VedderPrice

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Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes Amendments to Auditor Independence Rules to Address Certain Lending Relationships

Summary

On May 2, 2018, the SEC issued proposed amendments to its auditor independence rules concerning the independence of an audit firm that has a lending relationship with certain shareholders of an audit client. The proposed amendments seek to address the significant compliance challenges presented by the application of the so-called "Loan Provision" in the mutual fund context and certain circumstances in which, as a practical matter, an auditor's objectivity and impartiality are not impaired despite technical noncompliance with the Loan Provision. Currently, the Loan Provision generally provides that an audit firm is not independent if one of its lenders has record or beneficial ownership of more than 10% of the voting securities of a fund audit client.

The proposed amendments would:

- focus the independence analysis solely on beneficial ownership rather than on both record and beneficial ownership;
- replace the existing 10% bright-line shareholder ownership test with a "significant influence" test;
- apply a "known through reasonable inquiry" standard to the identification of beneficial owners of an audit client's equity securities; and
- amend the definition of "audit client" for a fund under audit to exclude funds that otherwise would be considered affiliates of the audit client.

Background: The Loan Provision

Rule 2-01 of Regulation S-X requires auditors to be independent of their audit clients both "in fact and in appearance." Rule 2-01(c) sets forth a nonexclusive list of circumstances that are considered inconsistent with the auditor independence standard, including the so-called Loan Provision—a restriction on certain debtor-creditor relationships. The Loan Provision generally provides that an auditor is not independent when the audit firm, any "covered person" in the firm or any of the covered person's immediate family members has a loan (including any margin loan) to or 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" (ICC), it also includes every entity within the ICC, regardless of whether the auditor actually provides audit services to those other entities. In sum, if an auditor is not independent under the Loan Provision with respect to only one fund in an ICC, no fund or other entity in the ICC can engage or retain that firm as an independent auditor.[1]

SEC Staff No-Action Relief

On June 20, 2016, the staff of the SEC's Division of Investment Management issued a no-action letter to Fidelity Management & Research Company (the Fidelity No-Action Letter),[2] temporarily addressing some of the issues that have arisen under the Loan Provision. In the Fidelity No-Action Letter, the SEC staff indicated that it would not recommend enforcement action if a registered fund or other entity in the fund's ICC employs an audit firm that has a relationship with certain lending financial institutions that might cause the audit firm not to be in compliance with the Loan Provision. The SEC staff conditioned its no-action assurances to Fidelity on certain requirements that were intended to ensure that, notwithstanding the audit firm's technical noncompliance with the Loan Provision, the firm remains objective and impartial with respect to the issues encompassed within its engagement. The relief set forth in the Fidelity No-Action Letter was to expire 18 months from the issuance date; on September 22, 2017, the SEC staff extended the no-action relief indefinitely and indicated that such relief would be "withdrawn upon the effectiveness of any amendments to the Loan Provision designed to address the concerns expressed in the [Fidelity No-Action Letter]."[3]

Proposed Amendments

Recognizing that the Loan Provision "may not be functioning as it was intended" and "presents significant practical challenges"[4] with "broader disruptive effects, particularly for funds,"[5] the SEC proposed amendments to the Loan Provision that are intended to "effectively identify those debtor-creditor relationships that could impair an auditor's objectivity and impartiality" and exclude "certain extended relationships" that pose no such risk. In so doing, the SEC also acknowledged that the Fidelity No-Action Letter "did not resolve all compliance uncertainty, was limited in scope and provided staff-level relief to the requestor based on the specific facts and circumstances in the request, and did not amend the underlying rule."

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1 Consequently, under the current rules, an auditor to one fund in the ICC must seek information regarding the record and beneficial owners of all of the other funds (and other entities) in the ICC and such owners' affiliates. As the proposing release notes, other funds in the ICC that are not being audited by the requesting audit firm are not required to provide this information and may not be willing to do so without first establishing information-sharing protocols, "all of which can require substantial time and expense incurred by auditors and funds."

2 See No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (June 20, 2016), available at: https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm

3 See No-Action Letter from the Division of Investment Management to Fidelity Management & Research Company (Sept. 22, 2017), available at: https://www.sec.gov/divisions/investment/noaction/2017/fidelity-management-research-092217-regsx-rule-2-01.htm

4 For example, the record ownership percentages of open-end funds may fluctuate within a given period for reasons beyond the control or knowledge of a lender who is also a fund shareholder of record.

5 The proposing release notes that noncompliance with the auditor independence rules could result in affected funds not being able to sell shares and funds—and indirectly, shareholders—"having to incur the cost of re-audits," because, in order for a registered open-end fund to make a continuous offering of its securities, a registered open-end fund must maintain a current prospectus by periodically filing post-effective amendments to its registration statement that contain updated financial information audited by an independent public accountant in accordance with Regulation S-X.

Beneficial Ownership-Focused

- The Loan Provision would apply only to beneficial owners of the audit client's equity securities and not holders of record.

