VedderPrice

August 2019

Investment Services Regulatory Update

Litigation and Enforcement Actions and Initiatives

SECTION 36(b) LITIGATION

Court Finds for Defendant Investment Adviser in Section 36(b) Excessive-Fee Case

On August 5, 2019, the U.S. District Court for the Central District of California found for the defendant, Metropolitan West Asset Management, LLC (MetWest), following a bench trial in an excessive fee case brought under Section 36(b) of the Investment Company Act of 1940 by a shareholder of the MetWest Total Return Bond Fund. The plaintiff's claim centered on a comparison between the fees charged by MetWest in its role as investment adviser to the fund versus the sub-advisory fees charged by MetWest in serving as a sub-adviser to unaffiliated funds. Specifically at issue in the trial were four of the *Gartenberg* factors: comparative fees, profitability, economies of scale and the independence of the independent directors and the care and conscientiousness with which they performed their duties—i.e., whether the board's approval of the advisory fee deserved substantial deference by the court. The court had previously granted the defendant's motion for summary judgment with respect to fall-out benefits and the nature and quality of services provided

The court's findings regarding the *Gartenberg* factors at issue were as follows:

- ***Deference Owed to the Board's Approval of the Advisory Fee.*** The court afforded the board's decision to approve the fund's advisory fee substantial deference on the basis of, among other things, the board's "sufficiently robust" 15(c) process. The plaintiff failed to persuade the court that the board's process was deficient simply because MetWest neither delineated the services it provided to sub-advised funds on a sub-advised-fund-by-sub-advised-fund basis nor provided the sub-advisory agreements to the board. In addition, the court concluded that the board's failure to negotiate a fee reduction did not prevent a finding that deference was owed. In this regard, the court concurred with the defendant's assertion that "it was not the Board's duty to negotiate the best deal possible, but instead to use its reasonable judgment in deciding whether to approve a fee once it had all relevant information."

- ***Comparative Fees.*** The court concluded that the services MetWest provided to the fund were significantly different from the services it provided to the sub-advised funds, noting, among other things, MetWest's responsibilities in calculating the fund's net asset value, satisfying redemption requests, providing compliance-related services, preparing public filings, assisting the board in fulfilling its duties and overseeing third-party service providers. The court also concluded that MetWest assumed substantial risks as adviser to the fund, which risks MetWest did not face — at least not to the same extent — when serving as sub-adviser. The risks cited by the court included reputational, financial, litigation and business risks, as well as cybersecurity risks, the threat of losing personnel essential to client relations, asset flight risk and risks associated with the fund's regulatory filings.
- ***Economies of Scale.*** The court did not believe that the plaintiff proved the existence of economies of scale, finding that the plaintiff's expert witness was not persuasive. Moreover, the court concluded that, even if the evidence showed that MetWest experienced some economies of scale, the evidence was insufficient to find that MetWest failed to share those economies of scale with the fund. The court determined that the fund benefited from MetWest's reinvestments in its organization—including through the addition of new employees, improving technology systems and increasing compensation for retention purposes. The court also noted the plaintiff's failure to cite any case law requiring that the realization of economies of scale result in the addition of fee reductions or breakpoints in the advisory fee schedule. The court further cited evidence that MetWest priced the fund to scale at the outset.
- ***Profitability.*** In finding that the plaintiff failed to prove that the profitability factor leaned in his favor, the court noted that MetWest's profit margins over the relevant period "generally rested below the median of reported profit margins that other asset managers comparable to MetWest received."

The court found in favor of MetWest and ordered the dismissal of the plaintiff's action in its entirety, on the merits and with prejudice. The case is *Kennis v. Metropolitan West Asset Management, LLC*, Case No. 2:15-cv-08162 (C.D. Cal. July 9, 2019).

OTHER LITIGATION MATTERS

Second Circuit Creates Split Regarding Private Right of Action for Rescission under Section 47(b) of the 1940 Act

On August 5, 2019, the U.S. Court of Appeals for the Second Circuit created a split with other courts regarding whether there is a private right of action for rescission under Section 47(b) of the Investment Company Act of 1940. The plaintiffs in the litigation, which was initiated in the U.S. District Court for the Southern District of New York, were investors in junior notes issued by a special-purpose vehicle organized as a trust that relied on the exemption from the definition of "investment company" provided by Section 3(c)(7) of the 1940 Act, under which an issuer all of whose securities are owned by "qualified purchasers" is not an investment company. The plaintiffs alleged that certain investors in the junior notes were not qualified purchasers, and therefore that the trust was in violation of the 1940 Act's registration requirements. Accordingly, the plaintiffs alleged that noteholders should be entitled to rescission of their investments in the notes under Section 47(b) of the 1940 Act, which provides that a contract made in violation of the 1940 Act, or whose performance involves a violation of the 1940 Act, is generally unenforceable by either party and permits the rescission of such a contract to the extent the contract has been performed. The district court concluded that no private right of action exists to assert rescission claims under Section 47(b), and it granted summary judgment to the defendants.

