VedderPrice

March 2018

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes Changes to Fund Liquidity Disclosure Requirements

On March 14, 2018, the SEC issued proposed amendments to the disclosure requirements concerning certain fund liquidity information. Fund liquidity reporting relates to new Rule 22e-4 under the Investment Company Act of 1940, as amended (the Liquidity Rule), which requires each fund to adopt and implement a written liquidity risk management (LRM) program reasonably designed to assess and manage the fund's liquidity risk.[1] A fund's LRM program must include certain components, including, among other things, that a fund classify the liquidity of each portfolio investment into one of four categories (or "buckets"): highly liquid investments, moderately liquid investments, less liquid investments and illiquid investments. Form N-PORT[2]—for which the compliance date has not yet occurred—requires a fund to publicly report the aggregate percentage of its portfolio investments that falls into each of the four buckets.[3] The SEC's proposed rule would eliminate the foregoing public reporting requirement.

Specifically, if adopted, the proposals would do the following:

- rescind the requirement in Form N-PORT that funds publicly disclose aggregate liquidity portfolio classification information on a quarterly basis;
- require funds to "briefly discuss" the operation and effectiveness of the LRM program during the most recently completed fiscal year in the annual report in order to "provide investors with enough detail to appreciate the manner in which a fund manages its liquidity risk";[4]

1 The SEC adopted the Liquidity Rule in October 2016. For a more detailed discussion of the Liquidity Rule, please see the Vedder Price White Paper, "SEC Adopts New Rules Mandating Open-End Fund Liquidity Risk Management Programs and Permitting Swing Pricing," published on October 28, 2016 and available at: http://www.vedderprice.com/SEC-Adopts-New-Rules-Mandating-Open-End-Fund-Liquidity-Risk-Management-Programs-and-Permitting-Swing-Pricing-10-28-2016/.

2 Form N-PORT requires mutual funds and exchange-traded funds (ETFs) to file with the SEC monthly portfolio investment information, including the liquidity classification assigned to each of the fund's portfolio investments. Position-level liquidity classification data is not publicly disclosed. The SEC has determined that data on individual securities is "necessary for our monitoring efforts, but not appropriate or in the public interest to be disclosed to investors or other market participants."

3 Currently, Form N-PORT requires this aggregate information to be disclosed to the public only for the third month of each fiscal quarter with a 60-day delay. Although the requirements of the Liquidity Rule and Form N-PORT are in effect, the compliance date has not yet occurred.

4 The proposing release suggests—as an example—that "as part of this new disclosure, a fund might opt to discuss the particular liquidity risks that it faced over the past year, such as significant redemptions, changes in the overall market liquidity of the investments the fund holds, or other liquidity risks, and explain how those risks were managed and addressed, and whether those risks affected fund performance." The proposing release also notes that no specific liquidity classification information—either security specific or in the aggregate—would be required, although a fund may provide such information if it wishes.

- make nonpublic the reporting about the percentage of a fund's highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, less-liquid derivatives transactions;
- allow funds the option of splitting a fund's holding into more than one liquidity bucket in three specified circumstances:

  (1) if portions of a position have differing liquidity features that justify treating the portions separately, such as when a fund holds a put option on a portion, but not all, of the fund's holding of the asset which significantly affects the liquidity characteristics of the portion of the asset subject to the put;

  (2) if a fund has multiple sub-advisers with differing liquidity views, such as where sub-advisers manage different sleeves of a fund and a single holding is held in multiple sleeves, a fund may report each sub-adviser's classification of the proportional holding it manages—effectively treating each portion as two separate and distinct securities—rather than putting the entire holding into one bucket, thus avoiding "the need for costly reconciliation"; and

  (3) if the fund chooses to classify the position through an evaluation of how long it would take to liquidate the entire position (rather than basing it on the sizes it would reasonably anticipate trading)—referred to as a "proportionality approach"; and
- require funds to publicly report holdings of cash and cash equivalents on a quarterly basis on Form N-PORT.

