GODFREY & KAHN S.C.

Investment Management Focus

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Legal and Regulatory Update

Latest Developments

SEC Staff Issues No-Action Letter Relaxing Certain In-Person Voting Requirements for Fund Boards

On February 28, 2019, the U.S. Securities and Exchange Commission (SEC) staff issued a no-action letter relaxing in-person voting requirements for registered investment companies and their series relating to the approval or renewal of advisory contracts (including approval of interim advisory contracts), principal underwriting contracts and Rule 12b-1 plans, as well as the selection of independent auditors (collectively, required approvals). The request for no-action relief was submitted by the Independent Directors Council (IDC) in an effort to help modernize the regulatory requirements governing fund directors.

Specifically, the SEC staff will not recommend enforcement if fund boards give required approvals by video conference, telephonically or by other means where all directors may participate and communicate with one another simultaneously during a meeting, in lieu of meeting in person as required by the 1940 Act, in the following circumstances:

Emergency or Unforeseen Circumstances:

The directors required for a required approval are unable to meet in person due to emergency or unforeseen circumstances, provided that (i) no material changes to the relevant contract, plan and/or arrangement are approved (or proposed to be approved) at the meeting, and (ii) such directors ratify the applicable approval at their next in-person board meeting.

The SEC's position with respect to emergency or unforeseen circumstances applies to the following required approvals:

- renewal of advisory contracts;
- renewal of principal underwriting contracts;
- renewal of a Rule 12b-1 plan; or
- selection of an independent auditor (if the auditor is the same as selected in the immediately preceding fiscal year).

Prior In-Person Meeting Discussions:

The directors required for a required approval previously fully considered and discussed the proposed matter in all material aspects at a prior in-person meeting but did not vote on the matter at the time, provided that no director requests an additional in-person meeting.

The SEC's position with respect to prior in-person meeting discussions applies to the following required approvals:

- approval or renewal of advisory contracts;
- approval of interim advisory contracts;
- approval or renewal of principal underwriting contracts;
- approval or renewal of a Rule 12b-1 plan; or
- selection of independent auditors.

Emergency or Unforeseen Circumstances

Emergency or unforeseen circumstances may include any situation that "could not have been reasonably foreseen or prevented and that makes it impossible or impracticable for directors to attend a meeting in-person," such as illness or death (including of family members), weather events, natural disasters, acts of terrorism or other travel disruptions.

Prior In-Person Meeting Discussions

In situations where a fund board has already met and fully discussed the proposed matter in all material respects at an in-person meeting but did not vote on the matter at that meeting, relief is granted in the following scenarios:

1. if the board prefers to defer voting until after a contingent event takes place (*e.g.*, shareholders of an adviser voting on a transaction constituting a change in control of the adviser);
2. if a majority of the independent directors have selected the independent auditor for certain funds in a fund complex and subsequently choose the same independent auditor at a later date for other series of the same complex that have different fiscal year ends and a majority of such directors have concluded that no additional information is needed from the independent auditor; or
3. if directors prefer to defer voting on a matter until further requested information is provided or previously provided information is confirmed, and the directors determine at an in-person meeting that the nature of the materials to be provided or confirmed would not be likely to change the vote of any director that is required.

Conclusion

The SEC staff acknowledged the IDC's position that the no-action relief "would remove significant or unnecessary burdens for funds and their boards" and indicated its belief that the relief would not "diminish the board's ability to carry out its oversight role or other specific duties." As discussed in our January 2018 Update, the SEC staff has indicated that it will continue to reevaluate fund board responsibilities in order to determine whether it makes sense to have a fund board responsible for each of the items assigned to them. To that end, the SEC staff granted no-action relief (as discussed in our October 2018 Update) relating to fund board review and approval of certain affiliated transactions by allowing boards to rely on a written report from the chief compliance officer instead of approving such transactions. This most recent no-action relief to relax certain in-person voting requirements signals the staff's continued commitment to reevaluating fund board duties.

