January 2020

Skadden

Investment Management Update

2 / SEC Re-Proposes Rules for Use of Derivatives by Registered Investment Companies

4 / SEC Proposes Amendments to the Proxy Rules Regarding Shareholder Proposals and Proxy Voting Advice

5 / SEC Proposes to Modernize Advertising and Cash Solicitation Rules for Investment Advisers

6 / SEC Issues Guidance on Non-Traded BDCs and Section 61(a) of the 1940 Act

8 / Update on Closed-End Fund Activism

10 / SEC Proposes Amendments to Exemptive Relief Process Under the 1940 Act

12 / SEC Expands 'Testing the Waters' Communications to All Issuers

13 / District Court Dismisses Excessive Fee Claim Against Calamos Following Two-Week Bench Trial

15 / Second Circuit Affirms Dismissal of Shareholder Breach of Contract Claims That Mutual Fund Violated the 1940 Act

15 / Securities Class Action Against Mutual Fund Reaches Partial Settlement

16 / District Court Dismisses Investors' Sections 11 and 10(b) Claims Against ETF Issuer

16 / 1940 Act, Section 36(b) Wrap-Up

17 / SEC Adopts New ETF Rule

18 / SEC Division of Investment Management Publishes FAQs Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation

20 / ADI: Improving Principal Risk Disclosure in Mutual Fund Summary Prospectuses

21 / ADI: Performance and Fee Disclosure in Fund Filings

22 / OCIE Risk Alert: Top Compliance Topics Observed in Examinations of Investment Companies and Observations From Money Market Fund and Target Date Fund Initiatives

24 / OCIE Risk Alert: Investment Adviser Principal and Agency Cross-Trading Compliance Issues

25 / LIBOR Updates

25 / New SEC Filing Fee Rate Effective October 1, 2019

26 / SEC Announces Extension of Temporary Measure to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions

Thomas A. DeCapo
Partner / Boston
617.573.4814
thomas.decapo@skadden.com

Kenneth E. Burdon
Counsel / Boston
617.573.4836
kenneth.burdon@skadden.com

Additional Contacts

Investment Management

Kevin T. Hardy
Partner / Chicago
312.407.0641
kevin.hardy@skadden.com

Michael K. Hoffman
Partner / New York
212.735.3406
michael.hoffman@skadden.com

Litigation

Eben P. Colby
Partner / Boston
617.573.4855
eben.colby@skadden.com

Michael S. Hines
Partner / Boston
617.573.4863
michael.hines@skadden.com

Associate **Michelle Huynh** contributed to this newsletter.

SEC Re-Proposes Rules for Use of Derivatives by Registered Investment Companies

On November 25, 2019, the Securities and Exchange Commission (SEC) re-proposed Rule 18f-4 under the Investment Company Act of 1940 (1940 Act). Initially proposed in 2015, the new exemptive rule would modernize the regulation of the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds (ETFs), closed-end funds and business development companies (BDCs). Rule 18f-4 would permit registered funds to enter into derivatives transactions and certain other transactions, notwithstanding the prohibitions and restrictions under Section 18 of the 1940 Act, provided that the funds comply with the specified conditions of the rule.

As part of the proposal, the SEC also proposed two new sales practice rules, including new Rule 15l-2 under the Securities Exchange Act of 1934 (Exchange Act) and new Rule 211(h)-1 under the Investment Advisers Act of 1940 (Advisers Act). These new sales practice rules would require a broker, dealer or investment adviser that is registered with (or required to be registered with) the SEC to exercise due diligence in approving a retail customer's or client's account to buy or sell shares of funds or listed commodity pools that seek to provide leveraged or inverse exposure to an underlying index.

