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August 2017

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

SEC Staff Guidance and Alerts

OCIE Issues Summary of Observations from Latest Cybersecurity Sweep Exams

On August 7, 2017, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert providing a summary of the staff's observations from sweep exams of broker-dealers, investment advisers and funds conducted pursuant to the Cybersecurity Examination Initiative announced on September 15, 2015, referred to by the staff as the "Cybersecurity 2 Initiative."[1] The Risk Alert notes that these latest sweep exams involved more validation and testing of procedures and controls surrounding cybersecurity preparedness than was previously performed, which is reflected in the staff's observations. In the exams, which included 75 broker-dealers, investment advisers and registered funds, the staff reviewed firms' cybersecurity policies and procedures, which included validation and testing to determine if the policies and procedures were implemented and followed. In addition, to better understand how firms managed their cybersecurity preparedness, the staff focused on the following areas: (1) governance and risk assessment; (2) access rights and controls; (3) data loss prevention; (4) vendor management; (5) training; and (6) incident response.

Notably, the staff observed an overall improvement in firms' awareness of cyber-related risks and the implementation of certain cybersecurity practices since OCIE's 2014 "Cybersecurity 1 Initiative"-related sweep exams. In particular, the staff noted that all broker-dealers, all funds and nearly all advisers examined maintained written cybersecurity-related policies and procedures addressing the protection of customer and shareholder records and information, in contrast to the staff's observations following the Cybersecurity 1 Initiative, in which "comparatively fewer broker-dealers and advisers had adopted this type of written policies and procedures."

<u>Issues Noted by the Staff and Areas for Improvement</u>

Despite these noted improvements, the staff's observations highlight certain areas "where compliance and oversight

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[1] As the staff explains in the Risk Alert, the Cybersecurity 2 Initiative built upon prior cybersecurity sweep exams, particularly OCIE's "Cybersecurity 1 Initiative." See https://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf (April 15, 2014) and https://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf (February 3, 2015). The staff examined a different population of firms in the Cybersecurity 2 Initiative than those that were examined in the Cybersecurity 1 Initiative.

could be improved":

- "*Reasonably Tailored*" *Cybersecurity Policies and Procedures*. Despite the staff's overall observation as to the widespread adoption of written policies and procedures, the staff found that "a majority of the firms' information protection policies and procedures appeared to have issues," including policies and procedures that were not sufficiently detailed because they provided employees with "only general guidance, identified limited examples of safeguards for employees to consider, were very narrowly scoped, or were vague, as they did not articulate procedures for implementing the policies."

- *Adherence to or Enforcement of Policies and Procedures*. Other issues noted by the staff in connection with policies and procedures included the apparent failure of firms to adhere to or enforce their policies and procedures or that policies and procedures did not reflect the firms' actual practices. For instance, certain policies called for ongoing reviews to determine whether supplemental security protocols were appropriate, when, in fact, such reviews were performed only annually, or not at all. Similar observations were made with respect to certain policies requiring all employees to complete cybersecurity awareness training; firms did not appear to ensure this training took place or that action was taken with respect to employees who did not complete the training.

- *Lack of Remediation Efforts*. A number of firms did not appear to fully remediate some of the high-risk observations that they discovered from conducting penetration tests and vulnerability scans on critical systems.

- *Issues with Security Patches*. A few firms had a significant number of system patches that included critical security updates that had not yet been installed. The staff also identified firms that used outdated operating systems that were no longer supported by security patches.

- *Incident Response Plans*. Although the "vast majority" of broker-dealers maintained response plans for data breach incidents and most had plans for notifying customers of material events, fewer than two-thirds of the advisers and funds appeared to maintain such plans.

- *Formal Processes for Verifying Fund Transfers*. Some of the broker-dealers did not appear to memorialize their processes for confirming authority to transfer customer funds to third-party accounts into written supervisory procedures. Instead, these broker-dealers appeared to have informal practices for verifying customers' identities in order to proceed with requests to transfer funds.

