GODFREY & KAHN S.C.

Investment Management Focus

April 2017

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Legal and Regulatory Update

Latest Developments

DOL Delays Fiduciary Rule

After weeks of anticipation and 193,000 public comment letters, the Department of Labor (DOL) issued a final rule on April 7, 2017 that delays the "applicability date" of certain provisions of the DOL fiduciary rule for 60 days. The rule delays the implementation date of the expanded fiduciary definition and the "Impartial Conduct Standards" in the best interest contract (BIC) exemption for investment advisers and other fiduciaries who make recommendations to "retirement investors" (which includes many smaller plans, participants in a 401(k) plan and IRA owners) from April 10, 2017 to June 9, 2017. The implementation date for the remaining provisions of the DOL rule will be January 1, 2018, unless the rule is further delayed or rescinded.

Expanded Fiduciary Definition

Effective June 9, 2017, the DOL fiduciary rule expands the definition of fiduciary under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (the Code) so that an investment adviser may become a fiduciary under ERISA or the Code *before* the adviser enters into an investment management agreement with a retirement investor. For example, an adviser may become a fiduciary:

- when marketing its services to prospective retirement investors, unless it can rely on the "hire me" exception, or the adviser is communicating with an independent plan fiduciary with financial expertise; or
- before the adviser is hired by a retirement investor if the adviser recommends the retirement investor transfer or roll over retirement assets to the adviser's firm.

Best Interest Contract Exemption

Conflicts of Interest. ERISA and the Code generally prohibit fiduciaries from acting on conflicts of interest, including using their authority to affect or increase their own compensation, in connection with transactions involving retirement investors. For example, an adviser has a conflict of interest when the adviser recommends a participant roll money out of an employer plan, such as a 401(k) plan, and into an IRA that will generate ongoing fees for the firm. In this example, an adviser must comply with the BIC exemption in order to receive compensation for its services. Please note that the adviser's compensation does not have to be for the recommendation, but may be for its services under an investment management agreement.

Third-Party Payments. ERISA and the Code generally prohibit fiduciaries from receiving payments from third parties in connection with transactions involving retirement investors. The BIC exemption allows investment advisers and their representatives to receive sales loads, Rule 12b-1 fees, and revenue sharing payments that, in the absence of an exemption, would not be permitted under ERISA and the Code.

Reliance on BIC Exemption by Investment Advisers

- The BIC exemption is available for recommendations to enter into an investment management agreement (sometimes referred to as "BIC for a day").
- The BIC exemption is available for rollovers.
- The BIC exemption is not available or needed for discretionary management of accounts.
- The BIC exemption is available for nondiscretionary management of accounts and is needed if an adviser receives payments from third parties in connection with transactions involving retirement investors and/or recommends clients invest in affiliated mutual funds.

Impartial Conduct Standards

The DOL release noted that "there is fairly widespread, although not universal, agreement about the basic Impartial Conduct Standards." The Impartial Conduct Standards, which are a key component of the BIC exemption, require advisers who intend to rely on the BIC exemption to:

- Give investment advice that is in the "**best interest**" of the retirement investor. The best interest standard has two chief components: prudence and loyalty.
    - *Prudence.* Recommendations must reflect the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
    - *Loyalty.* Recommendations must be based on the investment objectives, risk tolerance, financial circumstances, and needs of the retirement investor, without regard to the financial or other interests of the investment adviser representative, adviser or any affiliate, related entity, or other party.
- Charge no more than **reasonable compensation**. The obligation to pay no more than reasonable compensation to service providers is a feature of ERISA Section 408(b)(2) and Code Section 4975(d)(2) under current law that has long applied to advisers. The reasonableness of the fees depends on the facts and circumstances.
- Ensure that **statements** about services, recommended products and transactions, fees and compensation, material conflicts of interest and other relevant matters **are not materially misleading** at the time made.

Advisers relying on the BIC exemption must comply with the Impartial Conduct Standards beginning on June 9, 2017. We recommend that advisers incorporate the Impartial Conduct Standards into their compliance manuals for investment recommendations to retirement investors.

