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SEC / CORPORATE

ISS Updates Frequently Asked Questions for US Proxy Voting Policies and Procedures for 2017

Proxy advisory firm Institutional Shareholder Services (ISS) recently updated its frequently asked questions (FAQs) for US proxy voting policies and procedures (excluding compensation-related policies and procedures). The following is a brief summary of the new/updated FAQs.

Restricting Binding Shareholder Proposals

ISS has introduced new FAQs related to the restricting of binding shareholder proposals:

A small minority of presumably non-Delaware incorporated public companies prohibit shareholders from submitting binding shareholder proposals. ISS expressed its position that shareholders' ability to amend bylaws is a fundamental right, and shareholders should be permitted to submit binding bylaw amendment proposals. Substituting a supermajority vote requirement on binding shareholder bylaw amendments in lieu of the prohibition will be viewed by ISS as an insufficient restoration of a fundamental right. Further, ISS will generally view commitments to remove the restriction within a given period of time as insufficient to mitigate concerns. However, ISS will evaluate each company on a case-by-case basis based on such factors as shareholder outreach, complete disclosure, board views and planned actions.

Director(s) Receiving Less Than 50 Percent of Shares Cast

ISS has updated its FAQs to clarify that:

If a director receives less than majority support due to attendance issues, and that director attends 75 percent of the aggregate of his/her board and committee meetings the following year, ISS will view that as a sufficient response.

Attendance

ISS also clarified its position that:

Director absence is acceptable when only one meeting is missed and the total of all meetings was three or fewer, even though attendance is below the 75 percent reporting threshold. Because companies generally schedule their board and committee meetings more than a year in advance, for new directors who do not have this advanced notification, ISS will consider it an acceptable reason, if new directors miss meetings due to scheduling conflicts. If the proxy disclosure is unclear and insufficient to determine whether a director attended at least 75 percent of the aggregate of his/her board and committee meetings during his/her period of service, ISS will recommend a vote against or withhold from the director(s) in question.

Overboarded Directors

ISS has updated its FAQs to clarify its position that:

The boards of public companies and mutual fund families are counted when determining if a director is "overboarded." ISS does not include the boards of non-profit organizations, universities, advisory boards and private companies in determining whether a director is overboarded.

A summary of ISS' new/updated FAQs for 2017 US proxy voting policies and procedures is available here.

SEC Adopts Rule Requiring Hyperlinks to Exhibits Incorporated by Reference in SEC Filings

On March 1, in an effort to provide investors with easier access to exhibits to registration statements and periodic reports that are incorporated by reference from earlier filings, the Securities and Exchange Commission adopted rule and form amendments that require issuers to include hyperlinks to the originally filed exhibits. This requirement will apply to filings for which exhibits are required under Item 601 of Regulation S-K, as well as Forms F-10 and 20-F, but excludes exhibits that are filed with Form ABS-EE (related to asset-backed securities) and exhibits filed in XBRL (a machine readable data format that permits investors to more easily access, evaluate and compare financial information both across reporting periods for the same issuer and among different companies). To facilitate the inclusion of such hyperlinks, registrants will also be required to file registration statements and reports in HTML format. These rule and form amendments become effective on September 1, 2017, except that non-accelerated filers and smaller reporting companies that submit filings in ASCII format have until September 1, 2018 to comply.

The press release is available here, and the adopting release is available here.

Acting SEC Chairman Piwowar Makes Remarks at the 2017 SEC Speaks Conference, Including With Respect to "Accredited Investor" Definition

Acting SEC Chairman Michael S. Piwowar spoke at the SEC Speaks Conference on February 24, offering his remarks on a variety of topics, including the SEC's disclosure regime and "non-material" disclosure requirements (referring specifically to conflict minerals, pay ratio and resource extraction disclosure requirements) and the assessment of corporate penalties for wrongdoing, among others. Commissioner Piwowar also commented on what he termed "the artificial distinction between 'accredited' and 'non-accredited' investors" in relation to registration requirements under the Securities Act of 1933 (or exemption therefrom), arguing that the distinction and the resulting limitation on non-accredited investors investing in securities offered as part of certain exempt offerings effectively prevents them from earning the very highest expected returns and diversifying their portfolios.

The transcript of the acting chairman's remarks is available here.

