Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS: FUNDS

SEC Proposes to Modernize Fund Shareholder Reports and Disclosures

The SEC has proposed modifications to the disclosure framework for mutual funds and exchange-traded funds (ETFs). The proposal sets forth a layered disclosure approach to highlight key information for retail investors.

If adopted, the proposed modifications would:

- require streamlined shareholder reports that would include fund expenses, performance, illustrations of holdings and material fund changes;
- encourage the use of graphics or text features to promote effective communications; and
- promote a layered and comprehensive disclosure framework by continuing to make available online certain information that is currently required in shareholder reports but may be less relevant to retail shareholders.

Highlights from the proposal include the following:

Tailored Shareholder Reports. Under proposed Rule 498B, new investors would receive a fund prospectus in connection with their initial investment, as they currently do, but funds would not deliver annual prospectus updates to shareholders thereafter. Instead, funds would keep existing shareholders informed through streamlined annual and semi-annual reports, as well as timely notifications of material fund changes as they occur.

Certain changes to a registration statement, such as updates to existing risk disclosures, may be deemed not to be material and therefore not subject to the timely notification requirements under proposed Rule 498B. Proposed Rule 498B would not prohibit a fund from continuing to satisfy its prospectus delivery obligations by delivering a copy of the summary prospectus and any supplements to the summary prospectus to existing shareholders.

Current versions of the prospectus, which must include any material fund changes, would remain available online and would be delivered upon request in paper or electronically, consistent with the shareholder's delivery preference. Funds would continue to be subject to the same prospectus and registration statement liability and anti-fraud provisions for fund documents required to be made available online but not required to be delivered to existing shareholders (the summary and statutory prospectus and information required to be incorporated into those documents).

The proposal would require a fund company to prepare separate reports for each of its series but not for each class of a multi-class fund. The proposal also would provide additional flexibility for funds to add tools and features to annual reports that appear on their websites or are otherwise provided electronically. This could include video or audio messages, mouse-over windows, pop-up definitions, chat functionality and expense calculators.

A link to a hypothetical streamlined shareholder report issued by the SEC in connection with the proposal is available here.

Availability of Information on Form N-CSR and Online. Information currently required in shareholder reports that is not included in the streamlined shareholder report would be available online, delivered free of charge upon request, and filed on a semi-annual basis with the SEC on Form N-CSR. Such information includes the schedule of investments and other financial statements, while a graphical representation of a fund's holdings would be retained in the streamlined shareholder reports.

Exclusion of Open-End Funds from Scope of Rule 30e-3. The proposal would also amend the scope of Rule 30e-3, the optional internet availability of shareholder reports, to exclude open-end funds. The proposal would not affect the availability of Rule 30e-3 for closed-end funds. The SEC's rationale for narrowing the scope of this rule is based on its preliminary belief that the direct transmission of tailored reports represents a more effective means of improving investors' access to and use of fund information, and reducing funds' printing and mailing expenses, than allowing open-end funds to rely on Rule 30e-3.

Amended Prospectus Disclosure of Fund Fees and Risks. The proposal would amend prospectus disclosure requirements and related instructions to provide greater clarity and more consistent information regarding fees, expenses, and principal risks. The proposed amendments would: (1) replace the existing fee table in the summary section of the statutory prospectus with a simplified fee summary, (2) move the existing fee table to the statutory prospectus, and (3) replace certain terms in the current fee table with terms intended to be clearer to investors. The proposed amendments would also permit funds that make limited investments (up to 10% of net assets) in other funds to disclose acquired fund fees and expenses (AFFE) in a footnote to the fee table and summary instead of requiring AFFE to be presented as a line item in the table.

The amendments would preclude a fund from disclosing non-principal risks in the prospectus. An additional new instruction would require that funds describe principal risks in order of importance, with the most significant risks appearing first, and tailor risk disclosure to how the fund operates rather than rely on generic, standard risk disclosures. Proposed instructions would also prohibit the presentation of principal risks in alphabetical order.

Fee and Expense Information in Investment Company Advertisements. The proposed amendments would require that presentations of investment company fees and expenses in advertisements and sales literature be consistent with relevant prospectus fee table presentations and reasonably current. The proposed amendments to the advertising rules would affect all registered investment companies and business development companies.

The amendments would require fees and expenses in advertisements to include timely and prominent information about a fund's maximum sales load (or any other non-recurring fee) and gross total annual expenses.

