GODFREY KAHN S.C.

Investment Management Focus

October 2019

Legal and Regulatory Update

LATEST DEVELOPMENTS: FUNDS

SEC Encourages Funds to Review Performance and Fee Disclosures

The staff of the Division of Investment Management (IM) of the SEC recently published an Accounting and Disclosure Information to encourage funds to closely review their performance and fee disclosures. IM noted several observations:

- **Issues with Performance Tables.** Numerous funds failed to accurately reflect sales loads in their average annual returns table. In addition, some funds misrepresented negative fund performance as positive performance, transposed the performance data of one fund class with another, or transposed the performance of multiple benchmark indices.
- **Misstating Fund Recoupment of Previously Waived Expenses.** Several funds erroneously reported recoupments of previously waived expenses as positive fee waivers, causing net expenses of the fund to exceed gross expenses of the fund. Recoupments should either be reflected in the fee table as a separate line item or included in Other Expenses and reflected in the fund's gross expenses.
- **Failure to Disclose Acquired Fund Fees and Expenses (AFFE).** Funds should ensure that any fees and expenses associated with investments in other funds are accurately reflected in their fee table and expense example.
- **Providing Inaccurate Calculations in the Expense Example.** The Expense Example should be free of errors, reflect fee waivers only for the term of the fee waiver, and include fee items, such as AFFE.
- **Incorrectly Tagging Risk/Return Summaries.** Some funds incorrectly tagged data on their risk/return summaries in XBRL by either using the wrong tags, entering data incorrectly or associating the tagged information with the incorrect fund or class. Tagged data files carry the same liability as official filings.

Source: Performance and Fee Issues, ADI 2019-09 (Oct. 2, 2019), available here.

Godfrey & Kahn Investment Management Team Members Responsible for this Update:

Thomas M. Davison
414.287.9369
tdavison@gklaw.com

Ellen R. Drought
414.287.9517
edrought@gklaw.com

Carol A. Gehl
414.287.9255
cgehl@gklaw.com

Susan M. Hoaglund
262.951.7136
shoaglund@gklaw.com

Margaret L. Johnson
414.287.9514
mjohnson@gklaw.com

SEC Provides Recommendations to Improve Principal Risks Disclosure

IM staff recently issued recommendations to funds intended to improve principal risks disclosures for the benefit of fund investors.

Ordering Risks by Importance

The staff "strongly encourages" all funds to list their principal risks in order of importance, with the most significant risks appearing first. The staff believes this approach will better highlight for investors the risks that they should consider most carefully. The staff believes that funds that list their principal risks in alphabetical order could obscure the importance of key risks, especially when a fund includes many principal risks. For example, a real estate fund that lists risks alphabetically may describe a number of less relevant risks before describing the key risks of real estate investments. In some extreme cases, this presentation format could result in a fund's key risks being obscured to such an extent that it could render the disclosure potentially misleading.

The staff recognizes that ordering risks based on importance requires subjective determinations and that the relative importance of a risk can change with market conditions or with changes to a fund's investments. The staff believes that funds are best positioned to make these judgments of relative importance, and generally would not expect to comment on a fund's ordering of risks by importance.

Tailoring Risk Disclosures

The staff observed several fund groups that tailor their risk disclosure for each fund rather than rely on generic, standardized, risk disclosures across funds. While standardized disclosures across funds may be appropriate for certain risks, the staff encourages funds to tailor other risk disclosures to how the particular fund operates.

The staff also observed principal risk disclosures that describe investments that are not discussed in the funds' principal investment strategies. For example, some funds include credit risk disclosure that discusses the heightened risks associated with below investment grade or distressed securities even when the fund does not hold, or expect to hold, these types of investments. In order to provide investors with meaningful information, the staff encourages funds to tailor risk disclosures to more closely describe the principal risks associated with an investment in that particular fund.

Disclosing that a Fund is Not Appropriate for Certain Investors

In its principal risks disclosure, a fund may describe the types of investors the fund is intended for or the types of investment goals that may be consistent with an investment in the fund. The staff encourages funds to consider disclosing that a fund is not appropriate for certain investors given the fund's characteristics. For example, a fund seeking to provide a defined return over a specific time period generally may not be appropriate for an investor that does not intend to hold the fund for the specified period.

