GODFREY & KAHN S.C.

Investment Management Focus

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Legal and Regulatory Update

Latest Developments

SEC Adopts Targeted Changes to Public Liquidity Risk Management Disclosure

On June 28, 2018, the SEC adopted amendments to public liquidity-related disclosure requirements for certain open-end funds. The amendments rescind the requirement in Form N-PORT that funds publicly disclose aggregate liquidity classification information about their portfolios and create a new requirement that funds disclose information about the operation and effectiveness of their liquidity risk management program in fund shareholder reports. In addition, the SEC adopted amendments to Form N-PORT that will allow funds to report multiple liquidity classification categories for a single position under specified circumstances and adds a new requirement to report holdings of cash and cash equivalents. The amendments are effective September 10, 2018.

Rescission of Aggregate Classification Requirement and New Shareholder Report Section

Since the adoption of Rule 22e-4, the liquidity risk management program rule for registered investment companies (liquidity rule), funds and service providers have raised concerns that the public disclosure of a fund's aggregate liquidity classification information on Form N-PORT may not achieve its intended purpose and may confuse and mislead investors because of the subjective nature of the classification requirement. The SEC identified three general types of concerns. First, the quantitative presentation of aggregate liquidity information may imply precision and uniformity in a way that obscures its subjectivity. Second, public dissemination of aggregate classification information, without an accompanying full explanation of the underlying subjectivity, model risk, methodological decisions and assumptions that shape the information, may potentially mislead investors. Third, singling out liquidity risk in Form N-PORT, and not placing it in a broader context of the risks and factors affecting a fund's risk, returns and performance, may inappropriately focus investors on one investing risk over others. In light of these concerns, the SEC determined that effective disclosure of liquidity risks and their management would be better achieved through prospectus and fund shareholder report disclosure rather than Form N-PORT. The SEC noted that funds are already required to disclose in their prospectuses a summary of the principal risks of investing in a fund, including liquidity risk if applicable.

As originally proposed, funds would have been required to include disclosure regarding the operation and effectiveness of a fund's liquidity risk management program in the "management's discussion of fund performance" section of the fund's annual report. The amended rule requires funds to include the discussion in a new subsection of the shareholder report following the discussion of board approval of investment advisory contracts. To satisfy this new disclosure requirement, the adopting release notes that a fund generally may include a high level summary of the report required to be provided to the fund's board under the liquidity rule (such report must address the operation of the fund's liquidity risk management program and the adequacy and effectiveness of its implementation).

Amendments to Form N-PORT

Multiple Liquidity Classifications

The SEC adopted, as proposed, amendments to Form N-PORT to allow funds the option of splitting a fund's holdings into more than one liquidity classification category or "bucket" in certain specified circumstances. The SEC recognized in the adopting release that the original requirement set forth in the liquidity rule to classify each entire position into a single classification category poses difficulties for certain holdings, and that approach may not accurately reflect the liquidity of that holding or the liquidity risk management practices of a fund. As such, the SEC identified three circumstances where classification splitting would be permissible.

- *Different liquidity features.* Different liquidity features may justify treating a holding as two or more separate investments for liquidity classification purposes. For example, a fund may hold an asset that includes a put option on a percentage (but not all) of the fund's holding of the asset. The two portions of the holding may have significantly different liquidity characteristics, such that the fund believes the two portions should be classified in different buckets.

- *Sub-Advisers with differing liquidity views.* Sub-advisers managing different portions or "sleeves" of a fund's portfolio may have different views on the liquidity classification of a single holding that is held in multiple sleeves. In this circumstance, a fund may report each sub-adviser's classification of the proportional holding it manages, instead of classifying the entire holding in a single category. The SEC believes that this approach will avoid the need for costly reconciliation and may provide useful information on each sub-adviser's determination about the investment's liquidity.

- *Full liquidation/proportional approach.* The SEC recognizes that some funds may currently classify their holdings proportionally across buckets, based on an assumed full liquidation of the entire position, rather than using a single classification category based on "sizes that the fund would reasonably anticipate trading." In such circumstances, a fund would be allowed, but not required, to use the full liquidation/proportional approach.

The SEC amended Form N-PORT to require funds taking advantage of the foregoing classification splitting to indicate which of the circumstances is applicable. The SEC also clarified that the requirement to assign a position into a single bucket is specific to Form N-PORT. The liquidity rule requires funds to classify their positions among four categories for liquidity risk management purposes but does not require positions to be put into a single category. Accordingly, funds following the classification splitting approaches discussed above with respect to Form N-PORT may apply such splitting more generally in their classification processes under the liquidity rule.

Disclosure of Cash and Cash Equivalents

The SEC amended Form N-PORT to require funds to report in Part B all "cash and cash equivalents not reported on Parts C and D" in order to monitor whether a fund is compliant with its highly liquid investment minimum (HLIM).

