VedderPrice

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Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

SEC STAFF GUIDANCE AND ALERTS

SEC Staff Issues No-Action Letters to Facilitate Cross-Border Compliance with the Research "Unbundling" Provisions of the European Union's MiFID II

On October 26, 2017, the staff of the SEC, following consultation with European authorities, issued three no-action letters to provide guidance to market participants seeking to comply with the requirements of the European Union's (EU) Markets in Financial Instruments Directive II (MiFID II) that take effect on January 3, 2018.

MiFID II will, among other things, generally prohibit certain investment advisers from receiving or retaining "inducements" from a third party—such as commissions, fees or other monetary or non-monetary benefits, including, importantly, certain research from an executing broker-dealer—in connection with providing any investment or ancillary service to a client. Under MiFID II, an investment adviser can continue to receive research without violating the inducement prohibition if the investment adviser pays for that research (1) directly (i.e., out of the investment adviser's own resources); (2) with client approval, from a separate research payment account (RPA) controlled by the adviser, funded with client assets and subject to a research budget that is regularly assessed and agreed upon with the client; or (3) through a combination of (1) and (2). The practical effect of the foregoing is the required separation of bundled commission payments for research and brokerage services made by investment advisers subject to MiFID, either directly or by contractual obligation.[1]

Subject to various terms and conditions, the three no-action letters essentially provide that: (1) broker-dealers, for 30 months from MiFID II's implementation date, may receive separate payments for research—in hard dollars or through a MiFID II-governed RPA—without being considered, and possibly having to register as, an investment adviser under the Investment Advisers Act of 1940; (2) investment advisers may continue to aggregate client orders for purchases and sales of securities, with some clients paying different amounts for research because of MiFID II requirements, but with all clients continuing to pay the same average price and execution cost for a given security

1 An investment adviser may retain a non-EU domiciled investment adviser that is contractually required to comply with MiFID II or equivalent requirements. In general, the extent of MiFID II's impact on a U.S. firm depends largely on the organization's scope of business and services, client profile, trading platform and sub-advisory arrangements, among other things. Questions concerning the application of MiFID II should be directed to a member of Vedder Price's Investment Services Group, including Juan Arciniegas and Joseph Mannon. Please see the last page of this Regulatory Update for contact information.

in an aggregated order; and (3) investment advisers may continue to rely on the soft dollar “safe harbor” under Section 28(e) of the Securities Exchange Act of 1934 when making payments to an executing broker-dealer out of client assets for research alongside execution payments through the use of a MiFID II-compliant RPA, provided that conditions of the Section 28(e) safe harbor are otherwise met.

We discuss each of the three no-action letters in greater detail below.

Division of Investment Management Staff Issues Temporary No-Action Relief Concerning Advisers Act Treatment of Broker-Dealers Providing Research Services to Investment Managers Subject to MiFID II

In a letter to the Securities Industry and Financial Markets Association (SIFMA), the staff of the SEC’s Division of Investment Management provided assurance, on a temporary basis, that it would not recommend that the SEC take enforcement action under the Advisers Act against a broker-dealer that provides research services that constitute investment advice under Section 202(a)(11) of the Advisers Act to an investment adviser that is required under MiFID II, either directly or by contractual obligation, to pay for the research services from its own resources or from an RPA funded with its clients’ money, or a combination of the two. The letter states that such assurance will expire on July 3, 2020, 30 months after MiFID II’s January 3, 2018 implementation date (the Temporary Period), and may or may not be renewed at that time.

Background

SIFMA’s letter to the SEC staff requesting no-action assurance (the SIFMA Incoming Letter) stated that U.S. broker-dealers (and their EU broker-dealer affiliates) that provide research services to investment advisers subject to MiFID II can expect to receive separate payments for those research services. The SIFMA Incoming Letter expressed the concern that the receipt of such separate research payments might “inadvertently subject broker-dealers’ research services to the Advisers Act by creating questions about their ability to rely on the longstanding broker-dealer exclusion, and thereby disrupt existing business models that are already subject to a comprehensive regulatory framework overseen by the SEC and [FINRA] . . . .” This concern relates to the general exclusion of broker-dealers from the definition of “investment adviser” under the Advisers Act if the broker-dealer’s investment advisory services are “solely incidental to the conduct of his business as a broker or dealer” and the broker-dealer “receives no special compensation therefor” and the interpretation of “special compensation” vis-à-vis a separate, unbundled payment for research services. As articulated in a footnote to the SIFMA Incoming Letter,

> SIFMA members are concerned that, because the contours of what constitutes “special compensation” is not necessarily clear in the context of research services, the SEC or its staff might view a broker-dealer as receiving “special compensation” for investment advice it if receives payments for research services directly or indirectly out of an investment manager’s own money, from an RPA funded with the investment manager’s clients’ money, or a combination of the two.

