Investment Services Regulatory Update

October 2020

Monthly Version

VedderPrice

NEW RULES, PROPOSED RULES, GUIDANCE AND ALERTS 2

NEW RULES 2

SEC Adopts New Framework for Fund of Funds Arrangements 2

SEC Adopts Amendments to Shareholder Proposal Rule 3

GUIDANCE AND ALERTS 4

SEC Staff Issues FAQs on Form CRS Disciplinary History Information Accompanied by a Joint Statement from Chairman Clayton and Division Directors 4

SEC Proposes Conditional Exemption for Finders Engaging in Limited Capital Raising Activities 5

LITIGATION AND ENFORCEMENT PROCEEDINGS 6

SEC Settles Enforcement Proceeding Without Imposing a Penalty Against Adviser That Self-Reported Alleged Expense Waiver Misrepresentations 6

District Court Grants Great-West's Motion for Sanctions Following Trial Victory in Section 36(b) Case 6

New Rules, Proposed Rules, Guidance and Alerts

FINAL RULES

SEC Adopts New Framework for Fund of Funds Arrangements

On October 7, 2020, the SEC adopted new Rule 12d1-4 under the Investment Company Act of 1940 and related rule and form amendments that implement a new comprehensive rules-based framework for fund of funds arrangements involving investments by registered funds in other registered funds that exceed the limitations set forth in Section 12(d)(1) of the 1940 Act. In connection with the adoption of the final rule, the SEC also rescinded existing Rule 12d1-2 under the 1940 Act and existing fund of funds exemptive orders that fall within the scope of the new rule.

Background

Section 12(d)(1) of the 1940 Act generally prohibits any registered fund (acquiring fund) from (1) acquiring more than 3% of another fund's (underlying fund's) outstanding voting securities; (2) investing more than 5% of its assets in any one fund; and (3) investing more than 10% of its total assets in funds generally. These limits apply to both registered and unregistered funds with respect to their investments in a registered fund, and to registered funds with respect to their investments in unregistered funds. Over the years, statutory and rules-based exemptions and no-action relief, in addition to exemptive relief granted to many fund complexes, have relaxed these requirements but resulted in substantially similar fund of funds arrangements being subject to different requirements.

New Fund of Funds Framework

The new fund of funds framework is intended to continue to address the SEC's concerns regarding fund pyramiding (e.g., layering of fees) and undue control or influence over underlying funds while providing relief similar to that granted under current exemptive orders, but in a consistent manner, and will be available to registered open- and closed-end funds, including exchange-traded funds, as well as business development companies. The new framework steers board responsibility for such arrangements away from ongoing involvement to one of oversight. The responsibility to review fund of funds arrangements and make certain findings that address the SEC's concerns regarding pyramiding and undue control or influence is shifted to investment advisers.

New Rule 12d1-4 under the 1940 Act will permit an acquiring fund to purchase shares of an underlying fund in excess of the limits set forth in Section 12(d)(1) of the 1940 Act, subject to the following conditions:

- **Control and Voting.** An acquiring fund and its advisory group (i.e., the fund's investment adviser or sub-adviser and any person controlling, controlled by or under common control with the adviser or sub-adviser) generally may not "control" (as defined in Section 2(a)(9) of the 1940 Act) an underlying fund. In addition, an acquiring fund that holds more than 25% (in the case of an open-end fund or unit investment trust) or 10% (in the case of a closed-end fund) of an underlying fund's shares must use either mirror voting or pass-through voting with respect to the underlying fund shares, subject to exceptions for certain affiliated funds. This voting requirement represents a change from the rule as initially proposed in 2018, which would have required mirror voting or pass-through voting when an acquiring fund and its advisory group exceed the 3% limit of Section 12(d)(1) regardless of the type of underlying fund.
- **Investment Adviser Findings.** Before an acquiring fund invests in an underlying fund in excess of the 3% limit in Section 12(d)(1), the investment adviser of the acquiring fund must evaluate the complexity of the fund of funds structure and the underlying fund's fees and expenses, and must find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the underlying fund. (This replaces the

"best interest" finding set forth in the rule as initially proposed in 2018.) In addition, the investment adviser of the underlying fund must find that concerns of undue influence are reasonably addressed based on prescribed considerations. The investment adviser to each fund must report its findings, and the basis therefor, to the applicable fund's board no later than the next regularly scheduled board meeting. In a change from the rule as proposed in 2018, subsequent annual reporting to the board is not required. Different requirements apply where the fund is a unit investment trust or separate account funding variable insurance contracts.