Continued SEC Staff Monitoring Efforts

Recognizing that a broad range of industry commentators continue to believe that alternative approaches to liquidity classification would better achieve the SEC's goals, the SEC indicated in the adopting release that the staff will continue to re-examine more broadly the classification requirements and related elements of the liquidity rule. The adopting release notes that the SEC expects the staff evaluation will take into account at least one full year's worth of liquidity classification data from large and small fund complexes.

Sources: SEC Adopts Targeted Changes to Public Liquidity Risk Management Disclosure, SEC Press Release No. 2018-119 (Jan. 28, 2018), available here; Investment Company Liquidity Disclosure, Release No. IC-33142 (June 28, 2018), available here.

New Rule: SEC Provides for Optional Electronic Delivery of Shareholder Reports

On June 4, 2018, the SEC Commissioners voted 4 to 1 to pass Rule 30e-3 under the Investment Company Act to provide certain registered investment companies with a new "notice and access" method for delivering shareholder reports. Beginning January 1, 2021, funds have the option to satisfy their shareholder report delivery requirements by (1) making such report publicly accessible and free of charge on a website, and (2) sending fund shareholders a paper notice of such report's internet availability.

For funds that choose to rely on the rule, electronic delivery will replace paper delivery as the default method of transmitting shareholder reports. However, the rule allows for investors to elect to receive paper copies. The SEC has also amended Rule 498 under the Securities Act and various fund registration forms to help implement new Rule 30e-3. The SEC also issued a request for comment on two issues related to enhancing fund disclosure and processing fees charged by intermediaries in connection with mailing shareholder reports.

New Rule 30e-3 was adopted, in part, in an attempt to: (1) modernize the way shareholder reports are delivered; (2) reduce printing and mailing costs that are ultimately borne by investors; and (3) improve investor protection, including an extended transition period and the option to elect to receive shareholder reports in paper. SEC Chairman Clayton noted that the rule "significantly modernizes delivery options for fund information while preserving the right of fund investors to receive information in paper form as they do today."

Rule 30e-3 Overview and Requirements

Under Rule 30e-3 and subject to the conditions of the rule, registered investment companies and any series thereof are provided the option to make their shareholder reports, plus other required materials, publicly accessible and free of charge at a specified website address and mail fund shareholders a notice of the report's internet availability starting January 1, 2021. With the addition of Rule 30e-3, funds may satisfy the shareholder report delivery obligations by: (1) mailing such reports in paper; (2) delivering reports electronically to fund shareholders that have chosen this method under the SEC's electronic delivery guidance; (3) providing website accessibility and notice under Rule 30e-3; or (4) a combination of the foregoing.

Below are the various requirements that all funds choosing to rely on the rule must follow:

Website Requirements and Accessibility. Funds must publish their shareholder reports, most recent prior report and other required materials on a free, publicly accessible website. The website address must be specific enough to lead investors directly to the documents required to be made accessible to them electronically under the rule.

Availability of Quarterly Holdings. Funds must make quarterly holdings for the last fiscal period publicly accessible on the required website, along with the annual and semi-annual reports.

Election to Receive Paper Reports. Shareholders may elect to continue to receive paper reports and materials on a per-report basis or a one-time request to receive all future reports in paper at any time. A shareholder's election to receive paper reports with respect to one series will apply to other series held currently or in the future in the same account within the same fund complex or financial intermediary.

Notice Requirements and Optional Content. The rule requires Funds to mail a written notice (the Notice) of the report's availability to shareholders each time a new report is made available online. Funds seeking to rely on the rule must ensure the Notice complies with the following disclosure requirements:

- Contain a prominent legend in bold-face type and state that an important shareholder report is available online and in paper by request;
- State that the shareholder report contains important information about a fund, including its financial statements and portfolio holdings;
- Be in plain English;
- State the report is available on the Internet or, upon request, by mail, and encourage shareholders to access and review the report;
- Include the specified website where the shareholder report and other required portfolio information is posted;
- Include a toll-free telephone number to contact the fund or the investor's financial intermediary; and
- (1) Provide instructions as to how a shareholder may request, at no charge, a paper or e-mail copy of the shareholder report or other materials made accessible online and state that such shareholder will not receive a paper or e-mail copy unless specifically requested; (2) explain that a shareholder may elect to receive such reports or other materials at any time in the future and describe how a shareholder may do so; and (3) provide instructions describing how a shareholder can elect to receive such reports or other materials and communications via electronic delivery, if applicable.

The rule permits funds to include in the Notice certain content from the shareholder report itself, such as fund performance, information identifying the fund, a quick response code or other methods to access the website, and any information needed to identify the shareholder (e.g., account or control numbers). However, if a fund includes such optional content in the Notice, the fund must file the Notice with the SEC under Form N-CSR. A Notice may also accompany other mailed materials, such as a shareholder's account statement.