"Significant Influence" Test Applying Qualitative Factors to Replace the 10% Bright-Line Test

- The Loan Provision's bright-line 10% test would be replaced with a "significant influence" test similar to that referenced in other parts of the auditor independence rules. According to the SEC's proposing release, "an audit firm, together with its audit client, would be required to assess whether a lender (that is also a beneficial owner of the audit client's equity securities) has the ability to exert significant influence over the audit client's operating and financial policies." In the fund context specifically, those policies would include "the fund's investment policies and day-to-day portfolio management processes, including those governing the selection, purchase and sale, and valuation of investments, and the distribution of income and capital gains" (collectively defined in the proposing release as "portfolio management processes"). In the proposing release the SEC suggests that an audit firm could assess whether significant influence over the fund's portfolio management processes exists "based on an initial evaluation of the fund's governance structure and governing documents, the manner in which its shares are held or distributed, and any contractual arrangements, among other relevant factors."
- The proposing release also advises that it is "appropriate to consider the nature of the services provided by the fund's investment adviser(s) pursuant to the terms of an advisory contract" as part of the significant influence analysis. If the adviser has significant discretion over the fund's portfolio management processes—as is typically the case—and the shareholder does not have the ability to influence those processes, "significant influence generally would not exist." The proposing release adds that the ability to vote on approving the advisory contract or a fund's fundamental policies on a pro rata basis with all fund shareholders "generally should not lead to the determination that a shareholder has significant influence."[6]
- The significant influence test is based on the "totality of the facts and circumstances," and although it would include a consideration of the lender's beneficial ownership level in an audit client's equity securities, a specific percentage ownership would not be dispositive as to independence.[7]

Rebuttable Presumption at 20% Beneficial Ownership

- Consistent with existing accounting standards, however, a lender beneficially owning 20% or more of an audit client's voting securities is presumed to have the ability to exercise significant influence, "absent predominant evidence to the contrary." Conversely, "if the ownership percentage were less than 20%, there would be a rebuttable presumption that the lender does not have significant influence over the audit client, unless it could be demonstrated that the lender has the ability to exert significant influence over the audit client."

[6] In contrast, a private fund shareholder with a side letter arrangement, for instance, that allows for participation in portfolio management processes would, according to the proposing release, likely have "significant influence."

[7] The proposing release notes that although "significant influence" is not specifically defined, the concept "has been part of the [SEC's] auditor independence rules since 2000 and has been part of the accounting standards since 1971," and thus, "is one with which audit firms and their clients are already required to be familiar" and is applicable to funds under existing auditor independence rules. "Significant influence," according to the proposing release, could be indicated in several ways, including: (i) board representation; (ii) participating in policy-making processes; (iii) material intra-entity transactions; (iv) interchange of managerial personnel; or (v) technological dependency.

Application of a "Known Through Reasonable Inquiry" Standard to Identification of Beneficial Owners of an Audit Client's Equity Securities

- The proposed amendments include a "known through reasonable inquiry" standard, whereby an audit firm, in coordination with its audit client, would be required to analyze beneficial owners of the audit client's securities who are known through reasonable inquiry. If beneficial owners are not identified through reasonable inquiry, the SEC believes it unlikely that the auditor's objectivity and impartiality would be compromised by a debtor-creditor relationship with the lender.
- In a footnote in the Fidelity No-Action Letter, the SEC staff stated that it expects funds to develop policies and procedures reasonably designed to ensure that they make a reasonable inquiry whenever shareholders vote on the election of trustees/directors, the appointment of an independent auditor or other matters that similarly could influence the objectivity and impartiality of the independent auditor. The proposed amendments do not refer to any required policies or procedures regarding "reasonable inquiry" and, other than noting that the "known through reasonable inquiry" standard would be generally consistent with regulations implementing the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934,[8] the proposing release did not identify any particular processes that may or should be implemented to satisfy the standard.

Limitation on Definition of "Audit Client"

- To seek to address compliance challenges associated with the expansive definition of "audit client" in the fund context, the proposed amendments would exclude from that definition other funds that would be considered an "affiliate of the audit client" as it relates to the Loan Provision.

The proposing release requests comment on the proposed tailoring of the Loan Provision analysis to beneficial ownership, the replacement of the 10% bright-line test with a "significant influence" test, the inclusion of a "known through reasonable inquiry" standard and other elements of the proposed amendments.

Notably, the SEC is seeking comments on other potential changes to the Loan Provision and other provisions in Rule 2-01 that the SEC considered but determined not to propose at this time. These potential changes include adding a "materiality qualifier" to the proposed significant influence test and amending the definition of "covered person"—e.g., removing immediate family members, limiting the scope of audit firm personnel captured by the definition—for purposes of the Loan Provision or elsewhere in the auditor independence rules. In addition, the SEC is seeking comment on potential changes to the operation of the auditor independence rules, including how compliance is evaluated. For instance, the SEC asks if any changes related to the frequency with which, the date as of which or circumstances under which an auditor must assess compliance with the Loan Provision or other provisions of Rule 2-01 of Regulation S-X. Finally, noting that "[t]he existing Loan Provision encompasses lending

8 The proposing release notes that the "known through reasonable inquiry" standard is generally consistent with existing provisions of the federal securities laws, including Rule 502(d) of Regulation D (reasonable inquiry to determine if a purchaser is acquiring securities for himself or for others) and Item 18 of Form N-1A (identification of each person who owns of record or is known by the fund to own beneficially 5% or more of any class of the fund's outstanding equity securities). Thus, the proposing release states that "known through reasonable inquiry" is "a concept that already should be familiar to those charged with compliance with the provision."

arrangements that may change depending upon secondary market purchases of syndicated or other debt," the SEC asks if such secondary market relationships should be taken into account or excluded from the Loan Provision and whether such relationships raise concerns about auditor independence.

The public comment period on the proposed amendments will be open until July 9, 2018.

The SEC's proposing release is available at: https://www.sec.gov/rules/proposed/2018/33-10491.pdf

SEC RELEASES STANDARD OF CONDUCT RULEMAKING PROPOSALS

SEC Proposes New Rule that Would Require Broker-Dealers to Act in Best Interest of Retail Customers

On April 18, 2018, the SEC proposed a new rule under the Securities Exchange Act of 1934—"Regulation Best Interest" (Reg. BI)—that would establish a "Best Interest" standard of conduct for broker-dealers when making securities transaction recommendations to retail customers.