Rule 18f-4 Conditions

Proposed Rule 18f-4 would permit a registered fund to enter into derivatives transactions, subject to the following conditions:

- **Derivatives Risk Management Program:** The proposed rule would generally require a fund to adopt and implement a written derivatives risk management program with risk guidelines for funds that cover stress testing, backtesting, internal reporting and escalation, and periodic program review. The program would also be tailored by fund based on how a fund's use of derivatives may affect its risk profile.
- **Board Oversight and Reporting:** A derivatives risk manager, approved by the fund's board of directors, would be responsible for administering the fund's derivatives risk management program. The risk manager would report to the fund's board on the program's implementation and effectiveness and the results of the fund's stress testing.
- **Limit on Fund Leverage Risk:** A fund relying on Rule 18f-4 would generally have to comply with an outer limit on fund leverage risk based on value at risk (VaR). This outer limit would be based on a relative VaR test that compares the fund's VaR to the VaR of its "designated reference index." The fund's VaR would not be permitted to exceed 150% of the VaR of its designated reference index. If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed 15% of the value of the fund's net assets.
- **Exception for Limited Users of Derivatives:** The proposed rule would provide an exception from the program requirement and the VaR-based limit on fund leverage risk for a fund that either (1) limits its derivatives exposure to 10% of its net assets; or (2) uses derivatives only to hedge certain currency risks. Such fund would still be required to adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks.
- **Alternative Conditions for Certain Leveraged or Inverse Funds:** The proposed rule includes a set of alternative conditions for certain leveraged or inverse funds. Such a fund would be excepted from the proposed limit on fund leverage risk provided that, among other things, it (1) limits the investment results it seeks to 300% of the return (or inverse of the return) of the underlying index; (2) discloses in its prospectus that it is not subject to the proposed

limit on fund leverage risk; and (3) is a fund to which the new proposed sales practices rules would apply, prohibiting a retail investor from trading through a broker-dealer or investment adviser unless the broker-dealer or investment adviser were to approve the investor's account for such trading.

- **Reverse Repurchase Agreements and Unfunded Commitment Agreements:** The proposed rule would permit a fund to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, so long as the fund meets the asset coverage requirements under Section 18. The SEC noted that reverse repurchase agreements and similar financing transactions are not treated as derivatives transactions under the proposed rule because they are economically equivalent to a secured borrowing, and thus more closely resemble bank borrowings with a known repayment obligation rather than the more-uncertain payment obligations of many derivatives. The SEC also noted that a fund's obligations with respect to tender option bond (TOB) financing may be similar to reverse repurchase agreements in certain circumstances, depending on the facts and circumstances. And, to the extent that TOB financing is economically similar to a reverse repurchase agreement, the fund should treat obligations with respect to the TOB financing as a similar finance transaction under Rule 18f-4.

The proposed rule would permit a fund to enter into an unfunded commitment agreement if it reasonably believes, at the time it enters into such agreement, that it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements, in each case as they come due.

Reporting Requirements

The proposal would require funds to confidentially report to the SEC on Form N-LIQUID (to be renamed "Form N-RN") if the fund is not in compliance with the VaR-based limit on fund leverage risk for more than three consecutive business days. Forms N-PORT and Form N-CEN would also be amended to require funds to provide certain information regarding a fund's derivatives exposure and, as applicable, information regarding the fund's VaR. This information would be publicly available.

Rescission of Investment Company Release 10666

The SEC proposed to rescind a 1979 general statement of policy (Release 10666), which provides SEC guidance on how funds may use certain derivatives and derivatives-like transactions in light of the Section 18 restrictions. In addition, the staff in the Division of Investment Management is reviewing its no-action letters and other guidance addressing funds' use of derivatives and other transactions covered by proposed Rule 18f-4 to determine which letters and guidance, or portions thereof, should be withdrawn in connection with any adoption of the proposal. The SEC noted that it expects to provide a one-year transition period for funds while they prepare to come into compliance with Rule 18f-4 before Release 10666 is withdrawn.

Comment Period

The public comment period will remain open for 60 days after publication in the Federal Register.

See the proposing release.

SEC Proposes Amendments to the Proxy Rules Regarding Shareholder Proposals and Proxy Voting Advice

On November 5, 2019, the SEC issued two releases—"Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8" and "Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice" —proposing a number of amendments to the federal proxy rules. The first release proposed changes to certain procedural requirements relating to the submission of shareholder proposals and changes to the provision regarding the ability to exclude resubmitted proposals. The second release proposed amendments relating to the proxy voting advice business, particularly with respect to the exemptions from the proxy filing requirements for a proxy advisory firm's voting recommendations.