SIFMA warned that subjecting broker-dealers to additional regulation (i.e., as investment advisers) could ultimately prevent investment advisers subject to MiFID II from accessing U.S. research services and could place U.S. broker-

dealers at a competitive disadvantage vis-à-vis their European competitors when doing business with EU investment advisers.

No-Action Relief

In providing the requested relief, the SEC staff stated that its no-action position is "intended to address concerns that have arisen in light of the adoption of MiFID II while preserving choice in maintaining the SEC's long-standing approach to arrangements under section 28(e) of the [Exchange Act]." The staff also stated that the Temporary Period is intended to give the staff sufficient time "to better understand the evolution of business practices after the implementation of MiFID II," noting that EU regulators recently issued guidance on key aspects of MiFID II and that the Temporary Period would afford the industry "time to review, comprehend, and implement the guidance, and evaluate impacts on their business models." The staff stated that it would continue to monitor and assess the impact of MiFID II's requirements to determine if additional action is necessary.

The Division of Investment Management's staff No-Action Letter to SIFMA regarding treatment of broker-dealers under the Advisers Act is available at: https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

Division of Investment Management Staff Issues No-Action Letter Permitting Aggregation of Client Orders for Securities Transactions Subject to MiFID II

In a letter to the Investment Company Institute (ICI), the staff of the SEC's Division of Investment Management provided assurance that it would not recommend that the SEC take enforcement action under Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder, or Section 206 of the Advisers Act, against an investment adviser that aggregates client orders for the purchase or sale of securities in reliance on the staff's position in the 1995 no-action letter to SMC Capital, Inc. (SMC), while accommodating differing arrangements regarding the payment for research that will be required by MiFID II.

Background

In the SMC no-action letter, the SEC staff took the position that the mere aggregation of orders for advisory clients, including collective investment vehicles in which the adviser, its principals or employees have an interest, would not violate Section 17(d) of the 1940 Act, Rule 17d-1 thereunder or Section 206 of the Advisers Act if the adviser implements procedures designed to prevent any account from being systematically disadvantaged by the aggregation of orders.

The standard set forth in the 1995 SMC no-action letter required that (1) once an aggregated order was executed, the trade would be allocated among clients in accordance with a pre-trade written statement specifying the participating client accounts and the intended allocation among them (Allocation Statement), and, if the order was only partially filled, the trade would be allocated *pro rata* based on the Allocation Statement; (2) each client that participated in an aggregated order would participate at the average share price; and (3) transaction costs would be shared *pro rata* based on each client's participation in the transaction.

In its request for no-action relief, the ICI stated that following the implementation of MiFID II, within a given aggregated order, (1) clients (including registered funds) may pay total transaction costs that include the cost of execution as well as research services; whereas (2) other clients may pay different amounts in connection with the same trade (including possibly execution costs only). As a result of the various potential research arrangements and combinations thereof, clients may not pay a *pro rata* share of all costs (i.e., research payments) associated with an aggregated order. The ICI asserted that absent no-action relief expanding the relief in the SMC no-action letter, investment advisers might be forced to place into the market competing orders in the same security, possibly resulting in worse execution for clients overall and the potential for one set of clients to receive a benefit at the expense of another.

No-Action Relief

The relief granted by the SEC staff permits investment advisers to continue to aggregate client orders (including orders executed on behalf of registered funds) for purchases and sales of securities, with some clients paying different amounts for research because of MiFID II requirements, but with all clients continuing to pay the same average price and execution cost for a given security in an aggregated order. The relief is conditioned on the requirement that an investment adviser has adopted policies and procedures reasonably designed to ensure that:

(1) each client in an aggregated order pays the average price for the security and the same cost of execution (measured by rate);

(2) the payment for research in connection with the aggregated order will be consistent with each applicable jurisdiction's regulatory requirements and disclosures to the client; and

(3) the subsequent allocation of such trade will conform to the adviser's Allocation Statement and/or the investment adviser's allocation procedures.