Other Disclosure Considerations

Finally, the staff reminded funds of measures they can take to improve their risk disclosure so as to provide investors with clear, concise, relevant and timely information:

- The summary prospectus should provide investors with a concise summary of key information, including the principal risks of investing in the fund.
- Funds should present more detailed information about their principal risks and non-principal investment strategies elsewhere in the prospectus.

- Funds should disclose non-principal risks and non-principal investment strategies in the fund's statement of additional information rather than in the fund's prospectus.
- Funds should periodically review their risk disclosures, including the order of their risks.

Source: Improving Principal Risks Disclosure, ADI 2019-08 (Sept. 9, 2019), available here.

SEC Modernizes the Approval Framework for Exchange-Traded Funds

The SEC adopted new Rule 6c-11 under the Investment Company Act of 1940 to permit exchange-traded funds (ETFs) that satisfy certain conditions to come to market without the expense and delay of obtaining an exemptive order. Since 1992, the SEC has issued more than 300 exemptive orders for ETFs. The new rule will replace the individualized exemptive orders. The rule's standardized conditions are designed to level the playing field among most ETFs and protect ETF investors, while disclosure amendments will provide investors who purchase and sell ETF shares on the secondary market with new information.

Scope of Rule 6c-11

Rule 6c-11 will be available to ETFs organized as open-end funds, the structure for the vast majority of ETFs today. It will be available both to index ETFs and to transparent actively-managed ETFs and will not treat them differently. It will not, however, be available to non-transparent ETFs. The rule will be effective 60 days after publication in the Federal Register.

ETFs organized as unit investment trusts, leveraged or inverse ETFs and ETFs structured as a share class of a multi-class fund will not be able to rely on the rule and will continue to rely on their prior exemptive orders.

Conditions for Reliance on Rule 6c-11

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

Rule 6c-11 will permit an ETF to redeem shares only in creation unit aggregations; permit ETF shares to be purchased and sold at market prices, rather than net asset value (NAV); engage in in-kind transactions with certain affiliates; and in certain limited circumstances, pay authorized participants the proceeds from the redemption of shares in more than seven days, subject to the following conditions:

- **Portfolio Holdings Disclosure.** An ETF must post on its website, before the opening of trading on the ETF's primary listing exchange, the portfolio holdings (including the ticker symbol, CUSIP or other identifier; description of holding; quantity of each security or other asset held; and percentage weight of the holding) that form the basis for the ETF's next calculation of NAV, and the cash balancing amount for a creation unit.
- **Website Disclosure.** An ETF must disclose on its website the following data:
    - The ETF's NAV, market price and premium or discount, as of the close of the prior business day;
    - A table showing the number of days that the ETF's shares traded at a premium or discount during the last calendar year and the most recently completed calendar quarters since that year;
    - A line graph showing ETF share premiums or discounts for the last calendar year and most recently completed calendar quarters;

- The ETF's median bid-ask spread during the last 30 calendar days; and
- If the ETF's premium or discount is greater than 2% for more than seven consecutive trading days, a statement of this fact and a discussion of the factors that are reasonably believed to have materially contributed to the premium or discount, which must be maintained on the website for at least one year.

- **Basket Policies and Procedures.** An ETF must adopt and implement written policies and procedures that govern the construction of baskets and the process that will be used for the acceptance of baskets. An ETF may use a custom basket (e.g., one that is composed of a non-representative selection of the ETF's portfolio holdings or a cash substitution amount), provided the policies and procedures:
  - set forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders, including the process for any revisions to, or deviations from, those parameters; and
  - specify the titles or roles of the employees of the ETF's investment adviser who are required to review each customer basket for compliance with those parameters.
- **Recordkeeping.** An ETF must maintain copies of all written agreements between an authorized participant and the ETF or its service provider.

Rescission of Certain ETF Exemptive Relief

One year after the effective date of Rule 6c-11, the SEC will rescind exemptive relief previously granted to ETFs that will be permitted to operate in reliance on the rule. The SEC also will rescind most exemptive relief permitting ETFs to operate in a master-feeder structure (which very few ETFs currently use).

Fund of Funds Exemptive Relief. The rule does not rescind exemptive relief that permits ETF fund of funds arrangements. Moreover, ETFs relying on Rule 6c-11 that do not already have their own exemptive relief may enter into fund of funds arrangements as set forth in recent ETF exemptive orders until such time as the SEC issues a rule governing fund of funds arrangements.