Elements of Robust Policies and Procedures

In addition to the issues observed by the staff, the Risk Alert includes observations regarding elements of cybersecurity policies and procedures of firms that the staff believes had implemented "robust controls." Although the staff cautions that this should not be viewed as a comprehensive list, firms are advised that the following elements could be useful in the implementation of cybersecurity-related policies and procedures:

- *Maintenance of a comprehensive inventory of data, including risk classifications, and information about each service provider and vendor.*
- *Detailed cybersecurity-related instructions, including specific penetration tests, security monitoring, system auditing and reporting flow charts.*
- *Maintenance of prescriptive schedules and processes for testing data integrity and vulnerabilities, with prioritized action items based on testing results, as well as patch management policies to seek to ensure that system updates do not have unintended consequences.*
- *Established and enforced controls to access data and systems, including detailed "acceptable use" policies, mobile device controls and third-party vendor access controls.*
- *Mandatory employee training at on-boarding and periodically thereafter.*
- *Engaged senior management who vetted and approved the policies and procedures.*

The Risk Alert notes that OCIE will continue examining firms' cybersecurity compliance procedures and controls, including testing the implementation of those procedures and controls.

The Risk Alert is available at: https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf.

Division of Investment Management Releases Investment Company Reporting Modernization FAQs

On July 18, 2017, the staff of the SEC's Division of Investment Management released guidance in the form of frequently asked questions relating to the investment company reporting modernization reforms adopted in October 2016. Below is a summary of certain of the issues addressed by the staff in the FAQs.

Compliance Dates

- ***Form N-PORT:*** Funds in groups of related investment companies with net assets of more than $1 billion as of the most recent fiscal year-end have a compliance date of June 1, 2018. Because Form N-PORT must be filed within 30 days of each month-end, such funds would file their first report on Form N-PORT, with data as of June 30, 2018, no later than July 30, 2018. Funds in groups of related investment companies with less than $1 billion of net assets have a compliance date of June 1, 2019.[2]
- ***Form N-CEN:*** The compliance date is June 1, 2018 for all funds, and compliance is based on

[2] The FAQs also state that, when determining whether a fund is part of a "group of related investment companies" that has reached the $1 billion threshold that distinguishes larger and smaller entities for Form N-PORT compliance date purposes, assets of private funds relying on Sections 3(c)(1) or 3(c)(7) of the 1940 Act should be excluded from the calculation.

reporting period-end. Because Form N-CEN must be filed within 75 days of a fiscal year-end, a fund with a June 30 fiscal year-end must make its first filing for the fiscal year ended June 30, 2018 no later than September 13, 2018. A fund with a May 31 fiscal year-end would need to make its first Form N-CEN filing for the fiscal year ending May 31, 2019.

- ***Amendments to Regulation S-X:*** The compliance date is August 1, 2017, and compliance is based on reporting period-end. For instance, financial statements included in a report on Form N-CSR for the period ended June 30, 2017, would not need to comply with the amendments to Regulation S-X, even though that report is required to be filed by September 8, 2017 (i.e., 70 days after the period-end date). Rather, the new disclosure is required in all annual or semi-annual financial statements covering periods ending on or after August 1, 2017.

- ***Securities Lending Disclosure in Forms N-1A, N-3 and N-CSR:*** The compliance date is August 1, 2017, and compliance is based on reporting period-end. For open-end funds and separate accounts offering variable annuity contracts, the new disclosure is required in annual updates for fiscal years ending on or after August 1, 2017. For closed-end funds, the new disclosure is required in annual or semi-annual shareholder reports covering periods ending on or after August 1, 2017.

Other Filing Considerations

- ***Form N-Q:*** Once a fund begins filing reports on Form N-PORT, it no longer must file reports on Form N-Q even though the rescission date for Form N-Q is not until August 1, 2019. For example, a fund that is part of a group of investment companies with more than $1 billion would file a Regulation S-X-compliant portfolio schedule as Exhibit F to Form N-PORT relating to the third and ninth fiscal months beginning June 1, 2018, instead of a Form N-Q.