Other Conditions of the BIC Exemption

The final rule simplifies compliance with the BIC exemption during the transition period from June 9, 2017 to December 31, 2017 (the Transition Period). During the Transition Period, advisers will *only* have to comply with the Impartial Conduct Standards and not the other conditions of the BIC exemption, such as written disclosure requirements. Therefore, advisers will not need to prepare exhibits to their ADV brochures or client agreements acknowledging fiduciary status during the Transition Period. However, if an adviser has any

disclaimers of fiduciary status in these documents, the adviser should review and revise them in order to avoid materially misleading statements.

Presidential Mandate to Review the DOL Fiduciary Rule and BIC Exemption
By Memorandum dated February 3, 2017, President Trump directed the DOL to conduct an examination of the fiduciary rule and the BIC exemption "to determine whether [the fiduciary rule] may adversely affect the ability of Americans to gain access to retirement information and financial advice." The DOL will perform the required examination by January 1, 2018. Following completion of the examination, some or all of the rule and BIC exemption may be revised or rescinded, including the provisions applicable on June 9, 2017.

Steps to Consider Before June 9, 2017

- ***Add Impartial Conduct Standards to Compliance Manuals.*** Advisers who intend to rely on the BIC exemption should add Impartial Conduct Standards to their compliance manuals. Please contact your G&K attorney if you would like assistance.
- ***Review Advisory Agreements and ADV Brochures.*** You should review your investment advisory agreements and ADV brochures to ensure that you do not disclaim fiduciary status with respect to retirement investors.
- ***Rollover Recommendation Checklists.*** Even though not required during the Transition Period, we recommend you consider using rollover recommendation checklists and obtain relevant information from retirement investors before recommending IRA rollovers.
- ***Review Material Conflicts of Interest.*** You should consider whether you have any compensation structures that create a material conflict between the best interests of the retirement investor and the adviser, and take steps to eliminate or mitigate any conflicts. A "material conflict of interest" exists when an adviser or investment adviser representative has a "financial interest that a reasonable person would conclude could affect the exercise of its best judgment as a fiduciary in rendering advice to a retirement investor." For example, review whether you have any compensation structures that might incentivize an investment adviser representative to recommend a particular product over another for personal financial gain.
- ***Recordkeeping.*** Even though recordkeeping is not required during the Transition Period, we recommend you maintain sufficient records to demonstrate that you have adhered to the Impartial Conduct Standards.

Source: Definition of the Term "Fiduciary"; Conflict of Interest Rule-Retirement Investment Advice; Best Interest Contract Exemption (Prohibited Transaction Exemption 2016-01); Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs (Prohibited Transaction Exemption 2016-02); Prohibited Transaction Exemptions 75-1, 77-4, 80-83, 83-1, 84-24 and 86-128; 82 FR 16902 (April 7, 2017); available at https://www.federalregister.gov/documents/2017/04/07/2017-06914/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice-best.

Update on SEC Chair Approval Process

The Senate confirmation hearing for Jay Clayton, President Trump's nominee for SEC chairman, was held on March 23, 2017. On April 4, the Senate Committee on Banking, Housing and Urban Affairs approved Mr. Clayton's nomination in a 15-to-8 vote. The full Senate is expected to vote later in April.

Source: Jay Clayton Approved by Senate Panel to be SEC Chairman, Investment News, Hazel Bradford (April 4, 2017); available at http://www.investmentnews.com/article/20170404/FREE/170409982/jay-clayton-approved-by-senate-panel-to-be-sec-chairman.

SEC Staff Provides Custody Rule Guidance on SLOAs, First-Person Transfers, and Inadvertent Custody

On February 21, 2017, SEC staff released new guidance regarding whether an investment adviser is deemed to have custody pursuant to Rule 206(4)-2 (the Custody Rule) under the Investment Advisers Act of 1940 (the Advisers Act) in (1) a no-action letter issued to the Investment Adviser Association (IAA); (2) a new FAQ regarding the Custody Rule; and (3) an IM Guidance Update regarding inadvertent custody.

The Custody Rule requires a registered investment adviser with custody of client funds or securities to follow certain requirements, including a surprise examination of client assets by an independent public accountant. Under the Custody Rule, an investment adviser has custody of client funds or securities where it or its related person "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services" that it provides to clients. The Custody Rule also provides that "custody" includes any arrangement under which an investment adviser is "authorized or permitted to withdraw client funds or securities maintained with a custodian upon [its] instruction to the custodian."