Shareholder Proposals

The SEC voted to propose amendments to Rule 14a-8 under the Exchange Act, the shareholder proposal rule. The proposed amendments would (1) replace the current ownership requirements with a tiered approach combining the number of shares owned and the length of ownership; (2) require certain documentation when a proposal is submitted by a representative on behalf of a proponent; (3) require a proponent to provide information regarding the proponent's availability for engagement with the company; (4) amend the one-proposal rule to apply to a proponent's representative; (5) raise the levels of support that a proposal must receive to be resubmitted at future shareholder meetings; and (6) add a new provision that would allow exclusion of certain resubmitted proposals that have experienced declining shareholder support.

Proposed Amendments Regarding Proxy Voting Advice

In the release relating to proxy voting advice, the SEC proposed amendments to the proxy rules that would (1) codify the SEC's interpretation that proxy voting advice generally constitutes a "solicitation"; (2) condition the availability of the exemption from the proxy information and filing requirements for a firm's proxy voting recommendations on compliance with (A) additional disclosure requirements concerning material conflicts of interest and (B) new procedural requirements requiring an opportunity for companies to review the voting recommendations and provide feedback in advance of the firm's issuance of the recommendations, as well as a company option to include in the firm's voting recommendations a hyperlink to the company's views on those recommendations; and (3) provide examples of when the failure to disclose certain information in proxy voting advice may be considered misleading in violation of the proxy rules.

Comments on the proposals are due February 3, 2020. As these are proposed rules rather than final rules, calendar year-end companies currently receiving shareholder proposals for 2020 annual meetings should continue to analyze those proposals under the existing rules.

In addition, at the SEC meeting at which these proposing releases were approved, SEC Chairman Jay Clayton stated that the SEC staff has been instructed to prepare recommendations regarding "proxy plumbing" and universal proxy cards. The timing of any proposed amendments on these topics is uncertain.

A detailed description of both releases is available in our November 7, 2019, client alert regarding these proposals, "SEC Proposes Amendments to the Proxy Rules Regarding Shareholder Proposals and Proxy Voting Advice." And discussion of considerations for closed-end funds in connection with these two releases is available in our November 20, 2019, client alert, "Proposed Amendments to the Federal Proxy Rules: Considerations for Closed-End Funds."

SEC Proposes to Modernize Advertising and Cash Solicitation Rules for Investment Advisers

On November 4, 2019, the SEC voted to propose a series of rule and form amendments that are intended to modernize rules under the Advisers Act addressing investment adviser advertisements and payments to solicitors. The proposed amendments are intended to reflect changes in technology, the expectations of investors and the evolution of industry practices.

The proposed changes to the advertising rule include, among other things:

- updates to the definition of "advertisement" intended to ensure that it is flexible enough to remain relevant and effective in light of advances in technology and evolving industry practices;
- replacement of the advertising rule's prescriptive requirements, such as with respect to testimonials and past specific recommendations, with a principles-based approach to regulation of adviser advertising;
- specific guidance and/or rule-based provisions addressing common scenarios that have historically presented challenges for advisers since they are not expressly addressed in the existing advertising rule, such as performance portability; use of gross performance, hypothetical performance and related performance; and the appropriate tailoring of performance information for different audiences; and
- a compliance requirement that most advertisements be reviewed and approved in writing by a designated employee before dissemination.

The proposed rule would apply to all investment advisers registered, or required to be registered, with the SEC.

The proposed changes to the solicitation rule include, among other things:

- expanding the rule to cover solicitation arrangements involving all forms of compensation, rather than only cash compensation;
- expanding the rule to apply to the solicitation of existing and prospective clients and private fund investors rather than only to "clients";
- eliminating certain existing requirements where the purpose of the requirement can be achieved under other Advisers Act rules (such as the brochure delivery requirement);
- revising certain provisions to better reflect evolving practices since the rule's original adoption in 1979, including those with respect to the written agreement and solicitor disclosure requirements, the partial exemptions for impersonal investment advice and affiliated solicitors;
- revising the solicitor disqualification provision and providing a conditional carve-out for certain disciplinary events that is broadly consistent with routinely issued no-action relief; and
- adding exemptions to the rule for de minimis payments and nonprofit programs.