If the proposed amendments are adopted, the SEC expects to provide for a tiered set of compliance dates based on asset size. Specifically, the SEC proposes to align the compliance date for the proposed amendments with the revised compliance date previously adopted for Form N-PORT.[5]

The proposing release notes that, to further assist in providing investors with information about fund liquidity, the SEC staff expects to publish "aggregated and anonymized information about the fund industry's liquidity," similar to periodic reports issued by the staff about private fund industry data that is gleaned from Form PF filings.

The proposing release requests comment on the proposed elimination of the aggregate liquidity profile public disclosure requirement of Form N-PORT, the proposed replacement with a requirement that funds add a narrative discussion of their LRM program to annual reports, and other elements of the proposed amendments. Comments are due by May 18, 2018.

The proposing release is available at: https://www.sec.gov/rules/proposed/2018/ic-33046.pdf

[5] On December 8, 2017, the SEC adopted a temporary rule (the Temporary Rule) delaying by nine months the requirement that registered investment companies file reports on new Form N-PORT via the EDGAR system. Under the Temporary Rule, larger fund groups that previously would have been required to submit their first reports on Form N-PORT via EDGAR for the period ending June 30, 2018 (due no later than July 30, 2018) will submit their first reports on Form N-PORT via EDGAR by April 30, 2019. Smaller fund groups will begin submitting reports on Form N-PORT via EDGAR by April 30, 2020.

NEW RULES

SEC Delays Compliance Date for Certain Requirements of the Liquidity Risk Management Program Rule, Including Portfolio Investment Classifications

On February 21, 2018, the SEC adopted an interim final rule (the Interim Rule) delaying by six months the date by which open-end funds must comply with certain requirements of Rule 22e-4 under the Investment Company Act of 1940, as amended (the Liquidity Rule), including the requirement to classify each fund's investments into one of four liquidity categories (or "buckets"). The revised compliance date will be June 1, 2019, for larger entities[6] (revised from December 1, 2018), and December 1, 2019, for smaller entities[7] (revised from June 1, 2019).

Specifically, the following requirements of the Liquidity Rule have been delayed by six months pursuant to the Interim Rule:

- "bucketing" a fund's investments and certain related requirements that are dependent upon the classification requirement;
- determining and monitoring a fund's "highly liquid investment minimum" (or "HLIM");
- board approval of a fund's liquidity risk management (LRM) program, and the related annual review requirements; and
- recordkeeping and reporting requirements related to the elements of the Liquidity Rule that are being delayed.

The Interim Rule's adopting release identifies certain operational and compliance challenges associated with the Liquidity Rule as the basis for delaying the compliance date, including:

- **Role of Service Providers:** the lack of readily available market data for certain asset classes (e.g., fixed income) means that implementing the bucketing requirement "will be heavily dependent on service providers . . . with scalable liquidity models and assessment tools";
- **Systems Readiness:** "fund groups believe that full implementation of service provider and fund systems will require additional time for further refinement and testing of systems, classification models and liquidity data, as well as for finalizing certain policies and procedures"; and
- **Interpretive Guidance:** "funds are facing compliance challenges due to questions that they have raised about the Liquidity Rule Requirements that may require interpretive guidance," which, once provided by the staff, will need to be evaluated by funds and incorporated into their processes, as necessary.

[6] Funds that, together with other investment companies in the same "group of related investment companies," have net assets of $1 billion or more as of the end of the most recent fiscal year of the fund.

[7] Funds that, together with other investment companies in the same "group of related investment companies," have net assets of less than $1 billion as of the end of the most recent fiscal year of the fund.

The Interim Rule's adopting release states that the following requirements are not being delayed:

- The board's designation of the LRM program administrator;
- The general obligation that each fund implement an LRM program, including the required assessment, management and periodic review of the fund's liquidity risk;
- The 15% illiquid-investment limit and the related board and SEC reporting requirements; and
- The establishment of policies and procedures for redemptions in-kind for any fund that engages or reserves the right to engage in redemptions in-kind.

