SEC Chair Mary Jo White delivered the keynote address, titled the "Future of Investment Company Regulation," at the ICI's 2016 General Meeting in which she highlighted several recent SEC rule proposals and their current status, including fund reporting modernization, liquidity risk management and derivatives regulation, addressed focus areas for potential future regulation, and discussed other key challenges for the fund industry. Chair White specifically mentioned disclosure effectiveness and oversight of ETFs as issues of interest to the SEC in connection with the "next steps in the evolution of regulation for the asset management industry," in addition to discussing the use of technology and service providers as other emerging challenges. These issues and related initiatives noted by Chair White are summarized below:

Disclosure Effectiveness in the Fund Industry

- Chair White stated that she has directed staff in the SEC's Division of Investment Management (IM) to undertake a disclosure effectiveness initiative to consider ways to improve the form, content, and delivery of funds' disclosures.
- Chair White anticipates that the IM staff will focus on, among other things: (1) ways to leverage advances in technology to improve the presentation and delivery of disclosures; (2) ways to enhance disclosure about fund strategies, investments, risks and fees; (3) improvements to a fund's fee table to facilitate investor understanding of the information it presents and whether the most helpful information is required; (4) how funds can present risks most effectively and whether the requirement that a fund disclose certain factors that materially affected the fund's performance can be improved; and (5) whether all of the information in a prospectus or statement of additional information continues to be necessary or helpful to investors.

Although the IM staff's disclosure initiative is intended to assist funds and their sponsors in preparing effective disclosure materials, Chair White reminded the industry that it is each fund's ultimate responsibility to provide investors with the information that they need to make informed investment decisions. To this end, funds should: (1) continuously re-evaluate the purpose and value of all disclosure; (2) avoid boilerplate language; and (3) tailor disclosure as appropriate for each fund.

Oversight of ETFs

- Citing the May 2010 "flash crash" and the extreme market volatility on August 24, 2015, Chair White noted that the SEC staff has been focused on analyzing such events and "any broader implications they may have for how [the SEC] regulate[s] ETFs."
- In particular, the SEC staff is evaluating a number of areas related to the operation of ETFs, including: (1) the role that authorized participants and market makers play in the operation and trading of ETFs and how much they impact the liquidity in the markets; (2) the interconnectedness

of the prices of ETF shares and their portfolio holdings, and the impact on investors when the ETF's arbitrage mechanism does not function efficiently; and (3) the sales practices of broker-dealers in the market and how investors understand and use ETFs.

- Notably, Chair White stated that "further regulatory steps beyond additional disclosures may be needed to address some of these issues" concerning ETFs.

Use of Technology and Service Providers

Chair White advised that funds:

- be adequately prepared to promptly and effectively respond to risks that may be triggered by service providers and a fund's own use of technology, including implementing alternative and reliable means to satisfy the fund's regulatory requirements; and
- consider the full range of cybersecurity risks and consider appropriate tools and procedures to prevent breaches, detect attacks, and limit harm.

Other Issues

In addition to the foregoing topics, Chair White identified fund governance, valuation, performance advertising and intermediary fee arrangements as other challenges that funds should continue to work to address.

The text of Chair White's speech is available at: https://www.sec.gov/news/speech/white-speech-keynote-address-ici-052016.html.

SEC Chair Addresses Several Topics Regarding Mutual Fund Directors, Including Enforcement Actions and Oversight of Operational, Liquidity and Cybersecurity Risks, Among Other Issues

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 and the suspension of redemptions by the Third Avenue Focused Credit Fund);
- whether similar events could occur 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 Risk:

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 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,[6] 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
- in the second enforcement action,[7] 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.

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.

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

[7] 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.

Litigation and Enforcement Actions

Inadvertent Proxy Voting Instruction Results in Denial of State Law Appraisal Claim

