VedderPrice

October 2017

Investment Services Regulatory Update

New Rules, Propsed Rules, Guidance and Alerts

SEC STAFF GUIDANCE AND ALERTS

SEC Staff Extends No-Action Relief on Auditor Independence and the "Loan Provision"

On September 22, 2017, the staff of the SEC's Division of Investment Management (the Staff) issued a follow-up no-action letter (the Follow-Up Letter) to Fidelity Management & Research Company (FMR) extending its previous assurances, set forth in a letter dated June 20, 2016 (the Initial Letter), that, subject to certain conditions set forth in the Initial Letter, it would not recommend enforcement action to the SEC if a registered fund or other entity (a Fidelity Entity) in its "investment company complex" (as defined by Regulation S-X) employs a registered public accounting firm (an Audit Firm) that has relationships causing non-compliance with certain independence requirements under the so-called "Loan Provision."

Noting that the no-action assurances provided in the Initial Letter were temporary and expire eighteen months from issuance, the Follow-Up Letter states simply "[w]e now extend such assurances." However, the Follow-Up Letter notes that it "will be withdrawn upon the effectiveness of any amendments to the Loan Provision designed to address the concerns expressed in the [Initial Letter]."

Background

Rule 2-01(c) of Regulation S-X sets forth a non-exclusive list of circumstances that are considered inconsistent with an Audit Firm's independence, including the Loan Provision. The Loan Provision provides that an Audit Firm is not independent when the Audit Firm has a loan from "record or beneficial owners of more than ten percent of the audit client's equity securities." An "audit client," in turn, is defined to include any affiliate of the audit client and, when the audit client is an entity within an "investment company complex," it also includes every entity within the investment company complex, regardless of whether the Audit Firm actually provides audit services to those other entities.

FMR's initial request for no-action relief referred to discussions with Audit Firms about the "scope of their lending relationships," and identified "one or more of the following circumstances, each of which could have potential implications under the Loan Provision" (collectively, Lending Relationships):

- An institution that has a lending relationship with an Audit Firm holds of record, for the benefit of its clients or customers (for example, as an omnibus account holder or custodian), more than 10% of the shares of a Fidelity Entity;
- An insurance company that has a lending relationship with an Audit Firm holds more than 10% of the shares of a Fidelity Entity (in this case, a Fidelity registered fund) in separate accounts that it maintains on behalf of its insurance contract holders;
- An institution that has a lending relationship with an Audit Firm acts as an authorized participant or market maker to a Fidelity exchange-traded fund and holds of record or beneficially more than 10% of the shares of a Fidelity Entity.

Temporary No-Action Assurances Provided by the Initial Letter

As noted, the staff provided no-action relief in the Initial Letter to a Fidelity Entity that employs an Audit Firm that has a Lending Relationship causing non-compliance with the Loan Provision for a period of 18 months from issuance.

The SEC staff conditioned its temporary no-action assurances on the following requirements:

(1) the Audit Firm has complied with Public Company Accounting Oversight Board (PCAOB) Rule 3526(b)(1) and (2) (the provision governing independence communications), or, with respect to any Fidelity Entity to which Rule 3526 does not apply, has provided substantially equivalent communications;

(2) the non-compliance of the Audit Firm is with respect to the Lending Relationships; and

(3) notwithstanding such non-compliance, the Audit Firm has concluded that it is objective and impartial with respect to the issues encompassed within its engagement.

In granting the temporary no-action relief, the SEC staff cited the Audit Firm's representation to FMR that, notwithstanding the Firm's non-compliance with the Loan Provision due to a Lending Relationship, following an evaluation of the impact of this lending relationship on its independence, the Audit Firm has been able to maintain its impartiality and objectivity with respect to the planning for and execution of the Fidelity funds' audits, emphasizing, among other things, that the institution with which it has a lending relationship is not able to impact the impartiality of the Audit Firm or assert any influence over the Fidelity fund whose shares the institution owned or its investment adviser. Also important to the SEC staff in this regard was FMR's representation that "[t]hose responsible for the oversight of the Fidelity funds have not reached a different conclusion with respect to the Audit Firm's objectivity and impartiality."

