VedderPrice

March 2019

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

NEW RULES

SEC Adopts Interim Final Rule Amending Timing Requirements for Filing Reports on Form N-PORT

On February 27, 2019, the SEC adopted an interim final rule amending Rule 30b1-9 under the Investment Company Act of 1940 to:

- require reports on Form N-PORT for each month in a fiscal quarter to be filed with the SEC no later than 60 days after the end of that fiscal quarter, rather than 30 days after the end of each month; and
- require that funds, not later than 30 days after the end of each month, maintain the information required on Form N-PORT, and make that information available to the SEC promptly upon request.

These amendments have the effect of delaying the filing deadline for non-public fund data reported on Form N-PORT. The amendments do not change the substance of the information funds will need to provide to the SEC on Form N-PORT, nor do they affect the amount or timing of that information that will be made public. As with the original rule, the reports for the first two months of a quarter will not be publicly released, and the report for the final month of a quarter will be made public upon filing (with the exception of certain items identified on Form N-PORT).

The amendments are effective as of March 6, 2019. The SEC requests comments on various aspects of its amendments.

The adopting release for the interim rule is available at: https://www.sec.gov/rules/interim/2019/ic-33384.pdf

PROPOSED RULES

SEC Proposes Extending Ability to "Test the Waters" Prior to Registered Public Offerings

On February 19, 2019, the SEC proposed new Rule 163B under the Securities Act of 1933, which would permit issuers to engage in oral or written communications with potential investors—referred to as "testing the waters"—that are, or are reasonably believed to be, qualified institutional buyers or institutional accredited investors (QIBs or IAIs), either before or after filing a registration statement, to determine whether those investors might have an interest in the contemplated securities offering. Under the 1933 Act, written and oral offers during these periods are generally prohibited and subject to what are referred to as "gun jumping" restrictions. The SEC's proposal would represent an extension to all issuers, including investment companies and BDCs, of an exemption to the gun-jumping restrictions similar to the one that was established for "emerging growth companies" under the JOBS Act, which became law in 2012. Reliance on the proposed rule would not preclude reliance on other communications rules or exemptions under the 1933 Act.

As proposed, a fund could rely on Rule 163B to test the waters with QIBs and IAIs during its seeding period without filing a registration statement under the 1933 Act. Because funds generally must register as an investment company under the Investment Company Act of 1940 before offering their shares (unless, for example, they qualify as a BDC), many funds simultaneously file a registration statement under both the 1933 Act and the 1940 Act for efficiency reasons and may be less likely to rely on the proposed rule. However, funds that preliminarily engage in exempt offerings, such as certain closed-end funds and BDCs, may be more likely to rely on the proposed rule because they would be permitted to test the waters if they are considering a subsequent registered offering. The proposed rule would also permit funds to test the waters after filing a registration statement under the 1933 Act.

Comments on the SEC's proposal are due by April 29, 2019. The SEC's proposing release is available at:

https://www.sec.gov/rules/proposed/2019/33-10607.pdf

GUIDANCE AND ALERTS

SEC Staff Seeks Comment on the Application of the Custody Rule to Digital Assets and Issues Associated with Trades That Do Not Settle on a Delivery Versus Payment Basis

On March 12, 2019, the staff of the SEC's Division of Investment Management issued a letter to the Investment Adviser Association (IAA) seeking industry input on the application of Rule 206(4)-2 under the Investment Advisers Act of 1940 (the Custody Rule) to digital assets, as well as on issues arising from custodial trading practices that are not processed or settled on a delivery versus payment (Non-DVP) basis. In general, the staff is seeking to determine whether revisions to the Custody Rule could be helpful in addressing these topics.