Amended Disclosures to Investors

Finally, the SEC revised Form N-1A to provide ETF investors with additional information regarding ETF trading and associated costs. The amendments include a requirement that ETFs that do not rely on Rule 6c-11 must disclose median bid-ask spread information on their websites or in their prospectus.

Sources: SEC Adopts New Rule to Modernize Regulation of Exchange-Traded Funds, SEC Press Release 2019-190 (Sept. 26, 2019),available here; Exchange-Traded Funds, SEC Release IC-33646 (Sept. 26, 2019), available here.

LATEST DEVELOPMENTS: ADVISERS

SEC Provides Guidance Regarding Advisers' Proxy Voting Responsibilities

In August, the SEC issued guidance to assist investment advisers in fulfilling their proxy voting responsibilities. The guidance discusses the ability of advisers to establish a variety of different voting arrangements with their clients and matters they should consider when they use the services of a proxy advisory firm (proxy firm).

Proxy Voting Responsibilities of Advisers

Advisers owe their clients a duty of care and loyalty with respect to services undertaken on the clients' behalf, including proxy voting. Rule 206(4)-6 under the Investment Advisers Act of 1940 (Advisers Act) requires an adviser who exercises voting authority to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of its clients. The guidance clarifies how an adviser's fiduciary duty and Rule 206(4)-6 relate to an adviser's proxy voting on behalf of clients, particularly if the adviser retains a proxy firm. The guidance follows a question-and-answer format.

Question 1: How may an investment adviser and its client, in establishing their relationship, agree upon the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of that client?

The SEC provides a non-exhaustive list of potential arrangements for voting client securities, including:

- The adviser votes according to specific parameters designed to serve the client's best interest. For example, absent contrary instructions from the client or the adviser's determination that voting a particular proposal in a different way would be in the client's best interest, the adviser votes in favor of all management proposals.
- The adviser does not vote if it would impose costs on the client.
- The adviser votes only on particular types of proposals based on the client's preferences, such as proposals relating to corporate events (mergers and acquisition transactions, dissolutions, conversions, or consolidations) or contested elections for directors.
- The adviser does not vote on certain types of matters where the cost of voting would be high (e.g., voting on foreign securities that could involve the additional cost of hiring a translator), or the benefit to the client would be low (e.g., the vote would not be expected to have a material effect on the value of a client's investment).

Question 2: What steps could an adviser, who has assumed voting authority on behalf of clients, take to demonstrate it is making voting determinations in a client's best interest and in accordance with the adviser's proxy voting policies and procedures?

- An adviser should consider whether voting all of its clients' shares in accordance with a uniform voting policy would be in the best interest of each of its clients. In particular, if an adviser votes proxies on behalf of funds it should consider whether it should have different voting policies for some or all of its funds, depending on their investment strategy and objectives.
- An adviser should also consider whether certain types of matters may necessitate that the adviser conduct a more detailed analysis to consider factors particular to the issuer or the voting matter (e.g., corporate events or contested elections). An adviser should consider identifying in its voting policy the factors it will consider in determining which matters require company-specific evaluation, and how it will evaluate voting decisions.
- An adviser should consider reasonable measures to determine that it is casting votes on behalf of its clients consistently with its voting policies and procedures. For example, it could sample the proxy votes it casts on behalf of its clients as part of its annual review of its compliance policies and procedures.
- An adviser that retains a proxy firm to provide voting recommendations or voting execution services should consider additional steps to evaluate whether the adviser's voting determinations are consistent with its voting policies and procedures and in the client's best interest before the votes are cast. The SEC recommends an adviser:

- ○ Periodically assess a sampling of the "pre-populated" votes shown on the proxy firm's electronic voting platform before votes are cast.
- ○ Consider additional information that may become available (e.g., an issuer's or shareholder proponent's additional proxy materials).
- ○ Consider whether a higher degree of analysis may be appropriate where a matter is highly contested or controversial.

- An adviser must review and document, no less frequently than annually, the adequacy of its voting policies and procedures.

Question 3: What are some of the considerations that an adviser should take into account if it retains a proxy firm to assist it in discharging its proxy voting duties?

