Vedder Price

July 2019

Investment Services Regulatory Update

Litigation And Enforcement Actions And Initiatives

ENFORCEMENT MATTERS

SEC Chairman Jay Clayton Announces Modification to Process for Considering Contemporaneous Settlement Offers and Waiver Requests

On July 3, 2019, SEC Chairman Jay Clayton issued a statement regarding a modification to the process of considering certain settlement offers in enforcement matters that are accompanied by contemporaneous requests for waivers from statutory disqualifications and other collateral consequences. Mr. Clayton noted the SEC's long-held view that appropriate settlements may be preferable to litigation because "the sooner harmed investors are compensated, the offending conduct is remediated, and appropriate penalties are imposed, the better." With these priorities in mind, Mr. Clayton announced "that a settling entity can request that the Commission consider an offer of settlement that simultaneously addresses both the underlying enforcement action and any related collateral disqualifications."

Mr. Clayton noted that settlements with the SEC can have significant collateral consequences for the settling parties, including, among other things, the ability of a registered investment adviser to receive cash fees for solicitation under Rule 206(4)-3 under the Investment Advisers Act of 1940. These collateral consequences may be triggered by settlement provisions such as injunctions against future violations of the federal securities laws or a requirement to retain an independent compliance consultant. In light of these potentially severe consequences, the SEC often receives requests for waivers as part of the settlement negotiation process. However, the process of considering settlement offers and waiver requests has been bifurcated, with the Division of Enforcement handling settlement negotiations and the Division of Corporation Finance or the Division of Investment Management handling the "robust analysis" associated with waiver requests.

In his statement, Mr. Clayton indicated that the separation of negotiating settlements and analyzing waiver requests can result in an unnecessarily long and complex process that diminishes the investor benefits and resource preservation associated with settlement. Consequently, offers of settlement accompanied by contemporaneous waiver requests will now be presented to the SEC for consideration "as a single recommendation from the staff." Mr. Clayton stated that, in the event a settlement offer is accepted by the SEC but a simultaneous waiver request is rejected, in whole or in part, he would expect the party seeking the settlement and waiver to notify the SEC, typically within five business days, as to whether it agrees to move forward with the settlement only (i.e., without the waiver).

The full text of Mr. Clayton's statement is available here.

SEC Settles Charges against Custodian for Allegedly Overcharging Investment Company Clients

On June 27, 2019, the SEC announced that it had settled administrative proceedings against State Street Bank and Trust Company relating to allegations that State Street charged registered investment company clients for out-of-pocket expenses in connection with its custody of client assets in amounts that exceeded State Street's actual costs. The SEC alleged that in State Street's role as custodian and keeper of its clients' financial and other records, State Street violated Section 34(b) of the Investment Company Act of 1940, which prohibits making untrue statements of material fact in a fund's required records or reports, and caused violations of Section 31(a) of the 1940 Act and Rules 31a-1(a) and 31a-1(b) thereunder, which requires that a fund keep and maintain financial and other records. Without admitting or denying the SEC's findings, State Street agreed to pay disgorgement and prejudgment interest of $48.78 million, which State Street has been returning directly to the affected clients, and pay a civil penalty of $40 million. The order recognized that State Street self-reported its conduct to the SEC and provided substantial cooperation to the SEC staff during the investigation. On the same day, the Massachusetts Attorney General announced that State Street would pay a $5 million penalty to the state to resolve its investigation of the matter.

Read the SEC order here

NEW RULES, PROPOSED RULES, GUIDANCE AND ALERTS

GUIDANCE AND ALERTS

SEC Staff Provides Conditional No-Action Assurance for Index Funds Unable to Comply with Diversification Requirements Due to Large Index Constituents

On June 24, 2019, the staff of the SEC issued a no-action letter stating that it would not recommend enforcement action if an index-based fund exceeds the diversification limits of Section 5(b)(1) of the Investment Company Act of 1940 with respect to investments in individual issuers to the extent necessary to approximate the composition of the fund's index.

