July 10, 2017

ACA COMPLIANCE GROUP

ACA Insight

The weekly news source for investment management legal and compliance professionals

"The questions reflect several lines of inquiry the staff has been probing. It gives a good sense of some of the points advisers may want to be ready to respond to."

Electronic Messaging May Be Subject of New Sweep Examination

Advisory firms should consider preparing for what may be a new SEC sweep exam: electronic messaging. While it is not yet certain that such sweep exams have begun or are scheduled to begin, advisers would be wise to review their policies and procedures, as well as how they use and document such forms of communication as instant messaging, text/SMS messaging, emails sent and received on non-company systems, and personal or private messaging.

Some securities law offices are buzzing about an "information request list" that recently came into their possession. This questionnaire, which has no letterhead or

continued on page 2

High Court Will Review Protections for Whistleblowers Who Report Only Internally

Are whistleblowers protected from employer retaliation if they report wrongdoing to their employer but not to the SEC? The answer will depend on the U.S. Supreme Court, which this fall will review a lower-level court case dealing with that very question.

The high court on June 26 accepted a petition from **Digital Realty Trust**, a Maryland company. Digital Realty is challenging a ruling from the U.S. Court of Appeals for the Ninth Circuit upholding a lower court ruling that the company's firing of a whistleblowing employee was subject to the provisions of the Dodd-Frank Act forbidding

continued on page 3

DOL Seeks Public Input on Further Delay and Changes in Fiduciary Rule Exemptions

The dust is far from settled when it comes to Department of Labor Fiduciary Rule exemptions.

The DOL on June 29 issued a "request for information" seeking public input on extending the applicability date of certain exemptive provisions associated with the Fiduciary Rule, as well as possibly changing the requirements of those provisions in the exemptions. The result, if extended dates are adopted and/or those exemptive requirements are changed, may bring relief, confusion and perhaps some frustration

continued on page 5

Electronic Messaging

continued from page 1

marks identifying whether it originated with the SEC or elsewhere, is a little over two pages and requests 19 types of information, falling into the categories of "background information," "compliance program," "recordkeeping," and "security and privacy of information."

"Such a sweep definitely started back in April," said **Willkie Farr** partner and former SEC deputy chief of staff **James Burns**. "The questions reflect several lines of inquiry the staff has been probing. It gives a good sense of some of the points advisers may want to be ready to respond to about their own electronic messaging practices."

"As far as look and feel, this is definitely an SEC document," said **Shearman & Sterling** partner **Nathan Greene**.

The SEC itself remained mum on the subject, issuing a formal "no comment" when asked about the questionnaire. The lack of response is somewhat odd, as in the past the agency has publicly announced plans for at least some specialized examinations.

Worth reviewing

Whatever the origin of the document, advisers should give some thought to studying it, if only to see what examiners may one day ask for. Electronic messaging is the kind of topic that the SEC would inquire about, as it encompasses evolving technology and is widely used in a variety of different forms by advisory firms and other financial companies.

Electronic messaging through methods such as instant messaging, texts and more is a problem for advisers "because there is no way to monitor or police it," said **Stern Tannenbaum** partner **Aegis Frumento**. "The only answer is to have good policies and procedures, but then you have to answer the question of how you determine whether it's being followed. Do you spotlight personal employee email accounts? That raises privacy issues, and besides, an employee can then create a second email account."

"Probably the best method is to require certification from employees, so they know that if they are caught, they will have to pay," he said. In addition, he suggested, advisers could send notices to customers saying that advisory firm employees are forbidden to communicate with you except by company email, and that they should notify the adviser if an employee attempts to communicate by other means.

"Do you spotlight personal employee email accounts? That raises privacy issues, and besides, an employee can then create a second email account."

The questionnaire

The information request list makes clear in its opening paragraph that the term "electronic messaging" is not meant to include "email messages that are sent or received using the adviser's email system and retained by the adviser."

