VedderPrice

July 2018

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes New Rule to Permit Certain ETFs to Operate Without an Exemptive Order

On June 28, 2018, the SEC issued a proposed new rule under the Investment Company of 1940 (the 1940 Act)—Rule 6c-11—that would permit exchange-traded funds (ETFs) that satisfy certain conditions to launch and operate without first obtaining an individualized exemptive order from the SEC. In connection with proposed Rule 6c-11, the SEC proposed to rescind certain exemptive orders that have been granted to ETFs that could rely on the proposed rule. The SEC also issued proposed amendments that would require additional prospectus and/or website disclosure of information concerning ETF trading costs, including as to bid-ask spreads and premiums and discounts from the ETF's net asset value. At present, ETFs require specific exemptive relief from various provisions of the 1940 Act to operate. To date the SEC has granted more than 300 such orders, many with inconsistent terms and conditions. According to the proposing release, the proposed rule and amendments are "designed to create a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs."

Highlights of the SEC's ETF rule proposal and amendments are as follows:

- **Custom baskets permitted.** In order to facilitate efficient ETF operation and, in view of differences in exemptive order terms among ETF sponsors, to level the playing field, Rule 6c-11 would provide flexibility with respect to the use of "custom baskets," i.e., baskets that are composed of a non-representative selection of the ETF's portfolio holdings (e.g., baskets that do not reflect a *pro rata* representation or representative sampling of the ETF's portfolio holdings), or different baskets used in transactions on the same business day. The proposed rule would provide an ETF with the option of using custom baskets if it has adopted and implemented policies and procedures that "(i) set forth detailed parameters for the construction and

acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or deviations from, those parameters; and (ii) specify the titles or roles of the employees of the ETF's investment adviser who are required to review each custom basket for compliance with those parameters."

- **No distinction between index-based and actively managed ETFs.** As part of the effort to simplify the regulatory framework governing ETFs, ETFs that are able to rely on Rule 6c-11 would be subject to the same conditions, regardless of whether the ETF is index-based or actively managed. The SEC stated that it believes index-based and actively managed ETFs that comply with the proposed rule's conditions function similarly with respect to operational matters, despite different investment objectives or strategies, and do not present significantly different concerns under the provisions of the 1940 Act from which the proposed rule grants relief.
- **Full portfolio transparency required.** The proposed rule would require an ETF to disclose prominently on its website the portfolio holdings that will form the basis for the next calculation of its net asset value per share. This disclosure must be made each business day before the opening of regular trading on the primary listing exchange of the ETF's shares and before the ETF starts accepting orders for the purchase or redemption of creation units. In this regard, the SEC is seeking comment on whether it should consider exemptions for ETFs with non-transparent or partially transparent portfolios in connection with the proposed rule.
- **Additional disclosure requirements.** In addition to the portfolio holdings information, the SEC is proposing to require ETFs to disclose on their websites information regarding a published basket that will apply to orders for the purchase or redemption of creation units each business day, the median bid-ask spread for the ETF's most recent fiscal year and certain historical information about the extent and frequency of an ETF's premiums and discounts. In addition, proposed form amendments would require additional specific disclosure regarding ETF trading information and related costs formatted as a series of questions and answers.
- **No Intraday Indicative Value requirement.** One of the standard conditions currently required for operation of an ETF is dissemination of Intraday Indicative Value (IIV).[1] However, the SEC is not proposing to require the dissemination of an ETF's IIV as a condition of the proposed rule because, as stated in the proposing release, the SEC understands that IIV is no longer used by market participants when conducting arbitrage trading. Moreover, the proposing release notes that "IIV also may not reflect the actual value of an ETF that holds securities that do not trade frequently." In view of the foregoing, as well as the condition under proposed Rule 6c-11 requiring daily disclosure of portfolio holdings, the SEC stated that it did not believe an IIV requirement would be necessary.
- **Effect of proposed Rule 6c-11 on prior exemptive orders.** The SEC is proposing to amend and rescind the exemptive relief issued to ETFs that would be permitted to rely on the proposed rule. The proposed rescission of orders would be limited to the portions of an ETF's exemptive order granting relief with respect to an ETF's formation and operation.

