VedderPrice

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Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

SEC Interpretive Letter Permits Brokers to Charge Commissions on Sales of "Clean Shares" of Mutual Funds

On January 11, 2017, the staff of the SEC's Division of Investment Management issued an interpretive letter (the Interpretive Letter) expressing its view that, under the circumstances described in the letter, a broker that sells so-called "Clean Shares" –a class of mutual fund shares without any front-end load, deferred sales charge or other asset-based fee for sales or distribution–may charge its customers a commission for the sale of such shares.

The SEC staff issued the Interpretive Letter in response to a request by Capital Group Companies, Inc. (Capital Group), parent of Capital Research and Management Company, the investment adviser to the American Funds, which had noted that guidance from the staff "would alleviate many of the issues that have arisen for the mutual fund industry under the Department of Labor's fiduciary rule" (the DOL Rule) and, by letting brokers charge commissions for Clean Shares, "allow for a brokerage model where funds, ETFs, individual securities and other 'like' investment options could compete on returns and fees." The DOL Rule, which significantly expands the scope of who is considered a "fiduciary" of employee benefit plans, individual retirement accounts (IRAs) and other accounts and arrangements subject to the Employee Retirement Income Security Act of 1974 (ERISA) or Section 4975 of the Internal Revenue Code, poses considerable challenges to broker-dealers selling mutual funds to retirement plans. As Capital Group explained in its letter to the SEC staff requesting "narrowly-tailored interpretive guidance," the DOL Rule was designed to mitigate conflicts of interest in the provision of investment advice to retirement plan participants and, in seeking to address conflicts by eliminating financial incentives that could cause a broker to recommend one investment over another, the DOL Rule "shows a preference for arrangements in which the financial adviser receives payments only from the investor and not from third parties."

Section 22(d) of the 1940 Act prohibits a fund, its underwriter or any "dealer" from selling fund shares except at a current public offering price described in the prospectus. Rule 22d-1 permits mutual funds to sell shares at prices that reflect scheduled variations in, or elimination of, sales loads provided such sales load variations are disclosed in the prospectus and, pursuant to the Rule and SEC form disclosure requirements, each variation is applied uniformly to particular classes of investors or transactions and disclosed with specificity, among other conditions. Taken together, Section 22(d) and Rule 22d-1 generally have been interpreted as requiring that funds, and not broker-dealers, set the pricing on sales charges to investors. Consequently, Capital Group states in its letter, "broker-dealer firms would appear unable to unilaterally adjust their business models to preserve a brokerage option that meets the requirements of the DOL Rule."

Capital Group notes that certain broker-dealer firms are considering a brokerage platform on which they will apply their own commission to fund transactions, but "[o]ther firms are taking a more cautious approach, in part due to uncertainty around the applicability of Section 22(d)." In this regard, Capital Group notes that firms are unsure whether their sales-related activities under these new business models (i.e., commissions charged by brokers) could cause them to be treated as "dealers" by the SEC.

In response, the SEC staff concludes that, under the circumstances described in the Interpretive Letter, the restrictions of Section 22(d) of the 1940 Act do not apply to a broker, when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in Clean Shares. The Interpretive Letter also clarifies the staff's view that Section 22(d) does not prohibit a principal underwriter of Clean Shares from entering into a selling agreement with a broker that, acting as agent on behalf of its customers, charges its customers commissions for effecting transactions in Clean Shares. In addition, the staff notes that its position does not depend on whether the broker sells Clean Shares to investors in retirement accounts or nonretirement accounts.

In reaching its conclusions regarding the interpretation of Section 22(d), the SEC staff noted the following representations made by Capital Group:

- The broker will represent in its selling agreement with the fund's underwriter that it is acting solely on an agency basis for the sale of Clean Shares;
- The Clean Shares sold by the broker will not include any form of distribution-related payment to the broker;
- The fund's prospectus will disclose that an investor transacting in Clean Shares may be required to pay a commission to a broker, and if applicable, that shares of the fund are available in other share classes that have different fees and expenses;
- The nature and amount of the commissions and the times at which they would be collected would be determined by the broker consistent with the broker's obligations under applicable law, including, but not limited to, applicable FINRA and Department of Labor rules; and
- Purchases and redemptions of Clean Shares will be made at net asset value established by the fund (before imposition of a commission).

A copy of the Interpretive Letter is available at: https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm.