Following is a summary of the 19 items the questionnaire asks for:

1. **Kinds of messaging.** A description or definition of the advisers' use of electronic messaging services or platforms, including what is and is not permitted.
2. **Types of devices.** A description of the devices that are permitted or not permitted for use in electronic messaging.
3. **Written policies and procedures.** Copies of all written policies and procedures addressing the use of electronic messaging.
4. **Informal or unwritten policies and procedures.** A description of such policies and procedures that deal with electronic messaging.
5. **Persons responsible.** Names of all individuals responsible for overseeing the adviser's policies and procedures concerning electronic messaging, as well as a brief description of their roles and responsibilities.
6. **Monitoring and review.** A description of the adviser's processes for any ongoing monitoring and review of

electronic messaging communications.

7. **Evidence of monitoring or review.** A description of how the adviser "evidences" any ongoing monitoring or review of electronic messaging, along with examples of relevant reports.
8. **Violations detected.** A description of any violations of the electronic messaging policies and procedures or unauthorized use of electronic messaging found by the adviser during the review period, along with a description of the issues involved and actions taken.
9. **Summary of findings.** This would be a summary of all findings associated with internal audits or compliance reviews related to the adviser's use of electronic messaging, along with copies of written reports.
10. **Risk assessments.** Copies of any risk assessments or risk identifications related to electronic messaging and how the adviser addresses these risks, including indicating which risks are moderate or high.
11. **Maintenance records.** Whether the adviser maintains records of the devices and applications that are used for electronic messaging and by whom.
12. **Maintenance records methodology.** How the adviser maintains required records relating to electronic messaging.
13. **Third-party vendors.** Whether electronic messages are maintained by third-party vendors, along with a description of the process and a copy of any contracts with the vendor.
14. **Retention policies and procedures.** Copies of any written policies and procedures related to the retention of electronic messaging.
15. **Transmittal of sensitive information written policies and procedures.** Copies of written policies and procedures related to the transmittal of sensitive information, including non-public information and personal client information via electronic messaging.
16. **Informal policies and procedures on transmittal of sensitive information.** A description of these in relation to electronic messaging.
17. **Written policies and procedures addressing security measures.** Copies of such policies and procedures designed to ensure the security of sensitive information transmitted via electronic messaging.
18. **Informal policies and procedures addressing security measures.** A description of these in relation to ensuring the security of sensitive information transmitted via electronic messaging.
19. **Known breaches.** A description of any known breaches in securing information contained in electronic messages, as well as a description of actions taken in regard to those breaches.

High Court Will Review

continued from page 1

retaliation against whistleblowers. Digital Realty takes the position that the Dodd-Frank provisions should not apply, arguing that, as written, they apply only to whistleblowers who report to the SEC.

"This is a case that pits 'plain English' statutory interpretation against deference to administrative agency reading of statutes," said **Georgetown University School of Law** professor **Donald Langevoort**. "Here the SEC clearly includes internal whistleblowers in the realm of protection from retaliation, even though the statutory definition of whistleblower refers specifically to reporting to the SEC, not internally. So the case may be one of the first with the newly constituted Court to take up what has been a simmering issue for some time: how much power should agencies have to put their own meaning on a statutory provision?"

However the Supreme Court decides, its ruling is likely to impact investment advisers and others in the asset management industry. "Whistleblower protections apply to whistleblowers whose reporting leads to successful SEC enforcement actions either in administrative proceedings or enforcement actions in court," said **University of North Carolina at Chapel Hill** law professor **Thomas Lee Hazen**. "Thus, they would apply to advisory firms who end up as targets of SEC enforcement actions."

The Supreme Court will have differing appellate court rulings to consider. While the Ninth Circuit appellate court – as well as the U.S. Court of Appeals for the Second Circuit in another case – ruled that Dodd-Frank whistleblower protections apply not just to those employees who report directly to the SEC, but to those who just report internally, the Fifth Circuit U.S. Court of Appeals, in still another case, ruled the opposite way.

> *"The case may be one of the first with the newly constituted Court to take up what has been a simmering issue for some time: how much power should agencies have to put their own meaning on a statutory provision?"*

Tied into the question about the Dodd-Frank Act are two other pieces of legislation: the Sarbanes-Oxley Act, which has its own internal reporting provisions, and the Securities Exchange Act of 1934 and what they each require. So the Supreme Court will need to review what each law requires, whether and how Congressional intent applies, and the rulings from the three appellate courts.