General

Reg. BI would require broker-dealers, including natural persons associated with a broker-dealer, at or before the time of *recommending* any securities transaction or investment strategy involving securities to a "*retail customer*"[9] to do so without placing the financial or other interest of the broker-dealer ahead of the interest of the retail customer. Under Reg. BI, this standard would be achieved if the following three obligations are met:

1. **Disclosure Obligation.** The broker-dealer or associated person, before or at the time of making a securities recommendation, would be required to reasonably disclose in writing to the retail customer (a) the material facts relating to the scope and terms of the relationship, and (b) all material conflicts of interest[10] associated with the recommendation.
2. **Care Obligation.** The broker-dealer or associated person would be required to exercise reasonable diligence, care, skill and prudence to:

   (a) understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;

   (b) have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile[11] and the potential risks and rewards associated with the recommendation; and

   (c) have a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile.

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9 Reg. BI would define a "retail customer" as "a person, or the legal representative of such person, who: (1) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer, and (2) uses the recommendation primarily for personal, family, or household purposes."

10 The SEC proposed to interpret a "material conflict of interest" as one "that a reasonable person would expect might incline a broker-dealer—consciously or unconsciously—to make a recommendation that is not disinterested."

11 Under the proposal, "investment profile" would include, without limitation, age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance and other information.

3. **Conflict of Interest Obligation.** The broker-dealer would be required to establish, maintain and enforce written policies and procedures reasonably designed to:

   (a) identify, and disclose or eliminate, all material conflicts of interest that are associated with recommendations to retail customers[12]; and

   (b) identify, disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives associated with such recommendations.

Compliance

"Best Interest" is not defined in the proposed rule text. Compliance with the Best Interest requirement would be determined by the facts and circumstances of the particular recommendation, the particular retail customer and the application of the three obligations discussed above. Compliance would be determined only at the time a recommendation is made, and the Best Interest requirement would not continue into the future or create any requirement to monitor the suitability of the recommendation or reject a retail customer's final investment decision. Furthermore, *scienter* would not be required to establish violation of the Best Interest requirement.

In the Reg. BI proposing release, the SEC provided the following additional information regarding compliance with the three obligations under the Best Interest requirement:

1. **Disclosure Obligation Compliance.** Under the proposed rule, a broker-dealer would need to provide sufficient information to enable a retail customer to make an informed decision with regard to a recommendation. Such disclosure must be true and may not omit any material facts necessary to make the required disclosures not misleading. Disclosure should be concise, clear and understandable. No specific form or manner of written disclosure is being proposed. Investors should receive information early enough in the process to give them adequate time to consider the information received and make informed investment decisions, but not so early that the disclosure fails to provide meaningful information. Certain disclosures may be standardized, but certain recommendations may require tailored or additional disclosure. In conjunction with the proposed Best Interest rule, the SEC also proposed a rule that would require broker-dealers and investment advisers to provide to retail investors a short customer or client relationship summary using Form CRS.[12] However, use of Form CRS alone would not necessarily satisfy a broker-dealer's disclosure obligations under the proposed Best Interest rule.
2. **Care Obligation Compliance.** Under the proposed rule, a broker-dealer should generally make a reasonable effort to ascertain information regarding an existing customer's investment profile, and it must consider whether it has sufficient information, prior to the making of a recommendation. A broker-dealer would not be required to analyze all possible securities or investment strategies to find the single best investment option for the retail customer. However, broker-dealers should generally consider

[12] See the summary under "SEC Proposes New Disclosure Requirements for Financial Professionals" below.

reasonably available alternatives as part of having a reasonable basis for making the recommendation. While the cost associated with a recommended investment option generally would be an important factor, other factors (e.g., the product's or strategy's investment objectives, characteristics, liquidity, risks and potential benefits, volatility, and likely performance in a variety of market and economic conditions) should be considered in determining whether a recommendation is in the best interest of a retail customer. A broker-dealer may not simply recommend the least expensive option without further analysis of other relevant factors and the retail customer's investment profile. However, a broker-dealer would need to have a justification, based on other factors, for recommending a more expensive security or investment strategy over another reasonably available alternative. Furthermore, violation of the care obligation would not require fraud or deceit and therefore compliance could not be achieved merely through disclosure.

3. **Conflict of Interest Obligation Compliance.** In the proposing release, the SEC stated that reasonably designed policies and procedures to identify material conflicts of interest generally should:

   (a) define such material conflicts in a manner that is relevant to a broker-dealer's business and in a way that enables employees to understand and identify conflicts of interest;

   (b) establish a structure for identifying the types of material conflicts that the broker-dealer may face, including as the business evolves, and whether such conflicts arise from financial incentives;

   (c) provide for an ongoing (e.g., based on changes in the broker-dealer's business) and regular, periodic (e.g., annual) review for the identification of conflicts associated with the broker-dealer's business; and

   (d) establish training procedures regarding the broker-dealer's material conflicts of interest, how to identify such conflicts, as well as defining employees' roles and responsibilities with respect thereto.

Reg. BI would give broker-dealers flexibility to develop and tailor reasonably designed policies and procedures based on each firm's circumstances, which policies and procedures would be reviewed and modified as needed over time. The SEC also provided a list of concerns that broker-dealers should consider addressing in their conflict mitigation procedures, including the following:

- avoiding compensation thresholds that disproportionately increase compensation through incremental increases in sales;
- minimizing compensation incentives for employees to favor one type of product over another, proprietary or preferred provider products, or comparable products sold on a principal basis;
- eliminating compensation incentives within comparable product lines;
- implementing supervisory procedures to monitor recommendations that: are near compensation thresholds;

are near thresholds for firm recognition; involve higher compensating products, proprietary products or transactions in a principal capacity; or involve the rollover or transfer of assets from one type of account to another or from one product class to another;

- adjusting compensation for registered representatives who fail to adequately manage conflicts of interest; and
- limiting the types of retail customers to whom a product, transaction or strategy may be recommended.