The proposing release also included amendments to Form ADV designed to provide the SEC with additional information regarding advisers' advertising practices. See the proposing release. Comments on the proposed amendments were due December 10, 2019.

SEC Issues Guidance on Non-Traded BDCs and Section 61(a) of the 1940 Act

On October 17, 2019, the SEC's Division of Investment Management published guidance to assist BDCs whose common shares are not exchange-listed (non-traded BDCs) with the repurchase offer requirements of Section 61(a) of the 1940 Act.

Background

The Small Business Credit Availability Act, enacted in March 2018, amended Section 61(a) of the 1940 Act to permit a BDC to reduce its asset coverage requirements for senior securities from 200% to 150%, subject to certain conditions. These conditions require, among other things, that the change in asset coverage be approved either by a "required majority" of the BDC's board, or by a vote of the BDC's shareholders. With board approval, a BDC may rely on the 150% asset coverage requirement one year after the approval date; with shareholder approval, a BDC may rely on the 150% asset coverage requirement the day after such approval is obtained. See our April 9, 2018, client alert, "New Legislation Will Benefit Business Development Companies While Closed-End Funds Remain in Limbo," for a summary of the Small Business Credit Availability Act.

Section 61(a) also imposes an additional condition applicable to non-traded BDCs, requiring a non-traded BDC to extend "to each person that is a shareholder as of the date of an approval [by the board or shareholders], as applicable, the opportunity (which may include a tender offer) to sell the securities held by that shareholder as of that applicable approval date, with 25 percent of those securities to be repurchased in each of the 4 calendar quarters following the calendar quarter in which that applicable approval date takes place" (Condition).

Guidance

Following the amendments to Section 61(a), the SEC staff received inquiries regarding the Condition. The staff's responses to certain of these inquiries are summarized below.

- One single repurchase offer versus four separate repurchase offers: The staff noted that relevant portions of Section 61(a) can be read to allow a non-traded BDC to provide either one offer or four separate quarterly offers, in each case with the repurchases to be effectuated quarterly. The staff stated that the price at which each repurchase is effectuated should be based on the current net asset value of the non-traded BDC at the time of that repurchase, rather than the net asset value at the time of the offer.
- Whether a non-traded BDC could effectuate the repurchase of securities more quickly than required by the Condition: The staff noted that it would not recommend enforcement action if a non-traded BDC that has, or raises, sufficient funds to effectuate the repurchases more quickly does so, thereby enabling shareholders who accept the offer to have all their shares repurchased more quickly. However, the staff stated that a BDC planning to take this approach would need to (1) consider the consequences on the interests of any remaining shareholders, such as shareholder dilution and the potential effects on portfolio management; and (2) disclose, in conjunction with the offer to repurchase, its anticipated schedule for effectuating the repurchases because the timing of liquidity may be material to shareholders determining whether to accept the offer.
- Extending a repurchase offer under the Condition: The staff noted that in extending an offer to repurchase for the exclusive purpose of complying with the Condition, a non-traded BDC need not conduct the offer under Section 23(c) of the 1940 Act or under Sections 13(e) and 14(e) of the Exchange Act and the rules thereunder. The staff stated that a non-traded BDC

may use the forms, communications and filing processes under Section 23(c) of the 1940 Act or Section 13(e) of the Exchange Act and the rules thereunder that it would ordinarily use in extending an offer to repurchase or making a tender offer and encouraged non-traded BDCs to follow applicable SEC filing requirements and provide related documents to shareholders.

