Investment Services Regulatory Update

October 2019

VedderPrice

NEW RULES, PROPOSED RULES, GUIDANCE AND ALERTS....... 3

Guidance and Alerts..3

SEC Staff Issues Guidance on Performance and Fee Disclosure 3

New Rules...3

SEC Adopts “New Test-the-Waters” Rule 3

SEC Adopts New ETF Rule 4

LITIGATION AND ENFORCEMENT MATTERS 6

Enforcement Matters...6

SEC Settles Additional Share Class Selection Actions...6

SEC Settles with Adviser for Overcharging Clients...6

SEC Settles Charges Against Two Advisers Relating to Variable Insurance Portfolios........7

New Rules, Proposed Rules, Guidance and Alerts

GUIDANCE AND ALERTS

SEC Staff Issues Guidance on Performance and Fee Disclosure

On October 2, 2019, the Disclosure Review and Accounting Office staff in the SEC's Division of Investment Management issued guidance concerning certain performance and fee disclosure issues observed by the staff in fund filings. The staff's guidance was issued as Accounting and Disclosure Information (ADI) 2019-09 — Performance and Fee Issues. The ADI identifies fund disclosure failures or errors relating to the following disclosure categories:

- **Sales Loads.** Failure to reflect the deduction of maximum sales loads in the average annual return table, resulting in overstated performance.
- **Performance Presentations.** (1) Showing negative performance as positive performance in the bar chart and/or average annual return table. (2) transposing performance of fund classes—e.g., showing class A performance as class B performance and vice versa and (3) transposing performance of multiple benchmark indices.
- **Fee Waivers and Net Expenses.** Listing adviser expense recoupments as a positive fee waiver in the fee table, causing net expenses to be greater than gross expenses. This approach, the staff noted, is inconsistent with Form N-1A requirements, which permit two additional line items to reflect a fee waiver and net expenses only if there is a reduction in gross fees as a result of the waiver.
- **Acquired Fund Fees and Expenses.** Failure to reflect the appropriate amount of acquired fund fees and expenses.
- **Expense Example.** Failure to correctly calculate the expense example, which may be attributable to, among other things (1) arithmetic errors, (2) failure to reflect fee waivers for only the term of the waiver or (3) failure to include certain fee items, such as acquired fund fees and expenses.
- **Risk Return Summary.** Failure to correctly tag risk/return summaries in XBRL, such as by (1) using the wrong tags,(2) entering the data incorrectly or (3) associating the tagged information with the wrong fund or class. Importantly, the staff noted that "tagged data files carry the same liability as the related official filings."

The ADI advises funds to verify the accuracy of performance and fee disclosures prior to filing them with the SEC and providing them to investors.

The ADI is available here.

NEW RULES

SEC Adopts "New Test-the-Waters" Rule

On September 25, 2019, the SEC adopted Rule 163B under the Securities Act of 1933, which will permit issuers to "test the waters" prior to a registered public offering by engaging in oral or written communications with potential investors that are, or are reasonably believed to be, qualified institutional buyers (QIBs) or institutional accredited investors (IAIs), in order to gauge investor interest in the contemplated offering. Under Rule 163B, these communications may be made either before or after filing a registration statement for the offering without violating the "gun jumping" restrictions of the Securities Act. The relief that Rule 163B will provide to all issuers was

previously available only to an issuer that qualifies as an "emerging growth company" under the Securities Act.

Of note for investment companies, Rule 163B will not provide an exemption from the requirement that a fund register as an investment company under the Investment Company Act of 1940 before offering its shares. As a result, Rule 163B will be of limited use for most funds because funds generally file their initial Securities Act and 1940 Act registration statements simultaneously on the same form. For funds that engage in preliminary offerings that are exempt from the registration requirements of the Securities Act and the 1940 Act, such as certain closed-end funds and BDCs, Rule 163B would provide a useful way to test the waters if the issuer is considering a subsequent registered offering. Reliance on Rule 163B would not preclude reliance on other available communications rules or exemptions under the Securities Act.

The SEC adopted Rule 163B substantially as proposed. Minor revisions to the proposed rule include the elimination of certain ambiguous "anti-evasion" language and clarification that communications under the rule are not free writing prospectuses that must be filed.

Rule 163B will become effective 60 days after publication in the Federal Register.

The SEC's adopting release is available here.

SEC Adopts New ETF Rule

On September 26, 2019, the Securities and Exchange Commission (the "SEC") adopted Rule 6c-11 (the "Rule") under the Investment Company Act of 1940 (the "1940 Act"), the long-awaited "ETF Rule." ETFs that satisfy certain conditions will no longer be required to first obtain individualized exemptive orders from the SEC before launching and operating. The Rule will be effective sixty days after publication in the Federal Register, with a one-year transition period for compliance with the registration statement disclosure requirements.

