Investment Services Regulatory Update

August 2016

In This Issue

New Rules, Proposed Rules and Guidance

Public Statements, Press Releases and Testimony

Litigation and Enforcement Actions

Other News and Developments

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New Rules, Proposed Rules and Guidance

SEC Approves Adoption of Generic Listing Standards for Actively Managed ETFs

On July 22, 2016, the SEC issued orders to BATS Exchange, Inc. (BATS) and NYSE Arca, Inc. (NYSE Arca) approving proposed rule changes to adopt generic listing standards for actively managed exchange-traded funds (ETFs). The orders will enable the exchanges to list actively managed ETFs that satisfy the applicable criteria without first having to seek separate approval from the SEC's Division of Trading and Markets.

Section 19(b) of the Exchange Act requires a self-regulatory organization – including BATS, NYSE Arca and other exchanges – to obtain SEC approval for "any proposed rule or proposed change in, addition to, or deletion from" existing rules of the exchange. Since the listing or trading of a new securities derivative product qualifies as a proposed rule change, and ETFs are deemed to be "derivative products" for this purpose, exchanges, on behalf of an ETF sponsor, must seek SEC approval in order to launch a new ETF by submitting a rule change proposal with the SEC pursuant to Rule 19b-4 under the Exchange Act. This process, which can take several months or longer, can create uncertainty for the ETF sponsor.

Rule 19b-4(e) under the Exchange Act provides an exception from this requirement for ETF shares that satisfy "generic listing standards" that have already been approved by the SEC. In this connection, the SEC has already approved rule changes for several exchanges enabling passively managed, index-tracking ETFs that meet the generic listing requirements to be listed without SEC approval. However, prior to issuing the orders to BATS and NYSE Arca, the SEC had not approved generic listing standards for an actively managed ETF.

The generic listing standards in the orders to BATS and NYSE Arca generally codify various restrictions on portfolio composition that commonly appeared in the SEC's prior Rule 19b-4 orders for actively managed ETFs and are based on the generic listing standards applicable to index-based ETFs. The standards establish portfolio requirements and limitations which vary based on asset class and relate to, among other things, in the case of equity securities, minimum market capitalization, minimum trading volume, portfolio weightings, number of issuers and issuer listing requirements, with certain differences in criteria for U.S. versus non-U.S. stocks. Similarly, an actively managed ETF's fixed income portfolio securities must satisfy minimum original principal amount and other issuer criteria. The generic listing standards also set forth criteria for the portion of an actively managed ETF's portfolio represented by derivatives, with key distinctions in the treatment of listed vs. over-the-counter derivative instruments. Listed actively managed ETFs will be required to meet the applicable portfolio composition requirements both at the time of listing and on an ongoing basis.

The exchanges will still be required to apply for relief before listing actively managed ETFs that do not meet the new listing standards. In addition, actively managed ETFs themselves will continue to be required to obtain exemptive relief under various provisions of the Investment Company Act, which would not otherwise allow the ETF structure.

The generic listing standards for actively managed ETFs also include expanded website portfolio disclosure requirements, require that intra-day indicative values for actively managed ETFs be widely disseminated by one or more major market data vendors at least every 15 seconds during the trading day, and require each actively managed ETF to adopt a stated investment objective to be adhered to during "normal market conditions." In general, "normal market conditions" means the absence of trading halts in the applicable financial markets, operational issues such as systems failures causing the dissemination of inaccurate market information or *force majeure* events.

The SEC order issued to BATS is available at: https://www.sec.gov/rules/sro/bats/2016/34-78396.pdf.

The SEC order issued to NYSE Arca is available at: https://www.sec.gov/rules/sro/nysearca/2016/34-78397.pdf.