Furthermore, the relief does not apply to an investment adviser that is not subject to the requirements of MiFID II (either directly or contractually).

In a public statement accompanying the letter, the SEC stated that this relief provides clarity and consistency to investment advisers by permitting the continued aggregation of orders while addressing the differing arrangements regarding the payment for research that will be required by MiFID II.

The Division of Investment Management staff's no-action letter to the ICI concerning aggregation of client orders under MiFID II is available at: https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm.

Division of Trading and Markets Staff Provides No-Action Assurance Concerning MiFID II-Compliant Research Payments and Section 28(e)'s Safe Harbor

In a letter to SIFMA's Asset Management Group (SIFMA AMG), the staff of the SEC's Division of Trading and Markets provided assurance that it would not recommend that the SEC take enforcement action if, in compliance with MiFID II, an investment adviser uses client assets to make payment through an RPA for research alongside payments for execution services in reliance on the safe harbor of Section 28(e) of the Exchange Act.

Background

Under the Section 28(e) safe harbor, an investment adviser that satisfies the conditions of the section does not act unlawfully or breach its fiduciary duties solely on the basis that the investment adviser uses client commissions to pay a broker-dealer more than the lowest available commission rate for eligible research and brokerage services provided by the broker-dealer. To fall within the Section 28(e) safe harbor, advisers and other fiduciaries must make a good faith determination that the amount of commission paid is reasonable in relation to the value of the brokerage and research services being provided.

In its letter requesting no-action assurance, SIFMA AMG stated that investment advisers in the United States often rely on a client commission arrangement (CCA) structure to pay a single bundled commission to broker-dealers for order execution and Section 28(e)-eligible brokerage and research services. Under such a structure, the executing broker-dealer credits the portion of the commission for research to a CCA administered by the executing broker-dealer and retains the remainder of the commission payment. An alternative to the foregoing, as described in SIFMA AMG's letter, is an arrangement in which the executing broker-dealer forwards the research portion of the commission to a CCA administered by an external "aggregator" or administrator. In such circumstances, the investment adviser instructs the executing broker-dealer to deduct the portion of the commission payment for brokerage, including execution, from payments going to the CCA administered by that third party. In either case, the investment adviser receives research from a research provider or the executing broker-dealer that is paid for through a CCA funded with client assets.

SIFMA AMG asserted that although the commission paid by the client is bundled to include research and brokerage (including execution), it effectively becomes unbundled when, pursuant to the adviser's agreement with the executing broker-dealer, the executing broker-dealer retains its brokerage portion and credits (in the case in which the executing broker-dealer administers the CCA) or transmits (in the case in which an external "aggregator" administers the CCA) the research portion to the CCA.

SIFMA AMG's letter to the SEC staff stated that a "typical RPA" is expected to operate in a manner similar to the CCA model with two relevant distinctions: (1) the amount paid for research is identified separately from the amount paid for execution *before* the investment adviser makes the payments to the executing broker; i.e., the unbundling occurs at a different point in time; and (2) the RPA is required to be under the control of the investment adviser and the investment adviser is held responsible for the RPA. According to SIFMA AMG, despite these differences, an RPA structure does not change the economic arrangements for research payments already falling under Section 28(e) safe harbor, continues to protect against illegal payments to brokers that do not actually provide or pay for research and is consistent with the public policy of cost transparency.

SIFMA AMG's letter to the SEC staff stated that when an RPA is operated in connection with a CCA, the research payments continue to be paid to the executing broker-dealer and the payments into the CCA are then routed into an RPA. Although the investment adviser may in some circumstances engage the executing broker-dealer or a third-party administrator to administer the RPA, in all cases the executing broker-dealer is contractually required to collect

research payments alongside payments for execution services made by the investment adviser out of client assets and pay such amounts into the RPA.

No-Action Relief

In providing no-action assurance regarding an investment adviser seeking to operate in reliance on Section 28(e) of the Exchange Act if its pays for research through the use of RPA that conforms to the requirements of MiFID II, the SEC staff noted that the relief will apply only in the following circumstances:

(1) the investment adviser makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution;

(2) the research payments are for research services that are eligible for the safe harbor under Section 28(e);

(3) the executing broker-dealer effects the securities transactions for purposes of Section 28(e); and

(4) the executing broker-dealer is legally obligated by contract with the investment adviser to pay for research through the use of an RPA in connection with a CCA.