[1] As noted in the proposing release, exchanges, such as NYSE Arca, have their own requirements for dissemination of an ETF's IIV.

- **Leveraged and inverse ETFs and ETFs organized as UITs or as a share class of an open-end fund not covered by proposed rule.** ETFs that seek to provide returns that exceed the performance, or returns that have an inverse relationship to the performance, of a market index by a specified multiple over a fixed period—i.e., leveraged and inverse ETFs—would not be permitted to operate under the proposed rule. Similarly, ETFs organized as unit investment trusts (UIT ETFs) would not be able to rely on the proposed rule; rather, proposed Rule 6c-11 would be available only to ETFs that are organized as open-end funds.[2] In addition, ETFs that are structured as a share class of a multiple-class open-end fund would not be included in the scope of the proposed rule.

The SEC requests comment on all aspects of the proposed rule and disclosure amendments, including with respect to, among other things, the scope of the proposed rule (e.g., whether leveraged or inverse ETFs should be covered by the rule) and whether the SEC should create a new registration form specifically designed for ETFs.

Members of Vedder Price's Investment Services Group plan to publish a detailed analysis of the SEC's ETF rule proposal and amendments in the near future.

Comments on the proposal and amendments will be due 60 days after the date of publication of the SEC's proposing release in the *Federal Register.*

The SEC's proposing release is available at: https://www.sec.gov/rules/proposed/2018/33-10515.pdf

NEW RULES

SEC Adopts Targeted Changes to Fund Liquidity Disclosure Requirements

On June 28, 2018, the SEC adopted amendments to the disclosure requirements concerning certain fund liquidity information largely as proposed.[3] Fund liquidity reporting relates to new Rule 22e-4 under the Investment Company Act of 1940 (the Liquidity Rule), which requires each fund (other than money market funds and closed-end funds) to adopt and implement a written liquidity risk management (LRM) program reasonably designed to assess and manage the fund's liquidity risk.[4] 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. Previously, Form N-PORT[5]—on which funds have not yet begun reporting—would have required a fund to publicly report the aggregate percentage of its portfolio investments that falls into each of the four liquidity buckets. The SEC's final rule rescinds the foregoing public reporting requirement and, in its place, creates a new requirement that funds disclose information about the operation and effectiveness of their LRM programs in their shareholder reports.

---

2 Under the SEC's proposal, UIT ETFs would continue to be regulated pursuant to their exemptive orders, rather than a rule of general applicability. The proposing release noted that the "vast majority of ETFs currently in operation are organized as open-end funds."

3 The SEC issued the proposed amendments on March 14, 2018. A summary of the proposing release is included in the March 2018 issue of the Investment Services Regulatory Update, available at: https://www.vedderprice.com/-/media/files/vedder-thinking/publications/2018/03/isg-regulatory-update-march-2018.pdf.

4 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/.

5 Form N-PORT will require 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 will not be publicly disclosed. The SEC has determined that data on individual securities is "necessary for [its] monitoring efforts, but not appropriate or in the public interest to be disclosed to investors or other market participants."

Specifically, the amendments adopted by the SEC will:

- 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 next shareholder report (annual or semi-annual)[6] following the board's review of the LRM program, in order to "provide investors with enough detail to appreciate the manner in which a fund manages its liquidity risk";[7]
- 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 that 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 situations in which 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 the "proportionality" approach; and
- require funds to publicly report holdings of cash and cash equivalents on a quarterly basis on Form N-PORT.

As proposed, the required narrative discussion of the operation and effectiveness of a fund's LRM program during its most recently completed fiscal year would have been provided in the "management's discussion of fund performance" (MDFP) section of the fund's annual report. However, under the final amendments adopted by the SEC, the required narrative discussion will be included in a new section of a fund's shareholder report following the discussion of board approval of advisory contracts. The adopting release notes that, because the MDFP section is only required in a fund's annual report, moving the new required disclosure to a new section that may be included in either a fund's annual or semi-annual report will allow a fund to synchronize the annual board review of the fund's LRM program, as required under the Liquidity Rule, with the production of this narrative discussion in the shareholder report.