No-Action Letter

The no-action letter was issued in response to a request from the IAA that the SEC staff provide clarification on whether an investment adviser has custody if it acts pursuant to a standing letter of authorization (SLOA) or other similar arrangement established by a client with a qualified custodian. In its request, the IAA noted that clients commonly grant their investment adviser the limited power in a SLOA to disburse funds to third parties, as specifically designated by the client. In such an arrangement, the client instructs the qualified custodian for the client's account to accept the investment adviser's direction on the client's behalf to move money to the third party designated by the client on the SLOA.

In the no-action letter, the SEC staff affirmed its position that an investment adviser with the power to dispose of client funds or securities "for any purpose" other than authorized trading is deemed to have access to the client's assets. Further, a SLOA constitutes an arrangement under which an investment adviser is authorized to withdraw client funds or securities maintained with a qualified custodian upon its instruction to the qualified custodian. Therefore, an investment adviser entering into a SLOA would have custody of client assets and must comply with the Custody Rule. However, the SEC staff stated that such an investment adviser would not be required to obtain a surprise examination if the following requirements are met:

- The client provides an instruction to the qualified custodian, in writing, that includes the client's signature, the third party's name, and either the third party's address or account number at a custodian to which the transfer should be directed;
- The client authorizes the investment adviser, in writing, either on the qualified custodian's form or separately, to direct transfers to the third party either on a specified schedule or from time to time;
- The client's qualified custodian performs appropriate verification of the instruction, such as a signature review or other method to verify the client's authorization, and provides a transfer of funds notice to the client promptly after each transfer;
- The client has the ability to terminate or change the instruction to the client's qualified custodian;
- The investment adviser has no authority or ability to designate or change the identity of the third party, the address, or any other information about the third party contained in the client's instruction;
- The investment adviser maintains records showing that the third party is not a related party of the investment adviser or located at the same address as the investment adviser; and

- The client's qualified custodian sends the client, in writing, an initial notice confirming the instruction and an annual notice reconfirming the instruction.

The SEC stated that they understood that investment advisers and custodians will require "a reasonable period of time" to implement the processes and procedures necessary to comply with this relief. The SEC staff also noted that an investment adviser should include any client assets that are subject to a SLOA and result in custody in its response to Item 9 of Form ADV, starting with the next annual updating amendment after October 1, 2017.

New FAQ Regarding the Custody Rule

The SEC staff released a new FAQ (II.4) regarding the Custody Rule, clarifying that an investment adviser will not be deemed to have custody when it has the limited authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians, so long as the client has authorized the investment adviser, in writing, to make these transfers, and a copy of the authorization specifying the client's accounts is provided to the qualified custodians. In the FAQ, the SEC staff noted that "specifying" means that the written authorization signed by the client and provided to the sending custodian identifies the sending and receiving accounts by name and account number (including the ABA routing number or the name of the receiving custodian). This authorization does not need to be provided to the receiving custodian. The FAQ further clarified that an investment adviser's authority to transfer client assets between the client's accounts at the same qualified custodian or between affiliated qualified custodians is not considered custody. In such cases, the further specification of client accounts is not required.

IM Guidance Update Regarding Inadvertent Custody

The IM Guidance Update discussed situations in which an investment adviser may have inadvertent custody of client funds or securities that arises from provisions in the custody agreement entered into between an advisory client and a qualified custodian. This may happen when the custody agreement grants the investment adviser broader access to client funds or securities than the investment adviser's own agreement with the client does. Depending on the wording of the custody agreement, this could cause the investment adviser to have custody, even when the adviser did not otherwise intend to.

In the Guidance Update, the SEC staff provided several examples of cases in which a custody agreement permits the client's investment adviser to instruct the custodian to disburse or transfer funds or securities, resulting in the investment adviser having custody, including:

- A custody agreement granting the client's investment adviser the right to "receive money, securities, and property of every kind and dispose of same."
- A custody agreement pursuant to which a custodian "may rely on [adviser's] instructions without any direction from you. You hereby ratify and confirm any and all transactions with [the custodian] made by [adviser] for your account."
- A custody agreement providing authorization for the client's investment adviser to "instruct us to disburse cash from your cash account for any purpose…."

The Guidance Update explains that investment advisers may avoid inadvertent custody by preparing a letter to the custodian that limits the investment adviser's authority to "delivery versus payment," notwithstanding the wording of the custody agreement. The SEC staff recommends obtaining written consent from the client and custodian acknowledging the new arrangement.

