GODFREY & KAHN S.C.

Investment Management Focus

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Legal and Regulatory Update

Latest Developments

SEC Proposes Regulation Best Interest for Broker-Dealers and Reaffirms the Fiduciary Duty Requirement for Investment Advisers

On April 18, 2018, the SEC Commissioners voted 4 to 1 to propose two rules and an interpretation to address retail investor confusion about the relationships that they have with investment professionals and the harm that may result from that confusion. The SEC's objectives with this rulemaking are to: (1) enhance retail investor protection by (a) raising the standard of conduct for broker-dealers when they provide recommendations to retail investors, and (b) reaffirming, and in some instances clarifying, the standard of conduct for investment advisers; (2) preserve retail investor access (in terms of choice and cost) to a variety of types of investment services and investment products, including transaction-based brokerage accounts; and (3) raise retail investor awareness of whether they are working with a broker-dealer or investment adviser. SEC Chairman Jay Clayton said the proposed rules "should increase investor protection without adversely affecting investor choice" by bridging "any gaps between what retail investors expect from their investment professionals and what our laws require."

Proposed Rule: Regulation Best Interest

A broker-dealer making a recommendation to a retail customer (as defined in Regulation Best Interest) would have a duty 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-dealer ahead of the retail customer. A broker-dealer would satisfy this duty by complying with each of three specific obligations:

- ***Disclosure.*** Reasonably disclose to the retail customer the key facts about the relationship, including material conflicts of interest.
- ***Care.*** Exercise reasonable diligence, care, skill, and prudence, to:
  - understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;
  - have a reasonable basis to believe that the recommendation is in the particular retail customer's best interest based on that customer's investment profile; and

    - have a reasonable basis to believe that a series of recommended transactions is not excessive and is in the retail customer's best interest.

- ***Conflict of Interest.*** Establish, maintain and enforce written policies and procedures reasonably designed to identify and:

    - disclose and mitigate, or eliminate, material conflicts of interest arising from financial incentives; and

    - at a minimum disclose all other material conflicts of interest.

Proposed Rule: Customer/Client Relationship Summary (Form CRS)

Form CRS would be a new four-page standalone disclosure document that would supplement disclosures required in Form ADV for advisers and disclosures required under Regulation Best Interest for broker-dealers. Form CRS would highlight key differences in brokerage and advisory services, the legal standards of conduct, the fees a customer might pay, and certain conflicts of interest that may exist. The SEC prepared mock-up forms that would be used by standalone broker-dealers, standalone investment advisers, and dual-registered firms, complete with questions retail investors may want to ask their financial professionals.

The SEC also proposed to restrict standalone broker-dealers and their financial professionals from using the terms "adviser" or "advisor" as part of their title with retail investors. Investment advisers and broker-dealers would also need to disclose their registration status in certain retail investor communications.

Proposed Interpretation: Fiduciary Duty of Investment Advisers

The SEC proposed an interpretation to reaffirm and, in some cases, clarify the Commission's views of the fiduciary duty that investment advisers owe to their clients. By highlighting principles relevant to the fiduciary duty, investment advisers and their clients would have greater clarity about advisers' legal obligations.

The SEC also is requesting comment on: licensing and continuing education requirements for personnel of SEC-registered investment advisers; delivery of account statements to clients with investment advisory accounts; and financial responsibility requirements for SEC-registered investment advisers, including fidelity bonds.

Public comments are due 90 days following publication of the proposals in the Federal Register.

Sources: SEC Proposes to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Investment Professionals, SEC Press Release 2018-68 (Apr. 18, 2018), available here; Chairman Jay Clayton, Overview of the Standards of Conduct for Investment Professionals Rulemaking Package, Public Statement (Apr. 18, 2018), available here; Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, Release No. IA-4888 (Apr. 18, 2018), available here; Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889 (Apr. 18, 2018), available here; Regulation Best Interest, Release 34-83062 (Apr. 18, 2018), available here.