Notably, the Initial Letter indicated that more stringent requirements are needed in connection with certain shareholder votes. If shareholders are voting on: (1) the election of trustees or directors; (2) the appointment of an independent auditor; or (3) "other matters that similarly could influence the objectivity and impartiality of the independent auditor," the Fidelity Entity must make "reasonable inquiry" as of the record date of the shareholder meeting regarding the impact of the Loan Provision. Reasonable inquiry could include the review of available ownership records and contacting applicable owners to inquire whether a lending institution in a Lending Relationship owns of record or beneficially more than 10% of the shares of a Fidelity Entity. FMR represented that if the reasonable inquiry reveals that an institution in a Lending Relationship can exercise discretionary voting authority with respect to at least 10% of the Fidelity Entity's shares, the Fidelity Entity would not rely on the relief granted by the staff in the no-action letter and would instead take "other appropriate action, consistent with its obligations under the federal securities laws."

The SEC staff concluded that it would not object to a Fidelity Entity relying on an audit opinion from an Audit Firm "that has identified a failure" to comply with the Loan Provision, "where the failure to comply with the Loan Provision is limited to the Lending Relationships, including making a reasonable inquiry, as described within this letter and where the Audit Firm's judgment remains objective and impartial."

The Initial Letter is available at:
https://www.sec.gov/divisions/investment/noaction/2016/fidelity-management-research-company-062016.htm

The Follow-Up Letter is available at:
https://www.sec.gov/divisions/investment/noaction/2017/fidelity-management-research-092217-regsx-rule-2-01.htm

OCIE Identifies Most Common Advertising Compliance Issues

Through a risk alert issued September 14, 2017, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) provided a list of the most frequent compliance issues relating to Rule 206(4)-1 under the Investment Advisers Act of 1940 (the Advertising Rule) identified in connection with an examination initiative OCIE conducted in 2016 that focused on the use by investment advisers of accolades in marketing materials. The Advertising Rule generally prohibits an investment adviser, directly or indirectly, from publishing, circulating or distributing any advertisement that contains an untrue statement of material fact or that is otherwise false or misleading. The Advertising Rule broadly defines "advertising" to include any type of written communication addressed to more than one person, as well as any notice or announcement by radio or television, to be used in making a determination to buy or sell a security.

According to OCIE, the most frequent compliance issues relating to the Advertising Rule involved: (1) the presentation of misleading performance results, including the presentation of performance results without deducting advisory fees, the failure to disclose material limitations in benchmark comparisons and the use of hypothetical and back-tested performance results without sufficiently disclosing how the results were derived; (2) misleading one-on-one presentations subject to the Advertising Rule, particularly relating to the presentation of performance results

without deducting advisory fees; (3) misleading claims that materials comply with voluntary performance standards such as the Global Investment Performance Standards (GIPS®); (4) the use of materials containing “cherry-picked” trades, such as materials referring only to profitable stock recommendations; (5) misleading references to third-party rankings and awards, including circumstances in which the ranking or award is stale or the materials fail to note the relevant selection criteria; and (6) misleading uses of professional designations and client testimonials. OCIE also observed investment advisers that did not appear to have adequate compliance policies and procedures in place reasonably designed to prevent deficient advertising practices, particularly with respect to the process of reviewing and approving advertising materials before distribution, confirming the accuracy of performance results and, when using composite performance results, determining the parameters for including and excluding accounts.