The Interim Rule's adopting release also provides guidance for funds' compliance with the 15% limitation on illiquid investments during the six-month delay period. The SEC suggests that a fund could preliminarily identify certain asset classes or investments that the fund reasonably believes are likely to be illiquid based on previous trading experience or an understanding of the general characteristics of the asset classes it is preliminarily evaluating, or through other means. The SEC also notes that funds already have experience following the 15% limitation restricting purchases of illiquid assets when considering whether to purchase additional illiquid assets, and it further stated that funds may use reasonable approaches other than the one described in the adopting release.

The Interim Rule's adopting release also seeks comment on the delay in the classification, HLIM, and related reporting and recordkeeping requirements. For instance, the SEC asks if six months is a sufficient amount of time for funds to implement classification and other related requirements and, if not, how much additional time would be needed to comply. As to the board oversight requirements, the SEC asks if, instead of a delay, it should require the board to approve LRM programs without the classification and related requirements and, generally, whether the board approval requirements should be delayed. Comments on the foregoing and other questions raised in the adopting release must be received by the SEC on or before April 27, 2018.

The Interim Rule is available at: https://www.sec.gov/rules/interim/2018/ic-33010.pdf

SEC STAFF GUIDANCE AND ALERTS

SEC Staff Issues Liquidity Risk Management Program FAQs

On January 10, 2018, the staff of the SEC's Division of Investment Management issued guidance in the form of frequently asked questions (FAQs) relating to the liquidity risk management (LRM) program requirements of Rule 22e-4 under the Investment Company Act of 1940, as amended (the Liquidity Rule) which was adopted in October 2016. These FAQs address (i) the delegation of LRM program administrative duties to sub-advisers and (ii) the definition of, and applicability of the Liquidity Rule to, "In-Kind ETFs."

On February 21, 2018, the SEC staff issued additional FAQs to address other items under the Liquidity Rule.[8] These new FAQs address (i) liquidity classification by asset class; (ii) consideration of an investment's reasonably

[8] On the same day, the SEC adopted an interim final rule delaying by six months the date by which open-end funds must comply with certain requirements of the Liquidity Rule, including the "bucketing" requirement. See the summary under "NEW RULES" above.

anticipated trading size; (iii) price impact assumptions in liquidity classifications; (iv) classifying investments in pooled investment vehicles; (v) provisional investment classifications and related compliance monitoring; (vi) pre-trade activity and the 15% limitation on illiquid investments; (vii) reporting requirements; and (viii) investment classification considerations for ETFs. The following is a summary of the SEC staff's guidance.

Asset Class Liquidity Classification

- The Liquidity Rule permits a fund to classify and review portfolio investments according to asset class, provided the fund has a process for separately classifying and reviewing any investment "if the fund or its adviser has information about any market, trading, or investment specific considerations that are reasonably expected to significantly affect the liquidity characteristics of that investment as compared to the fund's other portfolio holdings within that asset class." The staff stated that a fund may establish a range of liquidity profiles that different investments within an asset class are reasonably expected to exhibit, as well as criteria for determining when an investment has made a "significant" departure from that range. The staff clarified that every departure from the typical range should not require separate classification and review but that funds should establish criteria for identifying "true significant outliers."
- A fund that uses asset class classification should establish a "reasonable framework" in its LRM program for identifying significant exceptions, which may involve an automated process. Any such framework or automated process should be tested periodically as part of the fund's required review of its LRM program.

Reasonably Anticipated Trading Size

- The Liquidity Rule provides that a fund must consider expected trade sizes and market depth in making liquidity classification determinations of its investments. For a fund that uses asset class classification, the staff stated that the Liquidity Rule permits the fund to determine reasonably anticipated trade sizes and market depth for all of its investments belonging to the same asset class as a group. For a fund that has significant variation in the sizes of its positions within an asset class, the staff indicated that the fund should consider whether using percentages of the full position, as opposed to fixed dollar amounts, may offer a more reasonable approach in considering reasonably anticipated trade sizes because using fixed dollar amounts on positions of widely varying size may result in unreasonable trade sizes in some cases.
- The Liquidity Rule does not require a fund, in determining reasonably anticipated trade sizes, to predict future portfolio management decisions that may be made in response to redemption requests or with respect to trades executed for reasons other than meeting redemptions. The staff stated that a fund should estimate the portion of an investment that it reasonably believes could be sold to meet redemptions, noting that a fund would be able to make certain simplifying assumptions in making such estimates (e.g., assuming all portfolio investments would be sold pro rata in response to a redemption). The staff also stated that it would not

consider a zero or near-zero reasonably anticipated trading size to be a reasonable assumption.