[6] The shareholder report disclosure requirement in the final rule includes an instruction that states: "If the board reviews the liquidity risk management program more frequently than annually, a fund may choose to include the discussion of the program's operation and effectiveness over the past year in one of either the fund's annual or semi-annual reports, but does not need to include it in both reports.

[7] The adopting 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." The adopting release also notes that such disclosure "could, but is not required to, include discussion of the role of the classification process, the 15% illiquid investment limit, and the [highly liquid investment minimum] in the fund's liquidity risk management process."

As noted in the adopting release, the SEC staff will continue to monitor and solicit feedback on the implementation of the Liquidity Rule and will inform the SEC what steps, if any, the staff recommends in light of its monitoring. As part of this evaluation process, the SEC expects that its staff will consider whether publishing a periodic report containing "aggregated and anonymized information about the fund industry's liquidity" would be useful and will provide a recommendation in this regard to the SEC.

The adopting release provides for a tiered set of compliance dates based on asset size, largely as proposed. Specifically, the compliance dates for the adopted amendments, other than the new shareholder report disclosure requirement, are aligned with the revised compliance dates previously adopted for Form N-PORT.[8] However, in a change from the proposed rule, the SEC is not aligning the compliance dates for the new shareholder report disclosure requirement with the revised compliance dates previously adopted for Form N-PORT. Instead, the SEC is providing funds with additional time so that funds have at least a full year of experience with their LRM programs before they are required to produce the new shareholder report disclosure.

Accordingly, the compliance dates for the amendments are as follows:

Form N-PORT Amendments	Compliance Date	First N-PORT Filing
Large Entities	June 1, 2019	July 30, 2019
Small Entities	March 1, 2020	April 30, 2020

Form N-1A Amendments	Compliance Date
Large Entities	December 1, 2019
Small Entities	June 1, 2020

The adopting release is available at: https://www.sec.gov/rules/final/2018/ic-33142.pdf

SEC Adopts Amendments Requiring Inline XBRL Reporting for Fund Risk/Return Summary Information

On June 28, 2018, the SEC adopted amendments requiring the use of the Inline eXtensible Business Reporting Language (XBRL) format for risk/return summary information of open-end funds (including exchange-traded funds (ETFs) organized as open-end funds). These amendments were adopted substantially as proposed by the SEC on March 1, 2017. However, the SEC's adopting release provides funds with one additional year for compliance with the new requirement, resulting in a two or three year compliance deadline depending on the level of assets under management.

"Inline XBRL" involves embedding risk/return data directly into an HTML document that is filed with the SEC (via EDGAR) and to which the data relates (e.g., a registration statement) so that a single SEC filing is "both human-readable and machine-readable for purposes of validation, aggregation, and analysis," instead of the current practice of making an additional, subsequent filing containing only XBRL data that is filed up to 15 business days

[8] 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 submit their first reports on Form N-PORT via EDGAR by April 30, 2020.

after the primary EDGAR filing to which it relates. As a result, the SEC is eliminating the 15 business day period in which funds are currently permitted to file their risk/return data in XBRL. The amendments also eliminate the requirement for funds to post Interactive Data Files on their websites.

Funds will be required to comply with the Inline XBRL requirements by the effective date of the registration statement, post-effective amendment or "form of" prospectus to which the information relates. Specifically, the amendments provide that:

- for post-effective amendments filed pursuant to paragraphs (b)(1)(i), (ii), (v), or (vii) of Rule 485 of the Securities Act of 1933, XBRL data must be filed either concurrently with the filing or in a subsequent post-effective amendment that is filed on or before the date that the post-effective amendment that contains the related information becomes effective;
- for initial registration statements and post-effective amendments filed other than pursuant to paragraphs (b)(1)(i), (ii), (v), or (vii) of Rule 485, XBRL data must be filed in a subsequent amendment on or before the date the registration statement or post-effective amendment that contains the related information becomes effective; and
- for a "form of" prospectus filed pursuant to Rule 497(c) or (e), the XBRL data must be filed concurrently with the filing.