The SEC staff cautioned that its position "is subject to modification or revocation at any time."

The Division of Trading and Markets staff's no-action letter to SIFMA AMG addressing Section 28(e)'s safe harbor and RPA arrangements is available at: https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf.

SEC Staff Denies Request for No-Action Relief Concerning Allocation of Certain Fund of Fund Operating Expenses to Underlying Funds in the Same Fund Family

On October 26, 2017, the staff of the SEC's Division of Investment Management denied granting no-action assurances under Section 17(d) of the Investment Company Act of 1940 and Rule 17d-1 thereunder to Mutual of America Capital Management LLC (MoA) regarding the proposed allocation of certain non-advisory operating expenses among funds in the Mutual of America Life Insurance Company fund complex for which MoA serves as investment adviser. After consulting with the Division of Enforcement, the Division of Investment Management denied the request for no-action relief "as a caution" to MoA and others against establishing an arrangement similar to that described below outside the parameters and conditions of an exemptive order granted under Rule 17d-1.

Request for No-Action Relief

Section 17(d) of the 1940 Act generally provides that no affiliated person of or principal underwriter for a registered investment company, and no affiliated person of such a person, may effect a transaction in which the investment company is a joint or joint and several participant in contravention of applicable SEC rules. Rule 17d-1 under the 1940 Act generally provides that no affiliated person of or principal underwriter for a registered investment company, and no affiliated person of such a person, may participate in or effect a transaction in connection with "any joint

enterprise or other joint arrangement or profit-sharing plan" in which the registered investment company is a participant without first obtaining an exemptive order from the SEC.

MoA sought assurance from the SEC staff that it would not recommend that the SEC pursue an enforcement action under Section 17(d) of the 1940 Act or Rule 17d-1 thereunder if the non-advisory operating expenses of the funds-of-funds in its complex—i.e., costs of legal and compliance services, costs of printing and distribution of fund prospectuses and shareholder reports, as well as certain licensing fees and directors, legal and auditing, and custodial fees—were allocated to underlying funds in the complex without first obtaining exemptive relief under Rule 17d-1.

In its request for no-action relief MoA emphasized that:

(1) the proposed expense allocation methodology would be subject to approval, prior to implementation, by the funds' board, including the independent directors, and periodically monitored thereafter by the board;

(2) the allocation of expenses would be disclosed to all fund shareholders;

(3) the amounts of the expenses at issue are expected to be immaterial (i.e., not expected to exceed one half cent per share for any fund);

(4) all funds would benefit since the funds-of-funds are primarily a means of distributing the underlying funds and, by attracting new assets to the entire fund complex, the funds-of-funds would reduce the expense ratio of all funds by an amount exceeding the extra expenses to be borne by the underlying expenses under the proposed methodology; and

(5) the funds should not be considered affiliated persons with each other for purposes of the proposed expense allocations.

As to the issue of affiliation, MoA cited prior SEC guidance regarding Rule 17d-1 indicating that it does not stand for the premise that funds with common officers, directors or investment advisers are always affiliated persons: "[t]hey may or may not be, depending on the facts" (internal citations omitted). MoA also stated that "[i]n most instances in which funds are deemed to be affiliated with each other by virtue of being managed by the same adviser, the conduct at issue is directed by the adviser," such as in the case of joint trading for funds. Here, MoA contended, "there is no such control by the adviser," and "[i]f anyone "controls" the funds in this case, it is their Independent Directors." On this point, MoA added, "the role of independent directors has never been held to be sufficient to create affiliation among funds."

MoA further argued that even if the funds were deemed to be affiliated with each other, the proposed expense allocation should not be prohibited since "abuses that Section 17(d) were designed to prevent are simply not present" and decisions by independent directors about expense allocations should not constitute a "joint enterprise or other joint arrangement" within the meaning of Rule 17d-1 that would necessitate an exemptive order. MoA also asserted that "[t]here is no precedent in which the allocations of expenses among funds in a fund complex, including those between funds-of-funds and underlying funds, has been found to violate Rule 17d-1," adding that "these types of expense determinations are done by all fund complexes, and few, if any, seek exemptive orders from the SEC."