An adviser should consider the following non-exhaustive list of factors:

- Whether the proxy firm has the capacity and competency (i.e., the adequacy and quality of the proxy firm's staffing, personnel and/or technology) to adequately analyze the matters for which the adviser is responsible for voting.
- Whether the proxy firm has an effective process for seeking timely input from issuers and its clients regarding its proxy voting policies, methodologies and peer group constructions, including for "say-on-pay" votes.
- Whether a proxy firm has adequately disclosed how it arrives at voting recommendations; the nature of any third-party information sources the proxy firm uses; and what steps the adviser should take to develop an understanding of when and how the proxy firm engages with issuers and third parties.

The SEC recommends an adviser review the proxy firm's policies and procedures regarding how it identifies and addresses conflicts of interest, including conflicts that generally arise from providing proxy voting recommendations and proxy voting services, conflicts that arise from activities other than providing proxy voting recommendations and services and conflicts presented by affiliations.

Question 4: What steps should an adviser consider taking when it becomes aware of potential factual errors, potential incompleteness, or potential methodological weaknesses in the proxy firm's analysis that may materially affect one or more of the adviser's voting determinations?

- An adviser's policies and procedures should be reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information. For example, an adviser should consider conducting a periodic review of its ongoing use of the proxy firm's research or voting recommendations, including an assessment of the extent to which factual errors, incompleteness or methodological weaknesses in the proxy firm's analysis (that the adviser is aware of and deems credible and relevant to its voting determinations) materially affected the proxy firm's research or recommendations.
- An adviser should also consider the effectiveness of the proxy firm's policies and procedures for obtaining current and accurate information. As part of this assessment, advisers may wish to communicate with proxy firms regarding the firm's engagement with issuers, the firm's efforts to correct any identified material deficiencies, the firm's disclosure of the sources of information and the firm's consideration of factors unique to a specific issuer or proposal.

Question 5: How can an adviser evaluate the services of a proxy firm that it retains, including evaluating any material changes in services or operations by the proxy firm?

- An adviser should consider requiring the proxy firm to update the adviser regarding business changes the adviser considers relevant. An adviser should also consider whether the proxy firm appropriately updates its methodologies, guidelines and voting recommendations on an ongoing basis, including in response to feedback from issuers and their shareholders.

Question 6: If an adviser has assumed voting authority on behalf of a client, is it required to exercise every opportunity to vote a proxy for that client?

No, if either of two situations applies. First, if an adviser and its client have agreed in advance to limit the conditions under which the adviser would exercise voting authority. Second, there may be times when an adviser that has voting authority may refrain from voting a proxy on behalf of a client if it has determined that refraining is in the best interest of that client. This may be the case where the adviser determines that the cost to the client of voting the proxy exceeds the expected benefit to the client.

Sources: SEC Clarifies Investment Advisers' Proxy Voting Responsibilities and Application of Proxy Rules to Voting Advice, SEC Press Release 2019-158 (Aug. 21, 2019), available here; Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release IA-5325 (Aug. 21, 2019), available here.

OCIE Issues Risk Alert Regarding Principal and Agency Cross Trading

The Office of Compliance Inspections and Examinations (OCIE) of the SEC issued a Risk Alert highlighting the most frequent principal trading and agency cross transaction compliance issues identified in examinations of advisers during the last three years.

Principal Trading. Section 206(3) of the Advisers Act prohibits an adviser from acting as principal for its own account to sell any security to a client or purchase any security from a client (principal trades) without disclosing in writing before the completion of the transaction the capacity in which the adviser is acting and obtaining the client's consent. An adviser entering into a principal trade with a client must satisfy the disclosure and consent requirements on a transaction-by-transaction basis — blanket disclosure and consent are not permitted. Proprietary and affiliated accounts of the adviser are generally subject to this provision.

Agency Cross Trading. Section 206(3) also prohibits an adviser, acting as broker for a person other than the advisory client, from effecting any sale or purchase of any security for the account of that client (agency cross transactions), without disclosing to that client in writing before the completion of the sale or purchase the capacity in which the adviser is acting and obtaining the consent of the client to the sale or purchase. An adviser is not required to provide transaction-by-transaction disclosure and consent of agency cross trading if the adviser complies with the conditions of Rule 206(3)-2, including consent and disclosure requirements.