The effective date of the amendments is 30 days after publication of the SEC's adopting release in the *Federal Register.* Compliance with the amendments will be required with respect to registration statements and post-effective amendments that are effective:

- two years after the effective date of the amendments for funds that are part of a "group of related investment companies" that has net assets of $1 billion or more as of the end of the most recent fiscal year (referred to as "large fund groups"); and
- three years after the effective date of the amendments for remaining funds.

The adopting release is available at: https://www.sec.gov/rules/final/2018/33-10514.pdf

SEC Adopts New Rule Providing Optional Internet Availability of Fund Shareholder Reports and Requests Comment on Improving Fund Disclosures and Intermediary Processing Fees

Summary

On June 4, 2018, the SEC adopted new Rule 30e-3 under the Investment Company Act of 1940 (1940 Act) which creates an optional "notice and access" method for delivering shareholder reports. The new rule allows certain registered investment companies—including mutual funds, exchange-traded funds, closed-end funds and certain registered unit investment trusts—to satisfy requirements to transmit shareholder reports by making them publicly accessible on a website, free of charge, and sending investors a paper notice of each report's availability, with

instructions for requesting a paper or email copy. The SEC is adopting an extended transition period for Rule 30e-3 with staged effective dates; the earliest that a fund may rely on the rule is January 1, 2021. The new rule is intended to modernize the manner in which funds deliver periodic information to investors and follows other recently adopted SEC rules, forms and amendments to modernize the reporting and disclosure of information by funds.

New Rule 30e-3

Rule 30e-3 creates an optional "notice and access" method for delivering shareholder reports. In order to rely on the rule, funds will be required to make their reports and other required materials publicly accessible, free of charge, at a website address specified in a short form paper notice to shareholders (a Notice), and meet certain other conditions, including protections for investors who continue to prefer paper reports or lack Internet access. To this end, Rule 30e-3 provides that investors may elect to receive paper reports on a per-report basis or through a one-time request to receive all future reports in paper.

Other elements of Rule 30e-3 are as follows:

- **Required Information**
  The Notice must (1) be in plain English; (2) contain a prominent legend in bold-face type stating that an important report to shareholders is available online and in paper by request; (3) state that the report contains important information about the fund, including its portfolio holdings and financial statements; (4) state that the report is available on the Internet or, upon request, by mail, and encourage shareholders to access and review the report; (5) include the website address where the shareholder report and other required portfolio information is posted (i.e., the "landing page" to those materials); and (6) include a toll-free telephone number to contact the fund or the shareholder's financial intermediary and (A) provide instructions describing how a shareholder may request, at no charge, a paper or email copy of the shareholder report or other materials required to be made accessible online and an indication that the shareholder will not receive a paper or email copy of the report unless requested, (B) explain that the shareholder can at any time in the future elect to receive paper reports and provide instructions describing how a shareholder may do so and (C) if applicable provide instructions describing how a shareholder can elect to receive shareholder reports or other documents and communications by electronic delivery.

- **Optional Content**
  The Notice may include (1) information identifying the fund, its sponsor (including any investment adviser or sub-adviser to the fund), a variable annuity or variable life insurance contract or insurance company issuer thereof or a financial intermediary through which shares of the fund are held; (2) a brief listing of other types of information contained in the shareholder report, such as fund performance, portfolio manager commentary and expense information; (3) a QR code or other methods to access the website; and (4) any information needed to identify the shareholder—such as control numbers or account numbers—"so that shareholders

may express their shareholder report transmission preference with ease."[9]

In addition to the optional content noted above, the rule's adopting release states that the SEC is "permitting additional flexibility regarding the content of the Notice," so long as it is limited to content from the shareholder report for which a Notice is being given. The adopting release identifies the following as information contained in shareholder reports that "may be communicative and appropriate—albeit not required" to be included in the Notice: graphical representations of fund holdings; a list of the fund's top holdings; performance information; a brief statement of the fund's investment objectives and strategies; the expense ratio or an expense example; and the name and title of the fund's portfolio manager(s). Pictures, logos or other designs may also be included "so long as the design is not misleading and the information is clear."