Sources: No-Action Letter, Investment Adviser Association (February 21, 2017), available at https://www.sec.gov/divisions/investment/noaction/2017/investment-adviser-association-022117-206-4.htm; Staff Responses to Questions About the Custody Rule (Updated as of February 21, 2017), available at https://www.sec.gov/divisions/investment/custody_faq_030510.htm; Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, Guidance Release No. 2017-01 (February 2017), available at https://www.sec.gov/investment/im-guidance-2017-01.pdf.

OCIE Issues Risk Alert Regarding Most Frequent Compliance Topics Identified in Examinations of Investment Advisers

On February 7, 2017, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert regarding the five most frequently identified topics in examinations of investment advisers. The risk alert reflects issues addressed in deficiency letters from over 1,000 investment adviser examinations over the past two years.

The issues addressed include deficiencies or weaknesses involving: (1) Rule 206(4)-7 under the Advisers Act (the Compliance Rule); (2) required regulatory filings; (3) the Custody Rule; (4) Rule 204A-1 under the Advisers Act (the Code of Ethics Rule); and (5) Rule 204-2 under the Advisers Act (the Books and Records Rule). The common themes identified by OCIE were noncompliance with certain explicit requirements of the rules, lack of timeliness, failure to correct inaccuracies and make updates, and lax enforcement of policies and procedures.

Compliance Rule

The Compliance Rule requires advisers to: (1) adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised persons, of the Advisers Act and the rules that the SEC has adopted under the Advisers Act; (2) review, no less frequently than annually, the adequacy of their policies and procedures and the effectiveness of their implementation; and (3) designate a chief compliance officer (CCO) responsible for administering the compliance policies and procedures.

Below are examples of deficiencies or weaknesses cited by OCIE under the Compliance Rule:

- *Compliance manuals are not reasonably tailored to the adviser's business practices.* OCIE found deficiencies in advisers' compliance programs where the programs did not take into account, among other things, the adviser's particular investment strategies, advisory fees, types of clients, trading practices and valuation procedures. Advisers should avoid using "off-the-shelf" compliance manuals and should take the time to craft policies and procedures that are reasonably tailored to the adviser's business practices.

- *Annual reviews are not performed or do not address the adequacy of the adviser's policies and procedures.* OCIE observed that certain advisers did not conduct annual reviews of their compliance policies and procedures. In addition, OCIE identified advisers that conducted annual reviews that did not address the adequacy of the advisers' policies and procedures and the effectiveness of their implementation. OCIE also observed that certain advisers did not address or correct problems identified in their annual reviews.

- *Adviser does not follow compliance policies and procedures.* OCIE found deficiencies when examining advisers that failed to adhere to practices described in their compliance manuals relating to marketing, expenses and employee behavior required by their compliance manual.

- *Compliance manuals are not current.* Advisers do not always update their manuals by removing references to investment strategies that are no longer pursued or personnel no longer associated with the adviser and fail to remove stale information about the firm.

Regulatory Filings

Advisers are required to accurately complete and timely file certain regulatory filings, including filing amendments to their Form ADV at least annually and more frequently if required by the instructions to Form ADV. Advisers to private funds with fund assets of at least $150 million are required to complete and file a report on Form PF. In addition, private funds generally must file Form D.

Below are examples of deficiencies or weaknesses cited by OCIE with respect to adviser regulatory filing obligations:

- *Inaccurate disclosures.* Certain advisers made inaccurate disclosures on Form ADV Part 1A or Part 2A brochures with respect to custody information, regulatory assets under management, disciplinary history, types of clients and conflicts.
- *Untimely amendments to Form ADVs.* Certain advisers did not promptly amend Form ADV when certain information became inaccurate or timely file annual updating amendments within 90 days of fiscal year end.
- *Incorrect and untimely Form PF filings.* Certain advisers with an obligation to file Form PF did not complete the form accurately or completely.
- *Incorrect and untimely Form D filings.* Certain advisers did not accurately complete and timely file Form Ds on behalf of their private fund clients.

Custody Rule

The Custody Rule prescribes a number of requirements designed to enhance the safety of client assets by protecting them from unlawful activities or financial problems of the adviser.