Under the Custody Rule, it is a fraudulent, deceptive or manipulative practice for an investment adviser to have custody of client assets unless the adviser complies with certain requirements or an exception applies. In 2003, the SEC amended the Custody Rule's definition of "custody" to include, among other things, arrangements under which an adviser is permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian. In a footnote to the adopting release for the 2003 amendments, the SEC discussed what is commonly referred to as the "authorized trading" exception. The SEC stated that an adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute "custody." Custodians, the SEC explained, are generally under instructions to transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account—i.e., a "delivery versus payment" arrangement which minimizes the risk that an adviser could misappropriate client funds or securities. As the SEC staff noted in its recent letter to the IAA, the footnote did not address authorized trading of securities that do not settle on a delivery versus payment basis. The SEC staff stated that questions surrounding Non-DVP trading should be considered by the SEC, adding that amendments to the Custody Rule are on the SEC's agenda. The staff, through the Division's Analytics Office, has also launched an information gathering initiative on Non-DVP practices.

As to digital assets, the SEC staff—noting the rapid growth in the digital asset market—seeks to inform its consideration of how digital assets' characteristics impact the application of the Custody Rule.

The staff encourages input from all interested parties. Comments should be submitted to IMOCC@sec.gov and insert "Custody Rule and Non-DVP Trading" or "Custody Rule and Digital Assets," as applicable, in the subject line. The staff did not provide a deadline for comments.

The SEC staff's letter to the IAA, which includes various questions on the foregoing topics, is available at: https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206

SEC Staff No-Action Letter Provides Fund Boards Relief from Certain In-Person Voting Requirements

In a no-action letter to the Independent Directors Council (IDC) dated February 28, 2019, the staff of the SEC's Division of Investment Management stated that it would not recommend enforcement action if a fund board does not under certain circumstances adhere to certain in-person voting requirements mandated by the Investment Company Act of 1940 and the rules thereunder. The relief would allow voting on certain matters currently subject to an in-person voting requirement to take place at a meeting conducted telephonically or by video conference (or any other means by which all participating board members may communicate with each other) under the following circumstances:

- The board members cannot meet in person because of an "unforeseen or emergency circumstance," so long as no material changes to the relevant agreement, plan or arrangement are proposed and the board members ratify the matter at the next in-person board meeting (Reason 1); or
- The board members needed to approve the matter previously discussed and considered all material aspects of the matter at an in-person meeting but did not vote on the matter at that time, provided no board member requests another in-person meeting (Reason 2).

The relief applies with respect to the following board actions:

- Renewal and, for Reason 2 only, approval of an investment advisory agreement or principal underwriting agreement under Section 15(c) of the 1940 Act;
- For Reason 2 only, approval of an interim investment advisory agreement under Rule 15a-4;
- Selection of a fund's independent public accountant under Section 32(a) of the 1940 Act, provided that if Reason 1 applies the accountant is the same as the accountant selected in the prior fiscal year; and
- Renewal and, for Reason 2 only, approval of a 12b-1 plan.

With respect to Reason 1, the IDC's letter to the SEC staff provided as examples of unforeseen or emergency circumstances illness or death, including of family members, weather events or natural disasters, acts of terrorism or disruptions in travel that prevent some or all board members from attending the meeting in person.

According to the SEC staff, this no-action relief would not diminish a board's ability to carry out its oversight role or other specific duties and would remove significant or unnecessary burdens for funds and their boards. Fund boards do not need to take action at this time and may rely upon the no-action relief at such time as it may be necessary.

The SEC staff's no-action letter to the IDC is available at: https://www.sec.gov/divisions/investment/noaction/2019/independent-directors-council-022819

The IDC's request for no-action relief is available at: https://www.sec.gov/divisions/investment/noaction/2019/independent-directors-council-022819-incoming.pdf

OCIE Issues Risk Alert on Transfer Agent Safeguarding of Funds and Securities

From October 2014 through September 2017, the SEC's Office of Compliance Inspections and Examinations (OCIE) conducted 75 examinations of transfer agents that also serve as paying agents, in which it examined for the possible misappropriation of funds and assessed the transfer agents' policies, procedures and controls for paying agent activities. On February 13, 2019, OCIE published a risk alert to highlight significant exam deficiencies observed by its staff and to identify robust practices in order to encourage transfer agents to review and strengthen their policies, procedures and controls related to their paying agent operations.