SEC Issues Risk Alert on Investment Adviser Examinations

The SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert addressing the most frequent advisory fee and expense compliance issues identified in investment adviser exams during the last two years. Below are the most frequent deficiencies pertaining to advisory fees and expenses:

- *Fee-Billing Based on Incorrect Account Valuations.* Because advisers generally assess fees as a percentage of the value of assets in each client's account, an incorrect account valuation will lead to an incorrect advisory fee being assessed to that client. For example, OCIE observed advisers that:

    - Valued assets in a client's account using a different metric than that which was specified in the client's advisory agreement, such as using an illiquid asset's original cost rather than valuing the asset based on its fair market value.

- Valued a client's account using a process that differed from the process specified in the client's advisory agreement, such as:
    - Using the market value of the account's assets at the end of the billing cycle, instead of using the average daily balance of that account over the entire billing cycle as specified in the advisory agreement.
- Including assets in the fee calculation that were excluded by the advisory agreement from the management fee, such as cash or cash equivalents, alternative investments, or variable annuities.

- *Billing Fees in Advance or with Improper Frequency.* OCIE observed, for example, advisers that:
    - Billed advisory fees on a monthly basis, instead of on a quarterly basis as stated in the advisory agreement or disclosed in Part 2A of Form ADV. Similarly, staff observed advisers that billed advisory fees in advance, despite the advisory agreement specifying that clients would be billed in arrears.
    - Billed a new client for advisory fees in advance for an entire billing cycle, instead of pro-rating such charges to reflect that the advisory services began mid-billing cycle. Staff also observed advisers that did not reimburse a client a pro-rated portion of the advisory fees when the client terminated the advisory services mid-billing cycle, despite disclosing that they would do so.
- *Applying Incorrect Fee Rate.* OCIE observed advisers that:
    - Applied a rate higher than what was agreed upon in the advisory agreement or double-billed a client.
    - Charged a non-qualified client performance fees based on a percentage of their capital gains inconsistent with Section 205(a)(1) of the Advisers Act.
- *Omitting Rebates and Applying Discounts Incorrectly.* OCIE staff observed advisers that did not apply certain discounts or rebates to their clients' advisory fees, as specified in the advisory agreements, causing the clients to be overcharged. For example, staff observed advisers that:
    - Did not aggregate client account values for members of the same household for fee-billing purposes, which would have qualified such clients for discounted fees according to the adviser's Form ADV or advisory agreement.
    - Did not reduce a client's fee rate when the value of that client's account reached a prearranged breakpoint level, which entitled that client to a lower fee rate according to the adviser's Form ADV or advisory agreement.
    - Charged a client additional fees, such as brokerage fees, when such client was in the adviser's wrap fee program and the transactions qualified for the program's bundled fee.
- *Disclosure Issues Involving Advisory Fees.* OCIE staff observed several issues with respect to advisers' disclosures of fees or billing practices. For example, staff observed advisers that:
    - Made a disclosure in the Form ADV that was inconsistent with their actual practices, such as advisers that disclosed a maximum advisory fee rate, but nevertheless had an agreement with a client to charge a fee rate exceeding that disclosed maximum rate.

- Did not disclose certain additional fees or markups in addition to advisory fees, such as advisers that did not disclose that they:
    - Collected expenses from a client for third-party execution and clearing services that exceeded the actual fee charged for those services by the outside clearing broker.
    - Earned additional compensation on certain asset purchases for client accounts or that they had fee-sharing arrangements with affiliates.
- *Adviser Expense Misallocations.* OCIE staff observed advisers to private and registered funds that misallocated expenses to the funds. For example, staff observed advisers that allocated distribution and marketing expenses, regulatory filing fees, and travel expenses to clients instead of the adviser, in contravention of the applicable advisory agreements, operating agreements, or other disclosures.

In response to OCIE staff's observations, some advisers elected to change their practices, enhance policies and procedures, and reimburse clients by the overbilled amount of advisory fees and expenses. OCIE staff also observed advisers that proactively reimbursed clients for incorrect fees and expenses that they identified through the implementation of policies and procedures that provided for periodic internal testing of billing practices.

Advisers should review their practices, policies, and procedures to ensure compliance with their advisory agreements and Form ADV disclosures in light of the fee and expense issues noted in the Risk Alert.

Source: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers, OCIE National Exam Program Risk Alert (Apr. 12, 2018), available here.