- **Fund of Funds Investment Agreements.** Before relying on Rule 12d1-4 to invest in excess of limits of Section 12(d)(1), the acquiring fund and the underlying fund must enter into a fund of funds investment agreement that includes certain specified terms, including any material terms necessary to enable the funds' investment advisers to make the necessary findings described above, a provision that permits either fund to terminate the agreement on 60 days' notice and a requirement that the underlying fund provide the acquiring fund with information on fees and expenses. This requirement does not apply if the acquiring fund and the underlying fund have the same investment adviser. The requirement for a fund of funds investment agreement replaces a provision in the proposed rule that would have prohibited an acquiring fund from redeeming shares of an underlying fund in an amount greater than 3% of the underlying fund's outstanding shares during any 30-day period.
- **Complex Structures.** Under Rule 12d1-4, fund of fund arrangements generally will be limited to two-tiered structures (i.e., a fund cannot acquire an underlying fund that itself invests in an additional third-tier underlying fund), except that a second-tier underlying fund may itself invest up to 10% of its total assets in a third-tier underlying fund. Certain additional limited exceptions to the 10% limit on third-tier funds also will available. The final rule eliminated a provision of the rule as proposed that would have required acquiring funds to disclose in their registration statements actual or intended reliance on Rule 12d1-4.

Related Amendments and Rescissions

As part of the revised fund of funds framework, the SEC is rescinding Rule 12d1-2 and fund of funds exemptive orders and no-action letters that fall within the scope of Rule 12d1-4. As a result, Rule 12d1-1 is being amended to enable funds relying on Section 12(d)(1)(G) to continue to invest in an unlimited amount of unaffiliated money market funds (e.g., cash sweep arrangements). Amendments to Form N-CEN will require that acquiring funds disclose if they relied upon Rule 12d1-4 or Section 12(d)(1)(G) during the reporting period.

Compliance Date and Transition Period

The final rule is effective 60 days after publication in the Federal Register, at which point funds may rely on Rule 12d1-4. In order to provide a transition period for compliance with the new framework, fund of funds exemptive orders and no-action letters and Rule 12d1-2 will be rescinded, and compliance with the amendments to Form N-CEN will be required, one year after the effective date of the rule.

The SEC's adopting release for Rule 12d1-4 is available here.

SEC Adopts Amendments to Shareholder Proposal Rule

On September 23, 2020, the SEC adopted amendments to Rule 14a-8 under the Securities Exchange Act of 1934, which provides the procedural and substantive requirements for the inclusion of shareholder proposals in a company's proxy statement to shareholders. The amendments were adopted largely as proposed and include the following:

- **Share Ownership.** Under the final rule, in order for a shareholder proposal to be eligible for inclusion, a shareholder must have continuously held voting

securities with the following market values for the following periods:

- $2,000 for at least three years;
- $15,000 for at least two years; or
- $25,000 for at least one year.

Previously, a shareholder was required to have continuously held for one year at least $2,000 in market value, or 1 percent, of a company's voting securities in order for the shareholder's proposal to be eligible for inclusion in the company's proxy materials.

- **Written Statements.** The final rule requires a statement from each shareholder submitting a proposal that such shareholder intends to hold the requisite amount of securities through the date of the company's shareholder meeting and is able to meet with the company no less than 10 and no more than 30 calendar days after the submission of the proposal. The written statement must include contact information as well as dates and times the shareholder is available to meet with representatives of the company.
- **One Proposal.** Under the final rule, a person may not submit more than one proposal for consideration at a shareholder meeting, either directly as a shareholder or indirectly as a shareholder representative. Previously, the one proposal rule applied to each shareholder.
- **Resubmission.** Under the final rule, a proposal previously included in the company's proxy materials within the preceding five calendar years is ineligible for resubmission if the most recent vote on the proposal occurred within the preceding three calendar years and received:
  - less than 5 percent of the votes cast if previously voted on once;
  - less than 15 percent of the votes cast if previously voted on twice; or
  - less than 25 percent of the votes cast if previously voted on three or more times.

  The SEC declined to adopt a provision permitting the exclusion of certain proposals for which support had declined compared to the immediately preceding shareholder vote on the matter.

The amendments will become effective 60 days after publication in the Federal Register and will apply to any shareholder proposal submitted after January 1, 2022, with a transition period permitting certain shareholders satisfying the prior share ownership threshold to submit proposals for consideration at a shareholder meeting held prior to January 1, 2023.

The SEC's adopting release is available here.

GUIDANCE AND ALERTS

SEC Staff Issues FAQs on Form CRS Disciplinary History Information Accompanied by a Joint Statement from Chairman Clayton and Division Directors

On October 8, 2020, the staff of the SEC's Division of Investment Management and Division of Trading and Markets issued supplemental guidance on the disclosure of disciplinary history information on Form CRS in the form of additional Frequently Asked Questions. An initial list of FAQs on Form CRS was issued by the SEC staff on November 26, 2019, and additional FAQs have been added periodically since then.