Compliance Issues Related to Principal and Agency Cross Trading

OCIE gave examples of the most common deficiencies or weaknesses with respect to principal and agency cross trading:

- **Failure to Comply with Section 206(3) for Principal Trades with Individual Clients**
    - Advisers that, acting as principal for their own accounts, purchased securities from, and sold securities to, individual clients without recognizing that the trades were subject to Section 206(3).
    - Advisers that recognized that they engaged in principal trades, but did not obtain prior client consent for each trade; failed to provide sufficient disclosure regarding the conflicts of interest and terms of the transaction; or obtained client consent after the completion of the principal trade.

- **Failure to Comply with Section 206(3) for Principal Trades with Pooled Investment Vehicles**
    - Advisers that effected trades between advisory clients and an affiliated pooled investment vehicle, but failed to recognize that the advisers' significant ownership interests in the pooled investment vehicle would cause the transaction to be subject to Section 206(3).
    - Advisers that effected principal trades between themselves and pooled investment vehicle clients, but did not obtain effective consent because the committee granting consent on behalf of the pooled investment vehicle was itself conflicted.
- **Failure to Comply with Section 206(3) for Agency Cross Trading**
    - Advisers that disclosed to clients that they would not engage in agency cross transactions, but in fact engaged in numerous agency cross transactions in reliance on Rule 206(3)-2.
    - Advisers that effected numerous agency cross transactions and purported to rely on Rule 206(3)-2, but could not produce any documentation that they had complied with the written consent, confirmation, or disclosure requirements of the rule.
- **Failure to Adopt and/or Follow Policies and Procedures**
    - Advisers that did not have policies and procedures relating to Section 206(3) even though they engaged in principal trades and agency cross transactions.
    - Advisers that failed to follow their established policies and procedures.

In conclusion, OCIE encourages advisers to review their written policies and procedures and the implementation of those policies and procedures.

Source: OCIE Risk Alert: Investment Adviser Principal and Agency Cross Trading Compliance Issues (September 4, 2019); available here.

OCIE Issues Risk Alert Relating to Oversight of Supervised Persons with Disciplinary Histories and General Compliance and Supervision Issues

OCIE issued a Risk Alert encouraging advisers to address the risks associated with employing supervised persons with disciplinary histories and to adopt policies and procedures to address those risks. OCIE examined over 50 advisers to assess the oversight practices of advisers that previously employed, or currently employ, any individual with a disciplinary history, focusing not only on supervisory practices concerning the individuals, but also the firm as a whole. OCIE remarked that supervisory practices firm-wide are important to setting a strong "tone at the top" and compliance culture.

Staff Observations of Deficiencies Specific to Disciplinary Histories

- **Full and Fair Disclosure.** For example, advisers:
    - Omitted material disclosures regarding disciplinary histories of supervised persons, often relying solely on supervised persons to self-report.
    - Included incomplete or misleading information.
    - Failed to promptly update Form ADV with new disciplinary events of supervised persons.
- **Compliance Programs.** For example, advisers did not have processes reasonably designed to confirm the accuracy of supervised persons' self-attestations regarding disciplinary events, including whether they were the subject of reportable events or bankruptcies.

Staff Observations of Deficiencies Related to Compliance and Supervision Generally

- **Supervision.** Many advisers did not adequately supervise or set appropriate standards of business conduct for their supervised persons. Examples include practices where the adviser did not:
    - Oversee whether fees charged by supervised persons were disclosed or assess whether the services clients paid for were performed.
    - Have advertising policies and procedures that provided sufficiently specific guidance to supervised persons who prepared advertising materials and websites.
    - Adequately monitor the activities of supervised persons working from remote locations.
- **Oversight.** Many advisers did not confirm that supervised persons responsible for implementing certain compliance policies and procedures were executing their duties, such as maintaining books and records.
- **Compliance Policies and Procedures.** Several advisers adopted policies and procedures inconsistent with their actual business practices and disclosures, most often in relation to fees and expenses.
- **Annual Compliance Reviews.** Many advisers failed to adequately document their annual reviews and appropriately assess applicable risk areas.