Price Impact Standard

- In classifying the liquidity of an investment, a fund must consider how quickly the fund may convert the investment to cash (or sell or dispose of it, as applicable) "without . . . significantly changing the market value of the investment." The staff stated that such price impact assumptions are subjective and may vary by fund, asset class or investment. Accordingly, a fund has flexibility in defining what amounts to a "significant change in market value" in its policies and procedures. In this regard, the staff stated that a fund need not use a fixed amount or a percentage as a price impact assumption and may have differing price impact standards for different investments or asset classes, although a fund may also choose a fixed number if determined reasonably.

Classifying Investments in Pooled Investment Vehicles

- For investments in other pooled investment vehicles such as mutual funds, ETFs, closed-end funds or private funds, a fund may focus on the liquidity of the pool's shares or interests rather than "look through" to the pool's underlying investments. The staff stated that it generally would be appropriate for a fund to look through to the pool's underlying investments only when the fund has reason to believe that doing so could materially alter its view of the liquidity of the pool's shares.

Provisional Classification Activity and Related Compliance Monitoring; Timing and Frequency of Classification of Investments

- The staff stated that regular monitoring of compliance with a fund's designated highly liquid investment minimum (HLIM) (if applicable) and the 15% limit on illiquid investments is essential to compliance with the Liquidity Rule. A fund should monitor changes in the value or size of an existing investment in conjunction with its daily net asset value calculations. However, the staff stated that monitoring for compliance with these limits does not require a fund to reclassify its existing investments on a daily basis because the fund may continue to use the classifications that it last verified and determined as part of its monitoring process (generally the last reported classification on Form N-PORT).

- With respect to classifying newly acquired investments, the Liquidity Rule does not specify a time period within which an investment must be classified, but does require at least monthly review of the classifications of a fund's investments. The staff stated that it would not object if a fund classifies a newly acquired investment during its next regularly scheduled monthly classification.

- The staff stated that intra-month reassessment of an investment's classification is required only when a fund becomes aware of changes in relevant market, trading and investment-specific considerations that are "reasonably expected to materially affect" the investment's current classification. A fund may identify in its policies and procedures events that could trigger an intra-month reassessment under this standard (e.g., a trading halt or delisting of a security, default or bankruptcy of an issuer or a counterparty, significant macroeconomic developments, natural disasters or political upheaval). The staff also stated that if an intra-month reassessment of an investment's classification is triggered, a fund need review only those investments that the fund reasonably expects to be materially affected by the trigger.

- The staff stated that use of "provisional classifications" (i.e., any liquidity classification other than a monthly classification reported to the SEC on Form N-PORT or a reclassification made pursuant to intra-month compliance monitoring) by a fund is purely voluntary, noting that a fund may conclude that provisional classifications are helpful in assessing and managing liquidity risk.
- If a fund falls below its HLIM or exceeds the 15% limit on illiquid investments based on compliance monitoring or by finalizing a provisional reclassification in accordance with its policies and procedures, the fund would be subject to applicable reporting requirements.