In the proposing release, the SEC clarified that the following practices, which generally involve conflicts of interest, would not be *per se* prohibited by or compliant with the Best Interest requirement:

- charging commissions or other transaction-based fees;
- receiving or providing differential compensation based on the product sold;
- receiving third-party compensation;
- recommending proprietary products, products of affiliates or a limited range of products;
- recommending a security underwritten by the broker-dealer or a broker-dealer affiliate, including initial public offerings (IPOs);
- recommending a transaction to be executed in a principal capacity;
- recommending complex products; and
- allocating trades and research, including allocating investment opportunities (e.g., IPO allocations or proprietary research or advice) among different types of customers and between retail customers and the broker-dealer's own account.

The public comment period on Reg. BI will be open until August 7, 2018.

The proposing release for Reg. BI is available at: https://www.sec.gov/rules/proposed/2018/34-83062.pdf

SEC Proposes New Disclosure Requirements for Financial Professionals

On April 18, 2018, the SEC proposed rules that would require investment advisers and broker-dealers to provide retail investors a short customer or client relationship summary on Form CRS. Form CRS is intended to address confusion among retail investors about the nature of their relationships with investment professionals by providing them with simple, easy-to-understand information about the relationship that would supplement more detailed disclosures required of investment advisers in Form ADV and of broker-dealers by proposed Regulation Best Interest.[13]

The SEC also proposed new rules under the Investment Advisers Act of 1940 (Advisers Act) and the Securities

[13] See the summary under "SEC Proposes New Rule that Would Require Broker-Dealers to Act in Best Interest of Retail Customers" above. In addition, see "SEC Division of Investment Management Director Dalia Blass Discusses Standard of Conduct Rulemaking Proposals and Liquidity Risk Management at PLI Investment Management Institute," under "Public Statements, Press Releases and Testimony" below.

Exchange Act of 1934 (Exchange Act) to reduce investor confusion in the retail marketplace for financial services by restricting the use of term "adviser" or "advisor" by broker-dealers and their associated persons and requiring investment advisers and broker-dealers to disclose certain information about their registration status in communications with retail investors.

Form CRS

Required Information

As proposed, Form CRS would be a standardized form limited to four pages on which investment advisers and broker-dealers would disclose the following in a mixture of tabular and narrative forms:

- introductory information describing the types of services and accounts offered to retail investors;
- information about the relationships between the firm and retail investors and the advisory/brokerage services offered to such investors;
- a description of the standard of conduct applicable to the services the firm provides to retail investors;
- a summary of the fees and costs that retail investors will pay for advisory/brokerage services;
- comparisons of brokerage and investment advisory services, applicable to stand-alone broker-dealers and investment advisers;
- a summary of conflicts of interest;
- where to find additional information about legal or disciplinary events, services, fees and conflicts of interest, as well as whom to contact about complaints; and
- key questions for retail investors to ask the firm's financial professionals.

Form CRS would be required by a new Part 3 to Form ADV and Rule 204-5 under the Advisers Act for investment advisers and by Form CRS and Rule 17a-14 under the Exchange Act for broker-dealers.

Delivery and Public Disclosure Requirements

Investment advisers would include their Forms CRS in a new Part 3 to Forms ADV; broker-dealers would be required to file Forms CRS with the SEC on EDGAR. Dual registrants would be required to do both.

Investment advisers and broker-dealers would deliver Form CRS to retail investors at or before the beginning of a client relationship and when there is a material change in the nature or scope of the client relationship. Firms would also be required to deliver Form CRS to existing retail clients within a specified period after the effective date of the proposal.

Under the proposal, investment advisers would be required to make an initial delivery of the Form CRS to a new retail investor at or before the time the firm enters into an investment advisory agreement with the investor, and broker-dealers would be required to make an initial delivery at or before the time a retail investor first engages the firm's services. Initial delivery for dual registrants would be required at or before the earlier of the two deadlines.

One-time delivery to existing retail clients would be required within 30 days of the date the firm is first required to include a Form CRS in its Form ADV, in the case of an investment adviser, or within 30 days of the date the firm is first required to file a Form CRS with the SEC on EDGAR, in the case of a broker-dealer. In addition, firms would be required to deliver a Form CRS to existing retail clients at or before the time:

- a new account is opened that is different from the investor's existing account(s); or
- changes are made to the retail investor's existing account(s) that would materially change the nature and scope of the firm's relationship with the investor.

Firms would also be required to post their Forms CRS to their websites, if they have one, and to communicate any changes to retail clients without charge within 30 days after updates are required to be made. Firms would be required to update their Forms CRS whenever any information in the form becomes materially inaccurate.

Exchange Act and Advisers Act Amendments

In conjunction with Form CRS, the SEC also proposed (1) a new rule under the Exchange Act that would restrict broker-dealers and associated natural persons of broker-dealers from using the term "adviser" or "advisor" in specified circumstances when communicating with retail investors, and (2) new rules under the Exchange Act and the Advisers Act that would require investment advisers, broker-dealers and their associated natural persons and supervised persons, respectively, to disclose, in communications with retail investors, their registration status with the SEC and the relationship of any associated natural person or supervised person, as applicable, with the firm.

The public comment period will be open until August 7, 2018.

The proposing release for Form CRS and the other proposals described above, Exchange Act Release No. 83063, is available at: https://www.sec.gov/rules/proposed/2018/34-83063.pdf

SEC Issues Interpretive Guidance regarding the Standard of Conduct for Investment Advisers

On April 18, 2018, the SEC proposed an interpretation of the "federal fiduciary standard" applicable to investment advisers under Section 206(1) and (2) of the Investment Advisers Act of 1940 (Advisers Act) in connection with the proposal that same day of new Regulation Best Interest, which would establish a standard of conduct applicable to broker-dealers.[14] The proposed interpretation is intended to provide additional guidance regarding the duties of loyalty and care applicable to investment advisers and to set forth a single description of the existing components of

[14] See the summary under "SEC Proposes New Rule that Would Require Broker-Dealers to Act in Best Interest of Retail Customers" above.

the fiduciary requirements under the Advisers Act.

