VedderPrice

November 2018

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

SEC STAFF GUIDANCE AND ALERTS

OCIE Announces Risk-Based Sweep Exam of Funds, ETFs and Advisers

On November 8, 2018, the SEC's Office of Compliance Inspections and Examinations (OCIE) published a risk alert announcing a series of risk-based examination initiatives focused on mutual funds, ETFs and advisers to assess industry practices and regulatory compliance in specific areas that the staff believes may have an impact on retail investors. The Risk Alert states that the sweep exam will focus on funds and/or advisers that fall into one or more of the following categories:

- **Index funds that track custom-built or bespoke indexes.** OCIE will seek to assess the risks and challenges associated with an index provider constructing and maintaining an index for a single fund or sponsor that may allow for a more complex or targeted investment strategy than traditional index funds. OCIE will seek to understand the roles of the adviser and index provider in selecting and weighting index components and ongoing index administration and will assess whether any conflicts of interest are appropriately addressed. OCIE will also review portfolio management practices for consistency with fund disclosures and will assess the adequacy of disclosures to the fund board about the services provided by index providers.
- **Smaller or thinly traded ETFs.** OCIE will evaluate the adequacy of investment risk disclosures to investors concerning smaller or thinly traded ETFs, including the potential for a rapid decline in the ETF's market price or an exchange delisting and risks relating to liquidating an ETF, including costs to investors. OCIE will also assess whether board oversight incorporates an ETF's ability to continue as an ongoing concern and whether tracking error is effectively monitored.
- **Funds with aberrational underperformance relative to their peer groups.** OCIE will seek to understand the reasons for a fund's "aberrational underperformance" relative to its peer group, including asset allocation

and security selection. In assessing fund compliance programs, OCIE will focus on portfolio management processes and consistency with disclosed investment objectives and strategies, as well as the accuracy and completeness of marketing materials, the allocation of investment opportunities and adherence to applicable leverage requirements.

- **Mutual funds with higher allocations to certain securitized assets.** OCIE will assess whether mutual funds investing in certain securitized assets, such as securitized auto loans, student loans, credit card receivables or mortgage-backed securities, or their advisers, have appropriate policies and procedures, and related oversight processes, specifically those addressing portfolio management activities and investment risks. OCIE will also evaluate valuation and pricing policies and procedures related to these investments.
- **Side-by-side management of mutual funds and private funds with similar strategies and/or common portfolio managers.** OCIE will assess advisers' policies and procedures for addressing conflicts of interest and other risks associated with side-by-side management, including those related to portfolio management practices. In addition to practices related to the allocation of investment opportunities, OCIE will review allocation practices for various fees and expenses and disclosures to investors and fund boards.
- **Funds managed by advisers that are relatively new to managing registered investment companies.** For these funds, OCIE will evaluate fund governance to ensure that boards are provided with sufficient information to perform their duties, the effectiveness of advisers' and funds' compliance programs and marketing and distribution efforts.

OCIE's announcement and a link to the risk alert are available at: https://www.sec.gov/ocie/announcement/ocie-risk-alert-registered-investment-company-initiative

OCIE Issues Risk Alert on the Cash Solicitation Rule

On October 31, 2018, the SEC's Office of Compliance Inspections and Examinations (OCIE) published a risk alert relating to compliance issues regarding fees paid to persons who solicit clients for investment advisers in accordance with Rule 206(4)-3 under the Investment Advisers Act of 1940, known as the Cash Solicitation Rule. The risk alert identified the following types of deficiencies involving the Cash Solicitation Rule that OCIE most frequently identified in deficiency letters sent to advisers:

- **Solicitor Disclosure Documents.** OCIE observed advisers whose third-party solicitors did not provide disclosure documents to solicited clients that contained all the disclosure information required by the Cash Solicitation Rule.
- **Client Acknowledgments.** OCIE observed advisers that did not timely receive client acknowledgments of receipt of the adviser's Form ADV Part 2A and the solicitor disclosure document. OCIE also observed advisers whose client acknowledgments either were undated or received after the clients had already entered into an investment advisory agreement with the adviser.

- **Solicitation Agreements.** OCIE observed advisers that paid fees to a solicitor without having a valid solicitation agreement in place or pursuant to a solicitation agreement that did not contain provisions required under the Cash Solicitation Rule.
- **Bona Fide Efforts to Ascertain Solicitor Compliance.** OCIE observed advisers that did not make bona fide efforts to confirm that third-party solicitors complied with solicitation agreements, as required by the Cash Solicitation Rule.
- **Conflicts of Interest.** OCIE observed practices of advisers that may cause fiduciary duty concerns, for example, where advisers make service provider recommendations to clients in exchange for client referrals from the service provider without proper disclosure of the conflict of interest.