Print Upon Request. Funds are required to send a free paper copy of any of the materials listed above upon request within three business days of such request.

Extended Transition Period and Rule Amendments. The SEC adopted an extended transition period with staggered effective dates, where the earliest date that a fund may rely on Rule 30e-3 is January 1, 2021. Existing funds that intend to rely on the new rule must begin notifying shareholders at the start of calendar 2019 for a two-year period by providing prominent disclosures that inform fund shareholders of the upcoming change in delivery method. The prominent disclosures and two year notice period will only be required until January 1, 2022.

In connection with the extended transition period, the SEC amended Rule 498 under the Securities Act and certain fund registration forms (e.g., Form N-1A). The amendments require funds intending to rely on Rule 30e-3 to include prominent disclosures on the cover page of their summary prospectuses and statutory prospectuses, and annual and semi-annual reports. The amendments are effective on January 1, 2019 for a temporary period of three years.

The extended transition period of two years was implemented by the SEC to provide funds with enough time to adopt all new requirements under the rule and to provide shareholders with advance notice of the change in transmission method, as well as the opportunity to elect to continue to receive paper reports. Funds may begin tracking shareholder preferences on January 1, 2019.

Requests for Comment

In addition to adopting Rule 30e-3, the SEC issued requests for comment on two separate issues related to disclosures and fees:

- *Disclosure.* The first request is directed at investors and seeks comments on how fund disclosure, including shareholder reports, may be improved based on design, delivery, and content of fund disclosures, and the use of technology to make disclosures more interactive and personalized.
- *Fees.* The second request concerns the processing fees charged by broker-dealers and other intermediaries for distributing or forwarding materials and reports to fund shareholders.

Comments on the two requests are due by October 31, 2018.

Sources: Optional Internet Availability of Investment Company Shareholder Reports, Release No. 33-10506 (June 5, 2018), available here; SEC Modernizes the Delivery of Fund Reports and Seeks Public Feedback on Improving Fund Disclosure, SEC Press Release No. 2018-103 (June 5, 2018), available here; Request for Comment on Fund Retail Investor Experience and Disclosure, Release No. 33-10503 (June 5, 2018), available here; Request for Comments on the Processing Fees Charged By Intermediaries for Distributing Materials Other Than Proxy Materials to Fund Investors, Release No. 33-10503 (June 5, 2018), available here; Chairman Jay Clayton, Statement on Investment Company Design, Delivery and Disclosures Rulemaking Package, Public Statement (June 5, 2018), available here.

Supreme Court Holds that SEC's Administrative Law Judges Were Unconstitutionally Appointed

In the past, there was never serious debate about the constitutionality of the SEC's appointment process for its Administrative Law Judges (ALJs) or their authority. This status quo, however, was recently shaken after *Lucia* v. SEC, where the U.S. Supreme Court held that ALJs for the SEC are "officers" of the United States for purposes of the Appointments Clause of the U.S. Constitution. The Appointments Clause provides that "principal officers" must be appointed by the President with the advice and consent of the Senate; "inferior officers" must be appointed by the President, a court of law or a department head; and non officer employees may be appointed through other means, such as selection by agency staff. In *Lucia*, there was no disagreement among the parties that ALJs should be viewed as "inferior officers." Accordingly, because the ALJ was appointed by SEC staff rather than the SEC, the Court found the ALJ's appointment to be unconstitutional. Not only does the decision require the rehearing of the petitioner's case, but it leaves unanswered questions moving forward. One inescapable consequence is that the SEC will be forced to examine the legitimacy of its administrative proceedings, potentially impacting its enforcement efforts.

Background

In 2012, the SEC issued an order instituting administrative cease-and-desist proceedings against Raymond Lucia (Lucia) and his investment company, Raymond J. Lucia Companies, Inc. (RJLC). An ALJ decided in July 2013 that RJLC and Lucia violated the anti-fraud provisions of the Advisers Act when they misrepresented facts to prospective investors regarding a particular wealth management strategy. Lucia challenged the ALJ's decision in an appeal to the SEC, arguing that the administrative hearing was invalid because the ALJ was not constitutionally appointed pursuant to the Appointments Clause. The SEC affirmed the ALJ's decision. The Court of Appeals for the D.C. Circuit later affirmed the SEC's decision, holding that ALJs are not "officers" within the meaning of the Appointments Clause.

Significance

On June 21, 2018, the day the Court's decision was released, the SEC issued an order, effective immediately, staying pending administrative proceedings set for hearing before an ALJ, including any such procedure pending before the SEC. The stay states that it is "prudent" to stay such proceedings and that the stay will "remain effective for 30 days" or until "further order of the Commission." The order does not preclude the SEC from assigning any proceeding currently pending before an ALJ to the Commission itself or any member of the Commission at any time.