Below are examples of deficiencies or weaknesses cited by OCIE with respect to the Custody Rule:

- *Advisers do not recognize that they may have custody due to online access to client accounts.* An adviser's online access to client accounts may meet the definition of custody when such access provides the adviser with the ability to withdraw funds and securities from the client accounts. OCIE observed that certain advisers may not have properly identified custody as a result of them having access to online accounts using clients' personal usernames and passwords.
- *Advisers do not recognize that they may have custody as a result of certain authority over client accounts.* OCIE observed that certain advisers did not appear to recognize that they may have custody over client accounts as a result of having (or related persons having) powers of attorney authorizing them to withdraw client cash and securities. Other examples of custody that appeared unrecognized include when advisers or their related persons served as trustees of clients' trusts or general partners of client pooled investment vehicles.
- *Advisers with custody obtained surprise examinations that do not meet the requirements of the Custody Rule.* OCIE observed that certain advisers did not provide independent public accountants performing surprise examinations with a complete list of accounts over which the adviser has custody or otherwise provide information to accountants to permit the accountants to timely file accurate Form ADV-Es. In addition, OCIE observed indications suggesting that surprise examinations may not have been conducted on a "surprise" basis (*e.g.*, exams were conducted at the same time each year).

Code of Ethics Rule

The Code of Ethics Rule requires an adviser to adopt and maintain a code of ethics that: (1) establishes a standard of business conduct that the adviser requires of all its supervised persons; (2) requires an adviser's "access persons" to periodically report their personal securities transactions and holdings to the adviser's CCO or other designated persons; and (3) requires that access persons obtain the adviser's pre-approval before investing in an initial public offering or private placement. In addition, an adviser must provide each supervised person with a copy of the code of ethics and any amendments, and require supervised persons to provide the adviser with a written acknowledgement of their receipt of the code. Advisers should also ensure that their Form ADV Part 2A brochure contains an accurate description of their code of ethics and an indication that the code of ethics is available to any client or prospective client upon request.

Below are examples of deficiencies or weaknesses cited by OCIE with respect to the Code of Ethics Rule:

- *Access persons not identified.* Certain advisers did not identify all of their access persons (*e.g.*, certain employees, partners or directors) for purposes of reviewing personal securities transactions.
- *Codes of ethics missing required information.* Certain advisers' codes of ethics did not specify review of the holdings and transactions reports, or did not identify the specific submission timeframes, as required by the Code of Ethics Rule.
- *Untimely submission of transactions and holdings.* Certain access persons submitted transactions and holdings less frequently than required by the Code of Ethics Rule.
- *No description of code of ethics in Form ADVs.* Certain advisers did not describe their codes of ethics in their Form ADV brochures and did not indicate that their codes of ethics are available to any client or prospective client upon request.

Books and Records Rule

The Books and Records Rule requires advisers to make and keep certain books and records relating to their advisory business.

Below are examples of deficiencies or weaknesses cited by OCIE with respect to the Books and Records Rule:

- *Did not maintain all required records.* Certain advisers may not have maintained all the books and records required by the Books and Records Rule, such as trade records, advisory agreements and general ledgers.
- *Books and records are inaccurate or not updated.* Certain advisers had errors and omissions in their books and records, such as inaccurate fee schedules and client records or stale client lists.
- *Inconsistent recordkeeping.* Certain advisers maintained contradictory information in separate sets of records.

Conclusion

The OCIE examinations resulted in a range of actions. Advisers took remedial measures such as enhancing written compliance procedures, policies or processes, changing business practices or devoting more resources or attention to the area of compliance. In addition, where appropriate, OCIE referred examinations to the Division of Enforcement for further action.

In sharing the information in the risk alert, OCIE hopes to encourage advisers to reflect upon their own practices, policies and procedures in these areas and to promote improvements in investment adviser compliance programs.

Source: National Exam Program Risk Alert, The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (February 7, 2017), available at https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf.

SEC Publishes FAQs on Guidance Update and Section 22(d) Interpretive Letter

On February 15, 2017, the SEC published frequently asked questions (FAQs) answering questions about two SEC publications we reported on in our *January 2017 Update*: (1) IM Guidance Update 2016-06, Mutual Fund Fee Structures, and (2) an interpretive letter to the Capital Group Companies, Inc. and Capital Research and Management Company.

IM Guidance Update

The SEC recognizes that, in connection with the DOL fiduciary rule, funds are considering new variations to sales loads that would apply uniformly to investors that purchase shares through a designated intermediary.