Pre-trade Activity and the 15% Limitation on Illiquid Investments

- The Liquidity Rule does not require classification of an investment prior to acquisition. However, the staff stated that a fund should implement reasonably designed policies and procedures to prevent the acquisition of an illiquid investment that would cause the fund to exceed the 15% limitation on illiquid investments. For example, a fund could preliminarily identify certain asset classes or investments it reasonably believes are likely illiquid based on previous trading experience or an understanding of the general characteristics of the asset class, or through other means. The staff also stated that this preliminary analysis could be performed through an automated process based on a list of such investments or asset classes that the fund reasonably believes are likely to be illiquid, provided that the process is periodically tested as part of the fund's required review of its LRM program.
- In evaluating the likelihood that an asset class or investment is illiquid, the staff stated that it does not believe it would be reasonable to assume that a fund is selling only a single trading lot when considering the market depth of the asset class or investment. A fund would not need to evaluate the actual size of its holdings in the asset class or engage in a full evaluation of its reasonably anticipated trading size for the asset class; rather, the staff stated that a fund may use any reasonable method to evaluate the market depth of an asset class or investment it identifies as likely being illiquid based on a preliminary evaluation.
- The staff also stated that a fund's policies and procedures could require additional monitoring in reviewing acquisitions as the fund's percentage of illiquid investments increases.

Related Reporting Requirements

- The Liquidity Rule, Rule 30b1-10 and Form N-LIQUID require reporting to the fund's board and the SEC when a fund exceeds the 15% limitation on illiquid investments or falls below its HLIM, if applicable. The staff stated that, in circumstances in which a provisional classification of an investment is made or a reclassification of an investment is made by a third-party service provider or sub-adviser that would result in the fund exceeding the 15% limitation on illiquid investments or falling below its HLIM, the fund may need a reasonable amount of time to determine and verify that a liquidity issue actually exists. The staff stated that this determination and verification process should generally be completed within three business days.

- The staff stated that the obligation for reporting a violation of the 15% limitation on illiquid investments or the HLIM to the SEC or the fund's board will be triggered, and the deadline for reporting such a violation will be calculated based upon, when the fund determines and verifies that it is not in compliance with either such standard rather than when the event occurs that gives rise to the fund making such determination and verification. However, the report should indicate that the fund was out of compliance with the relevant standard as of the trade date of the event that led to the fund being cut out of compliance rather than the date when it was determined and verified.

ETFs and Investment Classification

- Under the Liquidity Rule, ETFs that satisfy redemptions through in-kind transfers of securities positions and assets, other than a *de minimis* amount of cash, and that publish portfolio holdings on a daily basis are "In-Kind ETFs" that are exempt from certain LRM program requirements. (See "In-Kind ETFs" below.) The staff stated that it recognizes that an ETF that does not qualify as an In-Kind ETF but nevertheless redeems shares in-kind to a material extent may have a liquidity profile different from that of a similar ETF that primarily satisfies redemptions in cash. Accordingly, the staff stated that it may be appropriate for such an ETF to reflect these differences in its liquidity classification procedures and in designating its HLIM, if applicable.
- The staff also stated that the guidance in the immediately foregoing bullet point would apply equally to any mutual fund that redeems in-kind to any material extent.

Sub-Advised Funds

- A board may designate a sub-adviser as the Fund's LRM program administrator under the Liquidity Rule. The staff additionally stated that a program administrator may delegate specific responsibilities (e.g., providing liquidity classifications for the fund's investments) to a sub-adviser or other appropriate third party and, further, that entities with delegated responsibilities may sub-delegate to others, provided there is appropriate supervision. The staff noted that the fund retains ultimate responsibility for complying with the Liquidity Rule. Accordingly, the staff recommended that a fund implement policies and procedures governing the scope and conditions of delegating LRM program responsibilities.
- Because the Liquidity Rule requires funds—and not advisers—to adopt LRM programs, an investment adviser (including a sub-adviser) has no independent obligation to adopt and implement its own LRM program.
- Certain investment advisers (or sub-advisers) may provide advisory services to multiple funds in multiple fund complexes that have differing practices, including different LRM programs with unique policies and

procedures (including different LRM programs for funds in the same complex). The FAQs clarified that an entity administering multiple LRM programs that differ from one another is under no obligation to reconcile those programs, the programs' methodologies or the programs' outputs (e.g., different liquidity classifications of certain investments). Each fund's board-approved LRM program will control how an adviser or a sub-adviser carries out any of its responsibilities under Rule 22e-4 to that particular fund.