- **Three Business Day Delivery Requirement**
  Funds must send, at no cost to the investor and by U.S. first-class mail or other "reasonably prompt means," paper copies of the most recent annual and semi-annual reports of the fund and portfolio holdings of the fund as of its most recent first and third fiscal quarters to any person requesting copies of any such documents within three business days after receiving a request.

- **Notice May Accompany Account Statements**
  The Notice may be sent to an investor along with other materials, including a shareholder's account statement.

- **Required Mailing Period for Notice**
  The Notice must be sent to investors within 70 days after the close of the period covered by the related report.

- **Permitted Use of Consolidated Notices**
  A single, consolidated Notice may be used to alert shareholders to the online availability of shareholder reports for multiple funds. The Notice must incorporate all elements required by Rule 30e-3 with respect to each report covered by the Notice.

- **Availability of Quarterly Holdings**
  The Fund's quarterly holdings for the last fiscal year must also be publicly accessible on the website.

Elements Dropped from the Proposal

After considering industry comments, the SEC determined, among other things, not to require funds to mail a reply card with the Notice for investors to indicate their delivery preferences. The SEC also determined to eliminate from the final rule the proposed requirement that the Notice include the website address (URL) for each individual shareholder report.

Extended Transition Period

Rule 30e-3 is being implemented with "an extended transition period with staged effective dates" in order "[t]o inform investors in advance of the change of transmission method, and to accommodate systems and operations

[9] The adopting release for Rule 30e-3 cautions that if a fund were to choose to include information in the Notice such as control numbers, account numbers, etc., to identify the shareholder, "the fund should take appropriate measures to protect this information just as funds do today regarding other mailings, like account statements, that may contain sensitive information."

changes by funds, intermediaries and service providers necessary to implement the new optional transmission regime." In general, before relying on the rule, funds will be required to provide two years of notice to shareholders through disclosures which alert them to the change in transmission method and allow them to express their delivery preference. (See "Related Amendments" below.)

The earliest that a fund may rely on the rule to satisfy shareholder report transmittal requirements is January 1, 2021; funds wishing to do so must begin notifying shareholders at the start of 2019.

Funds newly offered during the period from January 1, 2019 through December 31, 2020 may rely on Rule 30e-3 starting on January 1, 2021 if they provide notice to shareholders starting with their first public offering. New funds offered on or after January 1, 2021 could rely on the rule immediately without providing advance notice. All other funds may not rely on the rule until they have completed a full two-year notice period or until January 1, 2022, whichever comes first.

Related Amendments

The SEC also adopted amendments to Rule 498 under the Securities Act of 1933 (1933 Act) and certain fund registration forms to require that funds intending to rely on Rule 30e-3 prior to January 1, 2022 provide prominent disclosures on the cover page or at the beginning of their summary prospectuses, and on the cover pages of their statutory prospectuses, and annual and semi-annual reports, informing investors of the upcoming change in delivery format options. These amendments to Rule 498 and Forms N-1A, N-2, N-3, N-4 and N-6 will be effective January 1, 2019 for a temporary period of three years (i.e., between January 1, 2019 and December 31, 2021).

Other amendments to Rule 498 will (1) require funds relying on Rule 30e-3 to include as part of the legend on the cover page or beginning of the fund's summary prospectus the website address required to be included in the Notice; and (2) include the Notice among the materials that are permitted to have equal or greater prominence when accompanying a summary prospectus. Similarly, the SEC amended Rule 14a-16 under the Securities Exchange Act of 1934 to include a Notice among the materials that are permitted to accompany a Notice of Internet Availability of Proxy Materials. Additionally, Rule 498 is amended to permit the inclusion of information about electronic delivery of prospectuses and other fund documents and communications.