It is unclear what steps the SEC will take to help ensure its ALJs are properly appointed. Since the Court did not address the SEC's ratification of the appointment of all its ALJs in November 2017, the SEC could rely on the ratification but may risk additional litigation. The SEC would likely refile charges if any cases are challenged and overturned on grounds similar to Lucia.

Sources: Raymond J. Lucia Cos., Inc. & Raymond J. Lucia, Sr., v. SEC, No. 17-130 (U.S. June 21, 2018); Buckley v. Valeo, 424 U.S. 1, 126 (1976); In the Matter of Raymond J. Lucia Companies, Inc. & Raymond J. Lucia, Sr., Release No. 75837 (Sept. 3, 2015), available here; In re: Pending Administrative Proceedings, Release No. 10510 (June 21, 2018), available here; SEC Ratifies Appointment of Administrative Law Judges, SEC Press Release 2017-215 (November 30, 2017), available here.

SEC Risk Alert: Compliance Issues Related to Best Execution

On July 11, 2018, the Office of Compliance Inspections and Examinations (OCIE) issued a risk alert with information concerning the most common deficiencies that the SEC staff has cited in recent examinations of registered investment advisers' compliance with their best execution obligations. The risk alert reflects many of the issues relating to best execution identified in deficiency letters from over 1,500 adviser examinations. This article summarizes the issues identified in the risk alert.

Best execution reviews. Advisers failed to periodically and systematically evaluate the execution performance of brokers used to execute client transactions.

Consider full range of materially relevant factors. Advisers failed to evaluate qualitative factors relating to the selection of a broker including, among other things, the broker's execution capability, financial responsibility and responsiveness. Also, advisers failed to solicit and review input from the adviser's traders and portfolio managers as part of their best execution review.

Comparative data. Advisers failed to seek out and consider the quality and costs of services available from brokers before utilizing a broker's services. The SEC staff observed that some advisers utilize a single broker for all clients without seeking comparisons from competing brokers initially and/or on an ongoing basis to assess their chosen broker's execution performance. The SEC staff also observed that some advisers relied solely on a cursory review of their broker's policies and procedures or a brief summary of the broker's services without seeking comparisons from other brokers.

Disclosure of best execution practices. Advisers must provide full disclosure of their best execution practices. The SEC staff observed some advisers who failed to disclose in their Form ADV brochures certain practices to clients or failed to comply with the practices described in their brochures.

Disclosure of soft dollar arrangements. Advisers failed to provide full and fair disclosure in Form ADV regarding their soft dollar arrangements. Some advisers did not adequately disclose the use of soft dollar arrangements or that certain clients may bear more of the cost of soft dollar arrangements than other clients. Also, some advisers did not adequately or accurately disclose the products and services acquired with soft dollars that did not qualify as eligible brokerage or research services under the Section 28(e) safe harbor.

Mixed use allocations. Advisers failed to make a reasonable allocation of the cost of a mixed use product or service or did not produce support (through documentation or otherwise) of the rationale for mixed use allocations.

Best execution policies and procedures. Advisers failed to have adequate compliance policies and procedures and internal controls regarding best execution and for those advisers that did have policies and procedures, some advisers failed to follow them. The SEC staff observed that some advisers do not (1) have any policies relating to best execution, (2) update their policies to take into account the type of securities currently traded by the adviser, or (3) monitor execution performance. The SEC staff also observed that some advisers did not allocate soft dollar expenses in accordance with their policies and did not follow their internal policies and procedures regarding the ongoing monitoring of execution price, research and responsiveness of their brokers.

Source: OCIE Risk Alert: Most Frequent Best Execution Issues Cited in Adviser Exams, available here.

SEC Proposes New Approval Process for Certain Exchange-Traded Funds

On June 28, 2018, the SEC proposed a new rule and amendments to Forms N-1A, N-8B-2 and N-CEN to modernize the regulatory framework for exchange-traded funds (ETFs). Proposed Rule 6c-11 would permit ETFs that satisfy certain conditions to operate within the scope of the Investment Company Act and go directly to market without obtaining an exemptive order. The proposed rule would also replace hundreds of individualized exemptive orders. Below are some of the highlights of the rule proposal.

Scope of Proposed Rule 6c-11

The proposed rule would define an ETF as a registered open-end management company that issues (and redeems) creation units to (and from) authorized participants in exchange for baskets of securities and a cash balancing amount (if any), and which issues shares that are listed on a national securities exchange and traded at market-determined prices.