Next Steps. The SEC has proposed an 18-month transition period. Accordingly, if adopted, the compliance date would be 18 months after the amendments' effective date. Comments on the SEC's proposal are due within 60 days after publication in the Federal Register.

Sources: SEC Proposes to Improve the Retail Investor Experience through Modernized Fund Shareholder Reports and Disclosures, SEC Press Release 2020-172 (Aug. 5, 2020), available here. Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements, SEC Release No. IC-33963 (Aug. 5, 2020), available here.

Great-West Prevails Against 401(k) Investors in Excessive Fee Litigation

On August 7, 2020, the U.S. District Court for the District of Colorado entered judgment in favor of defendants Great-West Capital Management, LLC and Great-Western Life & Annuity Insurance Co. in the latest round of excessive fee litigation. The plaintiffs, a group of investors who acquired shares of Great-West Funds as participants in retirement plans offered by their employers, brought suit in a consolidated shareholder derivative action in early 2016, alleging that the advisory and administrative service fees charged by Great-West were excessive.

Following a bench trial, the court ruled that plaintiffs failed to prove that Great-West's fees were so disproportionately large that they bore no reasonable relationship to Great-West's services and could not have been the product of arm's length bargaining. Additionally, the court found that plaintiffs failed to demonstrate they had suffered any actual damages.

The court adopted Great-West's proposed findings of fact and conclusions of law with respect to the *Gartenberg* factors. In doing so, the court found that: (1) the Great-West Funds Board of Directors' decision to approve Great-West's fees was entitled to substantial deference because the Board was independent, qualified and it engaged in a robust process in approving the fees; (2) the advisory fees and administrative fee were within the range of comparable funds; (3) plaintiffs failed to quantify any alleged economies of scale or show that those economies were not adequately shared with shareholders; (4) Great-West's profits were within the range of their competitors; (5) Great-West provided extensive, high-quality services in exchange for its fees; and (6) plaintiffs failed to identify any significant fall-out benefits to Great-West. Accordingly, the court found Great-West had not breached its fiduciary duties.

In addition, the court found plaintiffs had failed to prove their actual damages at trial. Accordingly, the court entered judgment in favor of defendants and ordered payment of defendants' costs after four years of litigation. The plaintiffs have appealed the decision.

Source: Obeslo, et al. v. Great-West Capital Mgmt., LLC et al., C.A. No. 16-cv-00230-CMA-SKC, 2020 WL 4558982 (D. Colo. Aug. 7, 2020).

LATEST DEVELOPMENTS: ADVISERS

SEC Adopts Rule Amendments Governing Proxy Solicitations

On July 22, 2020, the SEC adopted amendments to the rules that exempt proxy voting advice businesses from the information and filing requirements of the federal proxy rules to account for current market practices, including the prevalent use of proxy voting advice by institutional investors. In addition, the amendments codify the SEC's longstanding position that proxy voting advice generally constitutes a solicitation under the proxy rules and make clear that the failure to disclose material information about proxy voting advice may constitute a potential violation of the anti-fraud provisions of the proxy rules.

Highlights of the amendments include the following:

- the terms "solicit" and "solicitation" in Rule 14a-1 will include proxy voting advice that makes a recommendation to a shareholder as to its vote, consent or authorization on a specific matter for which shareholder approval is solicited;

- persons who provide proxy voting advice in reliance on certain exemptions must provide specific conflicts of interest disclosure and adopt and publicly disclose written policies and procedures reasonably designed to ensure that:

    - registrants that are the subject of the proxy voting advice have such advice made available to them at or prior to the time when the advice is disseminated to the proxy voting advice business's clients; and

    - the proxy voting advice business provides clients with a mechanism by which they can reasonably be expected to become aware of any written statements regarding its proxy voting advice by registrants who are the subject of such advice, before the applicable meeting.

Summary of Supplemental Guidance Issued to Investment Advisers. The SEC also outlined additional steps that an adviser who uses proxy advisory firms to assist with vote execution may take to demonstrate the adviser is making voting determinations in a client's best interest. The supplemental guidance focused on circumstances in which an adviser utilizes a proxy advisory firm's electronic vote management system to "pre-populate" ballots based on the adviser's voting instructions to the firm or automatically submits votes to be counted (automated voting).