Request for Comment on Fund Retail Investor Experience and Disclosure

The SEC is also seeking public comment on other ways to modernize and enhance fund information. Pursuant to a separate release, the SEC is soliciting input from individual investors and others regarding the delivery, design and content of fund disclosures, including shareholder reports, prospectuses, proxy statements and fund advertisements.

Request for Comment on Processing Fees Intermediaries Charge for Forwarding Fund Materials

Additionally, the SEC is seeking public comment and additional data on the current framework for processing fees that broker-dealers and other intermediaries charge funds for delivering fund shareholder reports and other materials to investors. This request for comment responds to concerns about the rules of the New York Stock Exchange and other self-regulatory organizations (SROs) under which intermediaries are permitted to seek reimbursement for forwarding shareholder reports and other fund materials to investors that are beneficial owners of

fund shares held in "street name" through the intermediaries. The SEC's request for comment states that "[w]ith the adoption of rule 30e-3, we believe it is appropriate to consider more broadly the overall framework for the fees that broker-dealers and other intermediaries charge funds, as reimbursement for distributing Fund Materials to investors." Among other things, the SEC requested comment on the clarity of SRO rules governing processing fees and related out-of-pocket expenses and on the transparency and reasonableness of these fees.

Comments on either of the SEC's two requests for comment described above must be submitted by October 31, 2018.

The adopting release for new Rule 30e-3 under the 1940 Act and amendments to Rule 498 under the 1933 Act and fund registration forms is available at: https://www.sec.gov/rules/final/2018/33-10506.pdf

The request for comment on fund retail investor experience and disclosure is available at: https://www.sec.gov/rules/other/2018/33-10503.pdf

The request for comment on processing fees associated with delivery of fund materials is available at: https://www.sec.gov/rules/other/2018/33-10505.pdf

SEC STAFF GUIDANCE AND ALERTS

SEC Staff Issues Additional Guidance Regarding Inadvertent Custody

In February 2017, the staff of the SEC's Division of Investment Management (the Staff) addressed circumstances in which an investment adviser may be deemed to inadvertently have custody of advisory client assets for purposes of Rule 206(4)-2 under the Investment Advisers Act of 1940 (the Custody Rule) because of the terms of the custodial agreement entered into between the advisory client and the qualified custodian, which would subject the investment adviser to the "surprise examination" requirement of the Custody Rule. Along those lines, the Staff provided no-action relief with respect to an investment adviser that acts pursuant to a standing letter of authorization satisfying the conditions set forth in the February guidance.

On June 5, 2018, the Staff provided additional guidance to questions regarding inadvertent custody under the Custody Rule. Specifically, the recent guidance provides that an investment adviser that does not have a copy of a client's custodial agreement, and does not know, or have reason to know, whether the custodial agreement would give the investment adviser inadvertent custody, does not need to comply with the Custody Rule with respect to the client's account if the sole basis for custody would be the terms of the custodial agreement. However, the Staff noted that this relief would not be available if the investment adviser recommended, requested or required a client's custodian. As many investment advisers maintain a "preferred list" of qualified custodians for client accounts, this guidance may not provide a viable solution for many investment advisers.

The FAQs regarding the Custody Rule, as revised, are available at:
https://www.sec.gov/divisions/investment/custody_faq_030510.htm

Litigation and Enforcement Actions and Initiatives

SEC ENFORCEMENT ACTIONS

Adviser Settles SEC Administrative Proceeding Regarding Conflicts of Interest Disclosure

Pursuant to an order dated June 4, 2018 (the Order), the SEC settled an administrative proceeding against investment adviser deVere USA, Inc. (DVU) alleging that DVU failed to disclose material conflicts of interest regarding compensation obtained from third-party product and service providers. The Order assessed a civil monetary penalty of $8,000,000, among other remedies.

According to the Order, DVU's primary business involved providing investment advice to holders of UK pension assets, specifically regarding transfers to overseas retirement plans that constituted "Qualifying Recognised Overseas Pension Schemes" (QROPS) under UK tax regulations. DVU would consult on the transfer of its client pension assets to QROPS, including recommending third-party QROPS trustees and custodians, and provide ongoing investment advice on a non-discretionary basis.