The Staff's Response

In denying MoA's request for no-action relief, the SEC staff emphasized that "some of the operating expenses proposed to be allocated to the Underlying Funds would not be incurred by, or otherwise attributable to, the Underlying Funds, but rather would be incurred by or attributable solely to the Fund of Funds." The staff stated that this "creates the potential for conflicts of interest and for participation by a Fund on a basis less advantageous than that of other participants, that is not present (or present to a much lesser degree) in the typical industry practice of allocating certain shared expenses among the relevant funds in a fund family without an order under rule 17d-1." Accordingly, the staff determined that its review under Rule 17d-1 was necessary in order to "guard against such conflicts to help ensure that each Fund's participation is consistent with the provisions, policies and purposes of the [1940] Act and no less advantageous than that of other participants."

The staff also challenged MoA's assertion that pursuing the proposed expense allocation without first obtaining exemptive relief is consistent with industry practice and the staff's previous guidance, noting that "[t]he industry practice over the past 30 years with respect to arrangements such as the proposed expense allocation among the Fund of Funds and the Underlying Funds has been to seek Commission orders under rule 17d-1 prior to implementing the arrangements."

In addition, the staff stated that, as in prior similar instances, it "view[s] the proposed allocation of the Fund of Funds' expenses among the Underlying Funds as an arrangement effected by the Adviser in which the Fund of Funds and the Underlying Funds have a joint participation within the meaning of rule 17d-1(c) and which requires a Commission order pursuant to rule 17d-1(a) under the [1940] Act."

MoA's request for no-action relief is available here:
https://www.sec.gov/divisions/investment/noaction/2017/mutualamericacapitalmanagement102617-incoming.pdf.

The SEC staff's response denying the requested relief is available here:
https://www.sec.gov/divisions/investment/noaction/2017/mutualamericacapitalmanagement102617.htm.

PROPOSED RULES

SEC Proposes Rules to Implement FAST Act Mandate

On October 11, 2017, the SEC voted to propose certain amendments to various disclosure requirements based on recommendations set forth in a November 2016 staff report prepared in response to a requirement of the Fixing America's Surface Transportation (FAST) Act. The proposed disclosure changes, which are most significant with respect to non-investment company registrants but also include changes applicable to investment companies and investment advisers, are intended to modernize and simplify disclosure requirements in a manner that reduces costs while continuing to provide investors with all material information, improve readability and navigability, discourage repetition and disclosure of immaterial information and provide for consistent rules regarding incorporation by

reference and hyperlinking. SEC Chairman Jay Clayton stated that "[t]he FAST Act has given the Commission the opportunity to update our rules, simplify our forms, and utilize technology to make decisions more accessible."

The following is a summary of the notable proposed changes applicable to investment companies and investment advisers:

- **Incorporation by Reference:** The proposals include several changes in the rules governing incorporation by reference, including:
  - Amendments of various rules imposing specific requirements and limitations on incorporation by reference under specified circumstances (i.e., Rule 411 under the Securities Act of 1933; Rules 12b-23 and 12b-32 under the Securities Exchange Act of 1934; Rules 0-4, 8b-23 and 8b-24 under the Investment Company Act of 1940; and Rule 0-6 under the Investment Advisers Act of 1940) to create a consistent approach to incorporation by reference and cross-referencing to disclosure found elsewhere in a filing (including financial statements);
  - An amendment of Item 10(d) of Regulation S-K that would eliminate the general prohibition on incorporating by reference documents that have been on file with the SEC for more than five years; and
  - Amendments of Rule 0-4 under the 1940 Act and Rule 0-6 under the Advisers Act that would (1) eliminate the requirement for a separate accountant's consent to be filed with any filing incorporating by reference a certificate of the independent registered public accountant filed previously or concurrently; and (2) eliminate current provisions that allow the SEC to refuse to permit incorporation by reference when, in the SEC's judgment, incorporation by reference would render a registration statement, report or application incomplete, unclear or confusing. The latter provision would be replaced with a general requirement that information may not be incorporated by reference in any case in which incorporating such information by reference would render the disclosure incomplete, unclear or confusing.
- **Hyperlinks and HTML:** The proposals include amendments to Rule 411 under the Securities Act, Rule 12b-23 under the Exchange Act and Rule 0-4 under the 1940 Act that would require hyperlinks to information incorporated by reference that is available on EDGAR, together with a specific description of the location of that information, as well as expanded requirements to file registration statements and shareholder reports in HTML format to support the proposed hyperlinking requirements.
- **Compliance with Section 16(a) of the Exchange Act (Item 405 of Regulation S-K):** The proposals include amendments to Item 405 of Regulation S-K that would permit registrants to rely on electronically filed Section 16 reports to determine whether there are any delinquencies required to be disclosed and that would eliminate the requirement in Rule 16a-3(e) under the Exchange Act for reporting persons to deliver to the registrant duplicates of Section 16 reports. However, the amendments would clarify that

although registrants may rely on electronically filed Section 16 reports, they are not required to limit their inquiry to those filings.