On appeal, the Second Circuit disagreed with the district court and ruled that, based on the text of the statute and its legislative history, Section 47(b) of the 1940 Act creates an implied private right of action to sue for rescission of a contract allegedly made in violation of the 1940 Act. In rendering its decision, the Second Circuit applied the U.S. Supreme Court's reasoning from its decision on private rights of action in *Alexander v. Sandoval* (2001), focusing on the text and structure of Section 47(b), which was added to the 1940 Act by a 1980 amendment. The Second Circuit found that Congress's implied intent was unambiguous even though there was no express right to sue under Section 47(b). The Second Circuit noted that the language of Section 47(b), which provides that "a court may not deny rescission at the instance of any party unless such court finds that under the circumstances the denial of rescission would produce a more equitable result than its grant and would not be inconsistent with the purposes of [the 1940 Act]," "necessarily presupposes that a party may seek rescission in court by filing suit" and "is thus effectively equivalent to providing an express cause of action."

In recent years, most courts have interpreted the 1940 Act as providing only a single private right of action under Section 36(b), expressly granted to investment company shareholders to recover excessive advisory fees from investment advisers and their affiliates. The Second Circuit acknowledged that it was creating a circuit split with its decision, noting that "the Third Circuit and several lower courts have reached the opposite result." In particular, the court noted the Third Circuit's decision in *Santomenno ex rel. John Hancock Trust v. John Hancock Life Insurance Co.* (2012), in which that court found that plaintiffs lacked a private right of action to seek rescission under Section 47(b). The Second Circuit stated that it did not find the reasoning in *Santomenno* persuasive.

The opinion was issued under the caption *Oxford University Bank v. Lansuppe Feeder Inc.*, No. 16-4061 (2d Cir. Aug. 5, 2019).

New Rules, Proposed Rules, Guidance and Alerts

GUIDANCE AND ALERTS

SEC Staff Issues No-Action Letter Extending Existing Multi-Manager Exemptive Relief to Non-Wholly-Owned Affiliated Sub-Advisers

On July 9, 2019, the staff of the SEC's Division of Investment Management issued a no-action letter to the BNY Mellon family of funds and BNY Mellon Investment Adviser, Inc. (collectively, BNYM) stating that the staff would not recommend enforcement action if a fund complex and adviser that previously obtained a "multi-manager" or "manager of managers" exemptive order engages any sub-adviser, regardless of the extent of the sub-adviser's affiliation with the adviser, without seeking an amended exemptive order from the SEC. The staff's no-action position is conditioned on compliance with several conditions set forth in the recent exemptive order issued to Carillon Series Trust and Carillon Tower Advisers, Inc., which was the first exemptive order issued by the SEC extending multi-manager exemptive relief to all sub-advisers, regardless of the extent of the sub-adviser's affiliation with the adviser.

BNYM's existing manager-of-managers exemptive order permits it to enter into and materially amend sub-advisory agreements with sub-advisers without obtaining shareholder approval and to disclose the fees paid to the sub-advisers on an aggregate, rather than on an individual, basis. However, BNYM's exemptive relief applies only to sub-advisers that are either unaffiliated with BNYM or that are wholly-owned subsidiaries of BNYM's ultimate parent company. In other words, the exemptive relief by its terms does not cover affiliated sub-advisers that are not wholly owned. The staff's no-action position effectively expands the scope of BNYM's exemptive relief to be in line with that granted to Carillon, subject to the conditions set forth in the Carillon exemptive order.

The exemptive relief in Carillon's recent order was subject to conditions similar to those in other multi-manager exemptive orders but with the following key differences:

- Elimination of a requirement that the adviser provide the board with quarterly information about the profitability of the adviser on a per sub-advised fund basis.
- Addition of a requirement that the board evaluate potential material conflicts of interest when a sub-adviser change is proposed or when the board considers an existing sub-advisory agreement as part of its annual 15(c) review process.
- Addition of a requirement that the adviser provide the board with certain information related to material conflicts of interest during the annual 15(c) review process, including:

– any material interest the adviser has in the sub-adviser and any material impact the proposed sub-advisory agreement may have on that interest;

– any arrangement or understanding involving the adviser that may have a material effect, or be materially affected by, the sub-advisory agreement;

– any material interest in a sub-adviser held directly or indirectly by an officer or director of the sub-advised fund, or an officer or director of the adviser; and

– any other information that may be relevant to the board in evaluating potential material conflicts of interest with respect to the sub-advisory agreement.