The additional steps would require advisers to consider:

- whether the adviser's policies and procedures are reasonably designed to ensure that it exercises voting authority in its client's best interest; specifically:
  - whether its policies and procedures address circumstances where the adviser becomes aware that an issuer intends to file or has filed additional soliciting materials with the SEC after the adviser has received the voting recommendation but before the submission deadline;
  - whether the adviser's agreements with any proxy advisory firms would permit a proxy advisory firm to utilize information regarding how the adviser intends to vote (due to the timing of pre-populated and automated voting, which typically occur prior to the submission deadline for proxies to be voted at the shareholder meeting); and
- disclosing (1) the extent of the use of automated voting and the circumstances under which it is used, and (2) how its policies and procedures address the use of automated voting in cases where it becomes aware that an issuer intends to file or has filed additional soliciting materials.

The SEC stated that an adviser's clients may not, without the recommended disclosure, have sufficient information to provide informed consent with respect to the use of automated voting for purposes of agreeing to the scope of the advisory relationship or as it relates to the adviser's obligation to provide full and fair disclosure relating to the advisory relationship.

While the compliance dates for the amendments to the proxy rules are not until December 1, 2021, the SEC's supplemental guidance for investment advisers is effective now.

Sources: SEC Adopts Rule Amendments to Provide Investors Using Proxy Voting Advice More Transparent, Accurate and Complete Information, SEC Press Release 2020-161 (July 22, 2020), available here. Exemptions from the Proxy Rules for Proxy Voting Advice, SEC Release No. 34-89372 (July 22, 2020), available here. Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, SEC Release No. IA-5547 (July 22, 2020), available here.

SEC Modernizes Accredited Investor Definition

The SEC has amended the definition of "accredited investor" in Rule 501(a) of Regulation D. Notably, the SEC did not amend the financial thresholds, even though those thresholds have been in place since 1982 and have not been adjusted for inflation. Rather, the amendments set forth new categories of accredited investors for individuals that are not based on financial thresholds, expand the list of entities qualifying as accredited investors, and revise the rules related to calculating "joint net worth" and "joint income" by permitting "spousal equivalents" to pool finances.

Categories Not Based on Financial Thresholds

The amendments create new categories of accredited investors for individuals based on qualifications other than income and net worth:

- *Professional certifications, designations or credentials*: The definition of accredited investor now includes individuals who hold certain professional certifications, designations or credentials in good standing, including Series 7, 65 and 82 licenses.
- *Knowledgeable employees*: The definition of accredited investor also now includes "knowledgeable employees" of a private fund (e.g., hedge funds, venture capital funds and private equity funds) investing in that private fund. "Knowledgeable employees" includes executive officers, directors, trustees, general partners, advisory board

members or persons serving in a similar capacity, and other individuals participating in the investment activities of the fund.

Additional Entity Types

The accredited investor definition enumerates several categories of entities that qualify as accredited investors. The recent amendments expand this list to include the following:

- SEC- and state-registered investment advisers, and exempt reporting advisers.
- Limited liability companies.
- Family offices with at least $5 million in assets under management that are not formed for the specific purpose of acquiring the securities offered.
- A catch-all category for entities owning investments in excess of $5 million and not formed for the specific purpose of acquiring the securities offered. This category is intended to capture entity forms such as Indian tribes, labor unions and governmental bodies, as well as entity types that may be created in the future.

Investors Advised by Third Parties

The SEC did not expand the accredited investor definition further to include investors who are advised by advisers or broker-dealers. The SEC determined that neither a recommendation by a broker-dealer nor advice by an adviser should serve as a proxy for an individual investor's financial sophistication or his or her ability to sustain the risk of loss of an investment or ability to fend for him or herself. Advisers should note that their clients who elect to participate in private securities offerings must themselves meet the accredited investor definition. An adviser's participation in a transaction on behalf of a client, whether in an advisory capacity or otherwise, does not itself qualify such clients as accredited investors.

Amendments to Subscription Documents

For advisers to private funds, these amendments will impact form subscription documents, including investor questionnaires. Advisers should take steps to review and amend their private fund form documents prior to the December 8, 2020 effective date.

Sources: SEC Modernizes the Accredited Investor Definition, SEC Press Release 2020-191 (Aug. 26, 2020), available here. Amending the "Accredited Investor" Definition, SEC Release No. 33-10824 (Aug. 26, 2020), available here.

OCIE Issues Risk Alert Regarding COVID-19 Compliance Risks and Considerations for Advisers

The SEC's Office of Compliance Inspections and Examinations (OCIE) has recently issued a Risk Alert to share some of its observations and recommendations from its efforts to engage with SEC registrants to assess the impacts of COVID-19. OCIE's observations and recommendations fall broadly into six categories.