Division of Investment Management Issues Guidance Update Concerning Business Continuity Planning for Funds

On June 28, 2016, the staff of the SEC's Division of Investment Management issued a Guidance Update (the Guidance) discussing business continuity plans (BCPs) for registered investment companies (funds).[1] The Guidance reviews various measures that the SEC staff believes a fund should consider when evaluating the robustness of its BCP as well as the BCPs of "critical fund service providers," which the staff identifies as the adviser, principal underwriter, administrator, transfer agent, custodian and pricing agent.

BNYM/SunGard Incident and Lessons Learned

In emphasizing the importance of robust business continuity planning in order to mitigate risks for funds and investors, the Guidance cites the August 2015 incident when Bank of New York Mellon (BNYM) experienced a malfunction in one of its third-party systems (SunGard's InvestOne) that prevented it from calculating accurate net asset values for hundreds of mutual funds and exchange-traded funds (ETFs). The Guidance notes that the SEC staff conducted outreach to the fund industry during the course of and following the BNYM incident which revealed that "some funds could have been better prepared for the possibility that one of their critical service providers would suffer an extended outage." The SEC staff advises that fund complexes consider how to mitigate the consequences of disruptive events, such as the BNYM incident, through compliance policies and procedures tailored to the nature and scope of the complex and that address, among other things, "potential disruptions in services (whether provided internally at the fund complex or externally by a critical third-party service provider) that could affect a fund's ability to continue operations, such as processing shareholder transactions." Noting that fund complexes outsource critical functions to third parties, the staff also advises that fund complexes conduct initial and ongoing due diligence of those third parties, including assessments of their service providers' business continuity and disaster recovery plans.

"Notable Practices"

The Guidance lists several "notable practices" observed by the SEC staff in recent discussions with fund complexes (which may be understood as recommended features of BCPs), including:

- BCP coverage of facilities, technology/systems, employees, and activities of the adviser and affiliated entities, as well as dependencies on critical third-party services;
- Involvement of a broad cross-section of employees from key functional areas, including senior management, in BCPs;
- Service provider oversight by key personnel, including the Chief Compliance Officer (CCO) of the fund complex and/or the CCO of other entities in the fund complex;

[1] On the same date that the Guidance was issued, the SEC published a release regarding proposed Rule 206(4)-4 under the Advisers Act, which would require every SEC-registered investment adviser to adopt and implement written business continuity and transition plans reasonably designed to address operational risks related to a significant disruption in the adviser's business (see summary below).

- Service provider oversight methods including, but not limited to, service provider presentations, on-site visits, questionnaires, certifications, independent control reports (such as Service Organization Control (SOC) reports prepared by independent auditors) and summaries of programs and testing;
- Annual BCP presentations to the fund board (either separately, or as part of the CCO's annual compliance report to the board or the board's annual 15(c) contract review process);
- Annual BCP testing, with results shared with the fund board; and
- CCO monitoring of business continuity outages, with reporting to the fund board as warranted.

Additional Considerations Regarding Critical Service Providers

The Guidance identifies certain additional recommendations regarding critical service providers that fund complexes should take into account, including:

- **Back-Up Processes and Contingency Plans**

  A fund complex should examine its critical service providers' backup processes and redundancies, the robustness of the providers' contingency plans, including reliance on other critical service providers, and how these providers intend to maintain operations during a significant business disruption.

  A fund complex should understand how its own BCP addresses risk that a critical service provider could suffer a significant business disruption and how the provider and the fund complex might respond under certain scenarios.

- **Monitoring Incidents and Communications Protocols**

  A fund complex should consider how to best monitor whether a critical service provider has experienced a significant disruption (such as a cybersecurity breach) that could impair the service provider's ability to provide uninterrupted services, the potential impacts such events may have on fund operations and investors, and the appropriate communication protocols. Such protocols might include:

  - Policies and procedures for internal communications across the fund complex, as well as with fund boards;
  - External communications plans that address ongoing discussions with the affected service provider, as well as other providers as warranted, and intermediaries, investors, regulators, and the press, as appropriate;
  - Maintaining updated and accessible contact information for essential communications with various constituents during an event; and
  - Providing timely communications that report progress and next steps, which may include posting updates to websites or using other portals to broadly disseminate information.