The public comment period will be open until January 2, 2018.

The proposing release for the proposed amendments, Securities Act Release No. 10425, is available at: https://www.sec.gov/rules/proposed/2017/33-10425.pdf.

The SEC's press release relating to the proposed amendments is available at: https://www.sec.gov/news/press-release/2017-192.

The SEC staff's Report on Modernization and Simplification of Regulation S-K is available at: https://www.sec.gov/reportspubs/sec-fast-act-report-2016.pdf.

Other Regulatory Developments

SEC Staff Reportedly Considering Measures to Streamline ETF Approval Process

According to a recent report by Bloomberg, SEC Chairman Jay Clayton has asked the SEC staff to craft a set of rule changes to streamline the ETF approval process.[2] Specifically, Chairman Clayton has reportedly asked the staff to revisit and build upon a set of rule changes originally advanced in 2008 that would have permitted ETFs with certain standard characteristics to enter the market without first obtaining specific exemptive relief, as currently required.[3] The 2008 proposal was abandoned in the wake of the global financial crisis.

IDC Calls on SEC Division of Investment Management Director Dalia Blass to Modernize Fund Directors' Regulatory Responsibilities

In a letter dated October 16, 2017, the Investment Company Institute's Independent Directors Council (IDC) asked new SEC Division of Investment Management Director Dalia Blass to conduct a "long-overdue," comprehensive review of fund independent directors' regulatory responsibilities to identify modifications that the staff and SEC should make to "enhance directors' effectiveness in today's environment on behalf of fund shareholders." The IDC's letter expressed the view that the current regulatory regime should be changed to enable directors to focus their attention and dedicate the majority of their time to the matters that are most important to shareholders' interests and to which directors can add the greatest value.

Commenting on the expansion of director responsibilities generally since the enactment of the Investment Company Act of 1940, the IDC stated that it was "troubled by requirements that hold directors accountable (i.e., liable) for functions that are more appropriately within the purview of fund management." In this regard, the IDC stated that the concern in the director community is not merely with the number of regulatory requirements, but "more importantly,

2 "SEC Is Said to Prepare Easier Path for New Exchange-Traded Funds," available at: https://www.bloomberg.com/news/articles/2017-11-06/sec-is-said-to-prepare-easier-path-for-new-exchange-traded-funds.

3 The 2008 proposals appeared in Exchange-Traded Funds, Investment Company Act Release No. 28193 (Mar. 11, 2008), available at: https://www.sec.gov/rules/proposed/2008/33-8901.pdf.

with the nature of some of the requirements, such as those that are outmoded or inconsistent with directors' oversight role."

The IDC called upon the Division of Investment Management to revisit earlier undertakings to review fund director responsibilities, such as the 2008 Director Outreach Initiative under former Director Andrew Donohue, which as a result of the "more pressing regulatory priorities" triggered by the global financial crisis of 2008–09, failed to result in any recommendations to the SEC.

The IDC asserted that, consistent with the "guiding principles" articulated by SEC Chairman Jay Clayton, "any review of directors' responsibilities should incorporate and reflect the significant industry, technological and regulatory developments that have occurred" and the opportunities such developments present for "rethinking directors' responsibilities and board governance requirements." As an example, the IDC cited the adoption in 2003 of the fund compliance rule, Rule 38a-1 under the 1940 Act, that established a "successful framework for board oversight that is well-accepted across the industry" and, given its success, "should serve as a model for modernizing other regulatory responsibilities of fund directors."