SEC Solicits Comment on Industry Guide 3

The Securities and Exchange Commission is engaged in a broad-based review of its disclosure regime, including its industry guides (which are disclosure policies applicable to registrants in specified industries). As part of that effort, on March 1, the SEC voted to solicit public input on whether Industry Guide 3 (which relates to statistical disclosure by bank holding companies) "continues to elicit the information needed for investors to make informed investment and voting decisions." As Industry Guide 3 was first published in 1976, the request for comment asks for feedback on, among other things, the scope and applicability of, potential improvements to the disclosure regime (such as new disclosures and the elimination or revision of current disclosures) prescribed by, and the effects of regulation on bank holding companies on, Industry Guide 3.

The press release is available here.

SEC Issues Inline XBRL Proposed Rule and Publishes International Financial Reporting Standards (IFRS) Taxonomy

On March 1, the Securities and Exchange Commission announced a proposed rule that would require the use of Inline XBRL (embedding XBRL data directly into filings, rather than as attachments) and would eliminate the requirement that filers provide XBRL data on their websites. The public comment period on the proposed rule is open until April 30, 2017.

Also on March 1, the SEC published a taxonomy on its website that enables foreign private issuers that prepare their financial statements in accordance with IFRS to submit their financial statements using XBRL. Foreign

private issuers may submit their financial statements in XBRL immediately, and, in any case, all foreign private issuers must do so for fiscal periods ending on or after December 15, 2017.

The press releases is available here and here. The proposing release for Inline XBRL is available here, and the adopting release for the IFRS taxonomy is available here.

INVESTMENT ADVISERS

DOL Proposes to Delay Fiduciary Advice Rule, Requests Comments on Delay and on Costs, Benefits of the Rule

On March 2, the US Department of Labor (DOL) published a proposed extension (the Proposal) of the effective date of what is commonly referred to as the "fiduciary rule" or the "fiduciary advice rule" (the Rule). The Rule provides that persons who provide investment advice or recommendations for fees or other compensation with respect to retirement plan assets will be fiduciaries under the Employee Retirement Income Security Act of 1974, as amended (ERISA). This change from prior interpretations of existing law would bring more categories of advisors within the definition of fiduciary. The Rule, by its terms, becomes effective in part on April 10, 2017, and in whole on January 1, 2018.

The entire Katten advisory is available here.

Registered Investment Advisers Take Note: New SEC Custody Rule Guidance

Registered investment advisers should take note of recent pronouncements by the staff of the SEC's Division of Investment Management (the Division) regarding Rule 206(4)-2 (the Custody Rule) of the Investment Advisers Act of 1940. The Division makes clear that many advisers may unwittingly have custody of client assets under the Custody Rule. Investment advisers should consider taking steps to avoid having imputed custody and take steps to comply with new requirements for standing letters of authorization.

The entire Katten advisory is available here.

BROKER-DEALER

FINRA Proposes Rule to Revise Qualification and Registration Requirements

On March 8, the Financial Industry Regulatory Authority filed a proposed rule change with the Securities and Exchange Commission to adopt amendments to the qualification and registration requirements for associated persons. The proposed rule change restructures the current qualification examinations, creates a general knowledge examination and specialized knowledge examinations, and revises the continuing education requirements. The new rule would also consolidate certain National Association of Securities Dealers' rules and New York Stock Exchanges' rules into the FINRA Rulebook.

More information is available here.

SEC Proposes Amendments to Rule 15c2-12

The Securities and Exchange Commission recently proposed amendments to Rule 15c2-12 under the Securities Exchange Act of 1934. Rule 15c2-12 prohibits dealers acting as an underwriter for a primary offering of municipal securities from purchasing or selling those securities after the occurrence of certain events.

To comply with the rule, underwriters typically provide event notices to the Municipal Securities Rulemaking Board (MSRB). The proposed amendment would change the list of events for which notice is to be provided to the MSRB to include (1) the incurrence of certain financial obligations of an obligated person; and (2) other events that reflect financial difficulties of an obligated person.

The rule proposal is available here.

UK/BREXIT DEVELOPMENTS

Government Publishes Report on UK Trade Options After Brexit

On March 7, the UK House of Commons International Trade Committee (Committee) published a report titled "UK trade options beyond 2019" (Report).

In the Report, the Committee examines different potential models for UK international trade after the United Kingdom leaves the European Union. The Report covers the UK's relationship with the World Trade Organization (WTO), the proposed free-trade agreement (FTA) between the United Kingdom and the European Union, and the implications of the United Kingdom trading with the European Union under WTO rules only.