Fifth Circuit Vacates DOL Fiduciary Rule

On March 15, 2018, the United States Court of Appeals for the Fifth Circuit issued a decision to vacate the DOL fiduciary rule and the best interest contract exemption (BICE). The Fifth Circuit's ruling will apply nationwide because the decision essentially removes the regulation from the Code of Federal Regulations. The DOL has several options now. It could petition the Fifth Circuit for an *en banc* rehearing, appeal the case to the U.S. Supreme Court, or end its defense of the rule and let the decision in *U.S. Chamber of Commerce v. DOL* stand. A DOL spokesman only said, "Pending further review [of the court decision], the department will not be enforcing the fiduciary rule."

In the absence of a petition or appeal, the Fifth Circuit is expected to officially vacate the fiduciary rule and BICE on or about May 7, 2018. If the fiduciary rule is vacated, the DOL's prior fiduciary advice definition (*i.e.*, the 1975 five-part test discussed in our May 2016 Update) will be restored. Under the prior definition, one-time rollover advice was not, in most cases, fiduciary advice if the adviser was not otherwise a fiduciary. However, if the adviser is a fiduciary to the plan, 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.

On the other hand, some industry observers expect the DOL to seek a stay of the Fifth Circuit's decision pending a rehearing or appeal to the Supreme Court. During a stay, the fiduciary rule would remain in effect for a year or more. The same observers expect the DOL to propose a new fiduciary regulation and exemptions during that time.

If the fiduciary rule is vacated, advisers will want to start to inventory their policies and procedures adopted in connection with the fiduciary rule and BICE. However, it would be premature for advisers to make changes until we know whether the DOL will petition or appeal the ruling. The DOL has until April 30 to petition for a rehearing and June 13 to appeal to the Supreme Court. In the interim, advisers that do not implement existing policies as written could face regulatory problems with the SEC or state regulators similar to the recent enforcement action against Scottrade. In that matter, the Massachusetts Securities Division alleged that Scottrade violated its own internal policies designed to ensure compliance with the DOL fiduciary rule. They alleged that Scottrade ran nationwide sales contests in which employees competed to bring in new business and assets, including retirement plan assets, in violation of their own internal policies.

Sources: Emile Hallez, DOL Rule Dead, Maybe, Following 5th Circuit Ruling, IGNITES (Mar. 19, 2018); U.S. Chamber of Commerce v. DOL, 17-10238 (5th Cir. Mar. 19, 2018); Mark Schoeff, DOL Fiduciary Rule Likely to Live on Despite Appeals Court Loss, Investment News (Mar. 16, 2018), available here; In the Matter of Scottrade, Inc., Docket No. E-2017-0045 (Feb. 15, 2018), available here; Alicia H. Munnell, The Fiduciary Rule Takes a Hit in the Fifth Circuit, Market Watch (Apr. 10, 2018), available here; Nick Thornton, Gibson Dunn: No 'Circuit Split' on DOL Rule; Decision Applies Nationwide, ThinkAdvisor (Mar. 19, 2018), available here.

SEC Announces 2018 Examination Priorities

OCIE released its 2018 examination priorities. The 2018 priorities are grouped into five categories:

1. matters of importance to retail investors, including seniors and those saving for retirement;
2. compliance and risks in critical market infrastructure;
3. FINRA and MSRB;
4. cybersecurity; and
5. anti-money laundering programs.

Several of these areas of focus are discussed in more detail below.

Retail Investors, Including Seniors and Those Saving For Retirement

OCIE noted that it will continue its focus on retail investors, specifically seniors and those saving for retirement, and will examine firms providing products and services to them.

Disclosure of the Costs of Investing. Examiners will review, among other things, whether fees and expenses are calculated and charged in accordance with the disclosures provided to investors. Examiners will also review fees charged to advisory accounts, particularly where the fee is dependent on the value of the account, to assess whether assets are valued in accordance with investor agreements, disclosures, and the firm's policies and procedures.

OCIE will focus on firms that have practices or business models that may create increased risks that investors will pay inadequately disclosed fees, expenses, or other charges. These include:

- advisory personnel that receive financial incentives to recommend that investors invest, or remain invested, in particular share classes of mutual funds where the investors may pay higher sales loads or distribution fees and the conflict of interest may not be disclosed to investors;
- accounts where investment advisory representatives have departed from the firm, and the accounts have not been assigned a new representative to properly oversee them;
- advisers that changed the manner in which fees are charged from commissions to a percentage of assets under management; and
- private fund advisers that manage funds with a high concentration of investors investing for the benefit of retail clients, including non-profit organizations and pension plans.