As reported by *Ignites* and the *Wall Street Journal* on June 1, 2016, an inadvertent proxy vote in favor of a buyout proposal for Dell Inc. (Dell), the computer technology company, resulted in the exclusion of certain mutual funds sponsored by T. Rowe Price & Associates, Inc. (T. Rowe) and other T. Rowe clients that relied on T. Rowe to direct the voting of their shares (together, the TR Petitioners) from approximately $190 million in additional sale proceeds, following the appraisal of Dell shares in a ruling by Vice Chancellor J. Travis Laster in Delaware Chancery Court on May 31, 2016 (the Appraisal Decision). In a decision earlier in May (the TR Petitioners Decision), the Delaware Chancery Court held that, because the holder of record of Dell shares for which the TR Petitioners sought appraisal did not dissent to the management-supported merger, the TR Petitioners did not satisfy the dissenter requirement under Delaware law and, consequently, could not pursue an appraisal. According to *Ignites*, the TR Petitioners held approximately 31 million Dell shares. Based on the evidence presented at trial, the Delaware Chancery Court concluded in the Appraisal Decision that the fair value of Dell's common stock at the effective time of the merger was $17.62 per share, not the $13.75 per share paid by Michael Dell and Silver Lake Management LLC. A discussion of the TR Petitioners Decision follows below:

On May 11, 2016, the Delaware Chancery Court issued an opinion regarding the ability of the TR Petitioners to pursue an appraisal of their Dell shares. As explained in the opinion, the buyout plan favored by Dell management was effected by a merger between Dell and three counterparties (the Merger) that gave rise to appraisal rights. The opinion states that a stockholder can pursue an appraisal only if the stockholder "neither voted in favor of the merger…nor consented thereto in writing." The appraisal statute defines the term "stockholder" as "a holder of record of stock in a corporation." The opinion states that the TR Petitioners were not holders of record for state law purposes. Instead, the TR Petitioners were beneficial owners who held their shares through a custodial bank, State Street Bank & Trust Company (the Custodian).[8] However, as the opinion notes, for purposes of Delaware law, the Custodian was not a holder of record either; it was a participant member of the Depository Trust Company (DTC), the depository institution. DTC, in turn, tracks the number of shares that each participant member holds using an electronic book entry system and, as is its practice, held the TR Petitioners' shares in the name of its nominee, Cede & Co. (Cede)[9] which was the holder of record for purposes of Delaware law and thus, had the legal right under Delaware law to vote the shares and demand appraisal.

Nevertheless, due to competing requirements and practices (including from stock exchange listing standards, federal law and contractual obligations), Cede was required to vote the TR Petitioners' Dell shares as T. Rowe directed. This resulted from what the opinion describes as a "daisy chain of authorizations": first, DTC transferred Cede's state law voting authority to the DTC participants by executing an omnibus proxy in their

[8] A footnote to the opinion notes that some of the TR Petitioners used other custodians, but the parties treated this variation as immaterial and briefed the matter as if State Street were the sole custodian, which the Delaware Chancery Court described as a "shared premise [that] simplifies one aspect of a complex situation."

[9] As the opinion explains, DTC primarily holds shares on behalf of its participants in fungible bulk, meaning that all of the shares are issued in the name of Cede without any subdivision into separate accounts of the custodian's customers.

favor,[10] meaning voting authority for the TR Petitioners rested with the Custodian (as noted, a participant member of DTC). The Custodian, in turn, outsourced to Broadridge Financial Solutions, Inc. (the Proxy Agent), the responsibility for collecting and implementing voting instructions from its account holders, including the TR Petitioners. In order to do so, the opinion states that the Custodian gave the Proxy Agent a power of attorney authorizing the Proxy Agent to execute proxies on the Custodian's behalf, meaning voting authority for the TR Petitioners' Dell shares then rested with the Proxy Agent. The opinion further notes that the Proxy Agent fulfilled its contractual obligations to the Custodian by communicating with the Custodian's account holders and obtaining voting instructions. As to T. Rowe, this process involved an additional party, Institutional Shareholder Services Inc. (the Proxy Advisory Firm) which was retained by T. Rowe to notify the firm about upcoming votes, provide voting recommendations, collect T. Rowe's voting instructions, and convey them to the Proxy Agent.

The opinion explains that when the Proxy Advisory Firm learns that an issuer has scheduled a meeting of stockholders, its web-based delivery platform, part of a computerized system maintained by the Proxy Advisory Firm (the ISS Voting System), would notify T. Rowe by generating a communication called a meeting record. T. Rowe personnel would view the meeting record through its "Proxy Recommendation System" (the TR Voting System), which would pre-populate the meeting record with voting instructions that matched T. Rowe's standard voting policies. When T. Rowe received a meeting record, the TR Voting System would send an e-mail automatically to the portfolio managers of the T. Rowe funds who were invested in that issuer so that they could review the meeting record and determine whether to depart from T. Rowe's standard voting policies. As the opinion explains, in order to vote, a T. Rowe portfolio manager could either leave the pre-populated voting instructions in place or submit different instructions. Thereafter, once finalized, the voting instructions would be sent to the Proxy Advisory Firm. In the next stage of the voting process, the Proxy Advisory Firm conveys the voting instructions to the Proxy Agent. Based on the transfer of voting authority from Cede to the Proxy Agent, the Proxy Agent then votes the shares over which it had received voting authority in accordance with the voting instructions it had received.