OCIE's announcement and a link to the risk alert are available at: https://www.sec.gov/ocie/announcement/ocie-risk-alert-transfer-agent-safeguarding

FINRA Interpretive Letter Provides Guidance on the Use of Pre-Inception Index Performance Data for Mutual Funds

FINRA Rule 2210 regulates communications by member firms with the public and imposes specific content and supervision standards, requiring among other things that a firm's communications be fair, balanced and not misleading. FINRA has historically interpreted Rule 2210(d) to prohibit the inclusion of hypothetical back-tested performance data. However, in a 2013 interpretive letter, FINRA staff stated that communications related to passively managed exchange-traded products containing pre-inception index performance (PIP) data provided only to institutional investors were consistent with FINRA Rule 2210, subject to certain conditions.

On January 31, 2019, FINRA issued an interpretive letter permitting the use of PIP data in mutual fund sales materials distributed solely to institutional investors, subject to certain conditions.

The conditions are as follows:

1. **Labeling and Use of Marketing Materials.** Any marketing materials that include PIP data must be clearly labeled "for use with institutions only, not for use with retail investors." Recipients of the materials that are financial intermediaries must be instructed not to circulate the materials to retail investors.
2. **Rules-based Indexes Only.** PIP data must concern an index that was created according to a predefined set of rules that cannot be altered except under extraordinary market, political or macroeconomic conditions.
3. **Prohibition on Use if Fund Changes to Active Management.** PIP data cannot be used to market a fund if the fund's investment strategy is altered to permit active management of the fund's portfolio.
4. **Availability of Index Methodology Information.** Marketing material containing PIP data must include an offer to provide an overview of the index methodology upon request and electronic marketing material must include a hyperlink to that information.

5. **Data Required to be Net of Fees and Expenses.** PIP data must reflect the deduction of the fund's current fees and expenses.
6. **Minimum Ten-Year Data Period.** PIP data must "reflect a period of time that includes multiple securities markets environments, and at a minimum, ten years of pre-inception data."
7. **Current Data.** PIP data must be current as of the most recently ended calendar quarter.
8. **Labeling of PIP Data.** PIP data must be clearly labeled and shown separately from the fund's performance and presented along with disclosure of the applicable dates for the PIP data and the dates for actual performance since inception.
9. **Fund Performance Data.** If the fund has been in existence for more than one year, the use of PIP data must be accompanied by prominent presentation of the Fund's actual performance since inception, reflecting the deduction of fees and expenses.
10. **Prospectus Considerations.** PIP data cannot be inconsistent with information in the prospectus, but may be used regardless of whether the fund prospectus contains the data.
11. **Required Disclosures.** PIP data must be accompanied by several cautionary disclosures, including that actual performance of the fund may vary significantly from the PIP data and reasons (if any) why the PIP data would have differed from actual performance during the period shown.

The interpretive letter reiterates FINRA's view that presentation of hypothetical back-tested performance in communications used with retail investors does not comply with FINRA Rule 2210.

The interpretive letter is available at: http://www.finra.org/industry/interpretive-letters/january-31-2019-1200am

Litigation and Enforcement Actions and Initiatives

ENFORCEMENT MATTERS

SEC Announces Settlements from Share Class Selection Disclosure Initiative

On March 11, 2019, the SEC announced settlements with 79 investment advisers that self-reported violations of the Investment Advisers Act of 1940 in connection with the SEC's Share Class Selection Disclosure Initiative. The SEC's Division of Enforcement launched the initiative in February 2018 to "promptly remedy potential widespread violations" of federal securities laws relating to an investment adviser's selection of mutual fund share classes for clients that pay a 12b-1 fee to the adviser or its affiliates notwithstanding the availability of a lower-cost share class of the same fund. With the initiative, the SEC sought to incentivize eligible advisers to self-report federal securities law violations associated with undisclosed conflicts of interest concerning this share class selection practice by offering certain standardized settlement terms without the imposition of a civil penalty.

Without admitting or denying the findings, each of the settling investment advisers consented to cease-and-desist orders finding violations of applicable sections of the Advisers Act, agreed to a censure and agreed to disgorge the improperly disclosed fees and distribute these monies with prejudgment interest to affected advisory clients. According to the SEC's press release, each adviser has also undertaken to review and correct all relevant disclosure documents concerning mutual fund share class selection and 12b-1 fees and to evaluate whether existing clients' assets should be moved to an available lower-cost share class.

