

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

NEW RULES

SEC Adopts New Rules Permitting Covered Investment Fund Research Reports

On November 30, 2018, the SEC adopted Rule 139b under the Securities Act of 1933, substantially as proposed, establishing a safe harbor under which unaffiliated broker-dealers may publish and distribute research reports on “covered investment funds”—registered investment companies, BDCs and certain commodity- or currency-based trusts or funds—without such publication or distribution being deemed an offer of securities. Establishing this new safe harbor was mandated by the Fair Access to Investment Research Act of 2017.

Rule 139b permits two types of research reports: (1) issuer-specific research reports and (2) industry reports. Each type of research report must be published or distributed in a broker-dealer’s “regular course of business.” In addition—in a change from the proposal—final Rule 139b requires any performance information included in a research report to be presented in accordance with certain standardized requirements (e.g., mutual fund performance must be presented according to the requirements of Rule 482). For issuer-specific research reports, a fund must have been subject to periodic reporting requirements for at least 12 months and be current in its reporting. Funds included in an industry report must also be subject to periodic reporting requirements but there is no 12-month reporting history requirement.

To help implement Rule 139b, the SEC also adopted Rule 24b-4 under the Investment Company Act of 1940, which frees a Rule 139b research report from SEC filing requirements if it is subject to the content requirements of FINRA or another self-regulatory organization, as well as an amendment to Rule 101 of Regulation M.

The new rules and amendments will be effective 30 days after publication in the Federal Register. The adopting release is available at: <https://www.sec.gov/rules/final/2018/33-10580.pdf>

SEC STAFF GUIDANCE AND ALERTS

Division of Investment Management Updates Investment Company Reporting Modernization FAQs

On November 14, 2018, the staff of the SEC's Division of Investment Management updated its frequently asked questions, originally released on July 18, 2017, relating to the investment company reporting modernization reforms adopted in October 2016 and revised in December 2017.¹ Among other things, the additional FAQs address:

- staff guidance on calculating performance returns in Form N-PORT without deducting sales loads or redemption fees;
- Form N-PORT and Form N-CEN filing requirements for funds that have been liquidated, merged or otherwise terminated; new funds that have not yet publicly issued shares; and funds that have filed a notice to elect to be regulated as a BDC; and
- how to respond to certain new Regulation S-X disclosure requirements relating to derivative contracts whose underlying assets are indices or baskets of investments.

The updated FAQs are available at: <https://www.sec.gov/investment/investment-company-reporting-modernization-faq>

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 indices.** OCIE will review the risks and challenges associated with an index provider constructing and maintaining an index for a single fund or sponsor that allows for a more complex or targeted investment strategy than traditional index funds. OCIE will review the roles of the adviser and index provider in selecting and weighting index components and performing 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 disclosure and review communication to the board about the services provided by index providers.

¹ The Division's original FAQs were summarized under the heading "Division of Investment Management Releases Investment Company Reporting Modernization FAQs" in the August 2017 edition of the Regulatory Update, which is available at <https://www.vedderprice.com/investment-services-regulatory-update-2017-08>.

- **Smaller or thinly traded ETFs.** OCIE will evaluate the adequacy of risk disclosures to investors concerning such ETFs, which include the potential for a rapid decline in the ETF's market price, an exchange delisting and liquidation. OCIE will also assess whether boards review ETFs' ongoing viability and whether tracking error is effectively monitored.
- **Funds with aberrational underperformance relative to their peer groups.** OCIE will review the reasons for such underperformance with a focus on portfolio management processes and consistency with stated 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 or their advisers have appropriate policies, procedures and oversight processes in place, 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. 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>

Public Statements, Press Releases and Testimony

SPEECHES

Remarks by Dalia Blass, Director of the SEC's Division of Investment Management, at the ALI CLE 2018 Conference on Life Insurance Company Products