The Order alleges that, between June 2013 and March 2016, DVU failed to disclose to clients certain compensation arrangements between QROPS trustees and QROPS custodians that presented material conflicts of interest. Specifically, upon the transfer of pension assets to a QROPS custodian, clients paid an annual "establishment fee" to the QROPS custodian. Although clients were aware of the establishment fee, the Order alleges that clients were not informed that the establishment fees served as the basis for payments by the QROPS custodian to an overseas DVU affiliate of an amount equivalent to 7% of the transferred assets, which were, in turn, paid directly to the DVU investment adviser representative that recommended the transfer as their primary source of compensation. QROPS custodians allegedly also paid bonuses to the DVU affiliate for meeting certain annual business targets. The Order provides that DVU failed to disclose similar compensation arrangements with the QROPS trustees, as well as certain QROPS assets and foreign exchange providers recommended by DVU.

The Order states that these compensation arrangements represented material conflicts of interest that were required to be disclosed to clients. Instead, according to the Order, DVU misrepresented itself as a "fee-only" operation and failed to tailor its policies and procedures to properly address the compensation arrangements and the conflicts of interest created by such arrangements. DVU's Form ADV similarly stated that DVU did not receive any portion of commissions or transaction fees, and that each DVU investment adviser representative further represented that investment adviser representatives received no economic benefit from any person other than the client.

The Order further alleges that DVU made material misrepresentations and omissions concerning QROPS benefits. According to the Order, DVU investment adviser representatives often omitted material information regarding the risk that transfers of UK assets to QROPS may result in U.S. income tax liability, and failed to disclose limits instituted on clients' investment choices by QROPS trustees.

Without admitting or denying the findings set forth in the Order, DVU agreed to be censured, to cease and desist from violating and causing violations of applicable provisions of the Investment Advisers Act of 1940 and the rules thereunder and to pay a $8,000,000 civil monetary penalty. In addition, the SEC ordered DVU to provide its employees with fiduciary duty training and to retain an independent compliance consultant to review and make recommendations with respect to DVU's compliance policies, procedures and systems.

The Order is available at: https://www.sec.gov/litigation/admin/2018/ia-4993.pdf

SECTION 36(B) LITIGATION

Defendant Investment Advisers Obtain Partial Summary Judgment in Section 36(b) Excessive Fee Suit

Summary

On June 13, 2018, the U.S. District Court for the District of New Jersey granted in part the defendants' motion for summary judgment in a shareholder action brought under Section 36(b) of the Investment Company Act of 1940 (1940 Act) against BlackRock Advisors, LLC (Adviser), BlackRock Investment Management, LLC (Sub-Adviser) and BlackRock International Limited (collectively, Defendants). The plaintiffs (Plaintiffs), shareholders of two mutual funds managed by the Adviser, BlackRock Global Allocation Fund, Inc. and BlackRock Equity Dividend Fund (together, the Funds), alleged that the Defendants breached their fiduciary duty to the Funds by receiving excessive investment advisory fees. The Plaintiffs claimed that the fees the Adviser received from the Funds violated Section 36(b) because the fees were higher than the fees the Sub-Adviser charges for sub-advisory services provided to other funds. The Defendants filed a motion for summary judgement, seeking a ruling that the decision of the Funds' board to approve the Adviser's investment advisory fees is entitled to substantial deference. The court agreed with the Defendants' contention that the Plaintiffs' complaint failed to allege facts demonstrating that the board's process in approving the Adviser's fees was deficient or that the Adviser withheld material information from the board. The court concluded that because there was "no genuine issue as to any material fact," the Defendants were entitled to summary judgment "as a matter of law." However, the court further held that material factual disputes existed regarding certain other factors to be examined by the court in a Section 36(b) action, including comparative fees, economies of scale and profitability, and, as such, summary judgment with respect to the entirety of the Plaintiffs' claims was not granted.