Electronic Investment Advice. OCIE will continue to examine investment advisers and broker-dealers that offer investment advice through automated or digital platforms, and will focus on compliance programs, marketing materials, investor data protection, and disclosure of conflicts of interest.

Wrap Fee Programs. Wrap fee programs that charge investors a single bundled fee based on a percentage of assets will also be reviewed, with a focus on whether investment advisers are acting consistently with their fiduciary duty and meeting their contractual obligations to clients. Areas of interest will include whether (1) the recommendations to invest in a wrap fee program and to continue in the program are reasonable, (2) conflicts of interests are adequately disclosed, and (3) investment advisers are obtaining best execution and disclosing costs associated with executing trades through another broker-dealer.

Senior Investors and Retirement Accounts and Products. Examinations of investment advisers offering products and services to investors with retirement accounts will focus on investment recommendations, sales of variable insurance products, and sales and management of target date funds.

Mutual Funds and Exchange-Traded Funds. OCIE will review mutual funds with poor performance or liquidity relative to peers, those that are managed by inexperienced advisers, and those that hold securities that may be difficult to value during stressed market conditions (e.g., securitized auto, student or consumer loans, or collateralized mortgage-backed securities).

Cybersecurity

With respect to cybersecurity, OCIE's examinations will continue to focus on areas such as governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

Anti-Money Laundering (AML) Programs

OCIE will review whether mutual funds and broker-dealers are properly adapting their AML programs to address their obligations. As an example, reviews will cover the customer due diligence requirement and will focus on whether entities are taking reasonable steps to understand the nature and purpose of customer relationships and properly address risks. OCIE will consider whether entities are filing timely, complete and accurate Suspicious Activity Reports, and whether entities are conducting robust and timely independent tests of their AML programs.

Sources: SEC Office of Compliance Inspections and Examinations Announces 2018 Examination Priorities, SEC Press Release 2018-12 (Feb. 7, 2018), available here; National Exam Program Examination Priorities, Office of Compliance Inspections and Examinations (Feb. 7, 2018), available here.

Liquidity Risk Management Program Rule

SEC Modifies Compliance Date for Certain Liquidity Rule Requirements

On February 21, 2018, the SEC adopted an interim final rule that delays, by six months, the compliance dates for certain elements of Rule 22e-4, the liquidity risk management program rule for investment companies (liquidity rule). Specifically, the requirements subject to the extension include portfolio classification, the highly liquid investment minimum (HLIM), board oversight, reporting requirements on Part D of Form N-LIQUID, and liquidity disclosures on Form N-PORT. The new compliance dates for these items will be June 1, 2019 for fund complexes with $1 billion or more in net assets (revised from December 1, 2018) and December 1, 2019 for fund complexes with less than $1 billion in net assets (revised from June 1, 2019).

Following the liquidity rule's adoption, SEC staff met with funds and service providers to discuss compliance and implementation challenges and operational issues relating to the liquidity rule. SEC staff learned from these meetings that, as a result of little available market data for certain asset classes (*e.g.*, fixed income), the implementation of the portfolio classification requirement will require funds to engage service providers to provide models and tools needed for bucketing and reporting. Further, many funds believe that the implementation of service provider and fund systems will require additional time for refinement and testing of systems, classification models and data. The liquidity rule's adopting release also noted that funds would be expected to conduct due diligence of service providers, which the SEC acknowledged would require additional time to accomplish. Finally, some funds have indicated that they require interpretive guidance with respect to certain aspects of the liquidity rule, and are facing compliance challenges as a result. In light of these findings, the SEC determined that a six-month delay is appropriate in order to provide funds and service providers additional time to address these challenges and to "promote a smooth and efficient implementation of the [liquidity] rule."

With respect to the HLIM requirement, the SEC noted that a fund's ability to establish and monitor an HLIM is dependent on a fund's ability to establish the kinds of policies, procedures and systems that are presenting the challenges noted above. Accordingly, the SEC determined that it was appropriate to delay the HLIM requirement's compliance date by six months. As a consequence, the compliance date for the classification and HLIM reporting requirements of Forms N-LIQUID and N-PORT will be similarly delayed, along with the related recordkeeping requirements.