- **Understanding the Interrelationship of Critical Service Providers' BCPs**

  A fund complex should consider how the BCPs of its critical service providers relate to each other to better ensure that funds can continue operations and/or promptly resume operations during a significant business disruption.

- **Contemplating Various Scenarios**

  A fund complex should generally have a plan for managing the response to potential disruptions under various scenarios, whether such disruptions occur internally or at a critical third-party service provider.

Although the SEC staff acknowledges that it is not possible for a fund complex to anticipate or prevent every business continuity event, the Guidance states that a fund complex should consider its compliance obligations under the federal securities laws when assessing its ability to continue operations during such an event.

The Guidance is available at https://www.sec.gov/investment/im-guidance-2016-04.pdf.

SEC Proposes New Rule and Rule Amendment Requiring Business Continuity and Transition Plans for Advisers

On June 28, 2016, the SEC proposed Rule 206(4)-4 under the Advisers Act that would require all SEC registered investment advisers to adopt and implement written business continuity and transition plans, including certain specific components, that are reasonably designed to address risks related to a significant disruption in the adviser's operations. The proposed rule is intended to help ensure that an adviser's policies and procedures minimize material service disruptions and any potential client harm from such disruptions. The SEC also proposed an amendment to Rule 204-2 under the Advisers Act, imposing certain record-keeping requirements regarding an adviser's business continuity and transition plans.

Proposed Rule 206(4)-4

Under the proposed rule, it would be unlawful for an adviser to provide investment advice unless the adviser adopts and implements written business continuity and transition plans and reviews those plans at least annually. These plans must include policies and procedures concerning: (1) business continuity after a significant business disruption, and (2) business transition in the event the adviser is unable to continue providing investment advisory services to clients. The proposing release states that business continuity situations generally include "natural disasters, acts of terrorism, cyber-attacks, equipment or system failures, or unexpected loss of a service provider or key personnel." Business transitions are described generally as including "situations where the adviser exists the market and thus is no longer able to serve its clients, including when it merges with another adviser, sells its business or a portion thereof, or in unusual situations, enters bankruptcy proceedings."

As proposed, an adviser's plan would be based upon the risks associated with the adviser's operations and specifically must address: (1) maintenance of critical operations and systems, and the protection, backup, and recovery of data; (2) pre-arranged alternate physical location(s) of the adviser's office(s) and/or employees; (3) communications with clients, employees, service providers and regulators; (4) identification and assessment of third-party services critical to the operation of the adviser; and (5) plan of transition that accounts for the possible winding down of the adviser's business or the transition of the adviser's business to others in the event the adviser is unable to continue providing advisory services. The proposing release states that while an adviser's plan must address the foregoing components, "the degree to which an adviser's plan addresses a required component will depend upon the nature of each particular adviser's business."

Annual Review. As noted, the proposed rule would also require each adviser to review the adequacy of its business continuity and transition plan on at least an annual basis, including a review of the adviser's effectiveness in implementing the plan.

The annual review should: (1) consider other regulatory changes and changes to the adviser's business that might suggest a need to revise the plan; and (2) address any weaknesses identified through prior testing, assessments or instances where the plan had to be carried out.

Proposed Amendment to Rule 204-2

Under the proposed amendment to Rule 204-2, advisers would be required to maintain copies of all written business continuity and transition plans that are in effect or were in effect at any time during the last five years after the compliance date of the amendment. Each adviser would also be required to maintain records documenting the annual review of its business continuity and transition plans that would be required by proposed Rule 206(4)-4.

Comments on the proposal must be submitted on or before September 6, 2016.

