VedderPrice

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Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

SEC STAFF GUIDANCE AND ALERTS

SEC Staff No-Action Letter Allows Fund Boards to Rely on CCO Representations for Affiliated Transactions

In a no-action letter to the Independent Directors Council (IDC) dated October 12, 2018, the staff of the SEC's Division of Investment Management stated it would not recommend enforcement action for violations of Sections 10(f), 17(a) or 17(e) of the Investment Company Act of 1940, if a fund's board of directors receives, no less frequently than quarterly, a written representation from the fund's chief compliance officer that transactions effected in reliance on Rules 10f-3,[1] 17a-7[2] or 17e-1[3] under the 1940 Act complied with procedures adopted by the board pursuant to the relevant exemptive rule, instead of the board itself determining compliance. In providing no-action assurance, the SEC staff noted the significant growth in the number and scope of director responsibilities resulting from market, regulatory and technological developments. With this backdrop, the SEC staff has undertaken a review of existing director responsibilities to consider whether they are appropriate and exercised in a manner that serves the shareholders' best interests.[4]

According to the SEC staff, its no-action position regarding board oversight of affiliated transactions is consistent with the SEC's approach in adopting Rule 38a-1 under the 1940 Act—the fund compliance program rule—which, among other things, assigns responsibility for the administration of the compliance program to the fund CCO. The proper role of the board, in contrast, is to oversee the fund's compliance program without becoming involved in the day-to-day administration of the program. Further to this point, the SEC staff agreed with the IDC's assertion that the no-action position would allow fund boards to avoid duplicating certain functions commonly performed by, or under the supervision of, fund CCOs.

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1 Rule 10f-3 exempts from the prohibitions of Section 10(f) of the 1940 Act certain securities purchases during the existence of an underwriting syndicate of which an affiliated person is a member. Section 10(f) generally prohibits any fund from knowingly purchasing or otherwise acquiring, during the existence of an underwriting or selling syndicate, any security (other than a security of which the fund is the issuer) a principal underwriter of which is one of the certain affiliated persons (as that term is defined in Section 2(a)(3) of the 1940 Act) of the fund, or affiliated persons of such affiliated persons of the fund.

2 Rule 17a-7 provides exemptive relief for funds seeking to engage in "cross trades"—i.e., purchase or sale transactions between affiliated funds, or between funds and other advisory accounts affiliated solely by reason of having a common investment adviser, common directors and/or officers—which are otherwise prohibited by Section 17(a) of the 1940 Act.

3 Rule 17e-1 defines when commissions or fees paid to affiliated brokers will be deemed not to exceed the usual and customary brokerage commission for purposes of Section 17(e)(2)(A) of the 1940 Act. Section 17(e)(2)(A) generally prohibits an affiliated person of a fund, or an affiliated person of such affiliated person, acting as broker, in connection with the sale of securities to or by such fund or any controlled company thereof, from receiving from any source a commission, fee, or other remuneration for effecting such transaction, which exceeds the usual and customary broker's commission if the sale is effected on a securities exchange.

4 *See* Dalia Blass, Director, Division of Investment Management, SEC, Keynote Address: ICI Securities Law Developments Conference (Dec. 7, 2017), available at: https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017.

The SEC staff's no-action letter to the IDC is available at: https://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218.htm

The IDC's request for the no-action position is available at: https://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218-incoming.pdf

Public Statements, Press Releases and Testimony

TESTIMONY

Testimony of Dalia Blass Before the House Subcommittee on Capital Markets, Securities and Investment

On September 26, 2018, Dalia Blass, Director of the SEC's Division of Investment Management, testified before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets, Securities and Investment on various regulatory initiatives and policy objectives recently undertaken or under consideration by the Division staff intended to, among other things, improve the retail investor experience and modernize the regulatory framework.

Of note, Ms. Blass stated that the Division is considering whether to propose rules to improve disclosure regarding variable insurance products, noting that these products, which have both investment and insurance features, are generally more complex than other retail investment products. Ms. Blass stated that the Division may recommend a new summary prospectus for variable insurance products to help investors better understand applicable costs and risks.

Noting the SEC's 2015 proposal for a new exemptive rule relating to the use of derivatives by registered funds, which was not adopted, Ms. Blass stated that the Division is considering whether to re-propose a new derivatives rule that would be "designed to enhance and modernize the regulatory framework." Other topics Ms. Blass discussed included, among other things, offering modernization for BDCs and closed-end funds, potential amendments to the marketing rules under the Investment Advisers Act of 1940, the recently proposed ETF rule, the Division's fund board outreach initiative and cryptocurrency-related funds.