The compliance date for board approval of the liquidity risk management program and the related annual review requirements is also being extended by six months. The SEC stated that it would be "unnecessarily burdensome" to require boards to conduct initial and annual reviews prior to the complete development of the fund's program. The SEC noted that, although a fund may implement a liquidity risk management program, board approval of such program will not be required until the extended compliance date.

Although several of the liquidity rule's requirements are being delayed, it is important to note that the compliance date for other elements of the liquidity rule have remained unchanged as indicated in the chart below. For example, the compliance dates for the general obligation to implement a liquidity risk management program and board approval of a program administrator are still December 1, 2018 for larger entities and June 1, 2019 for smaller entities. Notably, funds must comply with the 15% illiquid investments limitation (using the new definition of "illiquid investments" as provided in the liquidity rule) and related Form N-LIQUID reporting requirements by the existing compliance dates.

Because funds may not have implemented the liquidity rule's classification requirements by their existing compliance dates, the SEC provided the following guidance about how those funds may comply with the 15% illiquid investments limitations—short of full investment classification—during the period of the six-month extension. One method for a fund to comply with these requirements is to preliminarily identify certain asset classes or investments that the fund reasonably believes are likely to be illiquid. The fund could base this belief on its previous trading experience, on its understanding of the general characteristics of the asset classes it is preliminarily evaluating, or through other means. A fund could choose to determine that certain investments identified in such asset classes that it purchases are illiquid based solely on this preliminary evaluation, and not engage in any further analysis. Alternatively, if the preliminary evaluation establishes a reasonable basis for believing that an investment is likely to be illiquid, the fund may then, as a secondary step, determine whether that investment is illiquid through the full classification process set forth in the liquidity rule. The SEC stated that a fund could automate such a preliminary evaluation of asset classes or investments, and it could base that evaluation on the general characteristics of the investments the fund purchases. For example, in establishing the list of asset classes or investments that the fund believes have a reasonable likelihood of being illiquid, the fund could take into account the trading characteristics of the investment (for example, whether it is a restricted security) and use such characteristics to form the reasonable belief of illiquidity. The SEC expects that a fund making use of preliminary evaluations would conduct periodic testing as part of its required review of the adequacy and effectiveness of the liquidity risk management program's implementation.

The SEC provided the following chart to summarize the extension of various provisions of the liquidity rule discussed above:

Requirements Not Subject to Extension	Requirements Subject to Extension

Rule 22e-4:
• Liquidity Risk Management Program [§(b)]
  • Assessment, management, and periodic review of liquidity risk [§(b)(1)(i)]
  • Illiquid investments [§(b)(1)(iv)]
  • Redemptions-in-kind [§(b)(1)(v)]
  • Board designation of program administrator [§(b)(2)(ii)]
	Rule 22e-4:
	• Classification [§(b)(1)(ii)]
	• HLIM [§(b)(1)(iii)]
	• Board Oversight
	  • Initial approval of the liquidity risk management program [§(b)(2)(i)]
	  • Annual Board Reporting [§(b)(2)(iii)]

N-LIQUID: • Part A. General Information • Part B. Above 15% Illiquid Investments • Part C. At or below 15% Illiquid Investments	N-LIQUID: • Part D. Assets that are Highly Liquid Investments below the HLIM
N-CEN: • Item C.20. Lines of credit, interfund lending, and interfund borrowing • Part E.5. In-Kind ETF	N-PORT: • Item B.7. HLIM • Item B.8. Liquidity aggregate classification information • Item C.7. Liquidity classification information

Sources: SEC Votes to Modify Compliance Date for Open-End Fund Liquidity Classification, SEC Press Release No. 2018-24 (Feb. 21, 2018), available here; Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Release No. IC-33010 (Feb. 21, 2018), available here.

SEC Proposes Liquidity Rule Changes to Required Disclosures in Form N-PORT and Annual Reports

On March 14, 2018, the SEC proposed a new rule that would amend the public liquidity-related disclosure requirements for funds and add new public and private disclosure requirements. The proposed rule includes a new amendment to Form N-1A that would require that funds disclose information in their annual report to shareholders regarding the operation and effectiveness of their liquidity risk management programs. This disclosure would replace the requirement in Form N-PORT that funds publicly disclose on an aggregate basis the percentage of their investments that they have allocated to each of the four liquidity classification categories, sometimes referred to as "buckets." This means that, if adopted, funds would not have to report any bucketing information to the public.