  In addition, money market funds will no longer file reports on Form N-Q after the form is rescinded on August 1, 2019. For example, a money market fund with an August 31 fiscal year-end will make its final Form N-Q filing for the quarter ending May 31, 2019. This is because the filing will be due on July 30, 2019, 60 days after the reporting period end, which is before the rescission date for Form N-Q.

- ***Form N-SAR:*** Form N-SAR is scheduled to be rescinded on June 1, 2018. Accordingly, for funds with April 30 or May 31 fiscal year-ends, the Form N-SAR for fiscal year 2017–18 would be due after the rescission date. Nevertheless, in 2018, such funds will have the option of filing either a Form N-SAR 60 days after the fiscal year-end or a Form N-CEN 75 days after the fiscal year-end.

- ***Form N-CSR Certification:*** When a fund ceases filing Forms N-Q, the Form N-CSR certification must cover any change in internal control over financial reporting that occurred during the most recent fiscal half-year, rather than the most recent fiscal quarter as currently required.

Form N-PORT

- The SEC staff stated that it would not object if a fund distinguishes between the basis on which it calculates portfolio holdings and the basis on which it calculates risk metrics. Consequently, a fund that uses T+1 accounting for daily NAV calculations and for the reporting of portfolio holdings on Form N-PORT may calculate and report security- and portfolio-level risk metrics required by the form on a T+0 basis, subject to compliance with the general instructions to the form.

- The FAQs noted that some trusts that have multiple series all with the same fiscal year-end currently include in their shareholder reports and on Form N-Q portfolio schedules for each of the different series, as well as one set of financial statement notes that cover all of the different series combined into one document. The SEC staff confirmed that funds may continue this practice when filing their Form N-PORT Part F attachments.

- As stated in the adopting release for Form N-PORT, Form N-PORT filings made during the first six months after the June 1, 2018 compliance date (i.e., the reports covering the months ending June 30, 2018 through November 30, 2018) will not be made public. The first Form N-PORT that will be made publicly available will be the first report covering the third month of a fund's fiscal quarter that ends on or after December 31, 2018. However, even during the six-month non-public filing period, portfolio holding information on the Part F attachment for the first and third quarters of a fund's fiscal year will be made public.

- If no market value is available for a portfolio holding as of month-end, a fund may report values of portfolio holdings using the same internal methodologies consistent with how the fund reports internally and to current and prospective investors.

- Form N-PORT requires funds to report certain information about the collateral for securities subject to repurchase agreements. Funds should report this information separately for each category of investments (e.g., asset backed securities, corporate debt securities) but may aggregate the principal amount and value of collateral for each category of investments, even if the collateral is issued by multiple issuers.

- For Form N-PORT and in the amendments to Regulation S-X, the reporting of the notional amount is required for many different derivatives instruments, but can be calculated in different ways. The SEC staff indicated that unless the form or applicable rules specifically require calculating the notional amount in a particular manner, there is no prescribed calculation that funds must follow.

Regulation S-X Amendments

- Regulation S-X requires that funds disclose, in certain circumstances, the identities of the 50 largest components of the index or basket of investments underlying derivative instruments. For this purpose, funds should use the absolute value of short positions to determine the notional value of such positions. Different metrics may be used to calculate the magnitude of other index or custom basket components; for example, notional value should be used for swaps, while par value or value should be used for bonds and equity securities, respectively.

- Regulation S-X also requires funds to identify each investment that cannot be sold because of restrictions or conditions applicable to the investment. For this purpose, derivative instruments that may be exited through means other than sales need not be identified as restricted.

Form N-CEN

- Form N-CEN requires funds to report information on sub-transfer agents. This reporting requirement relates solely to arrangements where the functions of a fund's primary transfer agent are supported by one or more sub-transfer agents and not to other intermediary arrangements with, e.g., broker-dealer firms that are often referred to as "sub-accounting" or "Sub-TA" arrangements.