Sources: Response of the Chief Counsel's Office, Division of Investment Management (Feb. 28, 2019), available here; Request for No-Action Position Regarding In-Person Voting Requirements, Independent Directors Council (Feb. 28, 2019), available here.

BlackRock Beats Section 36(b) Excessive Fee Suit

BlackRock Advisors, LLC, BlackRock Investment Management, LLC and BlackRock International Limited (collectively, BlackRock) recently prevailed in a suit decided by a New Jersey federal judge involving over $1 billion in claims brought by shareholders of two of BlackRock's largest mutual funds who alleged they were charged excessive advisory fees. According to the plaintiffs, BlackRock's fees were approximately double the subadvisory fees charged to mutual fund clients sponsored by unaffiliated financial institutions and subadvised by BlackRock for substantially the same services. Following an eight-day bench trial, U.S. District Judge Freda L. Wolfson dismissed the plaintiffs' claims. The case is significant given the size of the claims and because, unlike many cases involving Section 36(b) of the 1940 Act, it went to trial. The plaintiffs have appealed the decision.

Section 36(b) of the 1940 Act imposes a fiduciary duty on investment advisers with respect to the compensation they receive for providing advisory services to funds. The standard for liability under Section 36(b) is whether an investment adviser charges a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining. The determination of whether an excessive fee has been charged is made by considering all relevant circumstances, including the factors set forth in the 1982 *Gartenberg* case and affirmed by the U.S. Supreme Court in 2010. The court in the BlackRock case analyzed the three *Gartenberg* factors that withstood the court's earlier summary judgment ruling (see our July 2018 Update): comparative fee structure, economies of scale and profitability.

The court's decision focused on the comparative fees factor. The court noted that the reasonableness of BlackRock's advisory fees was supported by data from Lipper, Inc. as well as an independent peer group analysis from BlackRock's expert, and that the subadvised funds were only available as allocation options within variable insurance products, rather than as direct investments. The court found that the plaintiffs' comparison between the fees charged to the proprietary BlackRock funds and the subadvised funds was "inapt" due to the substantially more extensive services BlackRock Advisors provides to the proprietary funds than the services that BlackRock Investment Management provides to the subadvised funds. The court stated that the plaintiffs presented little evidence that BlackRock offered subadvisory services "remotely comparable" to the "robust" services that it provides to the proprietary funds. In particular, the court found "substantial distinctions" between advisory and subadvisory services with respect to compliance, board administration, regulatory and financial reporting, determination of daily NAV and managing service providers. The court also noted that risks borne by BlackRock Advisors as adviser in managing the day-to-day operations of the proprietary funds were "all-encompassing" and were not present for BlackRock Investment Management as subadviser. The court concluded that, based on the differences in services and risks, as well as independent data supporting the reasonableness of BlackRock's fees, the fees charged to the proprietary funds and the subadvised funds were not comparable.

With respect to the economies of scale factor, the court cited testimony from the plaintiffs' expert witness and found that the plaintiffs had failed to demonstrate that the proprietary funds realized economies of scale, and therefore did not reach the issue of whether BlackRock Advisors adequately shared the benefits of economies of scale with the proprietary funds and their shareholders. Regarding the profitability factor, the court cited precedent for the position that "it is not a permissible approach under Section 36(b) to argue that the adviser 'just plain made too much money'" and also that disproportionate profitability may be a sign that the adviser's fees are excessive. The court noted that the estimated pre-tax profit margins for the proprietary funds never exceeded 65% during the relevant period and did not indicate excessive fees due to the robust suite of services BlackRock offered. Because plaintiffs' profitability argument "went hand-in-hand" with its argument that BlackRock offered comparable services to the proprietary funds and the subadvised funds, the court determined the plaintiffs failed to carry their burden of proof.