Background

Under Section 36(b) of the 1940 Act, investment advisers owe a fiduciary duty with respect to the compensation they receive for providing investment advisory services to registered funds, and fund shareholders have an express private right of action to enforce this duty against investment advisers and their affiliates that receive compensation from funds. In such cases, plaintiffs have the burden of proof to show, by a preponderance of the evidence, that investment advisory fees are excessive, i.e., "that the fees are so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."

To determine whether an advisory fee is excessive, courts consider the fee in light of the factors initially 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 were cited with approval by the U.S. Supreme Court in its 2010 decision *Jones v. Harris Associates, LP.*

The Court's Application of the *Gartenberg* Factors

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

- **The Board:** Despite the Plaintiffs' argument that the board's decision-making process should be discounted because the Defendants failed to provide complete or accurate information to the board, the Plaintiffs did not provide sufficient evidence to support that assertion. Further, no irregularities or deficiencies were identified in the board's decision-making, and the Plaintiffs failed to provide facts to support the claim that the board did not engage in a good-faith process designed to guard against excessive fees when it reviewed and approved the Adviser's fee.
- **Comparative Fee Structures:** The court stated that the comparability of the fees charged by the Adviser for the advisory services provided to the Funds and those charged by the Sub-Adviser for the sub-advisory services provided to the sub-advised funds raised a genuine issue of material fact as to whether the fees charged are so disproportionately large that they are necessarily outside of the range of what would have been negotiated at arm's length. In this case, the advisory fees charged by the Adviser to the Funds were more than double the sub-advisory fees charged by the Sub-Adviser to the sub-advised funds. Further, the court determined that the question of whether the peer funds identified in the Lipper data report provided by the Adviser to the board set the true arm's-length range of comparability for the Adviser's fees is a dispute that cannot be resolved at the summary judgment phase.
- **Economies of Scale:** The court found that the Plaintiffs had presented sufficient evidence, including information from an expert report, such that a factual dispute exists regarding whether the breakpoints in the Adviser's fee schedules were "appropriately fixed," and thus whether the Adviser adequately shared the benefits of economies of scale with the Funds and their shareholders.
- **Profitability:** The court found that the Plaintiffs had presented sufficient evidence to establish a genuine dispute of material fact as to whether the Adviser's profitability from the Funds is disproportionate to the services provided by the Adviser. In this regard, the Plaintiffs' expert compared the Adviser's profits under the Funds' fee schedules to the profitability that the Adviser would realize using the fee schedules governing the fees charged by the Sub-Adviser to the sub-advised funds, and the court determined that the applicability of this comparison would be dependent on the presentation of additional evidence regarding the comparability of the services the Adviser provides to the Funds to the services the Sub-Adviser provides to the sub-advised funds.

The order granting the motion for summary judgment was issued under the caption *In re Blackrock Mutual Funds Advisory Fee Litigation*, Case No. 14-1165.

Investment Services Group Members

Chicago

Cathy G. O'Kelly, *Co-Chair*.. +1 (312) 609 7657
Juan M. Arciniegas............ +1 (312) 609 7655
James A. Arpaia .... +1 (312) 609 7618
Deborah B. Eades .... +1 (312) 609 7661
Renee M. Hardt .... +1 (312) 609 7616
Joseph M. Mannon............ +1 (312) 609 7883
John S. Marten, *Editor*....... +1 (312) 609 7753
Maureen A. Miller .... +1 (312) 609 7699
Jacob C. Tiedt, *Editor*........ +1 (312) 609 7697
Junaid A. Zubairi................ +1 (312) 609 7720
Heidemarie Gregoriev .... +1 (312) 609 7817
Nathaniel Segal, *Editor*...... +1 (312) 609 7747
Adam S. Goldman.............. +1 (312) 609 7731
Mark Quade....................... +1 (312) 609 7515
David W. Soden................. +1 (312) 609 7793
Cody J. Vitello.................... +1 (312) 609 7816
Jeff VonDruska................... +1 (312) 609 7563
Jake W. Wiesen .... +1 (312) 609 7838

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

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

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

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

© 2018 Vedder Price. Reproduction of this content is permitted only with credit to Vedder Price.