A copy of the proposing release is available at:https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

SEC Staff Provides Temporary No-Action Relief on Auditor Independence and the "Loan Provision"

On June 20, 2016, the staff of the SEC's Division of Investment Management, in consultation with the Office of the Chief Accountant and the Division of Corporation Finance, issued a no-action letter to Fidelity Management & Research Company (FMR) assuring that, for at least the next 18 months from issuance, and subject to certain conditions set forth in the letter, the staff would not recommend enforcement action to the SEC if a registered fund or other entity (a Fidelity Entity) in its "investment company complex" (as defined by Regulation S-X) employs a registered public accounting firm (an Audit Firm), that has relationships causing non-compliance with certain independence requirements under the so-called "Loan Provision."

Background

Rule 2-01(c) under Regulation S-X sets forth a non-exclusive list of circumstances that are considered inconsistent with an Audit Firm's independence, including the Loan Provision. The Loan Provision provides that an Audit Firm is not independent when the Audit Firm has a loan from "record or beneficial owners of more than ten percent of the audit client's equity securities." An "audit client," in turn, is defined to include any affiliate of the audit client and, when the audit client is an entity within an "investment company complex," it also includes every entity within the investment company complex, regardless of whether the Audit Firm actually provides audit services to those other entities.

FMR's request for no-action relief refers to discussions with Audit Firms about the "scope of their lending relationships," and identifies "one or more of the following circumstances, each of which could have potential implications under the Loan Provision" (collectively, Lending Relationships):

- An institution that has a lending relationship with an Audit Firm holds of record, for the benefit of its clients or customers (for example, as an omnibus account holder or custodian), more than 10% of the shares of a Fidelity Entity;
- An insurance company that has a lending relationship with an Audit Firm holds more than 10% of the

shares of a Fidelity Entity (in this case, a Fidelity registered fund) in separate accounts that it maintains on behalf of its insurance contract holders;

- An institution that has a lending relationship with an Audit Firm acts as an authorized participant or market maker to a Fidelity exchange-traded fund and holds of record or beneficially more than 10% of the shares of a Fidelity Entity.

The No-Action Relief

As noted, the SEC staff provided temporary no-action relief to a Fidelity Entity that employs an Audit Firm that has a Lending Relationship causing non-compliance with the Loan Provision.

The SEC staff conditioned its temporary no-action assurance on the following requirements:

(1) the Audit Firm has complied with Public Company Accounting Oversight Board (PCAOB) Rule 3526(b)(1) and (2) (the provision governing independence communications), or, with respect to any Fidelity Entity to which Rule 3526 does not apply, has provided substantially equivalent communications;

(2) the non-compliance of the Audit Firm is with respect to the Lending Relationships; and

(3) notwithstanding such non-compliance, the Audit Firm has concluded that it is objective and impartial with respect to the issues encompassed within its engagement.

In granting this no-action relief, the SEC staff cited the Audit Firm's representation to FMR that, notwithstanding the Firm's non-compliance with the Loan Provision due to a Lending Relationship, following an evaluation of the impact of this lending relationship on its independence, the Audit Firm has been able to maintain its impartiality and objectivity with respect to the planning for and execution of the Fidelity funds' audits, emphasizing, among other things, that the institution with which it has a lending relationship is not able to impact the impartiality of the Audit Firm or assert any influence over the Fidelity fund whose shares the institution owned or its investment adviser. Also important to the SEC staff in this regard was FMR's representation that "[t]hose responsible for the oversight of the Fidelity funds have not reached a different conclusion with respect to the Audit Firm's objectivity and impartiality."

Notably, the no-action letter indicates that more stringent requirements are needed in connection with certain shareholder votes. If shareholders are voting on: (1) the election of trustees or directors; (2) the appointment of an independent auditor; or (3) "other matters that similarly could influence the objectivity and impartiality of the independent auditor," the Fidelity Entity must make "reasonable inquiry" as of the record date of the shareholder meeting regarding the impact of the Loan Provision. Reasonable inquiry could include the review of available ownership records and contacting applicable owners to inquire whether a lending institution in a Lending Relationship owns of record or beneficially more than 10% of the shares of a Fidelity Entity. FMR represented that if the reasonable inquiry reveals that an institution in a Lending Relationship can exercise discretionary voting authority with respect to at least 10% of the Fidelity Entity's shares, the Fidelity Entity would not rely on the relief granted by the staff in the no-action letter and would instead take "other appropriate action, consistent with its obligations under the federal securities laws."