The process leading to the vote of Dell shares began when Dell's board of directors approved the Merger on February 5, 2013, scheduled a meeting of stockholders for July 18, 2013 (the July Meeting) and set a record date of June 3, 2013 for the meeting. Dell filed its definitive proxy statement for the July Meeting on May 31, 2013, announcing the meeting date and record date, solicited proxies from Dell's stockholders, and asked them to vote "FOR" the Merger.

For the July Meeting, the opinion notes, the ISS Voting System generated a meeting record on July 9, 2013 (the July Meeting Record) and identified three agenda items, including approval of the merger agreement.[11] For a transaction that is supported by management, the T. Rowe default voting position was to vote "FOR" the transaction. Accordingly, the TR Voting System pre-populated the July Meeting Record with T. Rowe's default voting positions and sent an e-mail to all of the T. Rowe portfolio managers who held Dell stock in actively managed accounts. The opinion states that six of the portfolio managers decided to vote against the Merger and communicated their determinations to a T. Rowe Corporate Governance Specialist. Thereafter, on July 16, 2013, the Corporate Governance Specialist logged into the TR Voting System and changed the voting instructions in the July Meeting Record to vote "AGAINST" the Merger. Then, on the same day, relying on the voting instructions entered into the July Meeting Record by the Corporate Governance Specialist, a T. Rowe

[10] The opinion explains that the record holders for purposes of federal law are the DTC participants and therefore, DTC cannot simply vote the shares held in Cede's name. Therefore, to transfer its state-law voting rights to the federal-law record holders, DTC executes an omnibus proxy in favor of its participants.

[11] The other two items on the agenda were: (1) an advisory vote on golden parachute compensation payable in connection with the Merger; and (2) a proposal giving Dell authority to adjourn the July Meeting. The opinion notes that T. Rowe's default voting positions were to vote "AGAINST" an advisory vote on golden parachute compensation and "FOR" the authority to adjourn.

Business Analyst entered the "AGAINST" instructions into the ISS Voting System and transmitted those voting instructions to the Proxy Advisory Firm through its web-based portal. Another T. Rowe employee e-mailed the Proxy Advisory Firm to confirm that it had received the instructions to vote "AGAINST," which the Proxy Advisory Firm, in turn, confirmed.

The opinion states that on July 18, 2013, Dell convened the July Meeting for the sole purpose of adjourning it until July 24. The Proxy Advisory Firm updated the date of the meeting, but did not send out a new meeting record for the adjourned meeting. Nevertheless, the opinion notes, the T. Rowe Corporate Governance Specialist confirmed that T. Rowe's instructions to vote "AGAINST" remained operative in both the TR Voting System and the ISS Voting System. Thereafter, the meeting was adjourned again until August 2. Once again, the Proxy Advisory Firm updated the date of the meeting, but did not send out a new meeting record for the adjourned meeting. As with the first adjournment, the Corporate Governance Specialist reconfirmed that T. Rowe's instructions to vote "AGAINST" remained operative in both the TR Voting System and the ISS Voting System.

The opinion states that on August 2, 2013, Dell convened the adjourned meeting for the sole purpose of adjourning it again until September 12, 2013 (the September Meeting) and set a new record date of August 13 for the September Meeting. On August 12, the Proxy Advisory Firm updated the date of the meeting to September 12, but the ISS Voting System did not generate a new meeting record. As the opinion notes, the T. Rowe Corporate Governance Specialist confirmed for a third time that T. Rowe's instructions to vote "AGAINST" all three proposals remained operative in both the TR Voting System and the ISS Voting System.

The opinion then notes that on September 4, 2013, the ISS Voting System generated a new meeting record for the re-scheduled meeting (the September Meeting Record). The TR Voting System showed both the July Meeting Record and the September Meeting Record. The opinion explains that in the ISS Voting System, however, the September Meeting Record replaced the July Meeting Record, which had the effect of deleting the voting instructions that had been entered in the ISS Voting System.