OCIE’s risk alert is available at: https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf

Public Statements, Press Releases and Testimony

PUBLIC STATEMENTS

SEC Chairman Clayton Issues Statements Regarding 2016 Cyber Intrusion of EDGAR System

In September 2017, SEC Chairman Jay Clayton issued a public statement on cybersecurity that described a cyber hacking incident involving an intrusion into the SEC’s EDGAR test filing system in 2016 in which a third party exploited a software weakness to gain access to nonpublic information that may have provided the basis for illicit trading gains. Chairman Clayton stated that the weakness was patched “promptly after discovery.” In October 2017, Chairman Clayton provided an update to the September statement, noting that the SEC staff’s ongoing investigation of the 2016 incident revealed that one of the test filings accessed by the perpetrators included the names, dates of birth and social security numbers of two individuals. The press release containing the update stated that the SEC staff was reaching out to the two affected individuals to notify them of the breach and to offer them identify theft protection and monitoring services. The press release further indicated that the same procedures would be followed should it be discovered that any additional individuals were affected.

Chairman Clayton’s September statement also outlined the various cybersecurity risks faced by the SEC, noting that in May 2017 the SEC initiated an assessment of its internal cybersecurity risk profile and its approach to cybersecurity from the perspective of its regulatory and oversight functions. In the September statement, Chairman Clayton noted that the SEC receives, stores and transmits data in three broad categories—public-facing data in the form of publicly available filings; nonpublic information, including personally identifiable information, related to supervisory and enforcement functions; and nonpublic information, including personally identifiable information, related to the SEC’s internal operations. Chairman Clayton stated that the SEC is subject to frequent attempts by unauthorized actors to disrupt access to public-facing systems, access its data or cause other damage to its technological infrastructure. In particular, he noted that the EDGAR system is subject to risks involving attempts by cyber actors to compromise credentials of authorized users, gain access to data, submit fraudulent filings

and prevent public access through denial-of-service attacks. He further noted that the SEC faces risks involving actors seeking to gain access to nonpublic information relative to its oversight and enforcement functions that could be used as a means to obtain illicit trading gains. Chairman Clayton further noted that the SEC is subject to cybersecurity risk in connection with its use of outside vendors as well as risks related to unauthorized actions or disclosures by its own personnel.

Chairman Clayton noted that the SEC employs an agency-wide cybersecurity detection, protection and prevention program in light of the nature of the data it obtains and stores and the cyber-related threats it faces. He stated that the program includes cybersecurity protocols and controls, network protections, system monitoring and detection processes, vendor risk management and training for employees and is subject to periodic independent audits and reviews. Chairman Clayton noted the creation of a senior-level cybersecurity working group to coordinate information sharing, risk monitoring and incident response efforts. He also described the SEC's coordination efforts with other government entities as well as non-U.S. regulators on cyber matters, and noted the use by the SEC of its enforcement power both to ensure that market participants comply with their disclosure obligations regarding cybersecurity risks and "to vigorously pursue cyber threat actors who seek to harm investors and our markets."

In a press release issued in connection with his September 2017 statement, Chairman Clayton stated that "[c]ybersecurity is critical to the operations of our markets and the risks are significant and, in many cases, systematic," further noting that "[w]e must be vigilant," and that "[w]e also must recognize—in both the public and private sectors, including the SEC—that there will be intrusions, and that a key component of cyber risk management is resilience and recovery."

In October 2017, updating his September statement, Chairman Clayton described the steps the SEC has taken to improve the cybersecurity risk profile of the EDGAR system, which included a review of the 2016 intrusion by the Office of Inspector General, an investigation by the Division of Enforcement into potential illicit trading, modernization of the EDGAR system, a general assessment of the agency's cybersecurity risk profile and an internal review of the response to the 2016 intrusion. Chairman Clayton also noted that the SEC has plans to hire additional staff and to retain outside technology consultants and that a review is underway of the types of data the SEC takes in through its EDGAR system. "The 2016 intrusion and its ramifications concern me deeply," he said. "I am focused on getting to the bottom of the matter and, importantly, lifting our cybersecurity efforts moving forward."

