

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

GUIDANCE AND ALERTS

OCIE Risk Alert Highlights Risks Associated with Adviser and Broker-Dealer Use of Cloud-Based Storage of Customer Records

On May 23, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) published a risk alert identifying certain security risks associated with cloud-based and other network storage solutions used by investment advisers and broker-dealers for storing electronic customer records and information. OCIE's latest risk alert is intended to encourage firms to (1) review their practices, policies and procedures for storing electronic customer information and determine whether improvements are necessary; and (2) actively monitor vendors used for network storage to assess whether the services provided are sufficient to enable the firm to satisfy its regulatory obligations.

OCIE identified the following concerns that may raise compliance issues under the Safeguards Rule of Regulation S-P and the Identity Theft Red Flags Rule of Regulation S-ID:

- **Misconfigured network storage solutions.** Failure to adequately configure security settings on the firm's network storage solution to protect against unauthorized access—often a result of ineffective oversight at the solution's initial implementation—or failure to adopt policies and procedures addressing security configurations.
- **Inadequate oversight of vendor-provided network storage solutions.** Failure to ensure—through policies, procedures, contract terms or otherwise—that security settings on vendor-provided network storage solutions were configured in accordance with the firm's standards.

- **Insufficient data classification policies and procedures.** Policies and procedures that did not identify the different types of data stored electronically by the firm and the appropriate controls for each type of data.

The risk alert also includes examples of what OCIE considers effective configuration management programs, data classification procedures and vendor management programs, such as policies and procedures designed to support the initial installation, ongoing maintenance and regular review of the firm's network storage solution.

OCIE's announcement and a link to the risk alert are available at: <https://www.sec.gov/ocie/announcement/risk-alert-network-storage>

PROPOSED RULES

FINRA Proposes Broker Misconduct Rule

On May 2, 2019, FINRA released Regulatory Notice 19-17 and proposed FINRA Rule 4111 (Restricted Firm Obligations), which would authorize FINRA to designate "Restricted Firms" based on the number of event disclosures made by the firm and its registered persons. Restricted Firms would be subject to limitations on their operations and could be required to maintain restricted deposits that could be withdrawn only with FINRA's consent. The deposit requirement would be intended to preserve funds to pay amounts awarded in future arbitrations and to pay penalties resulting from future FINRA enforcement actions and to incentivize Restricted Firms to change their behavior.

FINRA also proposed new Rule 9559, which would provide a check and balance to Rule 4111 by establishing a proceeding that would allow a Restricted Firm to challenge the imposition of that status under Rule 4111 and receive an expedited review.

The comment period for the proposals expires on July 1, 2019.

Regulatory Notice 19-17 is available at: <https://www.finra.org/industry/notices/19-17>

SEC Issues Sweeping Securities Offering Reform Proposal for Closed-End Funds

On March 20, 2019, the SEC proposed a series of reforms to the registration and offering processes for registered closed-end investment companies (Registered CEFs). The proposal responds to the SEC's congressional mandate to extend offering reforms currently available to operating companies to Registered CEFs. The proposal includes a number of rule and form amendments that would result in greater consistency between the treatment of Registered CEFs and operating companies with respect to the registration, communication and offering processes under the Securities Act of 1933.

If adopted, the proposal would:

- Streamline the shelf registration process to allow Registered CEFs to raise additional capital more quickly and efficiently;
- Allow eligible Registered CEFs to qualify as “well known seasoned issuers” (WKSIs) and thereby make use of streamlined registration, communication and offering processes comparable to those currently available to operating company WKSIs;
- Adopt a number of changes to Registered CEFs’ ongoing reporting requirements, including a new requirement to file current reports on Form 8-K; and
- Provide Registered CEFs with greater flexibility to communicate with investors in connection with securities offerings both before and after filing a registration statement.

A detailed summary of the proposal is available at: <https://www.vedderprice.com/sec-proposes-closed-end-fund-offering-reform>

OTHER SEC RELEASES

SEC Grants Exemptive Relief for Non-Transparent ETF Structure

On April 8, 2019, the SEC issued a notice of its intent to grant exemptive relief from certain provisions of the Investment Company Act of 1940 allowing Precidian Funds LLC to introduce a new type of actively-managed ETF that would not be required to publicly disclose its portfolio holdings on a daily basis. On May 20, 2019, the SEC formally granted the requested exemptive relief to Precidian, subject to the conditions described below.

Traditional ETFs operate pursuant to exemptions from the 1940 Act that allow the creation and redemption of large baskets of shares at net asset value, and the secondary trading of shares at negotiated prices. This structure creates arbitrage opportunities for certain authorized participants and facilitates the secondary market trading of shares at prices reflective of the ETF’s net asset value. However, as a condition to the exemptive relief, ETFs are required to publicly disclose portfolio investments on a daily basis. Precidian stated that it believes active managers are reluctant to use a traditional ETF structure because the daily disclosure of portfolio holdings would create opportunities to front run the ETF’s trades, replicate or free ride the ETF’s portfolio or reverse engineer the ETF’s trading strategies.