- Further to the previous bullet point, an investment adviser, sub-adviser or other LRM program administrator, or its delegate, may classify the same investment differently across multiple funds based on the funds' differing LRM programs. The SEC staff noted that, under the Liquidity Rule, "a fund must take into account 'relevant market, trading, and investment-specific characteristics' in classifying its portfolio investments' liquidity," and that different funds (even funds within the same complex) are permitted to arrive at different conclusions.
- Pursuant to an LRM program administrator's ability to delegate, an LRM program administrator may adopt an approach whereby multiple entities (e.g., the investment adviser and a sub-adviser) may have input as to the liquidity classification of particular investments. A fund may consider addressing in its policies and procedures how to treat a circumstance in which the adviser and sub-adviser reach a different conclusion regarding the liquidity classification of a particular investment. The staff noted certain possible solutions, including allowing a specified party's determination to control, employing a factor analysis or hierarchy, or using the most conservative determination. However, the staff clarified that other methodologies could be used.
- In a multi-manager fund in which the various sub-advisers of distinct sleeves are responsible for designating the liquidity classifications of portfolio investments, each sub-adviser is permitted to classify the same investment differently even within the same fund; none of the fund, the LRM program administrator or the adviser or sub-adviser has any obligation to reconcile these differences for compliance purposes (e.g., monitoring compliance with the fund's HLIM, if applicable, or the 15% limit on illiquid investments).
- The staff noted that, notwithstanding the foregoing bullet point, Form N-PORT does not permit a fund to report more than one liquidity classification for a single investment.[9] Accordingly, an LRM program's policies and procedures should include a methodology for selecting a single liquidity classification for Form N-PORT reporting purposes in circumstances in which different sub-advisers classify the same investment differently for compliance purposes. For illustrative purposes only, the staff noted that a fund may choose to report the classification of the sub-adviser with the largest position in the asset, calculate a weighted average and round to the nearest liquidity classification or report the most conservative (i.e., the lowest) liquidity classification. The staff encouraged a fund with diverging liquidity classifications to report these policies and procedures in

[9] However, the proposed amendments issued by the SEC on March 14, 2018 would allow funds the option of splitting a fund's holding into more than one liquidity classification in three specified circumstances. See "SEC Proposes Changes to Fund Liquidity Disclosure Requirements" under "PROPOSED RULES" above.

the explanatory notes section of Form N-PORT.

In-Kind ETFs

Under the Liquidity Rule, ETFs that satisfy redemptions through in-kind transfers of securities positions and assets, other than a *de minimis* amount of cash, and that publish portfolio holdings on a daily basis are "In-Kind ETFs" that are exempt from certain LRM program requirements. The FAQs address the following considerations with respect to In-Kind ETFs under the Rule:

- For purposes of determining an ETF's status as an In-Kind ETF, the Liquidity Rule permits each ETF to determine what constitutes a *de minimis* amount of cash in its policies and procedures; the Rule does not establish a precise methodology. Rather, an ETF may take "a variety of reasonable approaches," provided the approach is applied consistently. The staff stated that it would not object to an approach that includes testing each individual redemption transaction or testing redemption transactions in the aggregate over a reasonable period of time to ensure that the cash amounts used are *de minimis*. For determining what is a "reasonable period of time," the staff suggested a day or a week for an ETF with frequent redemption basket activity or a month for an ETF with less-frequent redemption basket activity. However, the staff stated that in no event would a period in excess of one month be deemed reasonable.
- Although *de minimis* amounts may differ depending on the facts and circumstances of each ETF, the staff believes that it would be reasonable to determine that overall redemption proceeds paid in cash not exceeding 5% would be *de minimis*, but that it would be unreasonable to determine that redemption proceeds paid in cash exceeding 10% (subject to permissible exclusions, e.g., the amount of uninvested cash in the ETF's investment portfolio) are *de minimis*. An ETF should evaluate its particular facts and circumstances to determine whether an amount of cash in excess of 5% (subject to permissible exclusions) is *de minimis*, including whether such cash redemptions would give rise to liquidity risks substantially similar to those applicable to mutual funds.
- The SEC staff clarified that an ETF may exclude the cash portion of redemption proceeds that is proportionate to the uninvested cash in the ETF's investment portfolio for purposes of defining and testing compliance with the *de minimis* standard.
- Noting the practical considerations that would prevent an ETF that loses its status as an In-Kind ETF from coming into immediate compliance with the provisions of the Liquidity Rule from which In-Kind ETFs are exempt, the staff stated that it would not recommend enforcement against an ETF that loses its In-Kind ETF designation so long as the ETF comes into compliance with the Rule "as soon as reasonably practicable" after the In-Kind ETF designation is lost.
- A new ETF with little or no operating history may use a forward-looking analysis of its policies and procedures and expected redemption practices to determine that it is an In-Kind ETF. The staff stated, more generally, that