Form CRS is a brief relationship summary that broker-dealers and investment advisers (firms) are required to provide to retail investors that is designed to help retail investors make informed choices regarding what type of relationship—brokerage, investment advisory or a combination of both—best suits their particular needs and circumstances. It is also intended to allow retail investors to compare different firms' services, fees and other important information. Firms were required to file their first Forms CRS with the SEC, and deliver the Form to new and prospective clients who are retail investors, by June 30, 2020.

In connection with the publication of the additional FAQs, SEC Chairman Jay Clayton, Division of Investment Management Director Dalia Blass and Division of Trading and Markets Director Brett Redfearn issued a joint statement highlighting issues observed by the SEC staff regarding how firms have addressed the disciplinary history section in their Form CRS filings.

Key takeaways from the additional FAQs are as follows:

- Form CRS requires inclusion of the heading "Do you or your financial professionals have legal or disciplinary history?" and a "Yes" or "No" response. If the response is "No," firms are still required to include the heading and that response. It is not permissible for firms to omit the heading or the response.
- Firms may provide a separate "Yes" or "No" response to the above heading with respect to the firm and the firm's financial professionals (e.g., "Firm – No"; "Financial Professionals – Yes"), but firms may not modify the heading to address only the firm's disciplinary history.
- It is not permissible for firms to include additional information on Form CRS to explain the relevant disciplinary history.

The FAQs are available here, and the related joint statement is available here.

SEC Proposes Conditional Exemption for Finders Engaging in Limited Capital Raising Activities

On October 7, 2020, the SEC proposed a new, conditional exemption from broker-dealer registration for certain "Finders" who assist issuers with raising capital in private markets. If adopted, the proposed exemption would permit natural persons to engage in limited activities involving accredited investors without registering as brokers-dealers under the Securities Exchange Act of 1934. The proposed exemption would create two classes of Finders, Tier I Finders and Tier II Finders, each of whom would be subject to certain conditions based on the scope of their activities.

Importantly, Tier I and Tier II Finders would both be permitted to accept transaction-based compensation under the terms of the proposed exemption.

- **Tier I Finders.** A Tier I Finder would be limited to providing contact information of potential investors in connection with a single capital-raising transaction by a single issuer in a 12-month period. A Tier I Finder would be prohibited from having any contact with a potential investor about the issuer.
- **Tier II Finders.** A Tier II Finder would be able to solicit investors on behalf of an issuer, but the solicitation-related activities must be limited to: (1) identifying, screening and contacting potential investors; (2) distributing issuer offering materials to potential investors; (3) discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice regarding the valuation or advisability of the potential investment; and (4) arranging or participating in meetings with the issuer and potential investor.
- **Conditions for Tier I and Tier II Finders.** The proposed exemption includes a number of conditions for reliance by both Tier I and Tier II Finders, including, among other things, the issuer must be a non-reporting entity; the offering must be exempt from registration; the Finder must not engage in a general solicitation; the potential investor must be an accredited investor; and the Finder must have a written agreement with the issuer.
- **Additional Conditions for Tier II Finders.** In addition to the conditions for relying on the proposed exemption applicable to both Tier I and Tier II Finders, a Tier II Finder also must satisfy certain disclosure requirements and other conditions, including that the Tier II Finder must provide appropriate disclosures to a potential investor regarding the Tier II Finder's role and compensation and obtain a dated written acknowledgment of receipt of the required disclosures from the potential investor.

Activities beyond the Scope of the Proposed Exemption. The SEC identified certain activities of a Finder that would be beyond the scope of the proposed exemption, including structuring the transaction or negotiating the terms of the offering; handling customer funds, preparing sales materials, performing independent analysis of the sale; engaging in due diligence activities; providing financing to potential investors; or advising as to the valuation or advisability of the potential investment.

The SEC's proposed exemptive order is available here.

Litigation and Enforcement Proceedings

SEC Settles Enforcement Proceeding Without Imposing a Penalty Against Adviser That Self-Reported Alleged Expense Waiver Misrepresentations

On September 30, 2020, the SEC announced that it had settled administrative proceedings against an investment adviser for alleged compliance policy deficiencies and prospectus misrepresentations relating to the adviser's recoupment of previously waived fund operating expenses for four money market funds, causing the funds to incur approximately $5.2 million in additional expenses.