Chairman Clayton's September 2017 public statement on cybersecurity is available at:
https://www.sec.gov/news/public-statement/statement-clayton-2017-09-20

The SEC's press release relating to Chairman Clayton's September 2017 public statement is available at:
https://www.sec.gov/news/press-release/2017-170

The SEC's press release relating to the October 2017 update to Chairman Clayton's public statement is available at:
https://www.sec.gov/news/press-release/2017-186

PRESS RELEASES

SEC's Enforcement Division Announces Creation of Cyber Unit in Effort to Address Cyber-Based Threats

On September 25, 2017, the SEC announced the creation of a dedicated Cyber Unit within the Enforcement Division, which will focus on targeting cyber-related misconduct. The announcement comes on the heels of the recently disclosed 2016 hack of the SEC's EDGAR system that resulted in illicit trades on the basis of nonpublic information and included personal information of two individuals. According to the SEC's press release, the Cyber Unit has been in the planning stages for months. Robert A. Cohen, who has served as Co-Chief of the Market Abuse Unit since 2015, has been appointed Chief of the Cyber Unit. The Cyber Unit will include staff from across the Enforcement Division.

The SEC's press release states that in creating the Cyber Unit, the SEC seeks to leverage the Enforcement Division's expertise on targeting cyber-related misconduct and complement Chairman Jay Clayton's parallel initiative to implement an internal cybersecurity risk profile. Specifically, according to the press release, the Cyber Unit will target various types of cyber-related misconduct, including, but not limited to: (i) hacking to obtain material nonpublic information, (ii) market manipulation schemes where false or misleading information is spread on social media, (iii) violations involving distributed ledger technology, (iv) violations on the dark web, (v) hacks into retail brokerage accounts and (vi) cyber threats to trading platforms and other market infrastructure. The Cyber Unit will consolidate the Enforcement Division's recent focus on cybersecurity enforcement challenges, as reflected by the dedicated Cybersecurity page on the SEC website that compiles investor alerts, enforcement actions and other SEC resources relating to cybersecurity.

The SEC's press release announcing the creation of the Cyber Unit is available at:
https://www.sec.gov/news/press-release/2017-176

More information on the SEC's cybersecurity efforts is available at: https://www.sec.gov/spotlight/cybersecurity

Market and Product Developments

SEC Approves Three-Month Delay to New Continued Listing Standards for ETFs

On September 29, 2017, the SEC approved a proposed rule change (the Extension Proposals) filed by each of The NASDAQ Stock Market LLC, NYSE Arca, Inc., and Bats BZX Exchange, Inc. (the Exchanges) to delay until January 1, 2018 the implementation date of new continued listing requirements applicable to index ETFs listed in reliance on each Exchange's generic listing standards as well as to index and actively managed ETFs listed pursuant to specific Rule 19b-4 orders (non-generically-listed ETFs). The Exchanges submitted the Extension Proposals just a few days before the October 1, 2017 implementation date in light of concerns that issuers of listed ETFs did not have appropriate procedures and systems in place to monitor and ensure compliance with the new continued

listing standards, violation of which could lead to delisting. Pursuant to its authority under Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and Rule 19b-4(f)(6) thereunder, the SEC designated the Extension Proposals to become effective upon filing, allowing the Exchanges to immediately extend the implementation date and ETF issuers to avoid any potential disruption in the trading of their products.

By way of background, in 2016, the SEC approved generic listing standards applicable to actively managed ETFs for each of the Exchanges. Unlike the generic listing standards for index ETFs in effect at the time, which applied only at the time of initial listing, the generic listing standards for actively managed ETFs apply on a continuous basis. Accordingly, in connection with approving the continued listing standards for actively managed ETFs, the SEC staff requested that the Exchanges submit proposals to amend the generic listing standards for index ETFs to include a similar continued listing standard. The staff also requested that the Exchanges include rule changes to require issuers of non-generically-listed ETFs to comply on a continuous basis with certain representations included in their respective Rule 19b-4 orders. The Exchanges filed separate proposals with the SEC between September 2016 and January 2017. The SEC approved each Exchange's proposal in substantially the form proposed by mid-March 2017.