After one year, the SEC will rescind existing ETF orders. This means that ETFs (other than a small group of ETFs discussed below) will no longer be able to operate under their individualized exemptive relief, which over time has subjected ETFs to inconsistent terms and conditions. Instead, these ETFs will operate under a standard set of conditions designed to create a consistent, transparent, and efficient regulatory framework that should facilitate greater competition and innovation.

Vedder Price will analyze the impact of the Rule on ETFs and their sponsors, and will publish a comprehensive guide for implementing the new policies and procedures required by the Rule. The guide will also discuss the impact of the Rule on the operations of existing ETFs and the imposition of additional costs and burdens that may flow from the Rule. In the interim, what follows is an overview of the primary provisions of the Rule that were adopted substantially as proposed, and the provisions that were modified in response to industry comments.

Provisions Adopted as Proposed

Scope

- **Applicability to certain ETFs** Leveraged and inverse ETFs, ETFs organized as unit investment trusts ("UITs"), and ETFs organized as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio, are not covered by the Rule. Prior exemptive orders for such ETFs will not be rescinded.
- **Classification of ETF shares** Shares of ETFs relying on the Rule are classified as "redeemable securities" for various purposes under the 1940 Act and Securities Exchange Act of 1934 ("Exchange Act"). Shares of all ETFs are classified as redeemable for certain provisions of the Exchange Act.
- **No distinction between indexed-based and actively managed ETFs.** Under the Rule, both index-based and actively managed ETFs are subject to the same conditions.

- **No distinction between self-indexed and unaffiliated indexed ETFs.** Under the Rule, self-indexed ETFs are subject to the same conditions as ETFs with an unaffiliated index provider.
- **Rescission of certain prior exemptive orders** Effective one year after the effective date of the Rule, exemptive orders granted to ETFs covered by the Rule will be rescinded.

Transparency and Disclosure

- **Portfolio holdings publication.** The SEC adopted a "full transparency" requirement as proposed. An ETF must disclose prominently on its website the portfolio holdings that will form the basis for the next calculation of net asset value ("NAV") per share, which must be disclosed each business day before the opening of regular trading on the primary listing exchange of the ETF's shares.
- **No requirement to publish intraday indicative value.** Under the Rule, ETFs will not be required to publish an intraday indicative value ("IIV").
- **Bid-Ask spread publication.** ETFs must disclose on their websites information about median bid-ask spreads and certain historical information about the extent and frequency of premiums and discounts.
- **Cost Disclosure.** Additionally, the Rule includes registration form amendments requiring additional disclosure regarding ETF trading information and related costs.

Custom Baskets

- **Custom baskets permitted.** Baskets that are composed of a non-representative selection of the ETF's portfolio holdings are permitted, subject to certain disclosure requirements and potentially burdensome requirements to establish new policies and procedures for custom baskets.

Provisions That Were Not Adopted as Proposed or That Were Modified

Several provisions of the proposed rule were controversial and generated substantial industry feedback because they would have placed additional costs or operational burdens on ETFs. The SEC took these comments into consideration and made the following changes to the proposed rule. The changes primarily involved proposed requirements relating to transparency and disclosure provisions

Transparency and Disclosure

- **Basket publication.** The Rule eliminates the requirement to publish on an ETF's website a hypothetical basket that it would exchange for orders to purchase or redeem creation units based on the ETF's next calculation of NAV. While this requirement was designed to facilitate arbitrage by providing market participants with timely information regarding the contents of a basket that the ETF would accept that particular day, the SEC agreed with commenters that the proposed published basket was speculative and that it would be costly to implement and unnecessarily burdensome, particularly because basket composition information is not used by secondary market investors.
- **Portfolio holdings disclosure.** The Rule eliminates the proposal to require an ETF to disclose its portfolio holdings before it starts accepting orders for the purchase or redemption of creation units. This "second" portfolio holding publication requirement would have been in addition to the general pre-trading requirement to disclose portfolio holdings.
- **Bid-Ask spread publication.** The Rule modifies the proposal to require disclosure on an ETF's website of the median bid-ask spread disclosure over the most recent fiscal year to the most recent 30 calendar days.
- **Hypothetical bid-ask spread publication.** The Rule eliminates the proposal to require examples in an ETF's prospectus showing how bid-ask spreads would impact the return of a hypothetical investment.
- **Interactive calculator.** The Rule eliminates the

proposal to require an interactive calculator on an ETF's website allowing an investor to customize hypothetical bid-ask spread calculations.

If you have any questions, please contact the authors and attorneys W. Thomas Conner, Deborah Bielicke Eades or John Sanders of Vedder Price's Investment Services group, or your Vedder Price contact.

The SEC's adopting release is available here.