Protection of investors' assets. OCIE encouraged firms to review their compliance policies and procedures as well as their business practices, and make adjustments where appropriate, including in situations where investors mail checks to firms and firms are not picking up their mail daily. Firms may want to consider disclosing to investors that checks or other assets mailed to the firm's office location may experience delays in processing until personnel are able to access the mail or deliveries at that office location.

OCIE also encouraged firms to consider their policies and procedures around disbursements to clients. Firms may want to consider implementing additional steps to validate the identity of the client and the authenticity of disbursement instructions.

Supervision of personnel. OCIE suggested firms may wish to modify their compliance policies and procedures to address:

- Supervisors not having the same level of oversight and interaction with supervised persons when they are working remotely.

- Supervised persons making securities recommendations in market sectors that have experienced greater volatility or may have heightened risks for fraud.

- The impact of limited on-site due diligence reviews and other resource constraints associated with reviewing of third-party managers, investments, and portfolio holding companies.

- Communications or transactions occurring outside of a firm's systems due to personnel working from remote locations and using personal devices.

- Remote oversight of trading, particularly in high volume investments.

- The inability to perform the same level of diligence during background checks when onboarding personnel or to have personnel take requisite examinations.

Practices relating to fees, expenses and financial transactions. The recent market volatility and the resulting impact on investor assets and fees collected by firms may have increased financial pressures on firms and their personnel to compensate for lost revenue. While these incentives and related risks always exist, the current situation may have increased the potential for misconduct regarding:

- *Financial conflicts of interest*, such as: (1) recommending retirement plan rollovers to individual retirement accounts and retirement account transfers into advised accounts or investments in products that the firms or their personnel are soliciting; (2) borrowing or taking loans from investors and clients; and (3) making recommendations that result in higher costs to investors and that generate greater compensation for supervised persons, such as mutual funds with higher cost share classes when lower cost share classes are available.

- *Fees and expenses charged to investors*, such as: (1) advisory fee calculation errors, including valuation issues that result in over-billing of advisory fees; (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts.

OCIE suggested firms may wish to enhance their compliance monitoring in particular by validating the accuracy of their disclosures, fee and expense calculations and investment valuations. OCIE also stated that adviser firms that seek or have received financial assistance may have an obligation to update disclosures on their Form ADV Part 2.

Fraud. Firms should be cognizant that times of crisis or uncertainty can create a heightened risk of investment fraud and bear that in mind when conducting due diligence and in determining that an investment is in the best interest of an investor. OCIE encouraged firms and their personnel who suspect fraud to contact the SEC.

Business continuity. OCIE encouraged firms to review their continuity plans since many firms have shifted to predominantly operating from remote sites. These transitions may raise compliance issues and other risks that could impact protracted remote operations, including:

- Firms' supervisory and compliance policies and procedures utilized under "normal operating conditions" may need to be modified or enhanced to address some of the unique risks and conflicts of interest present in remote operations. For example, supervised persons may need to take on new or expanded roles in order to maintain business operations. These and other changes in operations may create new risks that are not typically present.

- Security and support for facilities and remote sites may need to be modified or enhanced. Firms should consider whether: (1) additional resources and measures for securing servers and systems are needed, (2) the integrity of vacated facilities is maintained, (3) relocation infrastructure and support for personnel operating from remote sites is provided, and (4) remote location data is protected.

Protection of investor and other sensitive information. OCIE recommended that firms pay particular attention to the risks regarding access to systems, investor data protection and cybersecurity. In particular, firms should assess their policies and procedures and consider the following enhancements:

- Remind clients to contact the firm directly by telephone for any concerns about suspicious communications and for the firm to have personnel available to answer these inquiries.
- Additional training and reminders for firm personnel related to phishing and other targeted cyberattacks; information sharing while using certain remote systems; encrypting documents and using password-protected systems; and destroying physical records at remote sites.
- Heighten reviews of personal access rights and controls as individuals take on expanded roles.
- Use validated encryption technologies to protect communications and data stored on all devices, including personally-owned devices.
- Secure and fully patch remote access servers.
- Address new or additional cyber-related issues related to third parties, who may also be operating remotely when accessing a firm's systems.

Source: OCIE Risk Alert: Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers (Aug. 12, 2020), available here.