On November 8, 2018, Dalia Blass, Director of the SEC's Division of Investment Management, delivered the keynote address at the annual ALI CLE conference on life insurance company products. Among other topics, she discussed the SEC's recent variable annuity summary prospectus proposal. Ms. Blass noted that the proposal "would introduce layered disclosure to insurance products, update the registration forms, take a fresh look at addressing discontinued contracts and leverage technology." Ms. Blass stated that the summary prospectus proposal could "significantly improve the experience of investors" as it would allow them to use the summaries as a "starting point" to obtain information that interests them and responds to their needs.² Ms. Blass also discussed the SEC's desire to promote regulatory consistency, noting the Division's recent relief granted to issuers of structured indexed annuities that permits filing audited financial statements prepared in accordance with SAP (statutory accounting principles) rather than GAAP (generally accepted accounting principles). Ms. Blass explained that the relief aligns the financial reporting standards applicable to these products with the standards used for other registered insurance products such as variable annuities. Finally, Ms. Blass reported that the SEC staff is monitoring the implementation of recently adopted rules, including the liquidity risk management rule. Ms. Blass stated that the liquidity rule's 15% limitation on illiquid investments does not require forced sales but rather it requires a fund to (1) stop acquiring illiquid investments, (2) provide notice to the SEC and (3) present a plan to its board of directors to address how the fund will bring its illiquid investments under 15% within a reasonable period of time—which, she added, is not saying that funds should just start selling illiquid investments. She concluded by noting the staff's active engagement on questions regarding implementation of the rule and that the staff remains available to advise and assist industry participants.

A transcript of Ms. Blass's remarks is available at: <https://www.sec.gov/news/speech/speech-blass-110818>

² For additional information regarding the proposed summary prospectus for variable insurance products, please see: <https://www.vedderprice.com/the-sec-variable-contract-summary-prospectus>.

Litigation and Enforcement Actions and Initiatives

SECTION 36(B) LITIGATION

District Court Issues Tentative Ruling Granting Partial Summary Judgment in Section 36(b) Excessive Fee Suit

On October 25, 2018, the U.S. District Court for the Central District of California issued a tentative ruling granting in part and denying in part defendant Metropolitan West Asset Management, LLC's (MetWest) motion for summary judgment in an excessive fee suit brought under Section 36(b) of the Investment Company Act of 1940 by a shareholder of the Metropolitan West Total Return Bond Fund. The plaintiff alleged that MetWest 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.

After reviewing the arguments and evidence presented, the Court granted the defendant's motion for summary judgment with respect to two of the *Gartenberg* factors—nature and quality of services and fall-out benefits—noting that the plaintiff did not offer a strong argument that those factors leaned in his favor. However, the Court denied summary judgment as to the other *Gartenberg* factors.

As to comparative fee structures, the Court stated that MetWest's reliance on peer group data as evidence of the reasonableness of the advisory fee was not sufficient to warrant summary judgment because comparing the fees charged by MetWest as a sub-adviser to unaffiliated funds to the advisory fee MetWest charged the fund could offer a "probative alternative" that could prevail at trial. The Court also refused to grant summary judgment on the care and conscientiousness of the board. In that regard, the Court stated that the board's decision to approve the advisory fee should be entitled to considerable weight unless the board's approval process was deficient or MetWest withheld material information from the board. However, the Court found that there was a triable issue of fact as to the approval process because the board did not receive or consider certain materials. (The identity of the materials the Court took issue with were redacted in the tentative ruling.) The Court also determined that there were triable issues of fact as to economies of scale and profitability.

The tentative ruling was issued under the caption *Kennis v. Metropolitan West Asset Management, LLC*, Case No. 2:15-cv-8162-GW-FFM.

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
Cody L. Lipke..... +1 (312) 609 7669
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

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
W. Thomas Conner..... +1 (202) 312 3331
Amy Ward Pershkov..... +1 (202) 312 3360
Emily T. Rubino..... +1 (202) 312 3385

London

Sam Tyfield..... +44 (0)20 3667 2940

Investment Services Group

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