Duty of Care

Under the proposed interpretation, an investment adviser's duty of care would be clarified to include duties to (1) act and provide advice in a client's best interest, (2) seek best execution of client transactions in circumstances in which the investment adviser may select broker-dealers and execute trades and (3) provide ongoing advice and monitoring over the course of the investment adviser's relationship with the client. As set forth in the proposal, the duty to act in a client's best interest includes the duty to make a reasonable inquiry to determine the client's investment profile, including the client's financial circumstances, level of sophistication, investment experience and objectives, and to provide personalized advice suitable to and in the best interest of the client based upon the client's investment profile. The investment adviser must also update the client's investment profile to reflect any changed circumstances. In determining whether investment advice is in the best interest of the client, the proposal indicates that an investment adviser should consider the cost, including fees and compensation, associated with the advice, as well as the investment product's or strategy's objectives, characteristics, liquidity, risks, potential benefits, volatility and expected performance under different market and economic conditions. With respect to an investment adviser's duty to seek best execution, the proposal clarifies that "the determinative factor is not the lowest possible commission cost but whether the transaction represents that best qualitative execution."

Duty of Loyalty

As stated in the proposed interpretation, an investment adviser's duty of loyalty requires that the adviser put its client's interest first and neither favor its own interests over those of a client nor unfairly favor one client over another. "An adviser must seek to avoid conflicts of interest with its clients, and, at a minimum, make full and fair disclosure to its clients of all material conflicts of interest that could affect the advisory relationship." The proposed interpretation cautions, however, that disclosure alone "is not always sufficient to satisfy the adviser's duty of loyalty and section 206 of the Advisers Act." Disclosure must be sufficiently clear and detailed to enable a client to understand the adviser's conflicts and business practices and make a reasonably informed decision whether to consent to them. The proposal states that consent to a conflict of interest (whether affirmative or implied) would not be appropriate in circumstances in which a client does not understand the nature of the conflict or in which the material facts regarding the conflict are not fully and fairly disclosed.

Proposed Enhanced Regulation

In addition, pursuant to the proposal, the SEC is seeking comment on whether rules should be proposed to establish for investment advisers (1) federal licensing and continuing education requirements applicable to adviser representatives, (2) requirements to deliver periodic account statements and (3) certain financial responsibility requirements, which may include requirements to maintain minimum net capital levels, obtain fidelity bond coverage and/or segregate assets.

The public comment period will be open until August 7, 2018.

The proposed interpretation and request for comment described above, Advisers Act Release No. 4889, is available at: https://www.sec.gov/rules/proposed/2018/ia-4889.pdf

SEC STAFF GUIDANCE AND ALERTS

SEC Staff Issues Share Class Selection Disclosure Initiative FAQs

On May 1, 2018, the staff of the SEC's Division of Enforcement (the Division) issued guidance in the form of frequently asked questions (FAQs) relating to the Division's February 12, 2018 announcement (the Announcement) of an initiative "intended to identify and promptly remedy potential widespread violations" of federal securities laws relating to an investment adviser's selection of mutual fund share classes for clients that pay a 12b-1 fee to the adviser or its affiliates, notwithstanding the availability of a lower-cost share class of the same fund (the Initiative). As stated in the Announcement, the Division will recommend that the SEC accept "favorable settlement terms" for advisers that self-report such conduct in accordance with the Initiative. The following is a summary of the SEC staff's guidance.

- The standardized settlement terms set forth in the Announcement will apply only to the conduct identified therein and only to eligible advisers that self-report such conduct in the manner set forth in the Announcement. Eligible advisers (referred to as Self-Reporting Advisers) are advisers that (1) received 12b-1 fees in connection with recommending, purchasing or holding for advisory clients mutual fund share classes that pay 12b-1 fees when a lower-cost share class of the same fund was available and (2) failed to disclose explicitly in their Forms ADV conflicts of interest associated with the receipt of such fees.
- The Initiative applies only to conflicts associated with 12b-1 fees and not to situations in which an adviser receives other fees in connection with recommending, purchasing or holding higher cost share classes.
- There is no minimum disgorgement amount required to self-report under the Initiative.
- The Division does not plan to recommend fundamentally different settlement terms with advisers based on "the severity and scope" of the conduct. Advisers should be prepared to enter into a settlement with the SEC under the standardized settlement terms described in the Announcement.
- Advisers must self-report to the Division in the manner set forth in the Announcement and not to another division of the SEC (e.g., Office of Compliance Inspections and Examinations (OCIE)).
- Advisers that have been or are being examined by OCIE in connection with matters covered by the Initiative but, as of February 12, 2018, had received communication from the Division "regarding possible violations

related to their failures to disclose the conflicts of interest associated with mutual fund share class selection" are eligible to self-report regardless of the outcome of the OCIE exam.