In a related development, the Investment Company Institute (ICI) issued a memorandum to its members and various constituents on February 1, 2017, to respond to "numerous questions from members regarding whether a broker could, consistent with the [SEC] staff's analysis in the [Interpretive Letter], receive a non-distribution related sub-transfer agent, administrative, sub-accounting or other shareholder servicing fee from fund assets ("sub-accounting fee")." The ICI states that the SEC staff's reasoning in the Interpretive Letter "implicitly allows a broker to receive non-distribution related sub-accounting fees," noting that the SEC staff describes Clean Shares as not having "any front-end load, deferred sales charge, *or other asset-based fee for sales or distribution*." The ICI also notes that, in concluding that Section 22(d)'s restrictions do not apply to a broker when it acts as its customers' agent and charges its customers commissions for effecting transactions in Clean Shares, the SEC staff emphasizes that those Clean Shares will not include any form of distribution-related payment to the broker. Thus, the ICI concludes that the SEC staff's reasoning "would be consistent with a broker receiving *non-distribution* related sub-accounting fees."

Public Statements, Press Releases and Testimony

OCIE Announces 2017 Exam Priorities

On January 12, 2017, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced its 2017 examination priorities for regulated entities, including funds and investment advisers. The examination priorities are organized into three broad categories: (1) matters of importance to retail investors; (2) risks specific to senior investors and retirement investments; and (3) issues related to market-wide risks. Within these groupings are several issues of potential interest to funds and their investment advisers, including the following:

ETFs: OCIE will continue to examine ETFs for compliance with applicable exemptive relief granted under the Exchange Act and the 1940 Act and with other regulatory requirements, as well as review ETFs' unit creation and redemption processes. OCIE will also focus on sales practices and disclosures involving ETFs and the suitability of broker-dealers' recommendations to purchase ETFs with niche strategies.

Money Market Funds: OCIE will examine money market funds for compliance with the amendments to Rule 2a-7 under the 1940 Act that became effective in October 2016. OCIE stated that examinations will "likely include assessments of the boards' oversight of the funds' compliance with these new amendments as well as review of compliance policies and procedures relating to stress testing and funds' periodic reporting of information to the [SEC]."

Cybersecurity: OCIE will continue its initiative to examine cybersecurity compliance procedures and controls, including testing the implementation of those procedures and controls.

Share Class Selection: OCIE will continue reviewing conflicts of interest and other factors that may affect firms' recommendations to invest, or remain invested, in particular share classes of mutual funds.

Electronic Investment Advice: Noting that investors are increasingly able to obtain investment advice through automated or digital platforms, OCIE stated that it will examine investment advisers and broker-dealers that offer such services, including "robo-advisers" that interact with clients primarily online and firms that use automated platforms for a portion of their services. Examinations will likely focus on "compliance programs, marketing, formulation of investment recommendations, data protection, and disclosures relating to conflicts of interest." OCIE will also review firms' compliance practices for overseeing algorithms that generate recommendations.

Wrap Fee Programs: OCIE will expand its focus on investment advisers and broker-dealers associated with wrap fee programs. Examinations will likely focus on "whether investment advisers are acting in a manner consistent with their fiduciary duty and whether they are meeting their contractual obligations to clients." Other areas of particular focus will be wrap account suitability, effectiveness of disclosures, conflicts of interest and brokerage practices, including best execution and trading away.

Never-Before-Examined Investment Advisers: OCIE stated that it will expand its “Never-Before Examined Adviser” initiative to include “focused, risk-based examinations” of newly registered investment advisers as well as of selected investment advisers that have been registered for a longer period but have never been examined.

Payment Order Flow: OCIE will examine select broker-dealers (e.g., market-makers and those that serve primarily retail customers) to assess compliance with duties of best execution when routing customer orders.

FINRA: OCIE will enhance its oversight of FINRA and, in addition to its inspections of FINRA’s operations and regulatory programs, will focus on assessing the quality of FINRA’s examinations of individual broker-dealers.

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

The examination priorities are available at: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.

Other Developments

Financial Stability Board Issues Final Recommendations for Addressing Potential Risks Asset Managers Pose to the Global Financial System

On January 12, 2017, the G-20’s Financial Stability Board (FSB) issued 14 policy recommendations (the Recommendations) to address four “structural vulnerabilities” from asset management activities. The areas that the FSB identified are: (i) liquidity mismatch between fund investments and redemption terms and conditions for open-end funds; (ii) leverage within funds; (iii) operational risk and challenges at asset managers in stressed conditions; and (iv) securities lending activities of asset managers and funds.

The FSB’s Recommendations are not binding but have historically proven influential. The FSB began assessing perceived systemic risks posed by asset managers in March 2015 and issued draft recommendations in June of last year. The fund industry strongly objected to those recommendations and the underlying premise that asset managers are a potential source of systemic risk. After receiving more than fifty comments on the draft recommendations, the FSB finalized the Recommendations. The FSB has left open the possibility of designating specific asset managers as globally systemically important financial institutions (i.e., “G-SIFIs”) in the future.