The SEC staff concluded that it would not object to a Fidelity Entity relying on an audit opinion from an Audit Firm "that has identified a failure" to comply with the Loan Provision, "where the failure to comply with the Loan Provision is limited to the

Lending Relationships, including making a reasonable inquiry, as described within this letter and where the Audit Firm's judgment remains objective and impartial."

A copy of the no-action letter is available at: http://edgar.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm

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).

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.

The New Requirement to Identify Beneficial Owners of Legal Entity Customers

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

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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.

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, 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

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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.

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, <u>and not the intermediary's underlying clients</u>, as its legal entity customer. In the preamble to the final rule, FinCEN confirms that the foregoing principle 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.

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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.

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 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.

Public Statements, Press Releases and Testimony

OCIE Announces Share Class Initiative Focused on Conflicts of Interest

On July 13, 2016, the SEC's Office of Compliance Inspection and Examinations (OCIE) issued a Risk Alert announcing the launch of a share class initiative (the Initiative) to examine whether registered advisers and their associated persons are receiving undisclosed compensation or other financial incentives when recommending certain share classes to clients. As part of its focus on retail investor protection (one of OCIE's 2016 examination priorities), OCIE seeks to identify conflicts of interest concerning advisers' compensation or financial incentives for recommending mutual fund and 529 Plan share classes that have "substantial loads or distribution fees."

In the Risk Alert, OCIE identifies the following situations as examples of a conflict of interest related to share class recommendations: (1) where the adviser is dually registered as a broker-dealer (or is affiliated with a broker-dealer) that receives fees from the sale of certain share classes; and (2) where the adviser recommends that clients purchase more expensive share classes of funds for which an affiliate of the adviser receives greater fees.

In seeking to identify such conflicts of interest, the Risk Alert indicates that the SEC staff will focus on adviser practices relating to share class recommendations and compliance oversight of the process, including the following “high risk areas”:

- **Fiduciary Duty and Best Execution.** In view of an adviser’s fiduciary duty to act in the client’s best interest, including to seek best execution for client transactions (which, according to the staff, may be defined as an obligation “to seek the most favorable terms reasonably available under the circumstances”), OCIE examiners are expected to review advisers’ investment practices associated with share class recommendations, as well as advisers’ books and records, in order to identify share classes held and purchased in client accounts and any related compensation received by the adviser or any of its associated persons.
- **Disclosures**. Noting an adviser’s duty to make full and fair disclosure of all material facts, OCIE staff will likely review an adviser’s practices surrounding its selection of mutual fund and 529 Plan investments in its clients’ accounts with “a focus on assessing the accuracy, adequacy, and effectiveness of the adviser’s disclosures regarding compensation for the sale of shares and the conflicts of interest created.”
- **Compliance Program**. Examiners will likely review the adviser’s practices surrounding its selection of mutual fund and 529 Plan share class investments in clients’ accounts and assess the adequacy and effectiveness of the adviser’s corresponding written policies and procedures (which must be reasonably designed to prevent violations of the Advisers Act and the rules thereunder).

The Risk Alert cautions that examiners may select additional topics based on other risks identified during the course of the examination.

The Risk Alert concludes by encouraging investment advisers to reflect upon their own practices, policies and procedures in these areas and to make improvements in their compliance programs as necessary.

The Risk Alert is available at: https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf.

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.