In its letter, the IDC summarized key developments in the fund industry and the evolution of directors' responsibilities and suggested that the SEC staff consider modifying certain areas of board responsibility. These areas included:

- Board involvement in fair valuation;
- Board review of payments under Rule 12b-1 distribution plans;
- Certain requirements identified by the IDC as "ritualistic," including board review of repurchase agreements (Rule 5b-3), affiliated transactions (Rules 10f-3, 17a-7 and 17e-1), custody of foreign assets (Rule 17f-5), fidelity bonds (Rule 17g-1), multiple share classes and related expense allocations (Rule 18f-3) and net asset value computation (Rule 22c-1);
- Certain fund governance requirements, including requirements to hold in-person meetings to approve advisory and distribution agreements; and
- Certain aspects of the "interested person" definition, including the prohibition on independent directors owning *de minimis* amounts of securities issued by unaffiliated sub-advisers or their parent companies.

A copy of the IDC's letter is available at: https://www.ici.org/pdf/30912a.pdf.

U.S. Department of the Treasury Issues Report on Asset Management and Insurance Regulation

On October 26, 2017, the U.S. Department of the Treasury (Treasury) released a report that examined the current regulatory framework for the asset management and insurance industries and made recommendations to ensure the regulatory framework is aligned with the "Core Principles" for financial regulation established in Executive Order 13772.

The report detailed Treasury's recommendations on a number of topics including systemic risk and stress testing; liquidity risk management; regulation of derivatives usage; regulation of ETFs; business continuity and transition planning; dual registration with the SEC and the Commodity Futures Trading Commission (CFTC); disclosure requirements under the federal securities laws; and the Department of Labor's (DOL) fiduciary rule.

Systemic Risk and Stress Testing

In its report, Treasury noted that the global financial crisis raised questions about how to address financial stability and create a regulatory framework to mitigate systemic risk. Treasury recognized that, with the passage of the Dodd-Frank Act and regulatory initiatives undertaken by the Financial Stability Board and other bodies, the resulting regulatory framework focuses on the assessment of systemic risk posed by specific financial entities and employs tools, including stress testing and risk management programs, "to address entities posing a heightened risk to the stability of the financial system."

Treasury's position, according to the report, is that "entity-based systemic risk evaluations of asset managers or their funds are generally not the best approach for mitigating risks arising from asset management." Instead, Treasury recommends that federal regulators focus on "potential systemic risks arising from asset management products and activities, and on implementing regulations that strengthen the asset management industry as a whole."

The report also stated that Treasury does not support "prudential stress testing of investment advisers and investment companies as required by Dodd-Frank." To this end, Treasury supports legislative action to amend Dodd-Frank to eliminate these stress testing requirements. However, "[i]n the alternative, Treasury supports the view that the stress testing provisions of Rule 2a-7 for money market mutual funds and Rule 22e-4 on liquidity risk management programs . . . satisfy the spirit of Dodd-Frank's stress testing requirements."

Liquidity Risk Management

Treasury expressed general support for a limitation on mutual fund investments in illiquid securities, but did not agree with the SEC's regulatory approach to implementing such a limit nor the timeframe with which the SEC seeks to implement such limit. Treasury stated that it supports the 15% limitation on illiquid assets for mutual funds in Rule 22e-4 under the Investment Company Act of 1940. However, Treasury stated that it prefers that the SEC adopt a principles-based approach to liquidity risk management rulemaking and "rejects any highly prescriptive regulatory approach . . . such as the bucketing requirement." To this end, Treasury stated that the SEC "should take appropriate action to postpone the currently scheduled December 2018 implementation of Rule 22e-4's bucketing requirement."

Derivatives

Treasury expressed general support for modernizing the regulation of the use of derivatives by funds but did not agree with all elements of the SEC's proposed approach to updating the regulatory framework. Treasury stated that the SEC should consider a derivatives rule that would include a derivatives risk management program and an asset segregation requirement, but reconsider what, if any, portfolio limits should be part of the rule. Treasury also stated that the SEC should reconsider the scope of assets that would be considered qualifying coverage assets for purposes of the asset segregation requirement.

ETFs

In order to streamline the ability of entrants to access the market, Treasury recommended that the SEC move forward with a "plain-vanilla" ETF rule that allows entrants to access the market without the cost and delay of obtaining exemptive relief orders.

Business Continuity and Transition Planning

Treasury discussed the SEC's June 2016 rule proposal related to business continuity and transition plans, as well as the historical regulatory requirements related to such plans. Treasury recommended that the current SEC proposal on business continuity and transition planning be withdrawn.