The SEC recently finalized rules related to liquidity risk management and has either already proposed or is in the process of drafting other rules that also reflect the issues raised by the FSB. Some of the Recommendations will be operationalized by the International Organization of Securities Commissions, which has been asked to work on the liquidity recommendations by the end of 2017 and on leverage measures by the end of 2018.

The FSB's Recommendations, which focus primarily on liquidity mismatch and leverage, are as follows:

Liquidity

Authorities should:

- Collect information on the liquidity profile of open-end funds in their jurisdictions proportionate to the risks they may pose from a financial stability perspective. They should review existing liquidity reporting requirements and enhance them as appropriate to ensure that they are adequate, and that required reporting is sufficiently granular and frequent.
- Review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by open-end funds to investors regarding fund liquidity risk, proportionate to the liquidity risks funds may pose from a financial stability perspective.
- Have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing redemptions both at fund inception and on an ongoing basis, taking into account the expected liquidity of the assets and investor behavior during normal and stressed market conditions.
- Reduce barriers to the use of liquidity risk management tools to increase the likelihood that redemptions are met even under stressed market conditions.
- Make available liquidity risk management tools to open-end funds to reduce first-mover advantage (including swing pricing, redemption fees and other anti-dilution methods).
- Require and/or provide guidance on stress testing at the level of individual open-end funds to support liquidity risk management to mitigate financial stability risk.
- Promote clear and transparent decision-making processes for open-end funds' use of exceptional liquidity risk management tools.
- Provide guidance on the use of exceptional liquidity risk management tools in stressed conditions, taking into account the costs and benefits of such action from a financial stability perspective.
- Give consideration to system-wide stress testing that could potentially capture effects of collective selling by funds and other investors on the resilience of financial markets and the financial system more generally.

As noted, the SEC has already taken steps to address many of these Recommendations, finalizing rules for increased liquidity and redemption-related disclosures, along with more granular reporting to the SEC, and rules mandating open-end funds to implement a liquidity risk management program and permitting the use of "swing pricing."

Leverage

Authorities should:

- Identify and/or develop consistent measures of leverage in funds to facilitate more meaningful monitoring of leverage for financial stability purposes, and help enable direct comparisons across funds and at a global level.
- Collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which may pose significant leverage-related risks to the financial system, and take action when appropriate.
- Collect national/regional aggregated data on leverage across its member jurisdictions based on the consistent measures it develops.

Operational Risks

Authorities should:

- Have requirements or guidance for asset managers to develop comprehensive and robust risk management frameworks and practices, especially with regard to business continuity plans and transition plans, to enable orderly transfer of client accounts and investment mandates under stressed conditions.

The SEC has proposed rulemaking related to business continuity and transition plans for investment advisers, and the staff of the Division of Investment Management has issued guidance concerning business continuity planning for funds.

Securities Lending

Authorities should:

- Monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities to detect the development of material risks or regulatory arbitrage that may adversely affect financial stability.

The Recommendations are available at: http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

Investment Services Group Members

Chicago

David A. Sturms, *Chair* ...... +1 (312) 609 7589
Juan M. Arciniegas .... +1 (312) 609 7655
James A. Arpaia .... +1 (312) 609 7618
Deborah B. Eades .... +1 (312) 609 7661
Renee M. Hardt .... +1 (312) 609 7616
Joseph M. Mannon .... +1 (312) 609 7883
John S. Marten, *Editor* .... +1 (312) 609 7753
Maureen A. Miller .... +1 (312) 609 7699
Cathy G. O'Kelly .... +1 (312) 609 7657
Junaid A. Zubairi .... +1 (312) 609 7720
Heidemarie Gregoriev .... +1 (312) 609 7817
Nicole M. Kuchera .... +1 (312) 609 7763
Luisa M. Lewis .... +1 (312) 609 7573
Travis N. Moyer .... +1 (312) 609 7739
Mark Quade .... +1 (312) 609 7515
Nathaniel Segal, *Editor* ...... +1 (312) 609 7747
Jacob C. Tiedt .... +1 (312) 609 7697
Cody J. Vitello .... +1 (312) 609 7816
Jeff VonDruska .... +1 (312) 609 7563
Jake W. Wiesen .... +1 (312) 609 7838

New York

Joel S. Forman .... +1 (212) 407 7775

Washington, DC

Bruce A. Rosenblum.......... +1 (202) 312 3379
Brendan R. Hamill............. +1 (202) 312 3010

London

Richard Thomas .... +44 (0)20 3667 2930
Sam Tyfield .... +44 (0)20 3667 2940

Investment Services Group

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.

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