"The problem is that the Exchange Act's whistleblower protection does not explicitly address whether first making an internal report disqualifies the employee from the Act's protections," said Hazen. "The Second and Ninth Circuits point to other provisions of the securities laws that encourage internal reporting and the Fifth Circuit rule is inconsistent with that goal."

"I would like to see the Supreme Court uphold the Ninth Circuit's view so as to encourage internal reporting as a first step," he said. "However, with the increasing number of literalist justices on the high court, there is a chance the Supreme Court may side with the Fifth Circuit."

"Ironically, even though the SEC supports extending Dodd-Frank anti-retaliation provisions to individuals who report internally only, the agency may receive more whistleblower complaints if the Supreme Court holds otherwise and reverses the Ninth Circuit decision," said **Mayer Brown** partner **Matthew Rossi**. "That's because if Dodd-Frank protects only whistleblowers who report to the SEC and not those who report only internally, employees will have an incentive to make complaints directly to the SEC without first providing their employers with an opportunity to address them."

"This would undoubtedly harm internal compliance efforts," he said. "However, this result may be less pronounced than some fear because Sarbanes-Oxley already provides some protection for whistleblowers, although to a lesser extent than Dodd-Frank. Moreover, the SEC may attempt to take action against investment advisers that retaliate against internal whistleblowers on the grounds that retaliation violates the adviser's compliance policies or code of ethics."

The case

Digital Realty employed **Paul Somers** as a vice president from 2010 to 2014, according to the Ninth Circuit appellate ruling. Somers made multiple reports to senior management in regard to possible securities law violations by the company, resulting in the Digital Realty terminating his employment, the Ninth Circuit said in recounting Somers' complaint in the lower U.S. District Court.

Somers then sued his former employer, alleging violations of several state and federal laws, the Ninth Circuit appellate ruling said. Among those was the Exchange Act's Section 21F, "Securities Whistleblower Incentives and Protection," which was added to the Exchange Act by the Dodd-Frank Act, and included anti-retaliation provisions.

"Digital Realty sought to dismiss the [Dodd-Frank Act] claim on the ground that, because Somers only reported the possible violations internally and not to the SEC, he was not a 'whistleblower' entitled to [the Dodd-Frank Act's] protections," the Ninth Circuit appellate court said.

The U.S. District Court ruled in favor of Somers, according to the Ninth Circuit appellate decision. "The District Court deferred to the SEC's interpretation that individuals who report internally only are nonetheless protected from retaliation under [the Dodd-Frank Act]."

"Digital Realty is glad that the Supreme Court has agreed to resolve the circuit split on this important legal issue that affects so many employers across America," said the attorney representing that company. An attorney representing Somers did not respond to an email or a voice mail seeking comment.

Other appellate court rulings

Here's how two other appellate courts ruled in similar cases:

- **The Fifth Circuit.** In *Asadi v. G.E. Energy*, the court in 2013 "strictly applied" the Dodd-Frank Act's definition of what constitutes a whistleblower as someone who discloses information only to the SEC, the Ninth Circuit appellate court said. It then applied that definition against the Dodd-Frank Act's anti-retaliation provision, and found that since the employee did not make his disclosures to the agency, the anti-retaliation provision did not apply.
- **The Second Circuit.** In *Berman v. Neo@Ogilvy*, the court in 2015 interpreted the provision "to extend protections to all those who make disclosures of suspected violations, whether the disclosures are made internally or to the SEC," according to the Ninth Circuit appellate ruling.

The Ninth Circuit appellate ruling

The appellate court said that it agreed with the district court that "the regulation is consistent with Congress's overall purpose to protect those who report violations internally as well as those who report to the government. This intent is reflected in the language of the specific statutory subdivision in question, which explicitly references internal reporting provisions of Sarbanes-Oxley and the Securities Exchange Act of 1934."