Staff Observations of Deficiencies Related to Disclosure of Conflicts of Interest

- **Compensation Arrangements.** Several advisers had undisclosed compensation arrangements, which resulted in conflicts of interests. For example:
    - The terms of forgivable loans to supervised persons were contingent upon certain client-based incentives that may have unduly influenced the investment decision-making process, resulting in higher fees and expenses for the affected clients.
    - Because supervised persons were required to incur all transaction-based charges associated with executing client transactions, supervised persons were incentivized to trade less frequently on behalf of their clients.

Staff Observations on Ways to Improve Compliance

The staff suggested that advisers who employ supervised persons with disciplinary histories consider:

- Adopting written policies and procedures that specifically address what must occur prior to hiring supervised persons with disciplinary histories, including investigating disciplinary events and determining whether barred individuals are eligible to reapply for their licenses.
- Enhancing due diligence practices associated with hiring supervised persons to identify disciplinary events, including conducting background checks and internet searches, fingerprinting personnel, using third parties to research potential new hires, contacting personal references and verifying educational claims.
- Establishing heightened supervision practices when overseeing supervised persons with certain disciplinary histories (e.g., misappropriation, unauthorized trading, forgery, bribery and making unsuitable recommendations).
- Adopting written policies and procedures addressing client complaints related to supervised persons.

Source: Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest (July 23, 2019), available here.

LITIGATION

Second Circuit Finds Private Right of Action under Section 47(b) of the Investment Company Act

The United States Court of Appeals for the Second Circuit diverged from the Third Circuit and several lower courts by ruling that Section 47(b) of the Investment Company Act provides a private right of action for any party to a contract created or performed in violation of the Investment Company Act.

The dispute in *Oxford University Bank v. Lansuppe Feeder, Inc.* emerged following an attempt by senior noteholders of a trust to liquidate and distribute trust assets after the trust failed to make interest payments to senior noteholders. The terms of the trust mandated that upon liquidation, trust assets be distributed with priority to senior noteholders. If distributed accordingly, senior noteholders would be compensated significantly while junior noteholders would receive no compensation for their investment.

Junior noteholders intervened in a lawsuit filed by a senior noteholder against the trustee, making a cross-claim that the trust had violated the Investment Company Act because it failed to register the trust with the SEC. While the Investment Company Act typically requires investment companies to register with the SEC, it provides a registration exemption for issuers whose notes are exclusively acquired by qualified purchasers. Relying upon this exemption, the trust never registered as an investment company. Junior noteholders alleged that because trust-issued notes were acquired by a non-qualified purchaser from an initial qualified purchaser, the registration exemption no longer applied and thus the trust violated the Investment Company Act by failing to register. Junior noteholders sought to rescind their investment in their notes under Section 47(b).

Despite the court's finding of a private right of action under Section 47(b), the claim asserted by junior noteholders failed on the merits because the junior noteholders sought to rescind the terms of the trust, a contract that did not violate the Investment Company Act. The court noted that while the contracts for the sale or transfer of unregistered notes to non-qualified purchasers may have violated the Investment Company Act and thus given rise to a valid claim for rescission, junior noteholders did not seek the rescission of these contracts and thus failed to state a claim.

Because Section 47(b) only provides a private right of action to a party to an unenforceable contract and shareholders are not parties to fund-related contracts, an influx of Section 47(b) rescission claims seems rather unlikely given that courts generally decline to treat prospectuses as contracts between shareholders and the respective funds. However, in *Northstar Financial Advisors, Inc. v. Schwab Investments*, the Ninth Circuit treated a proxy statement as a contract between shareholders and a fund. If such a theory were to obtain greater acceptance, investment company shareholders may have the ability to bring Section 47(b) rescission claims.

Source: Oxford Univ. Bank v. Lansuppe Feeder, Inc., No. 16-4061 (2d Cir. 2019).