Industry participants identified a number of challenges that certain ETF issuers may face in connection with the new continued listing standards, including: (1) that the listing standards would require issuers to develop significant compliance enhancements within a short timeframe; (2) that certain requirements related to circumstances or events outside of an issuer's control, requiring discussions and negotiations with third parties such as index providers; and (3) that the listing standards, as adopted, lacked clarity in some respects, and that additional interpretive guidance from the Exchanges was necessary.

In light of industry concerns regarding the ability of ETF issuers, in particular issuers of index ETFs, to build and test new compliance systems and procedures in advance of the previously anticipated October 1, 2017 implementation date, each Exchange filed a proposal to delay the effectiveness of the continued listing standards for nine months. As the SEC had not taken action by late September, the Exchanges withdrew their requests to extend implementation by nine months and submitted new proposals to extend the effective date by only three months to January 1, 2018. The SEC accepted these proposals and made them effective upon filing. At the same time, Nasdaq and Bats issued frequently asked questions, intended to provide guidance for issuers of index ETFs with respect to the continued listing standards. The Exchanges indicated that the FAQs will be updated, as needed, based on continuing conversations with issuers about the rule amendments.[1]

The SEC notices of filing for the Extension Proposals are available as follows:

Nasdaq: https://www.sec.gov/rules/sro/nasdaq/2017/34-81773.pdf

NYSE Arca: https://www.sec.gov/rules/sro/nysearca/2017/34-81775.pdf

Bats: https://www.sec.gov/rules/sro/batsbzx/2017/34-81777.pdf

1 The FAQs are available as follows:
Nasdaq: https://listingcenter.nasdaq.com/ViewPDF.aspx?Material_Search.aspx?mcd=LQ&cid=142&years=2017,2016,2015,2017,2016,2015,2014,2013,2012,2011,2010,2009,2008,2007,2006,2005,2004,2003,2002&sub_cid=&searchkeywords=&exactsearchddvalue=1&Print=N&materials=0&popularfl=

Bats: http://cdn.batstrading.com/resources/listings/FAQs%20-%20New%20Cont%20List%20Standards%20FINAL.pdf

Litigation and Enforcement Actions

SEC ENFORCEMENT ACTIONS

SEC Charges Adviser with Improperly Recommending Higher-Fee Mutual Funds

On September 14, 2017, the SEC settled charges against SunTrust Investment Services (SunTrust), a dual registered broker-dealer and investment adviser, related to SunTrust's collection of more than $1.1 million in allegedly improper fees over the course of approximately 3.5 years, from clients who invested via either discretionary or nondiscretionary wrap fee investment accounts offered through certain SunTrust advisory programs. The SEC made several allegations: (1) SunTrust and its registered representatives inappropriately invested client assets into certain mutual fund share classes when share classes with lower fees were available; (2) SunTrust did not adequately disclose the potential conflicts of interest presented by such share class selection; and (3) SunTrust's policies and procedures were not reasonably designed to prevent violations of the federal securities laws in connection with such share class selection. SunTrust's conduct was discovered during an SEC compliance exam and referred to SEC enforcement. SunTrust began reimbursing affected clients, with interest, prior to the SEC's enforcement investigation.

The SEC alleged that SunTrust's registered representatives, for SunTrust's advisory clients, purchased, recommended or held Class A shares of certain mutual funds when Class I shares of the same funds were available. Class A shares have 12b-1 fees, which are ongoing marketing and distribution fees, whereas Class I shares have no such fees.

The SEC further alleged that SunTrust did not adequately inform its advisory clients of the conflicts of interest presented by the share class selection and the receipt by SunTrust and its registered representatives of the 12b-1 fees. SunTrust disclosed in its Form ADV Part 2A brochures that SunTrust "may" receive 12b-1 fees as a result of investments in certain mutual funds and that such fees presented a "conflict of interest." However, the SEC stated that neither the Form ADV Part 2A brochures nor SunTrust's other disclosure documents stated that many mutual funds offered shares that did not charge 12b-1 fees. Further, the SEC alleged that none of SunTrust's disclosures stated that a SunTrust registered representative could purchase, hold or recommend—and sometimes did purchase, hold or recommend—mutual fund investments in share classes that paid 12b-1 fees to SunTrust, which SunTrust ultimately shared with its registered representatives as compensation, even though such clients also were eligible to invest in share classes of the same mutual funds that did not charge such fees and were less expensive.