"In view of that language and the overall operation of the statute," the appellate court said, "we conclude that the SEC regulation correctly reflects Congressional intent to provide protection for those who make internal disclosures as well as to those who make disclosures to the SEC."

DOL Seeks

continued from page 1

to advisers who would otherwise have had to comply with all the exemptive provisions by January 1.

"Public input on the Fiduciary Duty Rule and [related exemptions] has suggested that it may be possible in some instances to build upon recent innovations in the financial services industry to create new and more streamlined exemptions and compliance mechanisms," the DOL said in its request. These innovations and mechanisms include the development of:

- Mutual fund "clean shares," which would not carry a front-end load, deferred sales charge or other asset-based fee for sales or distribution;
- Fee-based annuities; and
- New technology, as well as advisory and data services, that would help satisfy the supervisory requirements contained within the exemptions.

The Department did not suggest a specific new applicability date for the exemptive provisions. It allowed 15 days for public comments on the date extension, and 30 days for public comments on topics that might relate to changes in the exemptions themselves. The comment period will begin when the request for information is published in the Federal Register.

"Given the information requested in the request for information and the amount of time it will take to evaluate that information, it is likely that an extension will be issued," said **Drinker Biddle** partner **Joan Neri**. "The focus of the request for information is on minimizing the overall compliance burden."

Recent history

The DOL's request for information is the latest in a chain of delays involving the Fiduciary Rule and its exemptions since the Trump administration took office. The Rule, which applies a fiduciary definition to all financial institutions, including advisers and broker-dealers, that provide retirement investment advice to investors was originally published, along with the exemptions, on April 8, 2016, with an applicability date of April 10, 2017.

One of those exemptions was the Best Interest Contract (BIC) exemption, which in many cases would require those providing fiduciary retirement advice to enter into contracts with clients. Those contracts would be required to state that fiduciaries will act in the best interest of the client. Another is an exemption for principal transactions.

Most of the exemptions, known as "prohibited transaction exemptions," are conditioned on what are known as the "impartial conduct standards:" providing advice in retirement investors' best interest, charging reasonable compensation, and avoiding misleading statements. Those exemptive provisions are currently in effect.

> *"Given the information requested in the request for information and the amount of time it will take to evaluate that information, it is likely that an extension will be issued. The focus of the request for information is on minimizing the overall compliance burden."*

On February 3 of this year, **President Trump** issued a Presidential Memorandum directing the DOL to further analyze the likely impact of the Fiduciary Rule in terms of how it would affect retirees receiving retirement advice (*ACA Insight*, 2/13/17). The Department on March 2 then delayed both the Rule and the exemptions for 60 days, and also sought public comment on general questions concerning both (*ACA Insight*, 3/6/17).

On April 7, the DOL adopted a final rule extending the applicability date of the Fiduciary Rule and the exemptions to June 9, while requiring fiduciaries relying on the exemptions to follow the impartial conduct standards until January 1, 2018, at which time the full compliance requirements would kick in (*ACA Insight*, 4/10/17). The Department on May 22 said it would not seek enforcement against fiduciaries until January 1, if those fiduciaries worked diligently and in good faith (*ACA Insight*, 6/5/17).

Now, with the issuance of its new request for information, it is beginning to look like the content of the exemptions themselves may change and/or the January 1 compliance date may be pushed further back.

It should be noted, said **Mayer Brown** partner **Lennine Occhino**, that "the January 1 date affects only certain of the compliance requirements of the full BIC exemption. I haven't seen any advisers that intend to rely on full BIC. At most, I have seen some advisers choosing to rely on the so called 'BIC lite,' also known as the 'level fee BIC,' for advice with respect to plan distributions and IRA rollovers. The Fiduciary Rule and conditions for BIC lite are fully in effect now."

BIC lite is a streamlined version of the full BIC exemption. It allows advisers with acceptable "level" fees to avoid some of the more onerous requirements of the full exemption. These include mandatory provisions in contracts with clients; formulating policies that prohibit quotas, bonuses and contracts under certain circumstances; and website disclosures.