- If a variable insurance product no longer files post-effective prospectus updates because, e.g., the variable insurance product is no longer being sold, the variable insurance product must still file annual reports on Form N-CEN.

The FAQs are available at: https://www.sec.gov/investment/investment-company-reporting-modernization-faq.

New Rules

ICI Raises Concerns About Compliance Deadlines and Urges SEC to Re-Examine Asset Classification in Letter on Liquidity and Fund Reporting Modernization Rules

In a letter to SEC Chairman Jay Clayton dated July 20, 2017 (the Letter), Paul Schott Stevens, President and CEO of the Investment Company Institute (ICI), expressed "deep concerns" about the fund industry's ability to meet the compliance deadlines for the liquidity risk management program and fund reporting modernization rules adopted by the SEC in October 2016. The Letter states that efforts by the ICI's member firms to implement these new rules have "reinforced our belief that the Commission needs to re-examine the asset classification element of [new Rule 22e-4 (the Liquidity Rule)] and the required frequency of portfolio holdings reporting."

The Letter requests that the SEC take the following actions: (1) adjust the compliance schedule for the Liquidity Rule's asset classification and related requirements as soon as possible, allowing the SEC time to make "targeted rule amendments"; (2) adopt amendments to the Liquidity Rule allowing funds to formulate their own policies and procedures for how to classify the liquidity of investments; (3) even if the SEC does not pursue the recommended rule amendments, adjust the compliance schedule for the Liquidity Rule and related reporting requirements by at least one year; (4) require quarterly, instead of monthly, reporting of portfolio holdings on Form N-PORT until the

SEC addresses information security concerns adequately; and (5) even if the SEC retains the monthly reporting requirement for portfolio holdings, delay the compliance dates for Form N-PORT and Form N-CEN for at least six months.

Certain of these recommendations are described in greater detail below:

- *Asset Classification Concerns:* Echoing concerns raised in its comment letter to the SEC when the Liquidity Rule was first proposed, the ICI notes that liquidity classifications–or “bucketing”–risked creating more correlated portfolios and trades across funds because funds would gravitate toward investments perceived as “more liquid.” The Letter states that such “herding” could “increase dislocations and volatility in financial markets by contributing to cliff events in liquidity.” The Letter acknowledges the SEC’s desire for uniformity and consistency in liquidity classification and the “surface appeal of such uniformity,” but warns that “the more a regulator insists upon uniformity and consistency in this area, the greater the likelihood of correlation, herding, and cliff events.” The ICI also expresses the view that there is “substantial risk” that the SEC and other regulators may overemphasize and be misled by such “limited, subjective and forward-looking information,” and that the public may be misled by or fail to fully understand the inherent limitations of the information. Thus, the ICI maintains that the Liquidity Rule should be amended to allow each fund to craft its own policies and procedures for classifying the liquidity of its investments. In this connection, the ICI notes that approaching asset classification on an individualized level “would respect the diversity of practices that have emerged in the industry and their validity; focus funds’ attention on comprehensive liquidity risk assessment, management and review; and greatly reduce the cost and complexity of implementing and administering the [Liquidity Rule].”

- *Quarterly Reporting on Form N-PORT:* The Letter notes the valuable and sensitive portfolio holding information funds will be required to report monthly on Form N-PORT and expresses the ICI’s concern with the SEC’s ability to protect such information. To this end, the Letter highlights recent reports by the SEC’s inspector general and the Government Accountability Office that raise concerns over the SEC’s ability at present to maintain the security of such data. The ICI contends that the SEC should delay the reporting of monthly portfolio holdings information until these data security concerns have been adequately addressed. In addition to thoroughly addressing these weaknesses, the ICI recommends that the SEC implement “aggressive” measures to protect data, including independent third-party testing and verification of its information security programs, and that such measures should be taken prior to requiring firms to commence monthly reporting of portfolio holdings.