The risk alert also reminded advisers to implement written policies and procedures reasonably designed to prevent deficiencies of the Cash Solicitation Rule and to review their policies, procedures and practices to promote improved compliance.

The risk alert is available at: https://www.sec.gov/ocie/announcement/risk-alert-investment-adviser-compliance-issues-related-cash-solicitation-rule

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

In a no-action letter to the Independent Directors Council (IDC) dated October 12, 2018, the staff of the SEC's Division of Investment Management stated it would not recommend enforcement action for violations of Sections 10(f), 17(a) or 17(e) of the Investment Company Act of 1940 if a fund's board of directors receives, no less frequently than quarterly, a written representation from the fund's chief compliance officer that transactions effected in reliance on Rules 10f-3 (purchases from affiliated underwriters), 17a-7 (cross trades) or 17e-1 (use of affiliated brokers) under the 1940 Act complied with procedures adopted by the board instead of the board itself determining compliance. The SEC staff noted the significant growth in the number and scope of director responsibilities resulting from market, regulatory and technological developments.

According to the SEC staff, its no-action position regarding board oversight of affiliated transactions is consistent with the SEC's approach in adopting Rule 38a-1 under the 1940 Act—the fund compliance program rule—which, among other things, assigns responsibility for the administration of the compliance program to the fund CCO. The proper role of the board, in the staff's view, is to oversee the fund's compliance program without becoming involved in the day-to-day administration of the program.

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

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

SEC STAFF REGULATORY RELIEF

Insurance Companies Obtain Relief to Use Statutory Financial Statements in Registration Statements Filed on Form S-1 for Certain Insurance Products

On September 28, 2018, the staff of the SEC's Division of Investment Management granted requests from certain applicant insurance companies to file audited financial statements prepared in accordance with statutory accounting principles (SAP)—instead of financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP)—in registration statements for certain index-linked annuities and group funding agreements registered on Form S-1. The staff granted the relief pursuant to Rule 3-13 of Regulation S-X, which allows the SEC, upon informal request, to permit a registrant to omit one or more financial statements required by Regulation S-X or to substitute "appropriate statements of a comparable character."

Non-variable index-linked annuities must register on Form S-1 or Form S-3. Unlike Forms N-4 and N-6 for variable annuity and variable life insurance contracts, respectively, which include prescribed circumstances where a variable product issuer can include SAP financial statements, Forms S-1 and S-3 generally require GAAP financial statements unless the issuer is a mutual life insurance company or the wholly-owned stock subsidiary of a mutual life insurance company.

In seeking this relief, the applicant insurance companies asserted that SAP financial statements audited by an independent auditor are "appropriate statements of a comparable character" for the Form S-1 registration statements for the insurance products at issue. Among other things, the applicants stated that investors would be most interested in information relevant to assessing the sponsoring insurance company's ability to fulfill its contractual obligations and, to that end, SAP financials include detailed information about an insurance company's balance sheet as well as its regulatory capital and surplus.

A footnote to each letter states that the staff would, under similar circumstances, be receptive to considering applications for relief under Rule 3-13 from other registrants seeking to file SAP financial statements in lieu of GAAP financial statements in registration statements filed for insurance products similar to the products described in the letters.

The letters are available at: https://www.sec.gov/divisions/investment/noaction/2018/athene-092818-regsx-rule-3-13.pdf

https://www.sec.gov/divisions/investment/noaction/2018/allianz-092818-regsx-rule-3-13.pdf

https://www.sec.gov/divisions/investment/noaction/2018/great-west-092818-regsx-rule-3-13.pdf

https://www.sec.gov/divisions/investment/noaction/2018/midland-092818-regsx-rule-3-13.pdf

Public Statements, Press Releases and Testimony

SPEECHES

Recent Remarks by Dalia Blass, Director of the SEC's Division of Investment Management, at Industry Conferences

ICI Securities Law Developments Conference (October 25, 2018)

Ms. Blass's remarks at the ICI Securities Law Developments Conference focused on fund disclosure, fund use of derivatives and SEC staff guidance. To enhance fund disclosures, Ms. Blass encouraged funds to "tell a clear story" with a "reliable roadmap of the fund's strategies and key risks." She said that the staff "regularly see[s] disclosure in which length trumps clarity and the story is buried." The "poster child," according to Ms. Blass, is alphabetized risk disclosure. She remarked that "the actual importance of risks rarely, if ever, coincides with the alphabetical order of those risks"—meaning that investors have to "work hard to identify what the fund already knows and should tell them."