- Non-traded BDC listing common shares: The staff stated that it believes that Section 61(a) does not provide an exception from the Condition for a BDC whose common shares become listed on a national securities exchange after the approval date. The staff explained, however, that it believes that the right to receive a repurchase offer or to sell securities pursuant to the Condition would not (1) transfer with the securities of the BDC if, following the listing of those securities, a shareholder were to sell them; or (2) attach to securities that a shareholder purchases subsequent to the approval date.

See the guidance.

Update on Closed-End Fund Activism

Activist Campaign Round-Up

Activist closed-end fund investors — such as Bulldog Investors, LLC; Special Opportunities Fund, Inc. (SPE), a closed-end fund advised by Bulldog; Saba Capital Management, L.P.; and Karpus Management, Inc. — continue to promote their agendas as the 2020 proxy season approaches.

Earlier this year, Saba submitted notice to Ivy High Income Opportunities Fund (IVH) of its intent to present at the 2019 annual shareholder meeting a nonbinding proposal requesting that the board of the fund take all necessary steps to declassify the board (such type of nonbinding proposal, a "declassification proposal"). IVH held its annual shareholder meeting on August 30, 2019, for the purpose of electing trustee nominees and voting on the declassification proposal. The proposal, which required the affirmative vote of a majority of the shares cast, received more "for" than "against" votes.

On September 9, 2019, SPE submitted notice to BrandywineGLOBAL — Global Income Opportunities Fund Inc. (BWG) of its intent to present at BWG's 2020 annual shareholder meeting a nonbinding proposal requesting that the board authorize a self-tender offer for all outstanding common stock of the fund and, if more than 50% of the fund's outstanding common stock is submitted for tender, to cancel the tender offer and either liquidate the fund or convert it to an ETF or an open-end fund (such type of nonbinding proposal, a "liquidity event proposal").

On September 13, 2019, Karpus Management, Inc. submitted notice to Duff & Phelps Utility and Corporate Bond Trust Inc. (DUC) of its intent to present a liquidity event proposal at DUC's 2020 annual shareholder meeting.

On October 8, 2019, Neuberger Berman High Yield Strategies Fund Inc. (NHS) announced the results of its 2019 annual shareholder meeting, noting that Saba failed to have its dissident nominees elected and that the fund's stockholders rejected Saba's proposal to terminate the fund's investment advisory agreement with the fund's investment adviser. Saba's nonbinding proposal to conduct a tender offer, which required the affirmative vote of a majority of the shares cast, received more "for" than "against" votes.

On October 11, 2019, Vertical Capital Income Fund (VCIF) released the results of its 2019 annual shareholder meeting, noting that shareholders of the fund approved the new investment advisory agreement between the fund and its investment adviser and reelected the lead independent trustee of the fund. Bulldog had previously submitted to VCIF notice of its intention to solicit proxies for the upcoming annual meeting to oppose the approval of a new investment advisory agreement between the fund and its investment adviser, and the reelection of the lead independent trustee of the fund.

Saba submitted declassification proposals to Western Asset Global High Income Fund Inc. (EHI) and Western Asset High Income Fund II Inc. (HIX) earlier this year, in connection with each fund's 2019 annual shareholder meeting held on October 25, 2019. The declassification proposals required the affirmative vote of a majority of the votes cast; for each fund, the declassification proposal received more "for" than "against" votes.

On November 1, 2019, The Swiss Helvetia Fund, Inc. (SWZ) announced the results of its 2019 annual shareholder meeting. At the meeting, shareholders were asked to vote on, among other things, proposals to (1) approve the proposed investment advisory agreement between the fund and Bulldog; (2) approve the replacement of the fund's fundamental investment objective with a nonfundamental investment objective of providing total return; and (3) approve amendments

to certain of the fund's fundamental investment restrictions. If shareholders approved these three proposals, the fund would, as soon as practicable thereafter, commence a tender offer for up to 15% of the fund's outstanding shares at a price of 95% of the fund's net asset value (NAV) per share. SWZ noted that although the votes cast for each of these three proposals exceeded the votes cast against, none of these proposals passed as they did not receive the required affirmative vote of a majority of the outstanding voting securities of the fund.

On November 4, 2019, Karpus Management, Inc. submitted notice to First Trust/Aberdeen Global Opportunity Income Fund (FAM) of its intent to present a liquidity event proposal at the 2020 annual shareholder meeting.