Regulation Best Interest Litigation

Seven states (California, Connecticut, Delaware, Maine, New Mexico, New York and Oregon) and the District of Columbia brought a lawsuit in September against the SEC challenging Regulation Best Interest (Reg BI) and seeking to vacate the rule. The plaintiffs allege that Reg BI undermines critical consumer protections for retail investors, increases confusion about the standards of conduct that apply when investors receive recommendations and advice from broker-dealers or advisers, "makes it easier for brokers to market themselves as trusted advisers (while nonetheless permitting them to engage in harmful conflicts of interest that siphon investors' hard-earned savings)" and contradicts Congress' express direction to adopt a uniform fiduciary standard. XY Planning Network, a network of registered investment advisers, and Ford Financial

Solutions, a registered investment adviser and member of the network, brought a similar suit alleging that they are injured by Reg BI because it causes them a "competitive disadvantage with respect to broker-dealers [and] makes it more difficult to differentiate their fiduciary standard of conduct from the lower standard of conduct now applicable to broker-dealers." The two suits were consolidated by the United States District Court for the Southern District of New York. More recently, the district court dismissed the suit, citing the court's lack of subject-matter jurisdiction. The court's order notes that the parties have already filed petitions for review in the U.S. Court of Appeals for the Second Circuit.

Sources: Joe Morris, Best Interest Backlash: N.Y., Calif. Suing SEC, IGNITES (Sept. 10, 2019); Joe Morris, RIA Network Sues SEC Over Reg BI, IGNITES (Sept. 11, 2019); Joe Morris, Reg BI Suits Consolidated, IGNITES (September 13, 2019); Ted Godbout, District Court Dismisses Suit Challenging SEC's Reg BI, National Association of Plan Advisors (Oct. 1, 2019).

Courts Reject Mutual Fund Excessive Fee Claims Following Trials

Kennis v. Metropolitan West Asset Management, LLC

Following a bench trial, the U.S. District Court for the Central District of California found for the defendant Metropolitan West Asset Management, LLC (MetWest) in an excessive fee case brought under Section 36(b) of the Investment Company Act by a shareholder of the MetWest Total Return Bond Fund. The plaintiff alleged that MetWest charged excessive advisory fees to the Fund in light of the firm providing substantially similar services for a lower fee as a sub-adviser to unaffiliated funds.

As reported in our *January 2019 Investment Management Update*, the court previously granted the defendant's motion for summary judgment as to two of the *Gartenberg* factors: nature and quality of services and fall-out benefits. Therefore, the trial focused on the following four factors: comparative fees, profitability, economies of scale and the care and conscientiousness of the Fund board.

While noting it was not dispositive, the court found Broadridge (formerly known as Lipper) data on comparative fees to be a "useful tool for comparison" and persuasive. The court found that the plaintiff did not demonstrate the type of profitability that goes to the question of whether the fee charged is beyond the arm's length range. MetWest's profit margins (excluding distribution and recordkeeping as expenses) ranged from 28.8% to 31.6% and "rested below the median of reported profit margins" for comparable asset managers. The plaintiff failed to meet his two-pronged burden to show that economies of scale were both realized and not sufficiently shared with investors. Even if economies of scale existed, MetWest "reinvested through adding new employees, improving technology systems, and by increasing compensation for retention purposes" during periods of the Fund's asset growth. In addition, the court cited "evidence that MetWest priced the Fund to scale at the outset, meaning that it priced the Fund below the level necessary to recoup costs in order to attract assets and investment." Finally, the court reviewed the board's 15(c) process and concluded it was "sufficiently robust." The court rejected an argument advanced by the plaintiff that the board's failure to negotiate (or even discuss) a lower advisory fee negates any deference owed to the board.

"Considering and weighing all the evidence presented at trial, the court concludes that MetWest provides substantially different services and takes on substantially different risks in exchange for the 35 bp fee charged to the Fund versus the subadvisory fees charged to the subadvised funds," the court decision reads. The court recognized various differences in services related to daily pricing and striking the NAV, satisfying shareholders' redemption requests, complying with securities laws, preparing public filings (including prospectuses, statements of additional information, annual and semi-annual reports), assisting the board, overseeing third-party service providers and client servicing. In addition to recognizing differences in services, the court also recognized differences in risk, finding that MetWest faced reputational, financial, litigation, regulatory and business risks, as well as cybersecurity risks, the threat of losing personnel essential to client relations, asset flight risk and risks associated with the fund's regulatory filings.

Chill v. Calamos Advisors LLC

Following a two-week bench trial, the U.S. District Court for the Southern District of New York in October found for the defendant Calamos Advisors LLC (Calamos) in an excessive fee case brought by shareholders of the Calamos Growth Fund. The plaintiffs alleged that Calamos breached its fiduciary duty under Section 36(b) by charging excessive investment advisory fees. The court granted partial summary judgment to Calamos in September 2018, concluding that plaintiffs failed to raise triable issues of fact related to two *Gartenberg* factors, economies of scale and fall-out benefits. Thus, the trial focused on the following four factors: the care and conscientiousness of the Fund board, comparative fees, profitability and nature and quality of services.