The questions

"The Department is particularly interested in public input on whether it would be appropriate to adopt an additional more streamlined exemption or other rule change for advisers committed to taking new approaches . . . based on the potential for reducing conflicts of interest and increasing transparency," the DOL's request for information states.

"If commenters believe more time would be necessary to build the necessary distribution and compliance structures for such innovations, the Department is interested in information related to the amount of time expected to be required," the request for information continued.

Occhino suggested that "the questions may provide some insight into amendments under consideration by the DOL."

Following is a summary of 18 question areas that the DOL, in its request for information, asked for comments on. The full wording for each topic can be found in the actual document.

1. Would a delay in the January 1, 2018 applicability date of the provisions in the BIC exemption, Principal Transactions exemption and amendments [to other exemptions] reduce burdens on financial service providers and benefit retirement investors by allowing for more efficient implementation responsive to recent market developments? Would such a delay carry any risk?
2. What has the regulated community done to comply with the Rule and [prohibited transaction exemptions] to date, particularly including the period since the June 9, 2017 applicability date? Are there market innovations that the Department should be aware of?
3. Do the Rule and [prohibited transaction exemptions] appropriately balance the interests of consumers in receiving broad-based investment advice while protecting them from conflicts of interest?
4. To what extent do the incremental costs of the additional exemption conditions (those that become effective on January 1) exceed the associated benefits and what are those costs and benefits? Are there better alternative approaches?
5. What is the likely impact on advisers' and firms' compliance incentives if the Department eliminated or substantially altered the contract requirement for IRAs? What should be changed?
6. What is the likely impact on adviser' and firms' compliance incentives if the Department eliminated or substantially altered the warranty requirements? What should be changed?
7. Would mutual fund clean shares allow distributing financial institutions to develop policies and procedures that avoid compensation incentives to recommend one mutual fund over another? If not, why? What legal or practical impediments do financial institutions face in adding clean shares to their product offerings? How long is it anticipated to take for mutual fund providers to develop clean shares and for distributing financial institutions to offer them, including the time required to develop policies and procedures that take clean shares into account?
8. How would advisers be compensated for selling fee-based annuities?
9. Are there other innovations that hold similar potential to mitigate conflicts and increase transparency for consumers? Do these or other innovations create

an opportunity for a more streamlined exemption?

10. Could the Department base a streamlined exemption on a model set of policies and procedures, including policies and procedures suggested by firms to the Department?

11. If the [SEC] or other regulators were to adopt updated standards of conduct applicable to the provision of investment advice to retail investors, could a streamlined exemption or other change be developed for advisers that comply with or are subject to those standards?

12. Are there ways in which the Principal Transactions exemption could be revised or expanded to better serve investor interests and provide market flexibility?

13. Are there ways to simplify the BIC exemption disclosures or to focus the investor's attention on a few key issues, subject to more complete disclosure upon request?

14. Should recommendations to make or increase contributions to a plan or IRA be expressly excluded from the definition of investment advice?

15. Should there be an amendment to the Rule or streamlined exemption for particular classes of investment transactions involving bank deposit products and HSAs?

16. To what extent are firms and advisers relying on the existing grandfather provision? Has the provision affected the availability of advice to investors?

17. If the Department provided an exemption for insurance intermediaries to serve as financial institutions under the BIC exemption, would this facilitate advice regarding all types of annuities?

18. To the extent changes would be helpful, what are those changes and what are the issues best addressed by changes to the Rule or by providing additional relief through a prohibited transactions exemption? ☙

ACA COMPLIANCE GROUP

ACA Insight

The weekly news source for investment management legal and compliance professionals

Published by:
ACA Compliance Group
(301) 495-7850
(301) 495-7857 (fax)
service@acainsight.com

Editor/Publisher:
Robert Sperber
(301) 502-8718
rsperber@acainsight.com

To Subscribe:
(800) 508-4140
subscribe@acainsight.com
Annual subscriptions (46 electronic issues, web access, and breaking news alerts) are $1,295.
Multi-user site licenses are available.

Customer Service:
(800) 508-4140
service@acainsight.com

On the Web:
www.acainsight.com