Ms. Blass' testimony is available at: https://www.sec.gov/news/testimony/testimony-2018-09-26-blass

SPEECHES

Stephanie Avakian, Co-Director of the SEC's Division of Enforcement, Assesses the Effectiveness of the SEC's Enforcement Program

On September 20, 2018, the SEC's Co-Director of Enforcement, Stephanie Avakian, delivered a speech assessing the effectiveness of the SEC's enforcement program. Ms. Avakian stated that a qualitative assessment of the Division's effectiveness makes clear that the SEC's enforcement program had a strong year, with enforcement actions that "addressed a wide array of conduct and spanned a broad landscape." Ms. Avakian also pointed to the breadth of the

Division's investor protection mandate as compared to the Division's resources, stating that the "wide gulf between our resources and our responsibilities translates into a need to think very carefully about how we allocate resources." Ms. Avakian asserted that an evaluation of the enforcement program based solely on the numbers—such as the number of cases brought or the dollar amounts of judgments or orders obtained in the fiscal year—would be misguided. Ms. Avakian cited two examples to illustrate the Division's approach to identifying challenges and risks facing investors and markets, and developing a response that addresses those challenges in a thoughtful and effective way, while maximizing the use of resources, namely, enforcement actions concerning initial coin offerings and digital assets and the mutual fund share class selection disclosure initiative. With respect to the latter, Ms. Avakian reported that the Division received a substantial number of self-reports and that she expected that the initiative would allow shareholders to be remunerated more broadly and quickly than if the Division had pursued enforcement in a traditional manner.

A transcript of Ms. Avakian's speech is available at: https://www.sec.gov/news/speech/speech-avakian-092018

PUBLIC STATEMENTS

SEC Chairman Clayton Issues Statement About SEC Staff Views

On September 13, 2018, SEC Chairman Jay Clayton issued a public statement about the "important distinction between the Commission's rules and regulations, on the one hand, and staff views on the other." Specifically, he noted the Commission's "longstanding position" is that the views of the staff—whether communicated in written statements, compliance guides, letters, speeches, responses to frequently asked questions or responses to specific requests for assistance—are "nonbinding and create no enforceable legal rights or obligations of the Commission or other parties." Chairman Clayton added that the SEC staff "[has] been and will continue to review whether prior staff statements and staff documents should be modified, rescinded or supplemented in light of market or other developments."

Chairman Clayton's statement is available at: https://www.sec.gov/news/public-statement/statement-clayton-091318

SEC Staff Withdraws Proxy Advisory Guidance

In 2003, to address the potential conflicts of interest that arise when investment advisers vote client proxies, the SEC adopted Rule 206(4)-6 under the Investment Advisers Act of 1940. This rule requires advisers to adopt and implement written proxy voting policies designed to ensure proxies are voted in clients' best interests, to describe these policies to clients and to provide clients information on how proxies are actually voted. In 2004, the SEC staff issued two no-action letters, to Egan-Jones Proxy Services and Institutional Shareholder Services, Inc., indicating that advisers may satisfy Rule 206(4)-6 by voting client proxies in accordance with recommendations provided by third-party proxy advisory firms, provided the advisers adopt and implement policies and procedures to ensure that the proxy advisory firms are not themselves subject to conflicts of interest. Under the guidance set forth in the no-action letters, before relying on a proxy advisory firm's recommendations, an adviser must first determine, among other things, that the advisory firm has the capacity and competency to adequately analyze proxy issues and can make such recommendations impartially and in the best interests of the adviser's clients. In 2014, the SEC staff issued additional guidance in Q&A format regarding advisers' responsibilities with respect to voting client proxies and using proxy advisory firms, including the responsibility to identify and address any conflicts of interest facing the proxy advisory firm.

In July 2018, SEC Chairman Jay Clayton announced that the SEC staff would host a roundtable later in the year to gather input from investors, issuers and other market participants on the proxy process, which may lead to changes in rules and staff guidance relating to proxy solicitations and proxy voting. On September 13, 2018, the SEC staff issued a public statement announcing that it was withdrawing the two 2004 no-action letters referenced above to facilitate discussion at the roundtable, which is now expected to take place in November 2018. The staff indicated that it would expect to use input from the roundtable to prepare any future guidance relating to the use of proxy advisory firms, including any changes to the guidance previously provided by the staff.