- *Adjust Compliance Schedule for Form N-PORT and Form N-CEN:* The Letter states that funds are currently not able to easily access, compile and report the “vast amount of new data” to be reported on Forms N-PORT and N-CEN. The ICI asserts that funds will have to create new systems to gather the data and transform it into the form required. The ICI further states that funds will have to test their systems to ensure accuracy and reliability. The ICI believes that "most" fund complexes will engage third parties to assist with such reporting, that these third parties have not yet fully developed their products for funds to evaluate and that it may be several months before such products are fully developed. Thus, the ICI suggests that the SEC delay the compliance dates for Forms N-PORT and N-CEN at least six months to give funds time to, among other things, develop new technologies, assess data sources, review and implement third-party vendor systems or build or enhance their own systems, test their systems to ensure quality and design processes and controls to ensure accuracy.

The Letter is available at: https://www.ici.org/pdf/liquidity_sec_clayton_ltr.pdf.

Proposed Rules

SEC Staff Continues to Work on Potential Amendments to the "Loan Provision" Concerning Auditor Independence

According to the SEC's updated 2017 regulatory agenda, a potential amendment to the so-called "Loan Provision" of Regulation S-X, regarding the impact of loans or debtor-creditor relationships on auditor independence, is in the "final rule stage," with the SEC's Office of Chief Accountant considering issuing a recommendation that the SEC amend the Loan Provision. The regulatory agenda, which is available on the "Reginfo.gov" website maintained by the Office of Information and Regulatory Affairs (part of the Office of Management and Budget), is a nonbinding indicator of the rulemaking plans of the SEC's chairman and staff.

As we have previously reported, SEC Commissioner Michael Piwowar gave a speech in early May 2017 in which he stated that he directed the SEC staff to begin working on amendments to the Loan Provision to "address unnecessary compliance issues and instead focus attention on lending relationships that actually threaten auditor independence." At that time, Commissioner Piwowar noted that "this rulemaking is consistent with my view that the Commission evaluate whether the rules and policies the agency implements are indeed achieving their intended objectives."

Background

As a reminder, Rule 2-01(c) under Regulation S-X sets forth a non-exclusive list of circumstances that are considered inconsistent with the "independence" of a registered public accounting firm (an Audit Firm), 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" (as defined in Regulation S-X), it also includes every entity within the investment company complex, regardless of whether the Audit Firm actually provides audit services to those other entities.

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 18 months from the issuance date, 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 in its investment company complex employs an Audit Firm that has relationships causing technical non-compliance as a result of the Loan Provision. Thus, although the no-action letter issued to FMR helped alleviate some of the compliance challenges faced by mutual funds with respect to the Loan Provision, it did not provide a "permanent fix."

Any further developments on the Loan Provision will be addressed in a future issue of the Regulatory Update.

SEC Defers Action on Application to List "Managed Portfolio Shares," a Type of Non-Transparent, Actively Managed ETF

On July 28, 2017, the SEC issued a release (the Release) designating a longer period for SEC action on a proposed rule change to permit the listing and trading of "Managed Portfolio Shares" on Bats BZX Exchange, Inc. (Bats). Managed Portfolio Shares are shares of a proposed type of non-transparent, actively managed exchange-traded fund (a Fund) that, as compared to actively managed ETFs approved to date, have the following principal distinguishing features:

1. Fund investments will be restricted primarily to long and/or short positions in U.S.-listed securities, shares issued by other U.S.-listed ETFs and cash and cash equivalents;
2. Portfolio holdings will be publicly disclosed on a quarterly basis, rather than on a daily basis;
3. Purchases and redemptions of creation units of Fund shares will be limited to transactions by or through an Authorized Participant (AP) transacting through its own separate confidential brokerage account (Confidential Account) held with a "Trusted Agent," a bank or broker-dealer, for the benefit of the AP, without disclosing the identity of such securities to the AP;
4. Prior to the commencement of trading on each business day, each Trusted Agent will be given both the holdings of a Fund and their relative weightings for that day, to permit an AP, or other market participant that has established a Confidential Account with a Trusted Agent (a Non-Authorized Participant Market Maker), to instruct the Trusted Agent to buy and sell positions in the portfolio securities and to permit arbitrage activity;
5. The "Verified Intraday Indicative Value" (VIIV) of a Managed Portfolio Share, based on the "consolidated midpoint of the bid ask spread" of the Fund's holdings as of the close of business on the prior business day, will be widely disseminated by one or more major market data vendors in at least one second intervals during regular trading hours and subject to validation by a pricing verification agent; and
6. A Fund will rely on dissemination of VIIVs and transactions by APs and Non-Authorized Participant Market Makers through Confidential Accounts, rather than daily holdings disclosures and transactions directly by APs, as the

primary basis for seeking to ensure Fund shares' secondary market trading efficiency.

Bats' proposed rule change was published for comment in the Federal Register on June 19, 2017. As explained in the Release, Section 19(b)(2) of the Exchange Act provides that, within 45 days of the publication of a notice of the filing of a proposed rule change by a self-regulatory organization, or within a longer period up to 90 days as the SEC may designate if it finds a longer period to be appropriate and publishes its reasons for so finding or as to which the applicable self-regulatory organization consents, the SEC will either approve the proposed rule change, disapprove the proposed rule change or institute proceedings to determine whether the proposed rule change should be disapproved. Noting that the 45th day after publication of the notice for this proposed rule change is August 3, 2017, the SEC announced that it is extending the 45-day period to September 17, 2017, in order to have "sufficient time to consider the proposed rule change and comment letters."

The July 28, 2017 notice extending the period for SEC action is available at:
https://www.sec.gov/rules/sro/batsbzx/2017/34-81247.pdf.

The June 13, 2017 notice summarizing the proposed rule change is available at:
https://www.sec.gov/rules/sro/batsbzx/2017/34-80911.pdf.

Litigation and Enforcement Actions

Section 36(b) "Excessive Fee" Litigation

Eighth Circuit Court of Appeals Affirms District Court's Dismissal of Complaint in Fund-of-Funds Section 36(b) Lawsuit, Ruling Plaintiff Lacks "Statutory Standing"

On July 24, 2017, the U.S. Court of Appeals for the Eighth Circuit (the Eighth Circuit) affirmed the decision of the U.S. District Court for the Southern District of Iowa (the District Court) entering summary judgment in favor of Principal Management Corporation (Principal) and dismissing a complaint filed by American Chemicals & Equipment Inc. 401(K) Retirement Plan (ACE) alleging that Principal breached its fiduciary duty under Section 36(b) of the 1940 Act by charging unfair and excessive fees.

Background

Section 36(b) of the 1940 Act provides that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser." Section 36(b) further provides for a private right of action "by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser. . . ."

ACE was a shareholder in six of the Principal LifeTime Funds, which were structured as target-date "funds of funds," meaning each LifeTime Fund invests in a portfolio of other mutual funds (i.e., underlying funds) designed to "maximize performance for investors targeting a specific retirement date." ACE sued Principal, the investment adviser for both the LifeTime Funds and the underlying funds, alleging that the management fees paid by the underlying funds in which the LifeTime Funds invested were "unfair and excessive" and indirectly reduced the net asset values of the LifeTime Funds. On February 3, 2016, the District Court, in entering summary judgment in favor of Principal, concluded that ACE lacked "statutory standing" under Section 36(b) because ACE – which was neither a shareholder of the underlying funds nor challenging the management fee that the LifeTime Funds paid directly to Principal – had no cause of action under Section 36(b).