The staff believes that the new disclosure, in addition to the summary of the principal risks of investing in a fund, will provide new and existing fund shareholders with information about the expected liquidity risk of the fund. Further, since the annual report is delivered to shareholders each year, this information may be more accessible to them. The proposed rule states that, to satisfy this proposed requirement, "a fund generally should provide information about the operation and effectiveness of the program, and insight into how the program functioned over the past year," as part of Management's Discussion of Fund Performance (MDFP). The proposed rule also provides that a fund would not be required, but is permitted, to disclose its classification process, whether there was any violation of the 15% illiquid investment minimum, and the level of its HLIM in the annual report.

This proposed new requirement replaces the current requirement in Form N-PORT that funds publicly disclose aggregate liquidity classification information about their investment portfolios. In light of this rescission, the staff is also proposing other revisions to Form N-PORT to allow funds to classify a single investment in more than one of the four buckets in certain circumstances, which would allow for more flexibility. This revision to Form N-PORT would be disclosed to the SEC on a non-public basis in light of the potential for investor confusion. The staff is also proposing that other information regarding holdings of cash and cash equivalents be added to Form N-PORT as a new disclosure requirement.

The rule proposal passed after a 3–2 vote and follows the SEC's February decision to delay the compliance dates of the liquidity rule by six months, which is discussed in more detail above. Chairman Jay Clayton stated that the "proposed rule is another step toward completing the implementation of the 2016 final rule in a manner that protects investors while minimizing unnecessary costs on funds." Public comments on the proposed changes to the liquidity risk management program disclosures are due on or before May 18, 2018.

Sources: Investment Company Liquidity Disclosure, Release No. IC-33046 (Mar. 18, 2018), available here; SEC Proposes Targeted Changes to Public Liquidity Risk Management Disclosure, SEC Press Release No. 2018-42 (Mar. 14, 2018), available here; Beagan Wilcox Volz, SEC Proposes Liquidity-Rule Changes, Hints at More to Come, IGNITES (Mar. 15, 2018).

Updated FAQs on Liquidity Rule Make Bucketing Requirement More Manageable

On February 21, 2018, the Division of Investment Management published responses to questions related to the frequency and timing of classifications of holdings pursuant to the liquidity rule. The FAQs provide guidance and clarification regarding the staff's expectations for funds as they begin to design their liquidity risk management programs. Certain responses are summarized below.

Asset Class Liquidity Classification

- A fund may use an asset class method of investment classification instead of classifying each portfolio investment, provided that the fund has a process for separately classifying and reviewing any investment within an asset class if the fund or its adviser has information about any market, trading or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of that investment as compared to the fund's other investments within the same asset class.
- The staff clarified that different investments within an asset class may be expected to exhibit a range of varying liquidity profiles, and it does not believe that investments falling within the range should trigger the process to separately classify and review an investment. Only deviations in a particular investment's liquidity characteristics from those of the range of others in its asset class that have a significant effect on those liquidity characteristics should trigger separate review and classification.
- A fund relying on the asset classification method should include in its policies and procedures a reasonable framework for identifying exceptions to classifications. The framework may rely on automated processes. The staff expects that a fund would conduct periodic testing of its framework and processes to determine whether they are properly identifying those investments that merit separate review. Furthermore, if a fund identifies a potential exception when using this approach, it need not necessarily reclassify an investment as long as the investment's liquidity remains within the liquidity bucket assigned to the asset class as a whole.

Reasonably Anticipated Trading Size

- A fund that classifies investments based on asset class may conduct an aggregated analysis of anticipated trading sizes for those investments. When a fund uses aggregated reasonably anticipated trading sizes for asset classes that have positions of widely varying size in its portfolio, the fund should consider whether using fixed dollar amounts (instead of using percentages of the full position) is a reasonable approach because using fixed dollar amounts on positions of widely varying size may result in unreasonable trading sizes in some cases.