Litigation and Enforcement Actions

Section 36(b) Excessive Fee Litigation Update

U.S. District Court Grants Defendant's Motion to Dismiss in State Farm Excessive Fee Case

On June 22, 2016, the U.S. District Court for the Central District of Illinois issued an order granting the defendant's motion to dismiss an excessive fee case brought under Section 36(b) of the 1940 Act against State Farm Investment Management Corporation (SFIMC) relating to five of the LifePath Funds, a group of target-date mutual funds advised by SFIMC. Each of the LifePath Funds invests all of its assets in a master portfolio that, in turn, invests its assets in a number of underlying funds. BlackRock Fund Advisors (BFA), an investment adviser that is not affiliated with SFIMC, serves as investment adviser to each master portfolio, and BFA or its affiliates serve as the investment adviser to most of the underlying funds in which the master portfolios invest.

In the complaint filed in July 2015, the plaintiffs alleged that the portion of the management fee SFIMC retains from the LifePath Funds is "so disproportionately large that it bears no reasonable relationship to the services rendered (if any) for that fee, and could not have been negotiated through arms-length bargaining." The plaintiffs alleged that SFIMC does not provide day-to-day investment services, or investment guidance or policy direction in connection with daily portfolio management, to the LifeTime Funds, and that the non-advisory monitoring, oversight and other services SFIMC provides to the LifePath Funds are minimal and do not justify the fees retained by SFIMC.

In granting the defendant's motion to dismiss, the District Court generally concluded that the plaintiffs' allegations were merely "speculative assertions" not supported by actual facts. Among other things, the court found that the plaintiffs failed to present facts to support their assertions that the non-advisory services provided by SFIMC under the LifePath Funds' management agreement did not merit the fees retained by SFIMC and that the board received inadequate information to fulfill its obligations to review and approve the management agreements.

The litigation was filed in the U.S. District Court for the Central District of Illinois under the name *Ingenhutt et al. v. State Farm Inv. Mgmt. Corp.*, Case No. 15-cv-1303.

U.S. District Court Denies Defendant's Motion to Dismiss in Metropolitan West Excessive Fee Case

On June 16, 2016, the U.S. District Court for the Central District of California issued an order denying the defendant's motion to dismiss an excessive fee case brought under Section 36(b) of the 1940 Act against Metropolitan West Asset Management, LLC (MetWest). In the complaint submitted in October 2015, the plaintiff alleged that MetWest, in managing the Metropolitan West Total Return Bond Fund, breached its fiduciary duties by charging fees "so disproportionately large that they bear no reasonable relationship to the value of the services provided by [MetWest] and could not have been the product of arm's-length bargaining." The complaint alleges that the fees charged to the Fund were as much as 497% higher than the rates MetWest negotiated at arm's length with other clients for the same or substantially the same services, allowing MetWest to retain the benefits of economies of scale resulting from the Fund's significant asset growth in recent years.

In moving to dismiss the plaintiff's complaint, MetWest argued that the plaintiff improperly compared the management fee rate MetWest charges as investment adviser to the Fund to the sub-advisory fees MetWest charges to funds outside the MetWest complex to which it provides sub-advisory services. MetWest noted that in each case the management fee MetWest charges to the Fund is less than the total management fee paid by each sub-advised fund. To counter these arguments, the plaintiff contended that there was no indication the non-advisory services MetWest provides to the Fund are comparable to the non-advisory services the sub-advised funds' investment advisers provide, and that in any event the comparison of the Fund's management fee to the management fees of the sub-advised funds may not be appropriate as there is no indication the sub-advised funds' fee rates were negotiated at arm's length. The District Court denied MetWest's motion to dismiss, concluding that the plaintiff alleged sufficient questions of fact relating to three of the Gartenberg factors—comparative fees, economies of scale and the independence and conscientiousness of the board.

The litigation was filed in the U.S. District Court for the Central District of California under the name *Kennis v. Metropolitan West Asset Mgmt., LLC*, Case No. 15-cv-8162.