Appeal

As explained in the Eighth Circuit's decision, consistent with SEC disclosure requirements, Principal calculated and disclosed the "Acquired Fund Fees and Expenses" (or AFFE) for each LifeTime Fund, which "reflects the underlying funds' total expenses, including management fees, apportioned according to the percentage of shares that the fund of funds [i.e., the LifeTime Fund] holds in the underlying funds and expressed as a percentage of the fund of funds' total assets." Consequently, the management fees that the underlying funds pay directly to Principal for its advisory services to those funds are reflected in the LifeTime Funds' AFFE, "weighted in accordance with the SEC's disclosure formula." On appeal from the District Court, in a claim described by the Eighth Circuit as "convoluted," ACE challenged and sought recovery of the AFFE's "revenue portion," i.e., "the proportional share of the overall management fee that is attributable to [Principal's] management of the assets in the Underlying Fund owned by the LifeTime Funds."

The Eighth Circuit, which reviewed the District Court's decision *de novo*, cited the District Court's conclusion that ACE was in fact challenging fees paid by the underlying funds "at a level once removed from [ACE's] security interest." Since Section 36(b) "only allows security holders to challenge fees paid by the entity in which they have an interest," the question was whether ACE asserted a claim in respect of compensation or payments "*paid by*" the LifeTime Funds to PMC.

In affirming the decision of the District Court that ACE lacked "statutory standing" to sue Principal under Section 36(b), the Eighth Circuit stated that the AFFE is not "compensation for services." Instead, the Eighth Circuit explained, the AFFE "simply *estimates* the fund of funds' costs of investing in other funds" (emphasis in original). Similarly, the AFFE is not a "payment of a material nature," since no entity pays the AFFE. As the Eighth Circuit stated, Section 36(b) is "*expressly* limited to claims regarding compensation or payments of a material nature *paid by* the LifeTime Funds or its shareholders" (emphasis in original).

On appeal, ACE also claimed that because the LifeTime Funds and the underlying funds are a part of the same registered investment company, Principal Funds, Inc. (Principal Funds), ACE may assert a Section 36(b) claim as a shareholder of this single entity. However, the Eighth Circuit noted that Principal Funds is organized as a "series company," a single corporation offering multiple investment options that are each treated by the courts and the SEC as separate registered investment companies for purposes of applying Section 36(b). Thus, the Eighth Circuit held that because each mutual fund is a separate registered investment company, ACE cannot sue on behalf of the underlying funds in which it lacks a security interest.

SEC Actions in Federal Court

SEC Files Fraud Charges Against Registered Representatives in Connection with Investments by Federal Employees in Variable Annuities

On July 31, 2017, the SEC filed a complaint alleging that four former registered representatives (the Registered Reps) of Keystone Capital Partners, Inc., a broker-dealer that did business under the name "Federal Employee Benefit Counselors," fraudulently induced federal employees to roll over significant funds from their federal Thrift Savings Plan (TSP) retirement accounts into privately issued higher-fee variable annuity products that the Registered Reps misled the federal employees into believing were affiliated with or approved by the federal government. The SEC complaint was filed in U.S. District Court, rather than as an administrative action, and sought permanent injunctions, disgorgement of ill-gotten gains, and civil penalties.

The SEC alleged that the Registered Reps sold approximately 200 variable annuities with a total face value of over approximately $40 million to federal employees using monies rolled over from their TSP accounts, earning the Registered Reps approximately $1.7 million in commissions on these sales. The SEC's complaint states that the Registered Reps targeted federal employees nearing retirement (age 59½ and over), with sizable funds invested in TSP accounts, and created the false impression that they were affiliated with, or approved by, the federal government. According to the complaint, the Registered Reps generated "TSP Reports" that did not disclose that the recommended investment option was actually a variable annuity (or that this "option" involved investing with a third party that has no government affiliation). The TSP Reports also allegedly failed to disclose the variable annuity costs, such as mortality and expense risk charge and guaranteed minimum withdrawal benefit rider fees or the surrender charge, although both liquidity and longevity protection were touted. Finally, the complaint charges that the defendants misleadingly obscured the difference between the annuity's cash value and the rider's benefit base.