Sources: In re BlackRock Mut. Funds Advisory Fee Litig., Civil Action No. 3:14-cv-01165 (D.N.J. Feb. 8, 2019); Notice of Appeal, In re Blackrock Mut. Funds Advisory Fee Litig., Civil Action No. 3:14-cv-01165 (D.N.J. Mar. 8, 2019); In re Blackrock Mut. Funds Advisory Fee Litig., Civil Action No. 3:14-cv-01165 (D.N.J. Jun. 13, 2018).

SEC Modifies Timing for Filing Form N-PORT

On February 27, 2019, the SEC issued an interim final rule modifying the timing requirements for filing monthly reports on Form N-PORT, while not changing the amount or substance of the data to be reported.

Changes to Form N-PORT Requirements

Below is a summary of key Form N-PORT requirements that did – or did not – change as a result of the SEC's amendments:

- Reports on Form N-PORT for each month in a fiscal quarter will now be required to be filed with the SEC no later than 60 days after the end of that fiscal quarter, as opposed to filing each monthly report no later than 30 days after the end of each month.
    - The monthly report on Form N-PORT for the third month of the fiscal quarter will continue to become publicly available, with the exception of the items described below.
    - The monthly reports on Form N-PORT for the first and second months of the fiscal quarter will remain non-public.
    - In addition, the SEC will not make public any information reported with respect to the following items (or explanatory notes relating to any of these topics): a fund's highly liquid investment minimum, derivatives transactions, country of risk and economic exposure, delta, liquidity classification for portfolio investments, or miscellaneous securities. While the SEC will not make public any of the foregoing information that is identifiable to any particular fund or adviser, the SEC reserves the right to use the information reported on Form N-PORT in its regulatory programs, including examinations, investigations, and enforcement actions.
- No later than 30 days after the end of each month, funds must maintain in their records the information that is required to be included in Form N-PORT. Registrants must be able to promptly make such records available to the SEC upon request.
- Although the SEC did not technically change the Form N-PORT compliance dates, the amendments exempt funds in larger fund groups (those with $1 billion or more in net assets) with fiscal quarters ending in March and April 2019 from the requirements to file January and/or February 2019 data, as applicable. The actual deadline depends on the fund's fiscal quarter end. Accordingly, the filing dates for larger funds groups' first reports on Form N-PORT are as follows:

Fiscal Quarter End	First Report on Form N-PORT must be filed on EDGAR by:	Required Monthly Data
March 31, 2019	May 30, 2019	March 2019
April 30, 2019	July 1, 2019	March, April 2019
May 31, 2019	July 30, 2019	March, April, May 2019

Compliance dates as late as 2020 continue to apply to smaller filers.

- The first six months of reports on Form N-PORT (*i.e.*, reports filed with the SEC with monthly data from the quarters ending March 31, 2019 through August 31, 2019) will continue to be kept non-public in order to allow funds and the SEC to address as necessary any technical issues that may arise with the data reporting process.

Finally, the SEC also amended Form N-LIQUID to provide for a voluntary explanatory notes section.

Impact

These changes come as a result of cybersecurity concerns regarding the sensitivity of Form N-PORT data. Because less timely data is less sensitive, the decision to delay filing of Form N-PORT data is intended to reduce the risks to the SEC and fund companies of a potential cybersecurity breach.

These are changes in timing only; the SEC made no changes to the required content or scope of the filings, and there is no change to the information on Form N-PORT that will be made available to the public. The SEC may request monthly Form N-PORT data from individual firms at any time 30 days after month-end. Therefore, the same detailed information must be generated, formatted and reconciled on the same 30-day timetable.

Finally, while the interim final rule became effective immediately without public comment, the rule release requests public comment on a number of points. The comment process may result in further changes to the SEC's Form N-PORT requirements and expectations.

Sources: Interim Final Rule, Amendments to the Timing Requirements for Filing Reports on Form N-PORT, Release No. IC-33384 (Feb. 27, 2019), available here; SEC Modifies Timing for Filing Non-Public Form N-PORT Data to Align With Its Approach to Data Management and Cybersecurity, SEC Press Release No. 2019-23 (Feb. 27, 2019).