The Report considers the potential future framework for trade in financial services and discusses the potential loss of passporting of UK financial services into the European Union, the drawbacks of trying to rely on an equivalence decision by the European Commission, and the possibility of an agreement between the United Kingdom and European Union, which sits somewhere between passporting and equivalence.

Among other things, the Committee recommends that the government should:

- seek the nearest achievable approximation to the existing passporting framework;
- provide clarity on how complex disputes in the financial services sector will be resolved without the involvement of the Court of Justice of the EU; and
- in relation to any transitional arrangements, try to avoid a sudden end to passporting and to include fully worked-out arrangements for dispute resolution relating to financial services.

The Report is available here.

FCA Highlights Best Execution Concerns at Investment Managers

On March 3, the UK Financial Conduct Authority (FCA) published a Press Release in which it expresses concern about how investment managers are failing to ensure effective oversight of best execution.

The FCA's concerns include:

- poor practices not being addressed despite the FCA's 2014 thematic review on the topic;
- poor use of management information on execution costs and an inability to show any improvement to execution process based on cost data, resulting in 'box ticking'; and
- compliance staff not being empowered to effectively challenge execution quality.

Despite this, the FCA also did see some good practice in firms, where best execution was considered throughout the investment decision making process, and not just by the dealing desk. The FCA states that firms with good practice had an effective governance process in place that challenged the overall costs of execution, renegotiated commissions and identified trends that helped improve future execution, which fed into a high-level trading strategy.

The FCA states that it will revisit best execution issues in 2017 to see what steps investment management firms have taken to assess gaps in their approach to achieving best execution and how they can show that funds and client portfolios are not paying too much for execution. If the FCA finds that firms are still not fulfilling their best execution obligations, it will consider appropriate action, including more detailed investigations into specific firms, individuals or practices.

The Press Release is available here.

FCA Summarizes Findings of a Review on the Use of Dealing Commission

On March 3, the UK Financial Conduct Authority (FCA) published a Press Release summarizing how firms have been failing to meet expectations on their use of dealing commission, based on a review of 31 investment managers between 2012 and 2015.

Particular issues identified include:

- research budgets—several firms did not limit their research spending to their budget, with no satisfactory explanation as to why;
- research polls and voting—a number of firms operated a research poll where analysts and portfolio managers allocated votes that generated research payments based on percentages of the total money/funding available for research, rather than specified monetary amounts; such that they were unable to assess value for money and could not demonstrate they were paying research providers appropriately using their clients' funds;
- systems, controls and record keeping—arrangements to demonstrate that only "substantive" research is paid for using dealing commission were generally poor or missing; and
- conflicts of interest—the majority of firms continued to treat the receipt of corporate access from brokers as a free provision. When these firms also operated limited controls and record keeping over research expenditure, they are exposed to the risk that corporate access or other non-permissible services might still influence the allocation of dealing commission expenditure. These findings suggest that this potential conflict and inducement risk is not being identified, monitored or managed effectively.

Due to the FCA's findings and the implementation of the revised Markets in Financial Instruments Directive (MiFID II), the FCA will continue to focus on the use of dealing commission. The FCA states that firms are expected to scrutinize this area in order to see a reduction in the dealing commission they spend on research and to help enhance the attractiveness of the UK investment management sector. Where the FCA identifies breaches of its rules or principles, it will consider appropriate action, including more detailed investigations into specific firms, individuals or practices.

The Press Release is available here.

HM Treasury Amends Definition of Financial Advice

On February 28, HM Treasury published its response (Response) to its consultation on amending the definition of "financial advice" for the purposes of article 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(RAO). The Response gives summaries of responses submitted to the consultation by market participants, as well as the government's position.

HM Treasury states that the majority of respondents agreed with amending the definition to bring it in line with the definition of "personal recommendation" in the Markets in Financial Instruments Directive. However, due to concerns that a narrowed definition could allow unregulated firms to provide misleading and unregulated advice, HM Treasury has provided for separate approaches for unregulated and regulated firms:

- For regulated firms, the definition of financial advice will be amended so that these firms will only be giving advice, requiring them to hold a permission to advise on investments under Article 53(1), where they provide a personal recommendation.
- For unregulated firms, the existing wider RAO definition of advice as "advising on investments" will remain in place. This means that unregulated firms will be limited to providing factual information about products.