SEC Settles Charges Against Morgan Stanley For Failing To Adopt Written Policies and Procedures Designed to Protect Customer Data

On June 8, 2016, the SEC announced settled administrative proceedings against Morgan Stanley Smith Barney LLC (MSSB), a registered investment adviser and broker-dealer, for failing to adopt written policies and procedures reasonably designed to protect customer records and information in violation of Rule 30(a) of Regulation S-P under the Securities Act (the Safeguards Rule). The Safeguards Rule, which the SEC adopted in 2000 and amended in 2005, requires SEC-registered broker-dealers, investment companies and investment advisers to adopt written policies and procedures reasonably designed to: (1) ensure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

According to the SEC, from at least August 2001 through December 2014, MSSB stored sensitive personally identifiable information (PII) of individuals to whom MSSB provided brokerage and investment advisory services on two of the firm's applications: the Business Information System Portal and the Fixed Income Divisions Select Portal (collectively, the Portals). The SEC order states that between 2011 and 2014, Galen J. Marsh (Marsh), then an MSSB employee, misappropriated data of approximately 730,000 customer accounts by gaining unauthorized access to the Portals and downloading and transferring the confidential customer data, including PII, to his personal server. Although MSSB had installed and maintained certain technology controls on its computer systems that, among other things, restricted employees from copying data onto removable storage devices and from accessing certain categories of websites, the SEC order indicates that Marsh was able to transfer customer data to his personal server by using his personal website. The order states that, at the time, MSSB's Internet filtering software did not prevent employees from accessing "uncategorized" websites, such as Marsh's website, from MSSB computers. The SEC found that from December 15, 2014 to February 3, 2015, portions of the data stolen by Marsh were posted to at least three different Internet sites with an offer to sell a larger quantity of stolen data in exchange for payment in digital currency.

The SEC order indicates that on December 27, 2014, MSSB discovered the data breach through one of its routine Internet sweeps, promptly took steps to remove the data from the Internet and notified law enforcement and other authorities.

According to the SEC, although MSSB had adopted written policies and procedures relating to the protection of customer PII, those policies and procedures were not reasonably designed to safeguard its customers' PII as required by the Safeguards Rule. In this regard, the SEC order cites the failure of MSSB's written policies and procedures to adequately address certain key administrative, technical and physical safeguards, such as: (1) reasonably designed and operating authorization modules for the Portals to restrict employee access to only the confidential customer data as to which such employees had a legitimate business need; (2) auditing and/or testing of the effectiveness of such authorization modules; and (3) monitoring and analyzing employee access to and use of the Portals to identify any unusual or suspicious patterns.

Although the SEC considered the remedial efforts promptly undertaken by MSSB and its cooperation afforded to the SEC staff, the SEC ordered that MSSB cease and desist from committing or causing future violations of the Safeguards Rule, censured the firm and required MSSB to pay a $1 million civil money penalty. By a separate settled administrative proceeding, the SEC barred Marsh from association with any broker, dealer or investment adviser, with the right to apply for reentry after five years. In a related criminal action, Marsh pled guilty to one count of exceeding his authorized access to a computer and thereby obtaining information contained in a financial record of a financial institution, in violation of 18 U.S.C. § 1030(a)(2)(A). Marsh was sentenced to 36 months' probation and ordered to pay restitution in the amount of $600,000.[6]

A copy of the order concerning MSSB is available at: http://www.sec.gov/litigation/admin/2016/34-78021.pdf.

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

6 United States v. Galen Marsh, No. 15 Cr. 641 (KTD) (S.D.N.Y.).

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).[7] 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)[8] 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 favor,[9] 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.

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7 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."

8 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.

9 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.

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.[10] 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 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

[10] 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.

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.

On June 29, 2016, Vice Chancellor Laster approved a settlement between Dell and certain TR Petitioners for an undisclosed amount, with the order stating that "under no set of circumstances would the consideration being provided to the Settling Petitioners be more favorable to other appraisal claimants than an adverse outcome on appeal, in which the non-settling petitioners would receive the amount advocated by Dell at trial plus an award of interest at the statutory rate."

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 were 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.