The SEC order stated that, over time as Class I shares became increasingly available to non-institutional investors, SunTrust did not update its compliance policies and procedures to require its registered representatives to identify or evaluate available institutional share classes. Further, the SEC alleges that SunTrust did not update or enhance its policies or procedures to address instances where its registered representatives were recommending, purchasing or holding Class A shares when less costly Class I shares were available. As a result, the SEC alleged that SunTrust

failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws in connection with the share class selections of its registered representatives.

The SEC's order found that SunTrust violated Sections 206(2), 206(4) and 207 of the Investment Advisers Act of 1940 and Rule 206(4)-7. Without admitting or denying the findings, SunTrust agreed to pay the penalty totaling $1,148,071.77 as well as disgorgement plus interest on any leftover amount of the avoidable 12b-1 fees that were refunded to clients. The firm also agreed to be censured.

The SEC's order is available at: http://www.sec.gov/litigation/admin/2017/34-81611.pdf

Investment Services Group Members

Chicago

Cathy G. O'Kelly, *Co-Chair* .... +1 (312) 609 7657
Juan M. Arciniegas .... +1 (312) 609 7655
James A. Arpaia .... +1 (312) 609 7618
Deborah B. Eades .... +1 (312) 609 7661
Renee M. Hardt .... +1 (312) 609 7616
Joseph M. Mannon .... +1 (312) 609 7883
John S. Marten, *Editor* .... +1 (312) 609 7753
Maureen A. Miller .... +1 (312) 609 7699
David A. Sturms .... +1 (312) 609 7589
Junaid A. Zubairi .... +1 (312) 609 7720
Heidemarie Gregoriev .... +1 (312) 609 7817
Nathaniel Segal, *Editor* .... +1 (312) 609 7747
Adam S. Goldman .... +1 (312) 609 7731
Travis N. Moyer .... +1 (312) 609 7739
Mark Quade .... +1 (312) 609 7515
Jacob C. Tiedt, *Editor* .... +1 (312) 609 7697
Cody J. Vitello .... +1 (312) 609 7816
Jeff VonDruska .... +1 (312) 609 7563
Jake W. Wiesen .... +1 (312) 609 7838

New York

W. Thomas Conner .... +1 (202) 312 3331
Joel S. Forman .... +1 (212) 407 7775
Luisa M. Lewis .... +1 (212) 407 7795

Washington, DC

Bruce A. Rosenblum, *Co-Chair* ...... +1 (202) 312 3379
Brendan R. Hamill .... +1 (202) 312 3010
Emily T. Rubino .... +1 (202) 312 3385

London

Richard Thomas .... +44 (0)20 3667 2930
Sam Tyfield .... +44 (0)20 3667 2940

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.

VedderPrice

Chicago New York Washington, DC London San Francisco Los Angeles Singapore
vedderprice.com

This Regulatory Update is only a summary of recent information and should not be construed as legal advice.

This communication is published periodically by the law firm of Vedder Price. It is intended to keep our clients and other interested parties generally informed about developments in this area of law. It is not a substitute for professional advice. For purposes of the New York State Bar Rules, this communication may be considered ATTORNEY ADVERTISING. Prior results do not guarantee a similar outcome.

Vedder Price P.C. is affiliated with Vedder Price LLP, which operates in England and Wales, and with Vedder Price (CA), LLP, which operates in California, and Vedder Price Pte. Ltd., which operates in Singapore.

© 2017 Vedder Price. Reproduction of this content is permitted only with credit to Vedder Price.