The SEC's announcement and links to each adviser's order settling the administrative proceeding are available at: https://www.sec.gov/news/press-release/2019-28

SECTION 36(b) LITIGATION

U.S. District Court Rules for Defendants in BlackRock Section 36(b) Excessive Fee Case

On February 8, 2019, following an eight-day bench trial, the U.S. District Court for the District of New Jersey ruled in favor of the defendants in an excessive fee case brought under Section 36(b) of the Investment Company Act of 1940 by shareholders of the BlackRock Global Allocation Fund, Inc. and BlackRock Equity Dividend Fund against BlackRock Advisors, LLC, BlackRock Investment Management, LLC and BlackRock International Limited (collectively, BlackRock), the funds' investment advisers and subsidiaries of BlackRock, Inc. The plaintiffs based their excessive fee claims on a "sub-advisory" or "reverse manager-of-manager" theory, alleging that the advisory fees charged to the funds, two of BlackRock's largest mutual funds, were excessive because they were higher than the fees BlackRock charged as sub-adviser to unaffiliated funds for purportedly the same services.

Prior to trial, the court had granted summary judgment to the defendants with respect to one *Gartenberg* factor—the independence and conscientiousness of the board, which the court determined weighed in BlackRock's favor. Accordingly, the trial was limited to three *Gartenberg* factors—comparative fee structure, economies of scale and profitability. After reviewing the evidence presented, the court concluded that the plaintiffs had failed to satisfy their burden to establish that the fees BlackRock charged to the funds were excessive under any of these factors. Following is further elaboration of the court's review of the three *Gartenberg* factors considered at trial:

- **Comparative Fee Structures.** The plaintiffs alleged that BlackRock provided substantially the same services as investment adviser to the funds and as sub-adviser to certain variable insurance funds sponsored and managed by unaffiliated insurance companies. After reviewing the evidence, the court concluded that the services BlackRock provided as investment adviser were not comparable to the services provided as sub-adviser, regardless of how those services may be described in the applicable advisory or sub-advisory agreements. In particular, the court noted the additional services an investment adviser provides, including compliance, board administration,

regulatory and financial reporting, daily valuation and publication of net asset values and overseeing third-party services providers. The court also noted the various entrepreneurial, reputational, legal and regulatory risks an adviser faces in sponsoring and managing funds. In addition, the court recognized differences between variable insurance products and mutual funds, including that variable insurance funds have very few shareholders and investors who are serviced at the policyholder level as compared to the thousands of shareholders a large mutual fund may have, which justify different fee structures.

- **Economies of Scale.** The plaintiffs alleged that BlackRock's estimated costs for managing the funds had increased at a slower rate than the funds' growth in assets, which the plaintiffs asserted demonstrated a disproportionality between the funds' asset growth and operating expenses attributable to economies of scale rather than cost savings. However, the court determined that the evidence presented at trial did not provide the per-unit transaction cost analysis that would have been needed to establish that economies of scale had been realized in the management of the funds. In this regard, the court noted that "numerous other factors," such as the adoption of new technologies or the renegotiation of fees payable to third-party services providers, could have caused BlackRock's estimated costs of operating the funds, expressed as a percentage of fund assets, to fall as the funds' assets increased over time.
- **Profitability.** The plaintiffs presented a "comparative theory of profitability," asserting that BlackRock's estimated profit margins on the funds indicated that the fees charged were excessive because BlackRock provided substantially the same services in exchange for lower fees as sub-adviser to unaffiliated funds and still maintained positive profit margins from those mandates. Because the court determined that the services provided by BlackRock as investment adviser to the funds were substantially different from the services provided as sub-adviser to unaffiliated funds, the court determined that the plaintiffs could not sustain the argument that BlackRock's profits were unjustified in light of any similarity in services.

The litigation was filed in the U.S. District Court for the District of New Jersey under the caption *In re BlackRock Mut. Funds Adv. Fee Litig.*, Case No. 14-cv-01165.

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