The TR Voting System automatically pre-populated the September Meeting Record with the default voting instructions called for by T. Rowe's voting policies, meaning the TR Voting System populated the September Meeting Record with instructions to vote "FOR" the Merger. The opinion states that no one from T. Rowe's proxy team logged into the ISS Voting System to check the status of T. Rowe's voting instructions. Thus, as part of the routine operation of the two systems, the default voting policies in the September Meeting Record, including voting "FOR" the Merger, were transmitted by the Proxy Advisory Firm to the Proxy Agent. The Proxy Agent then delivered its clients' proxies to Dell's proxy solicitor. The Merger was approved at the September Meeting.

The opinion explains that in August 2014, in connection with the required SEC filing by eight of the TR Petitioners that are mutual funds of Form N-PX disclosing how they voted their securities during the most recent twelve-month period ended June 30, the Proxy Advisory Firm generated the forms using data pulled from the ISS Voting System. The opinion states that T. Rowe personnel checked the forms for accuracy and filed them. According to the opinion, the forms stated that the eight TR Petitioners had voted "FOR" the Merger. The opinion explains that because T. Rowe had opposed the Merger publicly, "the disclosure that eight of the [TR Petitioners] had voted "FOR" the Merger generated inquiries" and T. Rowe began to investigate what happened.

The Delaware Chancery Court determined that "Dell has proven by a preponderance of the evidence that the [TR Petitioners] shares were voted "FOR" the Merger." Summarizing the chain of authority regarding the TR Petitioners' vote on the Merger, the opinion states that "Broadridge [i.e., the Proxy Agent] voted those shares in favor of the Merger through the Broadridge client proxies, which exercised the voting authority that Broadridge received from State Street [i.e., the Custodian] through a power of attorney, and which State Street had received from Cede through the DTC omnibus proxy." Therefore, the Delaware Chancery Court held that because the holder of record did not dissent as to the shares for which the TR Petitioners sought appraisal, the dissenter requirement was not met and the TR Petitioners' shares did not qualify for appraisal.

FINRA Publishes Targeted Exam Letter for Mutual Fund Waiver Sweep

In May 2016, FINRA published a targeted exam letter issued to certain unspecified broker-dealers in connection with FINRA's examination of whether member firms failed to provide or offer sales charge waivers to eligible accounts, including with respect to retirement accounts and charitable organizations. The mutual fund waiver sweep follows the identification of fund sales charge discounts and waivers as a focus area in each of the last two annual regulatory and examination priorities letters issued by FINRA. In addition, over the past year FINRA has accepted Letters of Acceptance, Waiver and Consent (AWCs) from several firms settling alleged rule violations concerning the firms' failure to establish and maintain a supervisory system and procedures reasonably designed to ensure that eligible customers who purchased mutual fund shares received the benefit of applicable sales charge waivers. In this connection, firms including AXA Advisors, LLC, Edward D. Jones & Co., L.P., LPL Financial LLC, Raymond James & Associates, Inc., Stifel Nicolaus & Company, Inc. and Wells Fargo Advisors, LLC, among others, submitted AWCs to settle such alleged violations and agreed to pay restitution to affected customers in varying amounts (an estimated $15 million in restitution in the case of Wells Fargo). In concluding these settlements, the firms neither admitted nor denied the charges, but consented to the entry of FINRA's findings.

The questions asked and requests of FINRA member firms in the sweep letter include, among others:

- If the firm had retirement plan or charitable accounts during the relevant period, has the firm initiated a look-back assessment to determine whether there have been any missed sales charge waivers to eligible accounts, including a description of how the firm is calculating the missed discounts?
- Provide a copy of any training materials given to supervisory personnel or sales staff specific to Class R shares during the relevant period.

The letter identifies the relevant period for each request as January 1, 2011 through December 31, 2015. Recipients of the letter are directed to respond with information and documents to FINRA staff on or before June 10, 2016.

The letter is available at: https://www.finra.org/industry/mutual-fund-waiver.

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 SEC's 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 in which 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 in which 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 three 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.

Other News and Developments

ICI Issues Memo Regarding the Adequacy of Fund Policies, Procedures and Disclosures in Light of Unanticipated Events Affecting 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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