Open-end funds. As proposed, Rule 6c-11 would be available only to ETFs that are organized as open-end funds. ETFs organized as unit investment trusts (UITs), ETFs structured as a share class of a fund that issues multiple classes of shares representing interests in the same portfolio, and leveraged or inverse ETFs would not be able to rely on the proposed rule. With respect to ETFs that are structured as a share class of a fund with multiple classes of shares, the SEC declined to provide relief from Sections 18(f)(1) and 18(i) of the Investment Company Act or to expand the scope of Rule 18f-3 under the Investment Company Act. Under the proposed rule, such ETFs would continue to request relief from Sections 18(f)(1) and 18(i) through the SEC's exemptive application process.

Index-Based ETFs and Actively Managed ETFs. The proposal would permit index-based and actively managed ETFs to operate under the proposed rule subject to the same conditions. The SEC stated that the rule "would provide a level playing field among those market participants." Also, the SEC believes it would be unreasonable to create meaningful distinction within the proposed rule between index-based and actively managed ETFs given the evolution of highly customized indexes over the last decade, which have blurred the distinction between the products, and it would be consistent with the SEC's regulation of other types of open-end funds, which does not distinguish between actively managed and index-based strategies.

Exemptive Relief under Proposed Rule 6c-11

Proposed Rule 6c-11 would provide an ETF that meets the conditions of the rule with exemptions from certain provisions of the Investment Company Act in order to allow the ETF to operate. Specifically, the rule would permit such ETFs to: redeem shares only in creation unit aggregations; issue shares to be purchased and sold at market prices rather than at NAV per share; engage in in-kind transactions with certain affiliates; and pay authorized participants the proceeds from the redemption of shares in more than seven days in certain limited circumstances.

Conditions for Reliance on Proposed Rule 6c-11

In addition to being within the scope of proposed Rule 6c-11, an ETF would need to satisfy certain conditions. The proposed conditions of the rule include the following:

- *Transparency.* An ETF would be required to provide daily portfolio transparency on its website. The proposed rule requires prominent disclosure of the portfolio holdings that will form the basis for each calculation of NAV per share and that those holdings be the ETF's portfolio holdings as of the close of business on the prior business day. The disclosure must be made each business day before the opening of regular trading on the primary exchange of the ETF's shares and before the ETF starts accepting orders for the purchase or redemption of creation units. Full transparency would be required for all ETFs, whether they use actively managed or index-based strategies.
- *Custom basket policies and procedures.* An ETF relying on the rule would be permitted to use baskets that do not reflect a pro-rata representation of the ETF's portfolio or that differ from other baskets used in transactions on the same business day if the ETF adopts written policies and procedures setting forth detailed parameters for the construction and acceptance of such custom baskets that are in the best interests of the ETF and its shareholders.
- *Website disclosure.* The proposed rule and form amendments would require ETFs to disclose on their websites historical information regarding premiums, discounts and bid-ask spread information to provide investors with information regarding an ETF's arbitrage process. For example, the proposed rule would require ETFs whose premium or discount to NAV was greater than 2% for more than seven consecutive trading days to post that information. The proposal would also require ETFs to post information regarding a published basket of securities at the beginning of each business day.

Rescission of Certain ETF Exemptive Relief

The proposed rule would also rescind exemptive relief previously granted to ETFs that would be able to rely on the rule. It would also rescind relief permitting ETFs to operate in a master-feeder structure, which the SEC believes very few ETFs currently utilize, but it would grandfather existing master-feeder arrangements involving ETF feeder funds. The proposed rule would not rescind exemptive relief that permits ETF fund-of-fund arrangements.

Proposed Amendments to Forms N-1A, N-8B-2 and N-CEN

The SEC also proposed several amendments to Form N-1A and Form N-8B-2 to provide more useful, ETF-specific information to investors who purchase ETFs on an exchange, as well as certain amendment to Form N-CEN.

- *Amendments to Form N-1A.* The SEC proposed amendments to the definitions, Item 3, Item 6 and Item 11 of Form N-1A.
    - Item 3 does not currently distinguish between ETFs and mutual funds. The proposed amendments will clarify that there are certain fees that are not reflected in the fee table for both mutual funds and ETFs, and to require new disclosure requirements that capture ETF-specific trading information and costs. The proposed rule contains changes that will affect both mutual funds and ETFs, and others that affect only ETFs, as well as exceptions for ETFs with limited trading history.

- Item 6 currently requires an ETF to: specify the number of shares it will issue or redeem in exchange for the deposit or delivery of baskets; explain that the shares of ETFs may only be purchased and sold on a national exchange through a broker or dealer; and disclose that the price of ETF shares is based on the market price and therefore the shares may trade at a premium or discount to the net asset value of the ETF. Item 6 also requires certain disclosures if an ETF that issues shares in creation units of less than 25,000. The proposed rule removes these requirements from Item 6.

- Item 11 currently specifies that an ETF may omit certain information required by Item 11 if the ETF issues or redeems shares in creation units of not less than 25,000 shares each. The proposed rule allows all ETFs to omit such information.