The court found that the independent trustees were careful, conscientious, and fully informed when approving Calamos' advisory fee. The court rejected plaintiffs' contention that the Fund's fees should be limited to fees charged to institutional or subadvised accounts, finding that comparison "inapt" because managing the Fund entails greater services and risks than advising other types of accounts. In addition, the court found that the fees charged by Calamos were not excessive in comparison to fees charged by similar funds, noting that although Calamos' fees were above industry average, the fees were still within range of advisory fees charged by Calamos' peers. The court found that Calamos' pre-tax, pre-distribution profits (estimated by Calamos to be between 29% to 55%) were not excessive and fell within the range of profit levels approved by other courts. The court found "incontrovertible evidence demonstrates that the Fund's performance was often underwhelming during the relevant period. Accordingly, this factor supports plaintiffs' contention that Calamos' fees were excessive." However, the court noted mitigating factors, such as the recent underperformance was contradicted by the Fund's since-inception performance. In addition, the court noted that shareholders and boards are more concerned with future performance and Calamos had recently made changes to its team and investment process in hopes of improving Fund performance. The court concluded that although the quality of the services marginally tended to support plaintiffs' claims, the other five *Gartenberg* factors decisively favored Calamos. Thus, the court ruled the plaintiffs failed to prove that Calamos breached its fiduciary duty.

Sources: Nick Godt, $78B MetWest Fund Defeats Excessive Fee Claims, IGNITES (August 12, 2019); Thomas J. Kennis v. Metropolitan West Asset Management, LLC, Case No. 2:15-cv-08162 (C.D. Cal. July 9, 2019); Chill et al v. Calamos Advisors LLC, Civil Action No. 1:15-cv-010114-ER (S.D.N.Y 2019).

COMPLIANCE DATES FOR FINAL RULES

<table>
<tr><th>Final Rule</th><th>Compliance Date(s)</th></tr>
<tr><td>Liquidity Risk Management Programs (Rule 22e-4)</td><td>Applicable Requirements of Liquidity Risk Management Program:
• Adoption and implementation of Liquidity Risk Management Program (including risk assessment)
• Board designation of program administrator
• 15% illiquid investment limit
• Adoption of policies and procedures for funds that engage in redemptions in-kind
• Related recordkeeping requirements
Compliance date has passed for all fund complexes.
Additional Requirements of Liquidity Risk Management Program:
• Portfolio classification (bucketing)
• Highly Liquid Investment Minimum (HLIM)
• Board oversight
• Related recordkeeping requirements
Fund complexes with $1 billion or more in net assets: compliance date has passed
Fund complexes with less than $1 billion in net assets: December 1, 2019</td></tr>
<tr><td>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)</td><td><u>Parts A, B and C</u>
Compliance date has passed for all fund complexes
<u>Part D</u> (if a fund's highly liquid investments fall below its minimum for more than 7 consecutive calendar days, it must file Part D)
Fund complexes with $1 billion or more in net assets: compliance date has passed
Fund complexes with less than $1 billion in net assets: December 1, 2019</td></tr>
</table>

<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:
compliance date has passed

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:
compliance date has passed

Fund complexes with less than $1 billion in net assets:
first filing date is June 1, 2020, based on March 2020 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, 2020</td><td>June 1, 2020</td><td>March 2020</td></tr>
<tr><td>April 30, 2020</td><td>June 29, 2020</td><td>March, April 2020</td></tr>
<tr><td>May 31, 2020</td><td>July 30, 2020</td><td>March, April, May 2020</td></tr>
</table>
Once funds are required to file reports on Form N-PORT, they must maintain in their records the information that is required to be included on Form N-PORT within 30 days of each month end and file reports on Form N-PORT for each fiscal quarter within 60 days of such quarter end.</td></tr>
</table>

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: compliance date has passed 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
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.
Form CRS, Client Relationship Summary	Form CRS must be filed by June 30, 2020. Initial delivery of Form CRS to all of an investment adviser's and broker-dealer's existing customers/clients who are retail investors due by July 30, 2020.