Other News and Developments

Financial Stability Board Issues Policy Recommendations to Address "Structural Vulnerabilities" in Asset Management Industry

On June 22, 2016, the Financial Stability Board (FSB)[11] issued proposed policy recommendations to "address risks to global financial stability associated with the relevant structural vulnerabilities from asset management activities," with a request for public comment by September 21, 2016. The recommendations are the product of an initiative launched by the FSB in March 2015.

The proposed policy recommendations seek to address financial stability risks associated with: (1) the mismatch between liquidity of fund investments and redemption terms and conditions for fund units; (2) leverage within investment funds; (3) operational risk and challenges in transferring investment mandates in stressed conditions; and (4) securities lending activities of asset managers and funds. Following receipt and review of public comments, the FSB intends to finalize the recommendations by the end of 2016, "some of which will then be operationalised by [the International Organizational of Securities Commissions (IOSCO)][12] and the relevant FSB working groups."

Notably, several of the policy recommendations appear to have been addressed, at least in part, by recent SEC rule proposals, including liquidity risk management.

The FSB's proposed policy recommendations are categorized by the four areas noted above and include the following:

(1) Recommendations to address liquidity mismatch between fund investment assets and redemption terms and conditions for fund units

Lack of information and transparency:

- Authorities should: (a) collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective; (b) review existing reporting requirements; and (c) enhance reporting requirements as appropriate to ensure that they are adequate, sufficiently granular and frequent.
- Authorities should: (a) review existing investor disclosure requirements; and (b) determine the degree to which additional disclosures should be provided regarding fund liquidity profiles.

Gaps in liquidity risk management tools both at the design phase and on an ongoing basis:

- In order to reduce the likelihood of "material liquidity mismatches arising from an open-ended fund's structure," authorities should have requirements or guidance stating that funds' assets and investment

[11] The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF) by the G20 and is an international body that monitors and makes recommendations about the global financial system.

[12] IOSCO is an international body of securities regulators founded in April 1983 and includes the SEC among its 211 members. SEC Chair Mary Jo White is a member of IOSCO's Board.

strategies should be consistent with the terms and conditions governing fund unit (share) redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected portfolio liquidity and investor behavior during normal and stressed market conditions.

- When appropriate, authorities should widen the availability of liquidity risk management tools (such as swing pricing, redemptions fees and other anti-dilution methods) to open-ended funds, and reduce barriers to the use of those tools to: (a) increase the likelihood that redemptions are met even under stressed market conditions; and (b) reduce first-mover advantage, where it may exist.

Adequacy of liquidity risk management tools to deal with exceptional circumstances:

- Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of "extraordinary liquidity risk management tools" (e.g., suspensions of redemptions, gates), and the processes should be made transparent to investors and the relevant authorities.

(2) Recommendations to address leverage within funds

- IOSCO should develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions, which would "enhance authorities' understanding of risks that leverage in funds may create, facilitate more meaningful monitoring of leverage, and help enable direct comparisons across funds and at a global level."

(3) Recommendations to address operational risk and challenges in transferring investment mandates or client accounts

- Authorities should have requirements or guidance for asset managers that are "large, complex, and/or provide critical services" to have comprehensive and robust risk management frameworks and practices, particularly with respect to business continuity and transition plans, "to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions."

(4) Recommendation to address securities lending activities of asset managers and funds

- Authorities should monitor indemnifications provided by securities lending agents and asset managers to clients in relation to their securities lending activities, i.e., authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.

The FSB's policy recommendations are available at: http://www.fsb.org/2016/06/proposed-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/.

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With significant experience in all matters related to design, organization and distribution of investment products, Vedder Price can assist with all aspects of investment company and investment adviser securities regulations, compliance issues, derivatives and financial product transactions, and ERISA and tax inquiries. Our highly experienced team has extensive knowledge in structural, operational and regulatory areas, coupled with a dedication to quality, responsive and efficient service.