Ms. Blass also criticized the use of standardized, generic risk disclosures that have not been tailored to a particular fund. She cited an example of a fund that invests almost entirely in common stock and holds only a small amount of derivatives but whose summary prospectus included derivatives risk disclosure that appeared first and was more than three times the length of the equity risk disclosures.

Ms. Blass also called for simplicity and clarity in fund disclosures, citing the following disclosure practices:

- Mutual fund summary prospectuses that are much longer than the brief documents the SEC intended;
- Individual sentences that contain over 70 words;
- Explanations of tracking error with more than 1,000 words;
- "Summary" risk disclosure that is identical to the full-scale risk disclosure in the statutory prospectus; and
- Passages full of jargon requiring the staff to "pull out the reference guides."

As to fund use of derivatives, Ms. Blass, noting concerns expressed by commenters about parts of the 2015 proposal, reported that the staff is taking a "fresh look" in crafting a new proposal and encouraged industry engagement with the staff on the issue.

Regarding SEC staff guidance, Ms. Blass noted the prior statement of SEC Chairman Jay Clayton to the effect that staff statements are nonbinding on the SEC and create no enforceable legal rights or obligations of the SEC or other parties. Consistent with this statement, Ms. Blass reported that the Division continues to review and assess prior staff statements and is evaluating whether the staff needs to make any changes to its prior guidance.

A transcript of Director Blass's remarks at the ICI Securities Law Developments Conference is available at: https://www.sec.gov/news/speech/speech-blass-102518

2018 IDC Fund Directors Conference (October 16, 2018)

In her remarks at the IDC Fund Directors Conference, Ms. Blass commented on two recent Division initiatives—the Board Outreach Initiative and the Investor Experience Initiative. She reported on findings from the Board Outreach Initiative, including (1) the shared approach by directors to frame their work from the perspective of the shareholder and to respect the line between oversight and management, (2) the emphasis placed by directors on ensuring that they are having the right conversations with regard to oversight, (3) the ways technology has transformed or will transform the work of directors, (4) the importance of director training and (5) the desire of directors for clarity from regulators regarding their responsibilities. Ms. Blass noted that the Division has already begun putting to work the results of the Board Outreach Initiative by developing an informal framework to guide the Division's thinking about director responsibilities, including whether directors' responsibilities are consistent with their oversight and policy roles and are clear and consistent with other regulatory actions. Ms. Blass then discussed areas of action, noting the recent no-action letter permitting directors to rely on CCO representations concerning affiliated transactions.

Director Blass then discussed three priorities of the Division, including (1) improving the retail investor experience, (2) modernizing the regulatory framework and engagement and (3) efficiently leveraging resources. She commented on the Investor Experience Initiative, stating that "ensuring investors have the tools they need to make informed investment decisions is foundational to our capital markets." Ms. Blass discussed the staff's request for comment, which seeks to improve the experience of individual fund investors by improving content, design and delivery of fund disclosure, as well as the proposed new rule for ETFs, which seeks to create a consistent, transparent and efficient regulatory framework, and she noted the importance of the role of directors in creating effective investor disclosure and overseeing ETFs and their compliance policies and procedures.

A transcript of Ms. Blass's remarks at the 2018 IDC Fund Directors Conference is available at: https://www.sec.gov/news/speech/speech-blass-101618

PRESS RELEASES

SEC Issues New Strategic Plan for Fiscal Years 2018–2022

On October 11, 2018, the SEC released a new strategic plan for fiscal years 2018 through 2022, outlining SEC Chairman Jay Clayton's top priorities for the agency over the next several years. The plan sets forth three broad strategic goals, focusing on investors, innovation and performance, and identifies agency initiatives in pursuit of these goals. Specifically, these goals direct the SEC to: (1) focus on the long term interests of retail investors; (2) recognize significant developments and trends in evolving capital markets and adjust the agency's efforts to ensure effective allocation of resources; and (3) elevate the agency's performance by enhancing its analytical capabilities and human capital development. Among the more notable initiatives associated with the foregoing goals is the SEC's undertaking to identify, and take steps to address, existing SEC rules and approaches that are outdated; i.e., those that are not functioning as intended in light of rapidly changing markets. The plan also notes the SEC's broad effort to modernize the design, delivery and content of disclosures so investors—and retail investors in particular—