Instead of daily portfolio disclosures, Precidian will calculate and publish a verified intraday indicative value (VIIV) every second throughout the trading day. This is intended to allow retail investors to make informed decisions about

whether to buy or sell shares and to provide authorized participants with information necessary to determine whether arbitrage opportunities exist. Instead of publicly disclosing the identities and quantities of securities that comprise a creation basket, each authorized participant will maintain an unaffiliated brokerage account to which Precidian will confidentially disclose the investments that comprise a creation basket on a daily basis. Under the new structure, authorized participants will monitor the VIIV and, if arbitrage opportunities exist, order the unaffiliated broker to create or redeem shares without the authorized participant ever knowing the identities or quantities of investments that comprise a creation basket. These features are intended to protect actively-managed ETFs from other market participants front-running the ETF's trades, replicating the ETF's portfolio and reverse engineering the ETF's investment process.

As a condition to the exemptive relief, Precidian has agreed to provide certain public disclosure about how the new ETF structure differs from traditional ETFs. Such disclosure includes: (1) that the lack of portfolio transparency may increase bid-ask spreads or cause the ETF's shares to trade at a premium or discount to NAV; (2) that market participants may attempt to reverse engineer the ETF's trading strategies; and (3) a legend on the outside cover of the ETF's prospectus highlighting the differences between the ETF and a traditional ETF. In addition, Precidian has agreed to comply with the requirements of Regulation FD, to take any remedial actions necessary if the ETF does not function as anticipated and to provide the SEC with other information necessary to facilitate the SEC staff's ongoing monitoring of the ETF.

Precidian's application for exemptive relief is available at: https://www.sec.gov/Archives/edgar/data/1499655/000114420419018151/tv518160_40-appa.htm

The order granting exemptive relief is available at: <https://www.sec.gov/rules/ic/2019/ic-33477.pdf>

Public Statements, Press Releases and Testimony

Highlights from SEC Speaks 2019

On April 8-9, 2019, the SEC held its annual SEC Speaks conference in Washington, D.C., which featured remarks from the Chairman and Commissioners, discussions regarding current enforcement initiatives and priorities for the upcoming year and an update on litigation and legislative developments.

Highlights from this year's conference included:

- **Chairman and Commissioner Speeches.** Chairman Jay Clayton summarized the SEC's work over the past year, emphasizing the SEC's three-part mission to protect investors, maintain fair and efficient markets and facilitate capital formation. He discussed factors and trends impacting the SEC's operations and highlighted the SEC's recent victory in *Lorenzo v. SEC* as well as the SEC's enhanced disclosure requirements for broker-dealers and investment advisers. Commissioner Robert J. Jackson Jr. discussed key topics which have received SEC attention over the past 15 months, including Regulation Best Interest, market structure, shareholder voting and cybersecurity. He also noted areas for reevaluation and possible regulatory update, including insider trading, Form 8-K reporting and compensation disclosure. Commissioner Hester M. Peirce discussed how staff-level guidance can provide valuable assistance to market participants, highlighting the value of no-action letters, and noting difficulties that arise when staff guidance is not made public. Commissioner Elad L. Roisman discussed recent efforts of the SEC to alleviate challenges and facilitate the IPO process for small companies.
- **Enforcement Trends and Priorities Relating to Retail Investors.** Conference participants discussed the Retail Strategy Task Force's focus on affinity fraud, the Division of Enforcement's Share Class Selection Disclosure Initiative, the Division of Enforcement's actions in connection with the improper diversion of municipal bonds from retail investors to broker-dealers and areas of focus for the Complex Financial Instruments Unit, which included an increased focus on protecting retail investors in light of increasingly complex products, including certain types of ETFs.
- **Use of Data Analytics by the Division of Enforcement.** Conference participants discussed the technology used by the Complex Financial Instruments Unit, the use of data analytics at the Division of Enforcement, the importance of blue sheets for detecting violations of the securities laws and the Retail Strategy Task Force's use of data analytics to understand patterns within certain demographic groups and to study how such groups are impacted by specific types of fraud.
- **Cooperation.** Conference participants discussed the importance of cooperation in SEC settlement orders, the types of cooperation credit that can be earned, the Division of Enforcement's use of cases to send messages about the benefits of cooperation and the benefits of self-reporting.
- **Miscellaneous Enforcement Priorities and Trends.** Conference participants discussed the significance of public-company financial fraud cases, themes of the SEC's Foreign Corrupt Practices Act-related enforcement actions, the focus by the Market Abuse Unit on the accuracy of representations made in the areas of exchanges, alternative trading systems and dark pools, the types of cases that were brought within the last year by the Cyber Unit, including in connection with initial coin offerings, exchange registration, broker-dealer registration and crypto fund registration, the FCPA Unit's continued commitment to coordinating with both domestic and international law enforcement partners and the importance of cross-border enforcement cooperation and cross-border supervisory cooperation.

- **Litigation Developments.** Conference participants discussed *Lorenzo v. SEC*, its resolution of fraud issues surrounding subsections (a) and (c) of Rule 10b-5 and its impact on the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*, developments in insider trading law, including the decision in *United States v. Martoma*, as well as developments in civil penalties for insider trading, including the decision in *SEC v. Rajaratnam*, the impact of *Kokesh v. SEC* on the statute of limitations for claims seeking disgorgement and other issues surrounding disgorgement by the SEC, recent challenges to Rule 30e-3, which allows qualified mutual funds to distribute most shareholder reports online, and challenges to the appointment of administrative law judges by the SEC.

A discussion of highlights from the 2019 SEC Speaks conference with a focus on litigation and enforcement trends is available at: <https://www.vedderprice.com/highlights-from-sec-speaks-2019>

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Investment Services Group

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