- *Amendments to Form N-8B-2*. The proposed rule would amend Form N-8B-2, used by ETFs structured as UITs to register under the Investment Company Act, to provide disclosures that mirror certain of the proposed disclosure changes in Form N-1A.

- *Amendments to Form N-CEN*. The proposed rule would add to Form N-CEN a requirement that the ETFs report if they are relying on proposed Rule 6c-11 and revise the definition of the term "authorized participant" for purposes of Form N-CEN.

The public comment period will remain open for 60 days following publication of the proposing release in the Federal Register.

Sources: SEC Proposes New Approval Process for Certain Exchange-Traded Funds, SEC Press Release 2018-118 (June 28, 2018), available here; SEC Proposed Rule: Exchange Traded Funds, SEC Release Nos. 33-10515; IC-33140 (June 28, 2018), available here.

SEC No-Action Letter: SEC Continues to Step Up Focus on Senior Investor Protection

On June 1, 2018, the SEC ratcheted up its protection of adults vulnerable to financial exploitation. In response to a request for no-action relief by the Investment Company Institute (ICI No-Action Letter), the SEC stated that it would not recommend enforcement proceedings if a mutual fund's transfer agent does not pay redemption proceeds in accordance with Section 22(e) of the Investment Company Act for the protection of "specified adults" under certain circumstances where financial exploitation is suspected. The no-action relief affords transfer agents the same flexibility that FINRA Rule 2165, adopted in 2017, provides broker-dealers.

Background on FINRA Rule 2165 and Section 22(e)

FINRA Rule 2165 enables a FINRA member who has reasonable belief that financial exploitation of a "specified adult" has occurred, is occurring, has been attempted or will be attempted, to place a temporary hold on the disbursement of funds from the specified adult's account. As used in FINRA Rule 2165 and the ICI No-Action Letter, the term "specified adults" means (1) a natural person age 65 and older or (2) a natural person age 18 and older who the transfer agent reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her interests.

Section 22(e) prohibits a mutual fund from delaying the payment of mutual fund redemption proceeds for more than seven days. The ICI argued in its request letter that, while this provides important protections to mutual fund shareholders, including from abuse by a fund's management company, "in light of FINRA Rule 2165, it results in a disparity between the tools a broker-dealer may use to protect its senior and other vulnerable adult investors and those available to mutual funds and their transfer agents."

The SEC determined that it would be appropriate to grant the relief requested by the ICI, subject to certain conditions.

Applicable Conditions

The no-action relief only applies to shares held in a non-institutional direct-at-fund account. To be able to rely on the relief, the following conditions apply:

- At the time of opening the account, the transfer agent holding the account must:
  - Request from the accountholder and maintain the name of and contact information for a trusted contact person age 18 or older who may be contacted about the customer's account (Trusted Contact Person); and
  - Disclose in writing to the accountholder that the transfer agent or an employee of the transfer agent is authorized to contact the Trusted Contact Person and disclose information about the customer's account to address possible financial exploitation or to confirm the specifics of the accountholder's current contact information, health status or the identity of any legal guardian, executor, trustee or holder of a power of attorney.
- With respect to any account that was opened prior to the issuance of the no-action relief, the transfer agent must comply with the two conditions specified above when updating the information for the account.
- Provided that the transfer agent makes reasonable efforts to obtain such information from the accountholder, the absence of the name of or contact information for a Trusted Contact Person will not prevent reliance on the no-action relief.
- The transfer agent may place a temporary hold on disbursement of redemption proceeds from an account provided that, in addition to satisfying the first two conditions specified above:
  - The transfer agent reasonably believes that financial exploitation of the specified adult who holds shares in the account has occurred, is occurring, has been attempted or will be attempted;
  - The transfer agent provides, not later than two business days after the temporary hold on the disbursement of redemption proceeds, notification orally or in writing of the temporary hold and the reason for the temporary hold to all parties authorized to transact business on the account and the Trusted Contact Person(s);
  - The transfer agent conducts an immediate internal review of the facts and circumstances that caused the transfer agent to reasonably believe that the financial exploitation of a specified adult has occurred, is occurring, has been attempted or will be attempted; and
  - Delayed redemption proceeds must be held in the transfer agent's Demand Deposit Account.
- The temporary hold permitted by the condition immediately above will expire not later than fifteen days after the date that the transfer agent first placed the temporary hold on the disbursement of redemption proceeds, unless otherwise terminated or extended by a regulatory agency or court of competent jurisdiction.
- The temporary hold may be extended for no longer than ten business days following the date authorized by the condition immediately above, provided that the internal review supports the reasonable belief that caused the transfer agent to initiate the hold.
- The transfer agent must establish and maintain written procedures reasonably designed to achieve compliance with these terms and conditions. The written procedures must identify the title of each person authorized to place, terminate or extend a temporary hold on behalf of the transfer agent.