On the same day, the Financial Conduct Authority (FCA) published a summary on its website of the implications of HM Treasury's decision (Summary). The Summary clarifies what the amendment will mean for the following types of firms:

- Regulated firms that hold a permission other than, or in addition to, a permission to advise on investments or to agree to advise on investments under article 64 of the RAO will be able to take advantage of the new exemption in article 53 without needing to have permission for providing advice on investments under article 53(1), as long as they do not provide personal recommendations.
- Regulated firms that do not hold the advising on investments or agreeing to advise on investments permission(s), but do hold another permission, will be able to provide advice on financial products and services without the advising permission. However, they will still need to seek the advising permission(s) if they want to provide personal recommendations.
- There will be no change for regulated firms that only hold permissions for advising on investments or for agreeing to advise on investments.

- There is no change for unregulated individuals and firms that are not authorized by the FCA; they will not be able to provide any form of regulated advice without authorization.

The Summary states that there is no need for firms to take any action now. Firms will not have to re-apply for existing permissions for advising on investments or agreeing to do so until the FCA's Handbook and Regulatory Guides have been amended.

It is planned that the government will introduce a statutory instrument to give effect to the amendment with an intention that the new definition will go into effect on January 3, 2018. In the meantime, the FCA will consult on changes to its Handbook and Regulatory Guides to coincide with the January 2018 changes.

The Response and Summary are available here and here.

EU DEVELOPMENTS

European Commission Publishes CMU Report on National Barriers to Capital Flows

On February 27, the European Commission (EC) published a report (Report) on its capital markets union (CMU) initiative addressing national barriers to capital flows. The Report sets out the initial findings of the EC's group of representatives of member states on national barriers to cross-border capital flows and the steps that the EC expects member states to take to address them.

The Report includes a section on barriers to the cross-border distribution of investment funds. As an illustration of the barriers, the Report states that a third of funds marketed cross-border are sold in only one other member state and another third in no more than four other member states. The Report goes on to highlight the disparities in national rules concerning the marketing of funds (particularly in relation to pre-marketing and reverse solicitation), administrative arrangements imposed on the Undertakings for the Collective Investment of Transferable Securities (UCITS) and alternative investment funds, and regulatory fees for cross-border marketing.

The EC requests that member states review their national rules on marketing and take further steps to map administrative arrangements, such as requiring that paying agent tasks be performed by a local credit institution or requiring a local distributor to be appointed once a fund is marketed to retail investors, with a view to eliminating unnecessary administrative burdens by 2019.

It also calls on member states to ensure that all fund notification-related fees charged by member states are published in a comprehensive and user-friendly manner on a single national public website. The Report states that the EC is assessing whether notification fees are compatible with an efficient notification procedure, the passporting rights provided for in legislation, and how to ensure that fees are proportionate and not excessive. To the extent fees are allowed, the EC will consider the introduction of a single public domain for fee-related information, in the form of a comparative website or a central repository.

The Report is available here.

ESMA Issues Opinion on UCITS Share Classes

On January 30, the European Securities and Markets Authority (ESMA) issued an opinion (Opinion) on share classes within Undertakings for Collective Investment in Transferable Securities (UCITS) funds. The Opinion sets out high-level common principles for setting up and operating share classes.

Currently there is no common uniformity within the UCITS framework applicable to the use of share classes in UCITS, with some countries prohibiting a fund/sub-fund from having different share classes altogether, while others permit share classes with varying degrees of flexibility. ESMA has issued the Opinion to seek to correct this diversity in application and ensure a harmonized approach across the European Union. The Opinion contains four principles designed to achieve these objectives:

- Common investment objective: share classes of the same fund/sub-fund should have a common investment objective with a common pool of assets. ESMA considers that hedging arrangements at share class level—with the exception of currency risk hedging—are not compatible with this objective, in particular, as such

UCITS that use derivative overlays and other techniques to protect investors in a share class from certain types of risk should be set up as separate funds/sub-funds;

- Non-contagion: UCITS managers should implement appropriate procedures to minimize the risk that features specific to one share class could have a potentially adverse impact on other share classes (for example, hedging arrangements for a share class should ensure that the notional of a derivative should not lead to a payment or delivery obligation exceeding the value of that share class);
- Pre-determination: all features of the share class should be pre-determined before the share class is set up; and
- Transparency: differences between share classes should be disclosed to investors when they have a choice between two or more classes.

To mitigate the impact on investors in share classes established prior to the Opinion, which may not comply with the principles, ESMA states that they should be allowed to continue for now. However, such share classes should be closed to new investors within six months of the publication of the Opinion (i.e., July 30), and for additional investment by existing investors within 18 months (i.e., July 30, 2018).

The Opinion is available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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