- Advisers are still eligible to report under the Initiative if the Division communicated with the adviser on or after February 12, 2018. Advisers contacted by the Division before February 12, 2018 should contact the applicable staff attorney to ask whether the adviser may participate in the Initiative.
- The Initiative applies to conduct by investment advisers with respect to advisory clients regardless of the type of account in which the advisory client's mutual fund shares are held and not when the investment advisor is acting in a capacity other than "recommending, purchasing, or holding 12b-1 fee paying share classes when a lower-cost share class of the same fund was available."
- Advisers must disclose conflicts associated with both making investment decisions in consideration of 12b-1 fees to be received and selecting more expensive share classes that pay 12b-1 fees when a lower-cost share class is available. Advisers that failed to disclose either conflict or both conflicts are eligible to self-report under the Initiative.
- The Initiative applies to adviser conduct with respect to all types of funds, including adviser recommendations regarding money market funds.
- Determining whether a lower-cost share class is "available" depends on a fund-by-fund analysis. Following is a non-exhaustive list of examples the Division would likely conclude are lower-cost share classes "available" for the same fund:
  - The client met the applicable investment minimum of a lower-cost share class for the same fund and could have purchased such shares.
  - The prospectus contains or contained language stating that the investment minimum for a lower-cost share class would be waived for the same fund for advisory clients.
  - The prospectus contains or contained language stating that the investment minimum for a lower-cost share class may be waived for the same fund for advisory clients, and the adviser had no "reasonable basis" to believe such waiver would not be made. The adviser must take steps to confirm its assumption that such waiver would not be made to establish a reasonable basis for this belief.
  - The adviser purchased a lower-cost share class of the same fund for other clients who were similarly situated.
- The Division does not anticipate extending the June 12, 2018 deadline for self-reporting under the Initiative; however, an adviser must only notify the Division of its intent to participate in the Initiative by submitting, at a minimum, its name and contact information by the deadline. The adviser will then have ten business

days (subject to extension) from the date of its notification to submit the questionnaire linked to the Announcement[15] and confirm its eligibility to participate in the Initiative.

- Under the Initiative's standardized settlement terms, advisers will be required to disgorge "ill-gotten gain and prejudgment interest thereon." Advisers are required to fill out the questionnaire linked to the Announcement and a related attachment[16] providing specific 12b-1 fee data. Advisers may also submit a supplemental narrative to provide the Division with additional details regarding the adviser's disclosure failures and disgorgement intentions. Division staff would then expect to discuss with each adviser the appropriateness of the adviser's disgorgement plans as submitted.
- Whether the Division will consider an adviser's offset to its advisory fee by the amount of 12b-1 fees received in recommending the amount of disgorgement will depend on the facts and circumstances of a particular case. The Division presented two scenarios. In the first scenario, the adviser contends its management fee would have been less absent the receipt of 12b-1 fees; in this case, the Division would not expect to recommend any offset to the disgorgement. In the second scenario, the adviser's annual management fees were reduced by the amount of 12b-1 fees received; in this case, the Division may recommend offset to the disgorgement.
- The requirements of each distribution by an adviser reporting under the Initiative will be identified in an order issued by the SEC. Typically, respondents will have 60 days from the entry of an order to notify the staff of how the adviser plans to calculate and perform its distribution. As soon as the staff has reviewed the proposal, the adviser will typically have 90 days to distribute funds.
- In recommending settlement terms to the SEC, the Division stated that it would consider "the potential for significant financial ramifications to the adviser and its clients if the adviser is required to satisfy the full monetary relief within a certain period." An adviser should identify the details of any such ramifications in its narrative submitted with its questionnaire.
- Settlements recommended by the Division as a part of the Initiative will be pursuant to Section 203(e) of the Investment Advisers Act of 1940 (Advisers Act) and will require advisers to agree to a "willful" violation of the Advisers Act.
- Advisers should consult with counsel concerning any potential collateral consequences that may arise from self-reporting under the Initiative. The SEC has also set up a dedicated e-mail address (SCSDInitiave@sec.gov) to receive inquiries regarding the Initiative. The Division noted that the SEC staff cannot provide legal advice.

The FAQs are available at: https://www.sec.gov/enforce/educationhelpguidesfaqs/share-class-selection-disclosure-initiative-faqs

[15] "Share Class Selection Disclosure Initiative Questionnaire for Self-Reporting Advisers," available at: https://www.sec.gov/divisions/enforce/scsd-initiative-questionnaire.pdf

[16] The Attachment to the Questionnaire is available at: https://www.sec.gov/divisions/enforce/scsd-initiative-questionnaire-attachment.pdf

OCIE Issues Risk Alert on Advisory Fee and Expense Compliance Issues Identi ied in De iciency Letters

On April 12, 2018, the staff of the SEC's Office of Compliance Inspections and Examinations (OCIE) published a National Exam Program Risk Alert (the Risk Alert) about the most frequent advisory fee and expense compliance issues identified in deficiency letters sent to registered investment advisers. These issues were gathered from over 1,500 adviser examinations completed by OCIE staff during the past two years. The "key takeaways," according to the Risk Alert, are that registered investment advisers "should review their practices, policies, and procedures to ensure compliance with their advisory agreements and client representations in light of the fee and expense issues noted in [the] Risk Alert."

The most frequent deficiencies identified by OCIE staff relating to advisory fees and expenses were categorized as follows:

- **Fee Billing Based on Incorrect Account Values.** OCIE staff observed that advisers incorrectly valued assets in client accounts, resulting in the over-billing of asset-based advisory fees. For instance, advisers used a different valuation methodology or process than the one specified in the client's advisory agreement.
- **Billing Fees in Advance or with Improper Frequency.** OCIE staff noted discrepancies between an adviser's billing practices and the methodology set forth in a client's advisory agreement or disclosed in Form ADV Part 2. Examples noted in the Risk Alert included advisers billing on a monthly basis in situations in which the advisory agreement provides for billing on a quarterly basis, and billing in advance for an entire billing period when the advisory services commenced or terminated other than at the beginning of a billing period.
- **Applying Incorrect Fee Rate.** OCIE staff observed instances in which a client was billed at a higher rate than provided for in the advisory agreement or in which a non-qualified client was charged a performance-based fee.
- **Omitting Rebates and Applying Discounts Incorrectly.** OCIE staff observed circumstances in which advisers omitted or did not correctly apply certain discounts or rebates to a client's account, resulting in clients being overbilled. Examples identified in the Risk Alert include failure to aggregate related client accounts—which would have qualified such clients for discounted fees—and failure to reduce a client's fee rate when the value of that client's account reached a prearranged breakpoint level. Another example of an inappropriate fee practice cited in this category is charging a wrap fee program client additional fees, such as brokerage fees, when the transactions should qualify for the wrap fee program's bundled fee.
- **Disclosure Issues Involving Advisory Fees.** OCIE staff also noted issues with respect to disclosure of an adviser's fees and billing practices. For example, OCIE observed that advisers contracted for an advisory fee in a client's advisory agreement that exceeded the maximum fee rate disclosed in the Form ADV. OCIE staff also observed advisers that failed to disclose certain additional fees or markups, in addition to advisory fees,