Dual CFTC and SEC Registration

Treasury summarized the regulatory history requiring certain entities to register with both the SEC and the CFTC. Among Treasury's recommendations with respect to dual registration issues were the following:

- The CFTC should amend its rules to provide that an investment company registered with the SEC and its adviser are exempt from dual registration and regulation by the CFTC as a CPO. To address concerns of *de facto* commodity pools operating without sufficient oversight, Treasury stated that the CFTC and the SEC should work together to identify a single regulator for these entities, with the goal that oversight of these entities will either remain with the SEC or be transferred to the CFTC and the National Futures Association (NFA).
- The CFTC should amend its rules to exempt private funds and their advisers from registration as CPOs if the advisers are subject to regulatory oversight by the SEC. Treasury also recommended that the CFTC review and determine what, if any, exemptions should be made available for SEC-exempt reporting advisers.

Disclosure Requirements

Treasury summarized the disclosure requirements under the federal securities laws and recent efforts to modernize these requirements. Among Treasury's recommendations with respect to disclosure issues were the following:

- The SEC should finalize its proposed rule to modernize shareholder report disclosure requirements and permit the use of implied consent for electronic disclosures.
- The SEC, the CFTC, self-regulatory organizations and other regulators should work together to rationalize and harmonize the reporting regimes. Treasury recommended that duplicative forms be combined and unnecessary or inconsistent data collection be eliminated. Additionally, Treasury stated that regulators should continue to utilize structured data where appropriate.
- The SEC should prioritize annuity-related disclosure reform by proposing a rule permitting a variable annuity summary prospectus and a streamlined prospectus update, while continuing to provide

appropriate disclosure to investors. Treasury also recommended that the SEC take steps to improve the efficiency and effectiveness of the regulation of insurance products under its jurisdiction.

DOL Fiduciary Rule

Treasury believes it is appropriate to delay full implementation of the DOL's fiduciary rule until the relevant issues, including costs of the rule and exemptions, are evaluated and addressed to best serve investors, and believes that such assessment and resolution of standard of conduct issues should include participation by the SEC and other regulators. Treasury believes that the SEC and the DOL should work together to address standards of conduct for financial professionals who provide investment advice to IRA and non-IRA accounts. In addition, Treasury recommended that the SEC and the DOL engage with state insurance regulators regarding the impact of the standards of care on the annuities market.

Treasury's report is available at: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

Legislative Developments

FAIR Act Expands Safe Harbor for ETF Research Reports Published by Broker-Dealers

On October 6, 2017, the Fair Access to Investment Research Act of 2017 (FAIR Act) was signed into law. The FAIR Act directs the SEC to amend Rule 139 under the Securities Act of 1933 to expand the Rule's safe harbor to provide that an investment fund research report regarding an ETF that is published or distributed by a broker-dealer, other than a broker-dealer that is, or is affiliated with, the ETF's investment adviser, will not constitute an offer to sell the ETF's securities pursuant to an effective registration statement, even if the broker-dealer participates in the offering of the ETF's securities.

The FAIR Act provides that the expanded safe harbor may not be conditioned on a broker-dealer's initiating or re-initiating research coverage of an ETF that is engaged in a continuous distribution of shares. The FAIR Act further provides that the expanded safe harbor may not require that an ETF covered by an investment fund research report be registered under the Investment Company Act of 1940 or be a reporting company under the Securities Exchange Act of 1934 for a period longer than that required by, or have a minimum float greater that that required by, Rule 139 and SEC Forms S-3 and F-3. In addition, the FAIR Act provides that the expanded safe harbor must require self-regulatory organizations to amend applicable rules to permit broker-dealers to rely on the expanded safe harbor, and must provide that a covered investment fund research report not be subject to Section 24(b) of the 1940 Act, although such reports would be subject to the 1940 Act and related rules to the extent they are not subject to a self-regulatory organization's content standards.

The FAIR Act requires the SEC to propose an amendment to Rule 139 to expand the safe harbor in a manner consistent with the foregoing within 180 days, and to adopt a final amended Rule within 270 days, of the October 6, 2017 enactment date. Beginning 270 days after the enactment date, if the SEC has not adopted a final amended Rule 139 expanding the safe harbor, broker-dealers may rely on an interim expanded safe harbor in accordance with the terms set forth above.

Nothing in the FAIR Act limits the applicability of applicable anti-fraud provisions of the federal securities laws to investment fund research reports covered by the expanded safe harbor, nor does the FAIR Act limit the authority of self-regulatory organizations to examine or supervise their members.

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