Rule 22d-1 under the Investment Company Act and Item 12(a)(2) of Form N-1A require that each variation in sales load be applied uniformly to particular "classes" of investors and disclosed in the prospectus with specificity. The Guidance confirms that investors who purchase shares through a designated intermediary would be a class, and, therefore, the disclosure should specifically identify each intermediary whose clients will receive a sales load variation. The Guidance permits sales load variation disclosure for multiple intermediaries to be included in an appendix to the statutory prospectus.

In the FAQs, a fund asks whether it can use different appendices for different intermediaries and deliver to an investor only the appendix related to the investor's particular intermediary, and the SEC responds: "No. For funds that choose to use an appendix to disclose sales load variations, all sales load variations for all share classes described in the prospectus must be disclosed in a single appendix."

Capital Group letter

The SEC's Division of Investment Management issued an interpretive letter indicating that the restrictions of Section 22(d) of the Investment Company Act do not apply when a broker acts as an agent for its customers and charges commissions for effecting transactions in mutual fund shares without a front-end sales load, deferred sales charge, 12b-1 fee or other asset-based fee for sales or distribution (referred to as "clean shares"). One of the conditions of the letter is that the fund's prospectus disclose that an investor transacting in clean shares may be required to pay a commission to a broker and, if applicable, that shares of the fund are available in other share classes that have different fees and expenses. Accordingly, any fund that offers clean shares should include such a disclosure in its prospectus.

The FAQs advise that if a fund already offers a share class that meets the requirements of the Capital Group letter, such as an institutional class, the fund does not need to make a filing pursuant to Rule 485(a) "solely to add the prospectus disclosure described in the [Capital Group] letter." The FAQs also clarify that a fund offering clean shares should disclose that an investor may be required to pay a commission to a broker in the narrative preceding the fee table in the prospectus.

Source: Frequently Asked Questions on IM Guidance Update 2016-06, SEC Division of Investment Management (February 15, 2017), available at https://www.sec.gov/divisions/investment/guidance/frequently-asked-questions-mutual-fund-fee-structures.htm.

Excessive Fee Update

Hartford Triumphant in Excessive Fee Case

As we reported in our *January 2017 Update*, the parties in *Kasilag v. Hartford Investment Financial Services* completed a bench trial in November 2016. On February 28, 2017, the judge ruled in favor of the defendant Hartford, holding that the plaintiffs failed to show Hartford's fees were excessively high under the *Gartenberg* factors established in 1982 and affirmed in 2010 by the U.S. Supreme Court in *Jones, et al. v. Harris Associates L.P.* The plaintiffs alleged that Hartford's fees were too high because it delegated advisory work to its subadviser, Wellington Management.

When applying the *Gartenberg* factors to the facts of this case, the judge found that the plaintiffs failed to carry their burden of proof of establishing that Hartford's fee was so disproportionate that it does not bear a reasonable relationship to the services the defendant rendered and could not have been negotiated at arm's length. With respect to the nature and quality of the services, the plaintiffs argued that the court should only look at the services provided by Hartford and the fees it retained after paying Wellington Management when considering those *Gartenberg* factors. The judge rejected that argument finding the fees must be judged in light of all of the services performed and noting the plaintiffs never alleged Wellington's subadvisory work was inadequate. In sum, the judge ruled that, after considering the specific factors of the nature of the services, the quality of the services and Hartford's profitability, the fee charged by Hartford was not so disproportionate that it could not have been negotiated at arm's length. The plaintiffs have appealed.

In *In re Russell Investment Shareholder Litigation*, which was set to go to trial in early March, the plaintiff was making an argument substantially similar to the argument made by the plaintiffs in the Hartford case. Due to an undisclosed "impediment to trial," the court issued an order saying the case was closed, and a representative from Russell stated the plaintiff voluntarily dismissed its complaint. Additionally, an excessive fee case involving Prudential Investments was dismissed in February 2017, and the parties confirmed that the dismissal was not as a result of a settlement or any payments.

Sources: Kasilag v. Hartford Investment Financial Services, LLC, Civil Action No. 11-cv-1083 (D.N.J. February 28, 2017); "Hartford Wins Excessive-Fee Case, While Russell Case Closed," Ignites, Joe Morris (March 1, 2017): ICI Memorandum "District Judge Rules for Defense in Section 36(b) Case" (March 7, 2017).