including situations in which advisers collected expenses from a client for third-party execution and clearing services that exceeded the actual fee charged for those services by the outside clearing broker.

- **Adviser Expense Misallocations.** OCIE staff observed instances in which advisers misallocated certain expenses to clients; for example, marketing expenses, filing fees and travel expenses.

OCIE's objective in publishing the Risk Alert was "to encourage advisers to assess their advisory fee and expense practices and related disclosures to ensure that they are complying with the Advisers Act, the relevant rules, and their fiduciary duty, and review the adequacy and effectiveness of their compliance programs."

The Risk Alert concluded by noting certain remedial measures taken in response to OCIE's observations, including reimbursement of clients by the overbilled amount of advisory fees and expenses, enhancement of policies and procedures and implementation of periodic internal testing of billing practices.

The Risk Alert is available at: https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf

Public Statements, Press Releases and Testimony

SEC Division of Investment Management Director Dalia Blass Discusses Standard of Conduct Rulemaking Proposals and Liquidity Risk Management at PLI Investment Management Institute

In her remarks at the PLI Investment Management Institute 2018 in New York on April 30, 2018, SEC Division of Investment Management (IM) Director Dalia Blass discussed two IM regulatory priorities that have been the subject of recent rulemaking developments—standards of conduct for investment professionals and liquidity risk management—and emphasized that the SEC is striving "to be a responsive regulator that seeks engagement from all."

Standards of Conduct for Investment Professionals

Director Blass explained that one of the primary objectives of the standards of conduct proposals is to provide clarity to retail investors about the different types of investment professionals, how they differ, and why it matters. To that end, Director Blass asserted that the proposed "Relationship Summary" disclosure document would be an instructive tool for investors by highlighting key differences between broker-dealers and investment advisers, including as to "(1) the principal types of services offered, (2) the legal standards of conduct that apply to each, (3) the fees the customer would pay, and (4) certain conflicts of interest that may exist." Echoing her introductory point of emphasis, Director Blass asked for public comment as to any "room for improvement" with the Relationship Summary proposal and solicited input from "Main Street investors … consumer groups … financial professionals … experts in financial literacy, information design, and marketing," among others.

On the proposed Regulation Best Interest (Reg. BI)—which would create a duty under the Securities Exchange Act of 1934 for a broker-dealer to act in the best interest of its retail customer, without putting the broker-dealer's interest ahead of those of the customer—Director Blass noted that the proposal seeks "to preserve the pay-as-you-go broker-dealer model by recognizing how it differs from the investment adviser model." Acknowledging a criticism of the proposal, that it does not define the term "best interest," Director Blass said "we have defined the contours of the obligation: a broker-dealer cannot put its interests ahead of the retail customer's and must comply with specific disclosure, care and conflict of interest obligations," adding that "[a]s advisers know, a principles-based standard can serve Main Street investors well."

Director Blass also discussed how Reg. BI compares to existing standards. As to existing suitability standards for broker-dealers under FINRA rules, Blass stated that "Reg. BI incorporates, but goes beyond suitability, in that it covers disclosure, care, and conflict obligations." Blass contended that the foregoing obligations "are key enhancements that cannot be satisfied by disclosure alone, that place greater emphasis on the importance of costs and financial incentives, and that could be directly enforced by the Commission." Contrasting Reg. BI to existing advice standards, Director Blass noted that "[t]he main difference is when each of the obligations will apply … Reg. BI duties are tied to each recommendation a broker-dealer makes, whereas an adviser's fiduciary duty applies to the ongoing relationship with a client."

Finally, Director Blass explained that the proposed interpretation to clarify the standards of conduct for investment advisers is intended to "draw together a range of sources and provide advisers with a reference point for understanding their obligations to clients."

Liquidity Risk Management

The second part of Director Blass's remarks concerned the liquidity risk management rule—Rule 22e-4 under the Investment Company Act of 1940—adopted by the SEC in 2016, including recent developments concerning the rule's implementation and aspects that have been the subject of "targeted changes," such as certain public reporting requirements. (These developments have been addressed at length in prior Regulatory Updates and Vedder Price White Papers.)[17] Notably, the prominent theme in Director Blass's discussion of the liquidity risk management rule is that the SEC staff has actively engaged with industry participants and concerned parties to understand and address, among other things, "unintended consequences" and important implementation and reporting questions relating to the new rule, and where appropriate, has recommended rule modifications. In this connection, for instance, Director Blass notes that proposed changes to the rule issued by the SEC in March would create a new requirement for funds to discuss their liquidity risk management programs in their annual shareholder reports, in lieu of certain public disclosure of aggregated fund liquidity buckets.

Revisiting her opening point of emphasis for industry engagement, Director Blass concluded her remarks by observing that "[q]uality engagement was extremely valuable to our efforts on investment professional relationships and liquidity" and that such public input "is all the more valuable in the final rule recommendations that we will need to make."