can access readable, useful and timely information to make informed investment decisions. The efforts of this particular initiative have already borne fruit with the SEC's adoption in June of new Rule 30e-3 under the Investment Company Act of 1940, which creates an optional "notice and access" method for delivering shareholder reports, as well as the more recent proposed rule changes designed to improve disclosure for investors about variable annuity contracts and variable life insurance policies. With respect to the SEC's resources, the agency will seek to expand the use of risk and data analytics to inform how it sets regulatory priorities and focus staff resources. This initiative, according to the strategic plan, will include developing a data management program that treats data as an SEC-wide resource with appropriate data protections, enabling rigorous analysis at reduced cost.

The SEC's strategic plan is available at: https://www.sec.gov/files/SEC_Strategic_Plan_FY18-FY22_FINAL_0.pdf

Litigation and Enforcement Actions and Initiatives

SECTION 36(B) LITIGATION

District Court Grants Summary Judgment in Section 36(b) "Manager-of-Managers" Excessive Fee Suit

On October 9, 2018, the U.S. District Court for the District of New Jersey granted defendant New York Life Investment Management, LLC's motion for summary judgment in an excessive fee suit brought under Section 36(b) of the Investment Company Act of 1940 by shareholders of four mutual funds managed by New York Life. New York Life managed the funds using a "manager-of-managers" structure, with sub-advisers providing portfolio management services. The plaintiffs alleged that New York Life's advisory fees were excessive because New York Life delegated "substantially all of its responsibilities" under its management agreements to sub-advisers and sub-administrators while retaining a substantial portion of the fees paid under those agreements.

Following the initiation of the case, two of the four funds in question were reorganized and ceased to exist—one fund was reorganized into another fund in the same complex and another was reorganized into a newly organized fund in another complex for which New York Life does not serve as investment adviser. New York Life moved for summary judgment with respect to all claims relating to these funds, asserting that the plaintiffs lacked standing to maintain the Section 36(b) action. In granting New York Life's motion for summary judgment with respect to the two funds that were reorganized, the Court noted that, under Section 36(b) case law, to have standing a shareholder plaintiff must be a security holder from the time the case is initiated throughout the pendency of the litigation. The Court held that the plaintiffs were no longer security holders of the funds that underwent reorganizations and that no exceptions to the general standing rules applied because the reorganizations resulted in the shareholders becoming investors in different funds.

With respect to the other two funds, the Court reviewed the allegations and evidence in accordance with the six-factor framework set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, and determined that all factors tipped in favor of New York Life. The plaintiffs' case primarily rested on assertions that the funds' board was not sufficiently independent and conscientious in reviewing the funds' advisory fees, but the Court determined that the plaintiffs had failed to present evidence that would lead a reasonable jury to find in the plaintiffs' favor on this point. Accordingly, the Court granted New York Life's motion for summary judgment with respect to these funds.

The opinion was issued under the caption *Redus-Tarchis v. New York Life Investment Management, LLC*, Case No. 14-7991.

District Court Grants Partial Summary Judgment in Section 36(b) Excessive Fee Suit

On October 3, 2018, the U.S. District Court for the Southern District of New York issued an opinion and order granting in part and denying in part defendant Calamos Advisors LLC's motion for summary judgment in an excessive fee suit brought under Section 36(b) of the Investment Company Act of 1940. In the suit, the plaintiffs, shareholders of the Calamos Growth Fund, alleged that Calamos charged excessive advisory fees to the Fund in light of the firm providing substantially similar services for a lower fee as a sub-adviser to unaffiliated funds.

The Court granted summary judgment with respect to two of the *Gartenberg* factors—economies of scale and fall-out benefits. Regarding economies of scale, the Court held that the plaintiffs had failed to provide evidence that the Fund's actual transaction costs per investor decreased as the Fund's assets grew, stating that "economies of scale cannot be inferred solely from the fact that operating expenses declined at a time when the at-issue fund's assets grew." Regarding fall-out benefits, although the plaintiffs pointed to other fees received by Calamos for services rendered, the Court noted that the plaintiffs offered no evidence that such fees constituted a fall-out benefit to Calamos. However, the Court denied summary judgment on the other four *Gartenberg* factors—the conscientiousness of the trustees' review process, nature and quality of services, profitability and comparative fee structures—concluding that there were relevant issues of fact on these points to be determined at trial.

The opinion and order were issued under the caption *Chill v. Calamos Advisors LLC*, Case No. 15 Civ. 1014.

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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.

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