- The transfer agent must retain records related to compliance with this relief, which will be readily available to the SEC upon request.

In addition to satisfying the conditions specified above, prior to imposing a temporary hold on the disbursement of redemption proceeds in reliance on the no-action relief: (1) the transfer agent must develop and document training policies or programs reasonably designed to ensure that the transfer agent's employees comply with the terms and conditions of the relief; and (2) the mutual fund for which the transfer agent acts as the recordkeeper must disclose in its prospectus or statement of additional information that the fund may place a temporary hold on the disbursement of redemption proceeds in accordance with the terms and conditions of the no-action letter. Further, the fund must have or establish, as part of its compliance policies and procedures pursuant to Rule 38a-1, escalation and periodic reporting protocols between the fund and the transfer agent.

Sources: Response of the Chief Counsel's Office, Division of Investment Management (June 1, 2018), available here; Request for No-Action Relief under the Redemption Requirements of Section 22(e) of the Investment Company Act of 1940 (May 30, 2018), available here.

SEC FAQs: Updated Guidance Regarding Inadvertent Custody

As we discussed in our *April 2017 Update*, the SEC staff issued IM Guidance Update 2017-01, Inadvertent Custody: Advisory Contract versus Custodial Contract Authority, in which the staff discussed situations where 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 adviser broader access to client funds or securities than what is permitted in the investment adviser's own agreement with the client. Depending on the wording of the custody agreement, this could cause the adviser to inadvertently have custody.

The SEC recently released two new FAQs (II.11 and II.12) regarding inadvertent custody, clarifying that if an adviser does not have a copy of a client's custodial agreement, and does not know, or have reason to know whether the agreement would give the adviser inadvertent custody, the adviser need not comply with the custody rule with respect to that client's account if inadvertent custody would be the sole basis for custody. The Division of Investment Management would not recommend enforcement action to the SEC under the custody rule against any such investment adviser if that adviser neither complied with the requirements of the custody rule nor indicated it has custody in its Form ADV filing. This relief is not available where the adviser recommended, requested, or required a client's custodian.

Sources: IM Guidance Update 2017-01 "Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority", available here;Staff Responses to Questions About the Custody Rule, available here.

Fifth Circuit Officially Vacates DOL Fiduciary Rule

On June 21, 2018, the United States Court of Appeals for the Fifth Circuit issued its mandate officially vacating the DOL fiduciary rule and the best interest contract exemption (BICE). The DOL's prior fiduciary advice definition (*i.e.*, the 1975 five-part test discussed in our *May 2016 Update*) has been restored. Under the prior definition, one-time rollover advice (e.g., a rollover from a plan to an IRA) was not, in most cases, fiduciary advice if the adviser was not otherwise a fiduciary. However, if the adviser or its affiliate is already a fiduciary to the plan (e.g., an investment adviser, investment manager or trustee), a rollover recommendation would still be a fiduciary act. *See* DOL Advisory Opinion 2005-23A. It also would be a prohibited transaction if the fiduciary recommendation causes the adviser to earn more from the IRA than it did from the plan.

Now that the fiduciary rule has been vacated, advisers should revisit their policies and procedures adopted in connection with the fiduciary rule and BICE, including their use of detailed rollover checklists. Advisers that do not implement existing policies as written could face regulatory problems with the SEC or state regulators. Please contact your G&K attorney if you would like assistance with this process.

With the DOL fiduciary rule vacated, the SEC and states are leading the regulatory efforts regarding the standard of care that advisers and brokers owe to their clients. As discussed in our [April 2018 Update](), the SEC proposed an interpretation to reaffirm and, in some cases, clarify the SEC's views of the fiduciary duty that advisers owe to their clients. The SEC also proposed Regulation Best Interest, which would require a broker making a recommendation to a retail customer to act in the best interest of the retail customer at the time the recommendation is made, without putting the financial or other interest of the broker ahead of the retail customer. Comments on both proposals are due August 7, 2018.

Source: U.S. Chamber of Commerce, et al. v. US. Dep't of Labor, et al., 885 F.3d 360 (5th Cir. 2018).

Litigation and SEC Enforcement Actions and Updates

Recent Excessive Fee Suit: *In re BlackRock Mutual Funds*

On June 13, 2018, the U.S. District Court for the District of New Jersey granted in part and denied in part a motion for summary judgment filed by defendants BlackRock Advisors, LLC (BRA), BlackRock Investment Management, LLC (BRIM), and BlackRock International Limited (collectively, BlackRock). While the court denied the motion for summary judgment insofar as BlackRock sought to dismiss the plaintiffs' claims, the court partially granted the motion by ruling that the approval by the board of directors and board of trustees of certain Blackrock funds of the fees charged by BRA was entitled to substantial deference, noting that the boards received "ample information" relating to the *Gartenberg* factors.