PIMCO Trustees Will Not Appeal "Fiduciary Exception" Order

As discussed in our *January 2017 Update*, the United States District Court in the Western District of Washington issued an order in the *Kenny v. PIMCO Investments* Section 36(b) excessive fee case, requiring the PIMCO independent trustees to turn over documents containing sensitive information. Although the documents had previously been redacted or withheld from the plaintiff under the attorney-client privilege, the court determined that the communications between the trustees and their counsel were not entitled to such privilege because a "fiduciary exception" applied.

In February 2017, the independent trustees determined not to appeal the judge's order to turn over the communications. Instead, they entered into an agreement with the plaintiff's attorneys to establish a framework for sharing and reviewing the relevant documents. The agreement notes that the trustees are not waiving the attorney-client privilege by turning over the documents, and provides a guide for how to proceed if a trustee asserts the privilege in situations not covered by the fiduciary exception. Further, the agreement establishes procedures to ensure the previously withheld documents do not become public, and details the limited circumstances under which the plaintiffs may share the information.

Source: Industry News Roundup: Pimco Directors Won't Fight Order to Turn Over Emails, Board IQ, Greg Saitz (February 28, 2017).

“Fiduciary Exception” Raised in Additional Cases

Plaintiffs in two cases have argued that the fiduciary exception, applied in the *Kenny v. PIMCO Investments* Section 36(b) excessive fee case, should allow them access to certain materials withheld under the attorney-client privilege. The first case, *Obeslo v. Great-West Capital Management*, involved a fund organized as a Maryland corporation. The plaintiffs in the case raised the fiduciary exception argument shortly after the *PIMCO* ruling in order to access an email between an independent director and an individual who served as in-house associate general counsel. The plaintiffs argued that, because the associate general counsel was not the independent director’s lawyer, the attorney-client privilege should not apply. The judge denied the plaintiffs’ motion to compel on the basis that the email was irrelevant to the issues of the case.

More recently, plaintiffs in the *Chill v. Calamos Advisors LLC* excessive fee case argued that the fiduciary exception should apply to fund board materials that had been withheld during discovery under the attorney-client privilege. The documents contain legal advice provided to the funds’ independent directors relating to their oversight of the funds, including their review and approval of fund advisory fees. Like the *PIMCO* case, the *Calamos* case involves a fund organized as a Massachusetts business trust. The judge is expected to rule on the fiduciary exception issue in April.

Source: Attorney-Client Privilege on Docket in Calamos Case, Fund Board Views, Hillary Jackson (March 31, 2017).

Pending Proposed Rules

Proposed Rule	Date of Proposal	Comment Deadline and Number of Comments Received
FinCEN Proposed Rule Requiring AML Programs for Investment Advisers	September 1, 2015	November 2, 2015 (not known)
SEC Proposed Rule Governing the Use of Derivatives by Registered Investment Companies	December 11, 2015	March 28, 2016 (200 comments; 68 meetings with SEC officials; two SEC staff studies and reports)
SEC Proposed Rule Requiring Investment Advisers to Adopt Business Continuity and Transition Plans	June 28, 2016	September 6, 2016 (34 comments and three meetings with SEC officials)

Compliance Dates for Final Rules

Final Rule	Compliance Date(s)
Amendments to Form ADV	October 1, 2017
Amendments to Books and Records Rule: Performance Information	October 1, 2017
FinCEN Clarifies and Strengthens Customer Due Diligence Requirements for Mutual Funds and Broker-Dealers	May 11, 2018
Investment Company Reporting Modernization: New Forms N-PORT and N-CEN	New Form N-PORT: Fund complexes with $1 billion or more in net assets: June 1, 2018 (first filing date is July 30, 2018, based on June 30, 2018 data) Fund complexes with less than a $1 billion in net assets: June 1, 2019 (first filing date is July 30, 2019, based on June 30, 2019 data) 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)
Swing Pricing	November 19, 2018 (for those funds that wish to implement swing pricing)
Amendments to Form N-1A, Regulation S-X and Form N-CEN associated with swing pricing	November 19, 2018
Liquidity Risk Management Programs (Rule 22e-4)	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
Amendments to Form N-PORT and Form N-CEN associated with liquidity rule	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
Amendments to Form N-1A associated with liquidity rule (information regarding redemptions)	June 1, 2017
Form N-LIQUID	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