The Registered Reps were also charged with failing to timely deliver the variable annuity prospectuses to investors. The complaint claims that the Registered Reps "knowingly disregarded," and acted contrary to, certain of the broker-dealer's compliance procedures, and that they falsely reported through the broker-dealer's systems that they had sent the prospectus to customers. In addition, the Registered Reps allegedly used customer signatures from executed documents to falsify signatures on documents that the customers never received.

The complaint charges the Registered Reps and "Federal Employee Benefits Counselors" with violating and aiding and abetting violations of the anti-fraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, among other things.

In conjunction with this action by the SEC, the SEC's Office of Investor Education and Advocacy (OIEA) and Broker-Dealer Task Force issued an Investor Alert on July 31, 2017, warning the more than 5 million TSP participants and investors in other federal government employee retirement plans, that fraudsters may target federal employees and pretend to be affiliated with a government agency.

The complaint can be found at: https://www.sec.gov/litigation/complaints/2017/comp-pr2017-135.pdf.

The Investor Alert is available at: https://investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-alert-fraudsters-may-target-federal.

SEC Administrative Proceedings

SEC Settles Charges Against Investment Adviser for Failing to Disclose Receipt of Revenue Sharing Payments from Third-Party Broker-Dealer

On July 19, 2017, the SEC announced settled administrative proceedings against KMS Financial Services, Inc. (KMS), a Seattle, Washington-based investment adviser, for failing to disclose to its advisory clients that it received revenue from a third-party broker-dealer (the Clearing Broker) for certain mutual fund investments that KMS selected for its advisory clients, and that it failed to seek best execution for its advisory clients.

According to the SEC order, since at least 2002, the Clearing Broker agreed to share with KMS certain revenues that the Clearing Broker received from the mutual funds in the Clearing Broker's no-transaction-fee mutual fund program (the NTF Program). As part of the NTF Program, the SEC alleged that the Clearing Broker waived the transaction fees it and KMS would otherwise charge clients, and instead KMS would get a percentage of revenues that the Clearing Broker received from the mutual funds in the NTF Program. The SEC alleged that these payments provided a financial incentive for KMS to favor the mutual funds in the NTF Program over other investments when giving investment advice to its advisory clients and thus created a conflict of interest.

The SEC order also states that, in 2014, KMS negotiated a reduction in execution and clearing costs paid to the Clearing Broker but that KMS neither passed on the reduction in brokerage costs to its advisory clients nor evaluated whether its clients were obtaining best execution. In addition, the SEC alleged that, in its Form ADV, KMS made inaccurate statements concerning best execution and omitted disclosure of compensation it received through the NTF Program.

As a result of the foregoing conduct and related compliance and disclosure failures described in the SEC order, the SEC found that KMS violated: (1) Section 206(2) of the Investment Advisers Act of 1940, which prohibits investment advisers from directly or indirectly engaging in any transaction, practice or course of business that operates as a fraud or deceit upon a client or prospective client; (2) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require, among other things, that a registered investment adviser adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser and its supervised persons; and (3) Section 207 of the Advisers Act, which makes it unlawful for any person to make any untrue statement of a material fact in any registration application or report filed with the SEC, or to omit to state in any such application or report any material fact which is required to be stated therein.

Without admitting or denying the SEC's findings, KMS agreed to pay disgorgement of $382,568.64, prejudgment interest of $69,518.43 and a civil money penalty of $100,000. KMS also agreed to cease and desist from committing or causing any violations and any future violations of the statute and rules cited in the SEC order and was censured. Lastly, KMS agreed to provide certain notices about the SEC order to its advisory clients on its website homepage, in its Form ADV brochures and in its September 30, 2017 quarterly statement from the Clearing Broker to KMS advisory clients, and to certify that it provided such notices.

The SEC order is available at: https://www.sec.gov/litigation/admin/2017/34-81169.pdf.

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