- When conducting a market depth analysis for an investment, a fund does not need to consider amounts it would reasonably anticipate trading for reasons other than meeting redemptions. Moreover, a fund should not attempt to predict its future portfolio management decisions related to meeting redemptions, but rather should estimate a portion of an investment that it reasonably believes it could choose to sell to meet redemptions. For example, a fund could conclude that selling portfolio investments *pro rata* would be a reasonable baseline assumption, and determine reasonably anticipated trading sizes accordingly. On the other hand, a zero or near zero size would not be a reasonable assumption.

Provisional Investment Classification Activity and Related Compliance Monitoring

- The staff believes it will be necessary for funds to engage in regular monitoring to ensure compliance with a fund's HLIM and the 15% limit on illiquid investments. Monitoring for compliance with these limits does not require a fund to reclassify its existing investments on a daily basis because the fund may use the classifications that it last verified and determined as part of this monitoring process (generally the last reported classification on Form N-PORT, done at least monthly).

Timing and Frequency of Classifications

- Generally, a fund may classify a newly acquired investment, or consider for reclassification an investment in which the fund has increased or decreased its position, during its next regularly scheduled monthly classification.
- An intra-month re-evaluation of an investment's liquidity classification is required when a fund becomes aware of changes in relevant market, trading and investment-specific considerations that are reasonably expected to materially affect an existing classification of that particular investment. A fund may comply with this intra-month review obligation by identifying in its policies and procedures events that it reasonably expects would materially affect an investment's classification.

Pre-trade Activity and the 15% Limitation on Illiquid Investments

- A fund is not required to classify an investment prior to acquisition. However, the fund's policies and procedures should be reasonably designed to appropriately limit illiquid investments so that the fund will not acquire any illiquid investment that would cause it to exceed the 15% limitation.

Source: Investment Company Liquidity Risk Management Programs Frequently Asked Questions, available here.

Litigation and SEC Enforcement Actions and Updates

Recent Excessive Fee Suits

Federal courts in three recent Section 36(b) cases against advisers to mutual funds found in favor of the defendant advisory firms because the plaintiffs did not meet the standard set forth by the U.S. Supreme Court in *Jones v. Harris* in 2010. The courts applied the factors set forth by the Second Circuit in the *Gartenberg* case in determining that the cases should either be dismissed or summary judgment should be granted for the defendants.

Pirundini v. J.P. Morgan Investment Management Inc.

In the first case, the U.S. District Court for the Southern District of New York granted a motion to dismiss filed by J.P. Morgan Investment Management Inc. (JPMIM). The court reviewed the *Gartenberg* factors in determining whether the advisory fees were excessive and determined that the complaint failed to plausibly allege that the advisory fees charged to the Fund were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining, which was the standard upheld in *Jones v. Harris*.

In its complaint, the plaintiff alleged that the 0.80% advisory fee charged by JPMIM to the JP Morgan U.S. Large Cap Core Plus Fund was excessive, and that the fees charged to similar funds that were either advised or sub-advised by JPMIM were significantly lower (0.60% and 0.40%), despite all three funds being managed by the same portfolio managers and receiving "substantially similar and in large part identical" services.

With respect to the *Gartenberg* "comparative fees" factor, the court found that the higher fee charged to the Fund, when compared to the lower fees charged to two other funds managed by JPMIM, was not "necessarily outside the range of what would have been negotiated at arm's-length." If the court found otherwise, it would "open the floodgates to Section 36(b) claims any time a shareholder could identify a mutual fund that pays a lower investment advisory fee than the fund he or she chooses to invest in." With respect to the *Gartenberg* "economies of scale" factor, the court rejected the plaintiff's claim. Although the Fund grew in size from $69.2 million to $9.86 billion between 2006 and 2016, the court found that the plaintiff alleged no facts regarding the impact of this growth on per-unit costs of performing services for the Fund. The court also cited the fact that JPMIM had reduced its advisory fee rate from 1.00% to 0.80% and had waived advisory fees under the fee waiver agreement, in some cases by more than 20%, as evidence of some sharing of economies of scale with the Fund and its investors. With respect to the care and conscientiousness of the Fund's board, the court found that the allegations were inadequate to support the plaintiff's claim, absent evidence of "a deficient approval process or that information was affirmatively misrepresented or withheld from the Board." Based on these findings and others, the court ruled that the plaintiff failed to state a claim for relief under Section 36(b). The plaintiff has appealed the decision to the Second Circuit Court of Appeals.