The BNYM no-action letter permits a fund to rely upon the Carillon exemptive order without the need to amend the fund's prior multi-manager exemptive order, subject to compliance with the conditions in the Carillon order. Among these conditions is a requirement that the fund obtain shareholder approval to operate as a fund using multi-manager relief for affiliated sub-advisers with respect to any existing or future sub-adviser going forward. Alternatively, a fund may continue to rely on its prior multi-manager order solely with respect to the types of sub-advisers covered by that order, but it may choose to comply with the conditions in the Carillon order instead of the conditions in the fund's existing multi-manager order, provided the fund does so with respect to all existing and future sub-advisers going forward.

Read the SEC staff's no-action letter to BNYM here.

BNYM's request for the no-action position is available here.

OCIE Issues Risk Alert Relating to Investment Adviser Oversight of Supervised Persons with Disciplinary Histories

On July 23, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert outlining its observations and recommendations following an examination initiative that focused on oversight practices at registered investment advisers that employ supervised persons with disciplinary histories. Although the initiative focused on practices relating to the oversight of employees with disciplinary histories, the risk alert also identified more general supervision deficiencies observed by the OCIE staff. The observations fell into the following three main categories:

- ***Supervised Persons with Disciplinary Histories.*** OCIE observed that many advisers failed to provide full and fair disclosure to clients of disciplinary events involving the adviser or its employees and that many advisers did not adopt compliance programs that adequately addressed the risks of employing individuals with disciplinary histories.

- ***Compliance and Supervision.*** OCIE observed that many advisers did not adequately supervise or establish standards of conduct for supervised persons, including with respect to supervised persons who work remotely, prepare their own advertising or otherwise exercise autonomy. OCIE additionally noted that many advisers had adopted supervision policies and procedures that were at odds with their actual practices and disclosures.

- ***Conflict-of-Interest Disclosures.*** OCIE observed many advisers with undisclosed compensation arrangements that resulted in conflicts of interest that could have affected the impartiality of advice given to clients.

The risk alert included recommendations for improving the compliance deficiencies observed by the OCIE staff, such as adopting and implementing tailored policies and procedures that address issues relating to hiring supervised persons with disciplinary histories, enhancing due diligence practices with respect to hiring practices and heightened supervision for employees with disciplinary histories or those who work remotely.

The OCIE risk alert is available here.

FINRA Issues Supplemental Guidance on Giving Credit for Extraordinary Cooperation

On July 11, 2019, FINRA issued Regulatory Notice 19-23 to restate and supplement its prior guidance to member firms on the circumstances under which FINRA awards credit for providing “extraordinary cooperation” during an investigation. FINRA’s original guidance on extraordinary cooperation was set forth in Regulatory Notice 08-70, issued in 2008. The latest guidance in Regulatory Notice 19-23 is intended to provide clarity to member firms on the differences between required disclosure versus extraordinary cooperation in order to provide incentives to member firms to assist FINRA after a violation has occurred.

When a member firm violates FINRA rules, providing extraordinary cooperation to FINRA can result in reduced sanctions. Specifically, when a firm provides extraordinary cooperation, FINRA may recommend a sanction on the low end of its Sanction Guidelines (e.g., a substantially reduced fine or no required undertakings) or forgo a formal disciplinary action entirely (e.g., instead issuing a cautionary action letter or a declaration of no further action). In light of these advantages, it is important for member firms to understand the circumstances under which FINRA may award such credit.

As set forth in Regulatory Notice 19-23, FINRA considers the following four factors in its analysis of whether to give credit for extraordinary cooperation:

- ***Providing Credit for Steps Taken to Correct Deficient Procedures and Systems.*** Firms may receive credit for taking actions that go beyond the baseline requirement to correct deficiencies, such as when a firm conducts an independent audit, hires an independent consultant or makes other organizational changes to prevent future violations.

- ***Providing Credit for Restitution to Customers.*** Firms must provide restitution promptly and completely. FINRA will also consider whether a firm made restitution before or after detection or intervention by a regulator.
- ***Self-Reporting Credit.*** FINRA rules require member firms to report internal determinations that certain laws, rules, regulations and standards of conduct have been violated. To gain credit for self-reporting, a firm must go significantly beyond what is otherwise required by FINRA reporting requirements.
- ***Providing Substantial Assistance to FINRA Investigations.*** Firms must provide FINRA with full information about the misconduct, including all relevant issues, products, markets and industry participants.

FINRA intends to publicize instances in which member firms receive credit as a result of extraordinary cooperation to further encourage firms to provide such cooperation. The publication of these instances will be done through press releases that note the factors leading to a firm receiving credit as well as the type of credit or lower sanction a firm received.

Read a copy of Regulatory Notice 19-23 here.

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Investment Services Group

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