The statement is available at: https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters

Litigation and Enforcement Actions and Initiatives

NORTHSTAR CASE

Ninth Circuit Affirms in Part District Court Dismissal of Class Claims in *Northstar Financial v. Schwab Investments* Case

In February 2016, the U.S. District Court for the Northern District of California granted a motion dismissing with prejudice the claims brought by Northstar Financial Advisors, Inc., on behalf of its clients who invested in the Schwab Total Bond Market Fund, against Schwab Investments, Charles Schwab Investment Management, Inc. and the trustees of the Schwab Trust. Northstar alleged that, between August 2007 and February 2009, Schwab had managed the Fund's investments in a manner that deviated from the Fund's stated investment objectives and policies, resulting in investor losses. Northstar claimed under Massachusetts law that the Fund's trustees breached a purported fiduciary duty owed directly to the Fund's shareholders, that the Fund breached a purported contract with its shareholders embodied in the Fund's proxy statement and prospectus and that the Fund's shareholders had claims against Schwab as third-party beneficiaries under the Fund's investment advisory agreement. Although the U.S. Court of Appeals for the Ninth Circuit had previously decided that these were legitimate claims under state law, the District Court, on remand from the Ninth Circuit, dismissed Northstar's claims with prejudice, determining that they were essentially claims of misrepresentation in the sale of securities and were therefore precluded from being brought as a class action by the federal Securities Litigation Uniform Standard Act (SLUSA). Following this decision, Northstar appealed the decision of the District Court to the Ninth Circuit.

On September 14, 2018, the Ninth Circuit issued an opinion affirming the District Court's dismissal of Northstar's class claims, agreeing that the claims were precluded by SLUSA. However, the Ninth Circuit concluded that the District Court had erred in dismissing the claims with prejudice and remanded the case to the District Court to give Northstar an opportunity to amend its complaint.

The Ninth Circuit's opinion was issued under the caption *Northstar Financial Advisors, Inc. v. Schwab Investment*s, et. al., Case No. 16-15303.

SEC ENFORCEMENT ACTIONS

SEC Settles Charges Against Firm for Inadequate Cybersecurity and Identity Theft Prevention Programs

On September 26, 2018, the SEC announced that it had settled administrative proceedings against Voya Financial Advisors, Inc., a dually registered broker-dealer and investment adviser, for the firm's alleged failure to (1) adopt written policies and procedures reasonably designed to protect customer records and information, in violation of Rule 30(a) of Regulation S-P (the Safeguards Rule); and (2) develop and implement a written Identity Theft Prevention Program as required by Rule 201 of Regulation S-ID (the Identity Theft Red Flags Rule). The deficiencies alleged by the SEC related to an April 2016 incident in which cyber intruders impersonating Voya registered representatives were able to request and receive a reset of representatives' passwords for a proprietary web portal used to access Voya customer information. Through this scheme, the SEC alleged that the intruders accessed personally identifiable information of 5,600 Voya customers. Furthermore, the SEC alleged that in two instances the intruders used customer information to create online customer accounts and access and change additional customer information. In addition, according to the SEC, Voya failed to notify customers when online profiles linked to their accounts were created or edited.

The Safeguards Rule requires every broker-dealer and investment adviser registered with the SEC to adopt written policies and procedures that are reasonably designed to ensure, and protect against any anticipated threats to, the security and confidentiality of customer records and information. The Identity Theft Red Flags Rule requires broker-dealers, investment advisers, investment companies and others to develop and implement a written identity theft prevention program that is designed to detect, prevent, respond to and mitigate identity theft. The SEC alleged that Voya violated the Identity Theft Red Flags Rule because it did not review and update its identity theft prevention program in response to changes in risks to its customers or provide adequate training to its employees. According to an SEC press release, the SEC's settlement with Voya is the first SEC enforcement action charging violations of the Identity Theft Red Flags Rule.

Without admitting or denying the foregoing, in settlement of the allegations, Voya agreed to be censured, pay a $1 million penalty, and retain an independent consultant to evaluate its policies and procedures for compliance with, and to cease and desist from violations of, the Safeguards Rule and the Identity Theft Red Flags Rule.

The SEC order is available at: https://www.sec.gov/litigation/admin/2018/34-84288.pdf

SEC Reaches Settlements with Two Registered Investment Advisers Regarding Improper Cross Trades

The SEC recently announced that it had settled charges with two investment advisers in connection with alleged violations of Section 17(a) of the Investment Company Act of 1940 relating to improper cross trades.