backwards-looking redemption history is not by itself dispositive, and that an ETF with an operating history may consider making material changes to its policies and procedures and its redemption practices to qualify as an In-Kind ETF.

The SEC staff expects to further update the FAQs from time to time to include responses to additional questions.

The FAQs are available at: https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq

Litigation and Enforcement Actions and Initiatives

SEC ENFORCEMENT INITIATIVES

SEC Announces Self-Reporting Initiative Regarding Mutual Fund Share Class Selection Disclosure

Summary

On February 12, 2018, the SEC's Division of Enforcement announced an initiative to "promptly remedy potential widespread violations" of federal securities laws relating to an investment adviser's selection of mutual fund share classes for clients that pay a 12b-1 fee to the adviser or its affiliates notwithstanding the availability of a lower-cost share class of the same fund (the Initiative). The Initiative seeks to incentivize eligible advisers to self-report federal securities law violations associated with undisclosed conflicts of interest concerning this share class selection practice by offering certain standardized settlement terms which require disgorgement of ill-gotten gains—i.e., reimbursement to impacted investors—but not the imposition of a civil penalty. Advisers that do not take advantage of the Initiative are warned that they may be subject to "greater penalties than those imposed in past cases involving similar disclosure failures." Participating advisers must self-report by notifying the Division of Enforcement by 12:00 a.m. Eastern time on June 12, 2018.

Background

Section 206(2) of the Investment Advisers Act of 1940, as amended (the Advisers Act), has been interpreted to require investment advisers to act in their clients' best interests, including an affirmative duty to disclose conflicts of interest; a finding of simple negligence is sufficient for a violation of Section 206(2). Section 207 of the Advisers Act prohibits advisers from willfully making untrue statements of material fact in registration applications or reports filed with the SEC and willfully omitting any material fact which is required by such applications and reports.

With respect to the prior enforcement actions alleging violations of the foregoing Advisers Act provisions, the Division of Enforcement notes that many advisers' disclosures were inadequate, including, for instance, where an adviser's Form ADV Part 2A brochure disclosed that the firm "may" receive 12b-1 fees as a result of investments in certain mutual funds—as opposed to explicit disclosure that the firm actually received such fees— and/or where the adviser failed to disclose that such fees present a conflict of interest.

The Initiative

The announcement concerning the Initiative advises that investment advisers that "did not explicitly disclose in applicable Forms ADV (i.e., the brochure(s) and brochure supplements) the conflicts of interest associated with the 12b-1 fees the firm, its affiliates or its supervised persons received for investing advisory clients in a fund's 12b-1 fee paying share class when a lower-cost share class was available for the same fund should consider self-reporting" pursuant to the Initiative.

The Division of Enforcement's announcement also notes that advisers that have already been contacted regarding possible violations of this nature are not eligible to self-report. However, advisers that are subject to pending examinations by the SEC's Office of Compliance Inspections and Examinations relating to this issue, but which have not been contacted by the Division of Enforcement, are eligible to self-report.

According to the announcement, the Initiative covers only eligible advisers. Notably, the "Division [of Enforcement] provides no assurance that individuals associated with these entities [i.e., eligible advisers] will be offered similar terms if they have engaged in violations of the federal securities laws."