OCIE Issues Risk Alert Regarding Ransomware

Over the summer, OCIE issued a Risk Alert regarding ransomware attacks on advisers, broker-dealers and investment companies. OCIE encouraged registrants to monitor cybersecurity alerts published by the Department of Homeland Security Cybersecurity and Infrastructure Security Agency and share this information with their third-party service providers. OCIE also shared observations of registrants enhancing cybersecurity preparedness and operational resiliency to address ransomware attacks utilizing the following measures:

- *Incident Response and Resiliency Policies, Procedures and Plans*. Assessing, testing and periodically updating incident response and resiliency policies and procedures, such as contingency and disaster recovery plans.
- *Operational Resiliency*. Determining which systems and processes are capable of being restored during a disruption so that business services can continue to be delivered.
- *Awareness and Training Programs*. Providing specific cybersecurity and resiliency training, including phishing exercises to help employees identify phishing emails.
- *Vulnerability Scanning and Patch Management*. Implementing proactive vulnerability and patch management programs that take into consideration current risks to the technology environment, and that are conducted frequently and consistently across the technology environment.
- *Access Management*. Managing user access through systems and procedures that limit access during onboarding, transfers, and terminations, re-certify users' access rights on a periodic basis, require the use of strong and periodically changed passwords, utilize multi-factor authentication and other strong access controls.
- *Perimeter Security*. Implementing perimeter security capabilities such as firewalls, intrusion detection systems, email security capabilities, and web proxy systems with content filtering.

Cybersecurity has remained a key examination priority for OCIE for many years. The SEC maintains a Cybersecurity Spotlight webpage that provides cybersecurity-related information and guidance, available here.

Source: OCIE Risk Alert: Cybersecurity: Ransomware Alert (July 10, 2020), available here.

Updates on the California Consumer Privacy Act: Enforcement Efforts, Finalized Regulations and New Initiatives

The California Attorney General (AG) recently started enforcing one of the broadest state-based privacy laws in the U.S.—the California Consumer Privacy Act (CCPA). Despite early enforcement, the AG regulations for the CCPA were finalized on August 14, 2020. Even though the regulations went through multiple versions, the final version still had some surprising changes. The most meaningful last-minute revision was the removal of a requirement that companies provide an offline version of their privacy policies to individuals before personal information is collected.

After its January 1, 2020 effective date, the CCPA was subject to a six-month ramp-up period, such that enforcement was not to begin until July 1, 2020. Despite various calls for delay, the AG stated in an interview with *The Washington Post* that he would continue with enforcement starting July 1st. By mid-July, several online reports surfaced confirming that the AG did indeed begin enforcement of the CCPA. To date, the AG has focused enforcement efforts on violations reported by individuals and blatant violations of the law, such as not having the required online privacy policy.

Generally, companies are subject to the CCPA when they are doing business in California and either (1) have revenue in excess of $25 million, or (2) collect the personal information of more than 50,000 California individuals, households, or devices. Following the release of the final regulations, it remains unclear if the revenue prong applies only to revenue earned in California, though many companies have taken the position the revenue prong applies to overall revenue. If a firm is subject to the CCPA, a key first step is to determine which personal information that the firm collects is and is not subject to the CCPA. Financial services firms such as advisers, broker-dealers and investment companies primarily rely on an exemption from the law for nonpublic personal information under the Gramm Leach Bliley Act (GLBA). If a firm collects and uses personal information subject to the CCPA, then the next pivotal step is to draft and post a compliant privacy policy and provide the policy when the firm collects personal information.

Clients of firms subject to the CCPA also must be given the right to know and request what data the firm has on them and to request that the firm delete that data. Certain data is exempt from these requests, such as client data that would fall under the GLBA. Firms subject to the CCPA must provide at least two methods for individuals to submit requests related to their data.

While many firms are still working on initial compliance efforts for the CCPA, a new ballot initiative has already arisen to amend the law. This November, Californians will vote on the California Privacy Rights Act (CPRA). If passed, the CPRA would expand rights under the CCPA to include a right to rectify incorrect personal information and the right to restrict how companies can use “sensitive” personal information. The CPRA would also create a new privacy agency to enforce the CCPA, as amended by the CPRA.

Sources: Letter from Alastair Mactaggart to the Initiative Coordinator, Cal. Office of the Attorney General, Submission of Amendments to The California Privacy Rights and Enforcement Act of 2020, Version 3, No. 19-0021 (Nov. 4, 2019), available here. Rachel Lerman, California Begins Enforcing Digital Privacy Law, Despite Calls for Delay, Wash. Post, July 1, 2020, available here. Zachary Willenbrink, CCPA Enforcement Begins Amid Pandemic, American Bar Association: Practice Points, August 2, 2020, available here.