The request for no-action assurance was submitted on behalf of sponsors of index-based mutual funds and ETFs concerned with the growth during the past year of a few constituents of certain broad-based, float-adjusted and market capitalization-weighted large cap U.S. equity indices to each represent more than 5% of the affected index and, in the aggregate, close to, or in some cases more than, 25% of the affected index. The incoming letter asserted that the requested relief would benefit the affected funds and their shareholders by: (1) minimizing tracking error; (2) allowing each fund to be managed consistent with its investment strategy and, for an affected ETF, its exemptive relief; (3) avoiding the expense associated with a shareholder vote to convert the fund to non-diversified status; and (4) avoiding portfolio management disruption.

To rely on the SEC staff's no-action position, an index-based fund must: (1) update its registration statement to reflect the fund's ability to exceed Section 5(b)(1)'s diversification limits and describe the associated risks; and (2) provide notice of the fund's updated diversification policy to shareholders. The no-action relief concerns specifically—and therefore, should be understood as being limited to—a fund that seeks to track the performance of a broad-based index created by an unaffiliated index provider not solely for the fund's use by investing all or substantially all of its assets in securities that comprise the index in approximately the same proportion as those securities are weighted in the index.

Read the SEC staff's no-action letter here

Read the incoming letter here

NEW RULES

SEC Adopts Amendments to Loan Provision of Auditor Independence Rules

Rule 2-01 of Regulation S-X currently 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. Among these is the so-called "Loan Provision," which 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 a margin loan) to or from record or beneficial owners of 10 percent or more of an audit client's equity securities. For this purpose, "audit client" is defined to include any affiliate of the audit client and, with respect to a registered investment company, any other entity in the same investment company complex—regardless of whether the auditor actually provides audit services to those other entities. Accordingly, if an auditor is not independent under the Loan Provision with respect to one registered fund, the auditor is technically prohibited from serving as an independent auditor to any fund or entity in the same complex.

On June 18, 2019, the SEC adopted amendments to Rule 2-01 of Regulation S-X to address the significant compliance challenges presented by the application of the Loan Provision in the investment company context in certain circumstances in which, as a practical matter, an auditor's objectivity and impartiality are not impaired despite technical noncompliance with the Loan Provision.

The SEC adopted the amendments largely as proposed, with a few exceptions.

Beneficial Ownership-Focus. As amended, the Loan Provision will 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 Percent Bright-Line Test. The Loan Provision's 10 percent test will be replaced with a "significant influence" test similar to that referenced in other parts of the auditor independence rules, including ASC Topic 353. Under this test, the audit firm and audit client must 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," including investment policies and portfolio management processes. According to guidance set forth in the adopting release, a fund shareholder would typically not have this ability if the fund's adviser has significant discretion over the fund's portfolio management process, which is typically the case.

Rebuttable Presumption at 20 Percent Beneficial Ownership. Consistent with existing accounting standards, a lender beneficially owning 20 percent or more of an audit client's voting securities will be presumed to have the ability to exercise significant influence, absent predominant evidence to the contrary. Conversely, if the ownership percentage is less than 20 percent, there will be a rebuttable presumption against significant influence.

Application of a "Known Through Reasonable Inquiry" Standard to Identification of Beneficial Owners of an Audit Client's Equity Securities. The 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 that are known through reasonable inquiry.

Definitions of "Fund" and "Audit Client." For purposes of the Loan Provision, the amendments define "fund" as excluding commodity pools and define "audit client" as excluding foreign funds and other funds that would be considered an affiliate of the audit client.

Prior to the adoption of the amendments described above, the staff of the SEC's Division of Investment Management provided conditional no-action relief from the Loan Provision, which temporarily covered many of the issues addressed by the amendments. Upon effectiveness of the amendments, this no-action relief will be withdrawn.

The amendments will become effective on October 3, 2019.

Read the SEC's adopting release here.

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Investment Services Group

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

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