According to the SEC's order, the adviser's contractual expense limitation agreements with the funds required the adviser to waive fees and/or reimburse fund expenses to the extent necessary to limit each fund's total operating expenses to an agreed-upon expense cap, which was disclosed in various fund filings. In addition to the contractual expense caps, the adviser had voluntary expense limitations with the funds intended to prevent the funds from experiencing a negative yield and that entitled the adviser to recapture waived fees or reimbursed expenses during the ensuing three year period, so long as the recouped amounts did not result in negative yields for the funds. The SEC alleged that the adviser recaptured waived or reimbursed expenses under the voluntary arrangement that resulted in the funds exceeding their contractual expense caps. According to the SEC's order, the fee table in the funds' prospectuses omitted the expenses associated with the recaptured amounts under the voluntary agreements and failed to inform investors that the funds exceeded their disclosed expense caps for the funds' most recent fiscal year. These alleged disclosure misrepresentations meant that the adviser failed to implement its written policies and procedures explicitly requiring recaptured expenses to be included within the "Other Expenses" line item of the fee table.

In light of the adviser's alleged prospectus misrepresentations and deficient policies and procedures, the adviser agreed to a censure and payment of disgorgement and prejudgment interest. In determining not to impose a civil penalty on the adviser, the SEC cited the adviser's self-reporting to the SEC, prompt remedial action, including hiring a third-party consultant to quantify the harm to affected investors, and cooperation with the SEC staff's investigation.

The order is available here.

District Court Grants Great-West's Motion for Sanctions Following Trial Victory in Section 36(b) Case

On August 7, 2020, the U.S. District Court for the District of Colorado issued a judgment in favor of Great-West Capital Management, LLC and Great-West Life & Annuity Insurance Co. (together, Great-West) in the Section 36(b) excessive fee litigation brought against Great-West, holding that the plaintiffs, investors in Great-West funds through retirement plans, failed to prove that Great-West breached its Section 36(b) fiduciary duties by charging excessive fees. Following that decision, Great-West filed a motion for sanctions against the plaintiffs' counsel under 28 U.S.C. § 1927.

On September 28, 2020, the District Court issued an order granting Great-West's motion for sanctions, holding the

plaintiffs' counsel personally liable for up to $1.5 million of Great-West's excess costs, expenses and attorneys' fees reasonably incurred in connection with the Section 36(b) litigation.

The District Court noted the standard set forth under 28 U.S.C. § 1927 that "[a]ny attorney . . . who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct." The court also noted that, from the outset of the case, both parties were aware that no plaintiff to pursue a Section 36(b) claim has ever won throughout the entirety of the section's existence.

In support of its position, the District Court cited the lack of credibility displayed by the plaintiffs' expert witness on which the bulk of the plaintiffs' case relied. The court recounted that Great-West identified flaws in the accuracy of the expert witness's testimony during the summary judgment stage, yet plaintiffs' counsel still pursued their claims and relied heavily on the expert witness at trial. At trial, the expert witness was thoroughly discredited and the court found his testimony to be non-credible.

Next, the District Court noted that even if it overlooked the inadequacy of the plaintiffs' expert witness, Great-West's presentation of favorable evidence would still warrant sanctions. For example, Great-West presented credible evidence that their fees were reasonable and that they did not breach any fiduciary duties. In addition, several testifying plaintiffs expressed that they were satisfied with the services Great-West performed.

Lastly, the District Court agreed with Great-West's assertion that the prospect of financial gain may have incentivized plaintiffs' counsel to litigate. The court underscored the fact that each individual plaintiff stood to gain a small amount relative to the millions of dollars at stake for the plaintiffs' counsel.

In conclusion, having found that "[p]laintiffs' attorneys were undeterred by the signs that their case was fatally flawed; they recklessly proceeded to trial in violation of their duty to objectively analyze their case," the District Court granted Great-West's motion for sanctions.

The order was issued under the caption *Obeslo v. Great-West Capital Mgmt., LLC*, No. 16-cv-00230-CMA-SKC.

Plaintiffs' counsel filed a notice of appeal of the motion for sanctions on October 28, 2020.

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
Cody J. Vitello .... +1 (312) 609 7816
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
Cody L. Lipke .... +1 (312) 609 7669
Kelly Pendergast Carr .... +1 (312) 609 7719
Mark Quade .... +1 (312) 609 7515
David W. Soden .... +1 (312) 609 7793
Jeff VonDruska .... +1 (312) 609 7563
Jake W. Wiesen .... +1 (312) 609 7838
Tyrique J. Wilson .... +1 (312) 609 7689

San Francisco

Rob Crea .... +1 (424) 204 9504

Washington, DC

Bruce A. Rosenblum, *Co-Chair* .... +1 (202) 312 3379
Marguerite C. Bateman .... +1 (202) 312 3033
W. Thomas Conner .... +1 (202) 312-3331
Amy Ward Pershkow .... +1 (202) 312 3360
Kimberly Karcewski Vargo .... +1 (202) 312 3385
John M. Sanders .... +1 (202) 312 3332

VedderPrice

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.

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.

© 2020 Vedder Price. Reproduction of this content is permitted only with credit to Vedder Price.