FINRA Relaxes Position on Marketing Back-Tested Performance Data

On January 31, 2019, the Financial Industry Regulatory Authority, Inc. (FINRA) issued an interpretive letter to Foreside Fund Services, LLC allowing passively managed open-end investment companies to use pre-inception index performance data (PIP data) in communications that are distributed solely to institutional investors, including intermediaries. As part of the interpretive relief, FINRA imposed several conditions regarding the use of PIP data, with the end result being that the use of PIP data in communications with retail investors is still prohibited.

Background

PIP data, often referred to as "hypothetical" or "back-tested" index data, model the performance of an index for a period of time prior to the inception date of the index. FINRA had historically prohibited the use of PIP data, considering it to be inherently false and misleading in violation of FINRA Rule 2210(d), which generally prohibits member firms from knowingly making or distributing false or misleading communications to the public. In a 2013 interpretive letter to ALPS Distributors, Inc., FINRA relaxed this position by permitting the use of PIP data for passively managed exchange-traded products in communications provided only to institutional investors, subject to certain other conditions. With the 2019 letter, FINRA has extended similar relief to open-end investment companies.

Interpretive Relief

To be consistent with FINRA's guidance in the new letter, in addition to complying with all other applicable FINRA rules and federal securities laws, use of PIP data with respect to passively managed open-end investment companies must comply with the following conditions:

- A FINRA member may use PIP data only in institutional communications, meaning written (including electronic) communication that is distributed or made available only to "institutional investors" (*e.g.*, financial services firms, persons (including natural persons) with total assets of at least $50 million, certain employee benefit plans, etc.); and
- Any PIP data must be shown separately from fund performance and must be calculated according to certain specifications. At a minimum, 10 years of PIP data must be reflected and be current as of the most recently ended calendar quarter, and the PIP data must be accompanied by certain required disclosures.

The above requirements are in addition to applicable FINRA rules and federal securities laws. Further, use of PIP data will be subject to the same supervisory and approval requirements applied to all other institutional communications. Finally, if a user of PIP data becomes aware that a recipient has distributed materials containing PIP data to retail investors, the user must cease distributing such materials to that recipient.

Sources: FINRA Interpretive Letter to Meredith F. Henning, Foreside Fund Services, LLC (Jan. 31, 2019), available here.

Compliance Dates for Final Rules

Final Rule	Compliance Date(s)
Investment Company Reporting Modernization: New Form N-CEN	June 1, 2018 for all funds (first filing date is 75 days from the end of a fund's fiscal year after June 1, 2018)
Liquidity Risk Management Programs (Rule 22e-4)	Requirements of Liquidity Risk Management Program Not Subject to Extension: • Adoption and implementation of Liquidity Risk Management Program (including risk assessment) • Board designation of program administrator • 15% illiquid investment limit • Establishment of policies and procedures for funds that engage in redemptions in-kind • Related recordkeeping requirements Fund complexes with $1 billion or more in net assets: December 1, 2018 Fund complexes with less than $1 billion in net assets: June 1, 2019 Requirements of Liquidity Risk Management Program Subject to Extension: • Portfolio classification (bucketing) • Highly Liquid Investment Minimum (HLIM) • Board oversight • Related recordkeeping requirements Fund complexes with $1 billion or more in net assets: June 1, 2019 Fund complexes with less than $1 billion in net assets: December 1, 2019
Form N-LIQUID (notice to SEC when a fund's level of illiquid investments exceeds 15% of its net assets or when its highly liquid investments fall below minimum)	Parts A, B and C Fund complexes with $1 billion or more in net assets: December 1, 2018 Fund complexes with less than $1 billion in net assets: June 1, 2019 Part D Fund complexes with $1 billion or more in net assets: June 1, 2019 Fund complexes with less than $1 billion in net assets: December 1, 2019

<table>
<tr><th>Final Rule</th><th>Compliance Date(s)</th></tr>
<tr><td>Amendments to Form N-CEN Associated with Liquidity Rule</td><td>Fund complexes with $1 billion or more in net assets: first filing date is no later than 75 days following the first fiscal year ending after December 1, 2018, based on fiscal year end data