The plaintiffs, who are shareholders in the BlackRock Global Allocation Fund and the BlackRock Equity Dividend Fund (the Funds), alleged that the advisory fees charged by BRA were excessive because they were approximately double the subadvisory fees charged to mutual fund clients sponsored by unaffiliated financial institutions and sub-advised by BRIM for substantially the same services.

The court found that the disputes of fact with respect to several of the *Gartenberg* factors were sufficient to withstand summary judgment. With respect to the *Gartenberg* "comparative fees" factor, the court rejected the defendants' assertion that BRA's advisory fee and BRIM's subadvisory fee could not be compared as a matter of law, but the court also remarked that the plaintiffs would have difficulty showing that BRA's advisory services and BRIM's subadvisory services are comparable in this case. With respect to the *Gartenberg* "economies of scale" factor, the court cited testimony from the plaintiffs' expert witness and found that the plaintiffs had raised a factual dispute as to whether the Funds have realized economies of scale and whether BRA adequately shared the benefits of economies of scale with the Funds and their shareholders. Regarding the *Gartenberg* "profitability" factor, the court also found a factual dispute as to whether BRA's profitability from the Funds was disproportionate to the service rendered. Lastly, the court found that the *Gartenberg* "conscientiousness" factor does not weigh in favor of finding that the advisory fee falls outside of the range of arm's-length bargaining in light of the court's finding that the boards' approval of BRA's advisory fee is entitled to substantial deference.

Source: In re Blackrock Mut. Funds Advisory Fee Litig., Civil Action No. 14-1165 (D.N.J. Jun. 13, 2018).

Recent SEC Enforcement Actions: *SEC Finds Advisers Violated Reporting Requirements by Failing to File Form PF*

On June 1, 2018, the SEC announced settlements with thirteen registered investment advisers stemming from their repeated failures to provide required information on Form PF that the SEC uses to monitor risk. Private fund advisers that manage $150 million or more of assets and are registered or required to be registered with the SEC are required to complete and make annual filings with the SEC on Form PF. The information on Form PF is designed to provide the Financial Stability Oversight Council with information important to its understanding and monitoring of systemic risk in the private fund industry. The SEC also uses information collected on Form PF in its regulatory program, including examinations and investigations, and publishes aggregated information and statistics derived from Form PF data.

The settlement orders found that the advisers were delinquent in their filings over multi-year periods. The orders also found that the advisers willfully violated the reporting requirements of the Advisers Act by failing to complete and file an initial report on Form PF for the first fiscal year they managed at least $150 million of private fund assets and annual updates thereto for the following fiscal years. The advisers were each fined $75,000 as a result, and during the course of the SEC's investigation, each adviser was required to remediate its failure by making the necessary filings.

Source: SEC Charges 13 Private Fund Advisers for Repeated Filing Failures, SEC Press Release 2018-100 (June 1, 2018), 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)
Rescission of Old Form N-SAR (N-CEN replaces N-SAR for census-type information)	June 1, 2018 for all funds
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)	Portfolio Classification, Highly Liquid Investment Minimum and Board Oversight 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 All Other 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

Final Rule	Compliance Date(s)
Form N-LIQUID	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
Amendments to Form N-CEN associated with liquidity rule	Fund complexes with $1 billion or more in net assets: first filing date is January 31, 2019, based on December 31, 2018 data Fund complexes with less than $1 billion in net assets: first filing date is July 30, 2019, based on June 30, 2019 data
Amendments to the certification requirements of Form N-CSR	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
Investment Company Reporting Modernization: New Form N-PORT	Fund complexes with $1 billion or more in net assets: first filing date is April 30, 2019, based on March 31, 2019 data Note that temporary rule 30b1-9(T) requires larger fund complexes 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 April 30, 2020, based on March 31, 2020 data

Final Rule	Compliance Date(s)
Rescission of Form N-Q (Funds are required to continue filing N-Qs until they begin filing N-PORTs)	Fund complexes with $1 billion or more in net assets: May 1, 2019 Fund complexes with less than $1 billion in net assets: May 1, 2020
Form N-1A (narrative disclosure regarding liquidity risk management program)	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 July 30, 2019, based on June 30, 2019 data Fund complexes with less than $1 billion in net assets: first filing date is April 30, 2020, based on March 31, 2020 data Note that temporary rule 30b1-9(T) requires fund complexes 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 (for larger fund complexes) and July 30, 2019, based on June 30, 2019 data (for smaller fund complexes) in lieu of submitting the information via EDGAR.
Optional Internet Availability of Fund Shareholder Reports (Rule 30e-3)	Funds electing to distribute shareholder reports at the earliest date possible (January 1, 2021) must begin including prominent disclosures on each applicable document starting January 1, 2019.