On September 14, 2018, the SEC announced that it had settled an enforcement action against Cushing Asset Management, L.P. relating to allegations that, in 2012, Cushing, on behalf of a hedge fund it managed, sold units of a publicly-traded MLP valued at approximately $33.5 million to two registered funds it also managed in an improper cross trade. According to the order, to execute the trade, Cushing traders contacted two separate brokers and placed corresponding buy and sell orders for the same number of units. These trades resulted in the firm's clients

incurring $125,000 in brokerage fees. The SEC alleged that these transactions constituted cross trades, and that Cushing caused the hedge fund to knowingly sell securities to the affiliated registered funds in violation of Section 17(a)(1) of the 1940 Act. Without admitting or denying the foregoing, in settlement of the allegations, Cushing agreed to cease and desist from violating Section 17(a)(1) and to pay a civil penalty of $100,000.

On September 27, 2018, the SEC announced that it had settled an enforcement action against Putnam Investment Management, LLC and a former Putnam portfolio manager relating to allegations that, over a four-year period, Putnam and the portfolio manager facilitated dozens of improper cross trades that disadvantaged certain clients. The SEC alleged that, between 2011 and 2015, the portfolio manager pre-arranged with broker-dealers to temporarily sell mortgage-backed securities owned by one Putnam advisory account and to repurchase them the next day at a small mark-up for another Putnam advisory account. The securities were sold at the bid, rather than at an average between the highest current independent bid and the lowest current independent offer as required by applicable rules. This caused Putnam to favor the buyers in the transactions over the sellers. The SEC alleged that Putnam and the portfolio manager caused Putnam clients to engage in improper cross trades in violation of Sections 17(a)(1) and 17(a)(2) of the 1940 Act. The SEC also alleged that Putnam and the portfolio manager violated antifraud provisions of the Investment Advisers Act of 1940 and that Putnam failed to adopt and implement adequate procedures to ensure compliance with cross trading rules and failed to reasonably supervise the portfolio manager. Without admitting or denying the foregoing, Putnam and the portfolio manager agreed to cease and desist from violating applicable provisions of the federal securities laws and to pay civil penalties of $1 million and $50,000, respectively.

The order for Cushing Asset Management is available at: https://www.sec.gov/litigation/admin/2018/ic-33226.pdf

The order for Putnam Asset Management is available at: https://www.sec.gov/litigation/admin/2018/ia-5050.pdf

SEC Obtains Consent Judgment against Hedge Fund Adviser for Alleged Scheme to Increase Profits above High-Water Mark

On September 13, 2018, the United States District Court for the Northern District of Georgia entered a consent order against Hope Advisors, LLC (Hope) and its principal in connection with trading activities allegedly designed to increase incentive payments from two hedge funds managed by Hope.

According to the SEC's complaint filed on May 31, 2016, the firm managed two hedge funds in which the only compensation was an incentive fee, calculated as a share of the profits earned in the funds' accounts each month. This fee was subject to a high-water mark—i.e., whereby the fee is earned for a given month only to the extent that the funds' profits exceed losses from previous monthly periods. The SEC alleged that between October 2014 and June 2016, Hope and its principal engaged in a continuous pattern of trading to inflate their incentive fee by structuring trading so that a profit would be realized at the end of the month, while deferring the realization of losses until the following month. The SEC claimed that these trades did not produce any actual profits for the funds but, rather, were designed solely to manipulate the high-water mark and generate incentive fees. According to the SEC, the firm and its principal would have earned almost no incentive fees but for the allegedly fraudulent trading patterns.

The consent judgment orders Hope and its principal to pay $1,237,235 in disgorgement and $250,000 in civil penalties, and enjoins the parties from further violation of the securities laws.

The SEC litigation release about the matter is available at: https://www.sec.gov/litigation/litreleases/2018/lr24285.htm

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
Jacob C. Tiedt, *Editor*........ +1 (312) 609 7697
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
Mark Quade .... +1 (312) 609 7515
David W. Soden................. +1 (312) 609 7793
Cody J. Vitello .... +1 (312) 609 7816
Jeff VonDruska.................. +1 (312) 609 7563
Jake W. Wiesen .... +1 (312) 609 7838
Cody L. Lipke, *Law Clerk** . +1 (312) 609 7669

New York

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
W. Thomas Conner...................... +1 (202) 312-3331
Amy Ward Pershkow....................+1 (202) 312 3360
Brendan R. Hamill........................+1 (202) 312 3010
Emily T. Rubino............................ +1 (202) 312 3385

London

Sam Tyfield ....+44 (0)20 3667 2940

* Law Clerk. A Law Clerk is not licensed to practice and is supervised by Vedder Price P.C. attorneys admitted in the state of Illinois.

Investment Services Group

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