The transcript of Director Blass's remarks is available at: https://www.sec.gov/news/speech/blass-remarks-pli-investment-management-institute-2018

[17] The SEC adopted the liquidity risk management rule in October 2016. For a more detailed discussion of the rule, please see the Vedder Price White Paper, "SEC Adopts New Rules Mandating Open-End Fund Liquidity Risk Management Programs and Permitting Swing Pricing," published on October 28, 2016 and available at: http://www.vedderprice.com/SEC-Adopts-New-Rules-Mandating-Open-End-Fund-Liquidity-Risk-Management-Programs-and-Permitting-Swing-Pricing-10-28-2016/

Litigation and Enforcement Actions and Initiatives

SEC ENFORCEMENT ACTIONS

SEC Reaches Settlements with Three Registered Investment Advisers on Share Class Selection Allegations

On April 6, 2018, the SEC announced that it had settled charges with three investment advisers in connection with alleged fiduciary duty breaches relating to share class selection. Summaries of the allegations and settlement terms are set forth below.

Securities America Advisors, Inc.

As described in the order relating to settlement with Securities America Advisors, Inc. (SAA), SAA, a registered investment adviser, is alleged to have invested advisory client assets in mutual fund share classes that charged 12b-1 fees even though those clients were eligible for less expensive, non-12b-1 share classes. This arrangement, which is alleged to have constituted a conflict of interest that was not adequately disclosed in SAA's Form ADV, is alleged to have resulted in SAA's affiliated broker-dealer receiving at least 12b-1 fees from advisory clients' investments in higher fee funds, a portion of which were paid to the affiliated broker-dealer's registered representatives who also acted as representatives of SAA for the relevant advisory client accounts, and to have been inconsistent with SAA's duty to seek best execution. SAA is also alleged to have failed to adopt written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (Advisers Act) and the rules thereunder in connection with its mutual fund share class selection practices. As a result, SAA is alleged to have violated Sections 206(2), 206(4) and 207 of, and Rule 206(4)-7 under, the Advisers Act.

Without admitting or denying the foregoing allegations, in settlement of the allegations, SAA agreed to be censured; to cease and desist from violating Sections 206(2), 206(4) and 207 of, and Rule 206(4)-7 under, the Advisers Act; and to pay disgorgement and prejudgment interest in an aggregate amount of over $5.0 million and a civil penalty of $775,000.

Geneos Wealth Management, Inc.

As described in the order relating to a settlement with Geneos Wealth Management, Inc. (Geneos), Geneos, a registered investment adviser and broker-dealer, is alleged to have invested advisory client assets in mutual fund share classes that charged 12b-1 fees even though those clients were eligible for less expensive, non-12b-1 share classes. This arrangement, which is alleged to have constituted a conflict of interest that was not adequately disclosed in Geneos's Form ADV, is alleged to have resulted in Geneos receiving over $1 million in 12b-1 fees from its advisory clients' investments in higher fee funds and to have been inconsistent with Geneos's duty to seek best execution. Geneos is also alleged to have failed to disclose arrangements with two third-party broker-dealers in which the broker-dealers shared with Geneos revenues received from mutual funds in the broker-dealers' no-transaction-fee mutual fund program, which arrangements resulted in approximately $386,000 in payments to

Geneos. Finally, Geneos is alleged to have failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with its mutual fund share class selection practices and revenue sharing arrangements. As a result, Geneos is alleged to have violated Sections 206(2), 206(4) and 207 of, and Rule 206(4)-7 under, the Advisers Act.

Without admitting or denying the foregoing allegations, in settlement of the allegations, Geneos agreed to be censured; to cease and desist from violating Sections 206(2), 206(4) and 207 of, and Rule 206(4)-7 under, the Advisers Act; and to pay disgorgement and prejudgment interest in an aggregate amount of over $1.5 million and a civil penalty of $250,000.

PNC Investments LLC

As described in the order relating to a settlement with PNC Investments LLC (PNCI), PNCI, a registered investment adviser and broker-dealer, is alleged to have invested advisory client assets in mutual fund share classes that charged 12b-1 fees even though those clients were eligible for less expensive, non-12b-1 share classes. This arrangement, which is alleged to have constituted a conflict of interest that was not adequately disclosed in PNCI's Form ADV, is alleged to have resulted in PNCI receiving over $5.1 million in 12b-1 fees from its advisory clients' investments in higher fee funds and to have been inconsistent with PNCI's duty to seek best execution. PNCI is also alleged to have received approximately $500,000 in marketing support payments from three mutual fund complexes, which payments would be made only when PNCI invested advisory clients' assets in share classes that charged 12b-1 fees. This arrangement is also alleged to have created an undisclosed conflict of interest. Furthermore, PNCI is alleged to have improperly charged over $105,000 in advisory fees to orphaned accounts whose adviser representative had left the firm and for which PNCI had failed to assign a new representative within 30 days. Finally, PNCI is alleged to have failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with its mutual fund share class selection practices and treatment of orphaned accounts. As a result, PNCI is alleged to have violated Sections 206(2), 206(4) and 207 of, and Rule 206(4)-7 under, the Advisers Act.

Without admitting or denying the foregoing allegations, in settlement of the allegations, PNCI agreed to be censured; to cease and desist from violating Sections 206(2), 206(4) and 207 of, and Rule 206(4)-7 under, the Advisers Act; and to pay disgorgement and prejudgment interest in an aggregate amount of over $6.4 million and a civil penalty of $900,000.

The order for SAA is available at: http://www.sec.gov/litigation/admin/2018/ia-4876.pdf

The order for Geneos is available at: http://www.sec.gov/litigation/admin/2018/34-83003.pdf

The order for PNCI is available at: http://www.sec.gov/litigation/admin/2018/34-83004.pdf

The SEC's press release summarizing these three settlements is available at: https://www.sec.gov/news/press-release/2018-62

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

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