Sources: Pirundini v. J.P. Morgan Inv. Mgmt. Inc., 17 Civ. 3070 (GBD), 2018 WL 1084140 (S.D.N.Y. Feb. 14, 2018); Joe Morris, J.P. Morgan Quashes Excessive-Fee Suit, IGNITES (Feb. 15, 2018).

Goodman v. J.P. Morgan Investment Management Inc.

In another case involving JPMIM, the U.S. District Court for the Southern District of Ohio granted the adviser's motion for summary judgment. The plaintiffs argued that JPMIM's fees for advising mutual funds were excessive given the significantly lower fees it charged to similar funds which it served as sub-adviser. In analyzing the facts using the *Gartenberg* factors, the court found that the "comparative fees" factor weighed in favor of JPMIM. The plaintiffs' argument that the fees were excessive was not persuasive because, even assuming that the services JPMIM provided as adviser and sub-adviser were substantially the same, the evidence showed that "the risk undertaken and scale of services are different." The court cited different risks and responsibilities faced by JPMIM as adviser, such as liquidity risks, business risks, operational risks, litigation risks and reputational risks, as opposed to those faced by JPMIM as subadviser, which merit additional fees for JPMIM's role as adviser. In addition, the court found that there was no evidence to support a finding that the board of trustees failed to engage in a robust approval process for the investment advisory agreement, concluding that the board's approval was entitled to considerable weight. Following the district court's decision, the plaintiffs appealed to the Sixth Circuit Court of Appeals.

Source: Goodman, et al. v. J.P. Morgan Inv. Mgmt. Inc., et al., Nos. 14-cv-414, 15-cv-2923 (S.D. Ohio Mar. 9, 2018), available here.

Zehrer v. Harbor Capital Advisors, Inc.

In the third case, the U.S. District Court for the Northern District of Illinois granted a motion for summary judgment in a Section 36(b) case brought against Harbor Capital Advisors, Inc. (Harbor), which uses a "manager of managers" structure for its mutual funds. The plaintiffs alleged that the advisory fees charged to two funds advised by Harbor were excessive given that most of Harbor's duties were delegated to sub-advisers.

The decision focused on the board of trustees' 15(c) review process of the investment advisory agreements for the funds, citing depositions of independent trustees, Harbor's profitability materials and Lipper data, among other evidence. The court found that the board of trustees' decision with respect to the advisory agreement was "due substantial deference" as the plaintiffs did not provide any evidence suggesting that the board had conflicts of interest that compromised its ability to serve as a "watchdog" on behalf of the funds. Further, even if the board could have "driven a harder bargain" with respect to the advisory fees, the legal standard did not require the board to do so. In analyzing the nature and quality of services provided by Harbor (one of the *Gartenberg* factors), the court rejected the plaintiffs' argument that only the services provided directly by the adviser should be considered, and those provided by sub-advisers should be excluded. Rather, the "combined services should be considered against the entire advisory fee." The court also found that based on comparative fee data, no reasonable trier of fact could find that Harbor's fees fall outside the range of fees paid by comparable funds. With respect to profitability, Harbor cited its pre-tax profit margins of 37.6% and 38.5% as being in line with industry standards, and that the subadvisory fees were appropriately included in Harbor's expenses. The decision notes that the board received materials reflecting Harbor's profitability both with and without the subadvisory fees. The court found that there was no evidence to question the way the board weighed the profitability factor. After reviewing these and other *Gartenberg* factors, the court concluded that the plaintiffs had failed to identify any genuine issue of material fact.

Source: Zehrer v. Harbor Capital Advisors, Inc., Case Nos. 14 C 00789, 14 C 07210, 2018 WL 1293230, (N.D. Ill. Mar. 13, 2018).

Compliance Dates for Final Rules

Final Rule	Compliance Date(s)
FinCEN Clarifies and Strengthens Customer Due Diligence Requirements for Mutual Funds and Broker-Dealers	May 11, 2018
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

Final Rule	Compliance Date(s)
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
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

Final Rule	Compliance Date(s)
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
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
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.