Additional information regarding the standardized settlement terms and the process and conditions for self-reporting is provided in the Division of Enforcement's announcement, available at: https://www.sec.gov/enforce/announcement/scsd-initiative

SECTION 36(b) LITIGATION

Section 36(b) Excessive-Fee Suit Against JP Morgan Dismissed

Summary

On February 14, 2018, a U.S. District Court judge for the Southern District of New York (the Court) granted a motion to dismiss a shareholder action brought under Section 36(b) of the Investment Company Act of 1940, as amended (the 1940 Act) against J.P. Morgan Investment Management Inc. (JP Morgan), the investment adviser to the JP Morgan U.S. Large Cap Core Plus Fund (the Fund), alleging that JP Morgan breached its fiduciary duty to the Fund by charging excessively high investment advisory fees. The plaintiff, a Fund shareholder, filed the suit in April 2017, claiming that the fee JP Morgan charges the Fund violates Section 36(b) because it is higher than the fees JP Morgan charges for advisory services it provides to other funds. The Court agreed with JP Morgan's contention that the plaintiff's complaint failed to allege facts demonstrating why the higher fee "bears no reasonable relationship to the services rendered" and falls "outside the range of what arm's length bargaining could produce." Consequently, the Court concluded that the plaintiff failed to state a claim for relief under Section 36(b).

Background

Section 36(b) of the 1940 Act imposes a fiduciary duty on investment advisers with respect to the compensation they receive for providing advisory services to mutual funds, and it provides fund shareholders with an express private right of action to enforce this duty against advisers and their affiliates that receive compensation from funds. In such cases, the burden of proof rests on the plaintiffs to show, by a preponderance of the evidence, that the advisory fee is excessive, i.e., that the fee is "so disproportionate that it does not bear a reasonable relationship to the service the defendant rendered and could not have been negotiated at arm's-length."

To determine whether an advisory fee is excessive, courts consider the fee in light of the factors set forth in the 1982 decision of the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, which was cited with approval by the Supreme Court in *Jones v. Harris*.

The Court's Application of the *Gartenberg* Factors

Applying the "*Gartenberg* factors," the Court concluded the following:

- **Comparative Fee Structures:** The plaintiff failed to plausibly suggest that the fees JP Morgan charged for the Fund are so disproportionately large that they are necessarily outside of the range of what would have been negotiated at arm's length "merely because one or two mutual funds pay lower [fees]."
- **Economies of Scale:** The plaintiff's allegations, including that the "sharp growth" in the Fund's net assets (from approximately $70 million in 2006 to almost $10 billion in 2016) was "not accompanied by a parallel growth in advisory services," were "insufficient to show that the Fund achieved economies of scale because they do not address the Fund's actual transaction costs and whether those costs increased or decreased as the assets under management grew." Even if the Fund realized economies of scale, the Court concluded that the plaintiff failed to adequately allege that the benefits are not being shared with the Fund's investors. In this regard, the Court noted that although the advisory agreement did not include breakpoints, JP Morgan had reduced and waived advisory fees in the past.
- **Nature and Quality of Services:** The plaintiff's reliance on the investment performance of the Fund alone—particularly since the performance was "about the same" as its peers—was inadequate to show that the nature and quality of JP Morgan's services rendered the Fund's fees excessive.
- **Profitability:** "[A]rmed with no evidence of the costs [that JP Morgan] incurs to provide the Fund with investment advisory services," the plaintiff's claim that, essentially, the Fund is profitable due to its high fees is "plainly insufficient to support liability under Section 36(b)."
- **Fall Out Benefits:** The Fund's "captive relationship" with JP Morgan did create additional benefits to JP Morgan, including the ability to provide affiliated services to the Fund and create an additional sub-advised fund at low cost; however, these facts, according to the Court, did not favor either party.

- **Care and Conscientiousness of the Board's Decision in Approving the Fund's Fee Rate:** The plaintiff failed to provide facts to support the claim that the Fund's Board did not engage in a good-faith process designed to guard against excessive fees when it reviewed the Fund's investment advisory agreement.

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 (212) 407 7715
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
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

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