Litigation and Enforcement Matters

ENFORCEMENT MATTERS

SEC Settles Additional Share Class Selection Actions

On September 30, 2019, the SEC announced settlements with 16 investment advisers that self-reported violations of the Investment Advisers Act of 1940, as well as an additional settlement with one investment adviser that did not self-report, in connection with allegedly inadequate disclosures relating to the advisers' practices for selecting mutual fund share classes for advisory clients. The settlements were part of the SEC's Share Class Selection Disclosure Initiative, which the SEC launched in February 2018 to address potentially widespread violations of the federal securities laws relating to the practice by investment advisers of selecting for advisory clients high-cost mutual fund share classes that charge 12b-1 fees when a lower-cost share class of the same fund is available. In March 2019, the SEC previously announced similar settlements with 79 investment advisers under the initiative that resulted in more than $125 million in disgorgement and interest being returned to investors.

In the September 30 settlements, each investment adviser, without admitting or denying the allegations, agreed to be censured, consented to a cease and desist order finding violations of applicable sections of the Advisers Act and agreed to disgorge allegedly improperly disclosed fees, with interest, and to distribute the funds to clients. In the aggregate, the September 30 settlements resulted in more than $10 million in disgorgement and interest being returned to investors. In addition, the settling investment adviser that did not self-report was ordered to pay a $300,000 civil penalty. Similar to the March 2019 settlements, each settling investment adviser has also undertaken to review and correct all relevant disclosures concerning mutual fund share class selection and 12b-1 fees, and to evaluate whether existing clients' assets should be moved to an available lower-cost share class.

The SEC's announcement and links to each investment adviser's settlement order are available here.

SEC Settles with Adviser for Overcharging Clients

On September 17, 2019, the SEC announced that it had settled administrative proceedings against three Raymond James entities for allegedly charging advisory fees on inactive retail client accounts and charging excess commissions for brokerage customer investments in certain unit investment trusts (UITs). The SEC alleged that Raymond James failed to consistently perform promised, ongoing suitability reviews of inactive client accounts and, as a result, failed to move client assets to lower-fee brokerage accounts, in violation of the policies and procedures described in its Form ADV Part 2A brochures. The SEC also alleged that Raymond James recommended that clients accelerate the frequency of UIT transactions, resulting in the payment of additional sales charges and processing fees, without adequately determining whether these recommendations were suitable. The SEC further alleged that Raymond James misapplied pricing data to UIT positions held by advisory clients and failed to apply available sales charge discounts to certain clients' purchases of UITs, causing clients to overpay fees. Without

admitting or denying the allegations, the three Raymond James entities agreed to be censured; to cease and desist from future violations; to disgorge over $11 million of allegedly inappropriate client advisory fees and UIT commissions, plus over $1 million in interest, which Raymond James will return directly to affected clients; and to pay a $3 million civil penalty.

Read the SEC order here.

SEC Settles Charges Against Two Advisers Relating to Variable Insurance Portfolios

On September 16, 2019, the SEC announced that it had settled administrative proceedings against two Prudential Financial subsidiaries for allegedly failing to disclose certain conflicts of interest and making misleading disclosures to the boards of trustees of certain Prudential-advised mutual funds relating to (1) the funds' securities lending practices and (2) promised reimbursements for certain foreign taxes. The funds in question serve as investment options for variable annuity and variable life insurance contracts sponsored by Prudential and its affiliated insurance companies. According to the SEC, Prudential's tax department directed the funds' affiliated securities lending agent to recall securities on loan from the funds in advance of the securities' dividend record dates, solely to preserve the character of the dividends for tax purposes, which benefited Prudential and its affiliated insurance companies but resulted in lost securities lending revenue and investment income for the funds. The SEC alleged that Prudential failed to identify, or took inadequate steps to address, the conflict between Prudential and the funds, noting that at no time between 2005 and 2015 were compliance personnel consulted on the recall practice. The SEC also alleged that Prudential represented to the funds' boards of trustees that it would reimburse the funds for additional taxes or other adverse effects resulting from the funds' changes in tax status from regulated investment companies (RICs) to partnerships for U.S. federal income tax purposes—a conversion proposed by Prudential in 2005. However, by March 2018, according to the SEC, Prudential owed the funds more than $58.6 million in past-due foreign tax reimbursements, and the funds did not receive approximately $25 million in additional investment income they would have earned on that revenue had it been paid when due. Without admitting or denying the allegations, the two Prudential entities agreed to be censured; to cease and desist from future violations; to disgorge over $27.6 million; and to pay a $5 million civil penalty. The SEC order recognized that Prudential self-reported the conduct to the SEC, cooperated with the staff's investigation and previously reimbursed over $155 million to the funds. Read the SEC order here.

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