Fund complexes with less than $1 billion in net assets: first filing date is no later than 75 days following the first fiscal year ending after June 1, 2019, based on fiscal year end data</td></tr>
<tr><td>Amendments to the Certification Requirements of Form N-CSR

(each certifying officer must state that such officer has disclosed in the report any change in internal control over financial reporting that occurred during the most recent fiscal half-year, rather than most recent fiscal quarter)</td><td>Fund complexes with $1 billion or more in net assets: March 1, 2019

Fund complexes with less than $1 billion in net assets: March 1, 2020</td></tr>
<tr><td>Investment Company Reporting Modernization: New Form N-PORT (As Amended)</td><td>Fund complexes with $1 billion or more in net assets: first filing date is May 30, 2019, based on March 31, 2019 data. The actual filing date depends on a fund's fiscal quarter end.

<table><tr><th>Fiscal Quarter End</th><th>Deadline for First Form N-PORT</th><th>Required Monthly Data</th></tr><tr><td>March 31, 2019</td><td>May 30, 2019</td><td>March 2019</td></tr><tr><td>April 30, 2019</td><td>July 1, 2019</td><td>March, April 2019</td></tr><tr><td>May 31, 2019</td><td>July 30, 2019</td><td>March, April, May 2019</td></tr></table>
Note that larger fund complexes are required to maintain in their records the information that is required to be included in Form N-PORT beginning no later than July 30, 2018, based on June 30, 2018 data, in lieu of submitting the information via EDGAR.

Fund complexes with less than $1 billion in net assets: first filing date is June 1, 2020, based on January, February, and March 2020 data. The actual filing date depends on a fund's fiscal quarter end.</td></tr>
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Final Rule	Compliance Date(s)
Rescission of Form N-Q (funds are required to continue filing Form N-Qs until they begin filing Form N-PORTs)	Fund complexes with $1 billion or more in net assets: May 1, 2019 (a fund's last Form N-Q reporting period will be the fiscal quarter ending December 31, 2018, January 31, 2019 or February 28, 2019, as applicable) Fund complexes with less than $1 billion in net assets: May 1, 2020 (a fund's last Form N-Q reporting period will be the fiscal quarter ending December 31, 2019, January 31, 2020 or February 28, 2020, as applicable)
Form N-1A (narrative disclosure regarding operation of a fund's liquidity risk management program in new subsection of the applicable shareholder report)	Fund complexes with $1 billion or more in net assets: December 1, 2019 Fund complexes with less than $1 billion in net assets: June 1, 2020
Amendments to Form N-PORT Associated with Liquidity Rule	Fund complexes with $1 billion or more in net assets: first filing date is August 29, 2019, based on June 30, 2019 data. The actual filing date depends on a fund's fiscal quarter end. Note that larger fund complexes are required to maintain in their records the information that is required to be included in Form N-PORT associated with the liquidity rule beginning no later than January 31, 2019, based on December 31, 2018 data, in lieu of submitting the information via EDGAR. Fund complexes with less than $1 billion in net assets: first filing date is June 1, 2020, based on January, February, and March 2020 data (this is the same date as the Form N-PORT compliance date for fund complexes with $1 billion or less in net assets). The actual filing date depends on a fund's fiscal quarter end.
Optional Internet Availability of Fund Shareholder Reports (Rule 30e-3)	Funds electing to distribute shareholder reports via electronic delivery at the earliest date possible (January 1, 2021) must begin including prominent disclosures on each applicable document (summary prospectus, statutory prospectus and annual and semi-annual shareholder reports) starting January 1, 2019.
FAST Act Amendments Impacting Registration Statement and N-CSR Filings	All investment company registration statement and Form N-CSR filings made on or after April 1, 2020 must be made in HTML format and include a hyperlink to each exhibit identified in the filing's exhibit index, whether the exhibit is included in the filing or incorporated by reference.