Earlier this year, Saba Capital Management, L.P. submitted declassification proposals to BlackRock New York Municipal Bond Trust and BlackRock Credit Allocation Income Trust and a liquidity event proposal to BlackRock Muni New York Intermediate Duration Fund, Inc. For each fund, the declassification proposal received more "for" than "against" votes. On December 3, 2019, Saba issued an open letter to the board of trustees of each fund, requesting that each board take action on the proposals.

Goldstein Request for SEC Guidance

On December 4, 2019, SPE Chairman Phillip Goldstein submitted a request for a determination to the staff of the Division of Investment Management of the SEC as to whether certain potential amendments to the fund's bylaws would contravene the 1940 Act, particularly Sections 16(a), 18(i) and 36(a).[1] The potential amendments include share ownership limitations, a majority voting requirement for contested director elections and a continuing director bylaw that would confer certain powers specifically upon continuing directors.[2] The request also seeks interpretive guidance regarding (1) certain senior security voting rights contained in Section 18 of the 1940 Act; and (2) a fund board's fiduciary duty in considering anti-takeover measures not expressly permitted by the 1940 Act.

The request identifies various potential interpretations that could render SPE's proposed bylaw amendments violative of the 1940 Act. In particular, it posits that "holdover" directors that can result from a majority voting requirement in contested elections could no longer be considered "elected" for purposes of Section 16(a), that share ownership limitations could be inconsistent with Section 18(i) and that a continuing director bylaw could raise concerns under Sections 16(a), 18(i) and 36(a). The request also points to various references to fiduciary standards of conduct in the anti-takeover context expressed in the past by the IM staff and contained in Delaware case law and requests that the IM staff provide guidance regarding the fiduciary duty of boards of directors of registered investment companies when considering measures "that may impair the effectiveness of a shareholder vote."

The IM staff last directly addressed closed-end funds' use of corporate defenses in an interpretive letter to Boulder Total Return Fund, Inc. in 2010. While a registered closed-end fund, Boulder was managed by a well-known closed-end fund activist investor, Stewart Horejsi. The Boulder no-action request was in essence an interpretative roadmap for denying the request, which the IM staff did. This had a chilling effect on closed-end fund corporate defense activity. Similarly, Mr. Goldstein, chairman of SPE and a member of SPE's investment advisor, Bulldog, is also a well-known closed-end fund activist investor, and this letter too sets out arguments that, if accepted by the SEC, could provide a similar chilling result on corporate defenses.

SEC Engagement on Activist Issues

The SEC has formed a working group to examine closed-end fund corporate governance matters and has been meeting with industry participants on these topics. We have stated to the IM staff that the industry would also benefit from the opportunity for formal involvement and dialogue on the issues raised by Mr. Goldstein's request. As part of its focus on corporate governance matters, we believe that the SEC or the IM staff will soon issue a request for comments on topics related to closed-end fund corporate governance and activist issues. Industry participants should strongly consider participating in any such comment process and public dialogue in order to ensure the SEC receives a broad range of views and understands all of the ramifications of any position it takes. Even in the absence of a formal request for comments from the SEC or the IM staff, industry participants may nonetheless wish to express their views to the SEC and the IM staff through direct reach-out and, for example, in connection with responses to the rule-making requests for the "Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8" and/or "Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice" proposals discussed above; the comment period for both proposals ends February 3, 2020.

[1] Section 16(a) requires that investment company directors be "elected" by the investment company's outstanding voting securities, Section 18(i) requires that all investment company voting stock have equal voting rights and Section 36(a) permits the SEC to bring an action against investment company directors for "breach of fiduciary duty involving personal misconduct."

[2] These powers would include the power to amend the fund's bylaws, waive the share ownership limitation, determine the number of directors and fill any vacancies. In addition, the continuing director bylaw may provide for indemnification exclusively for current and former continuing directors.

SEC Proposes Amendments to Exemptive Relief Process Under the 1940 Act

On October 18, 2019, the SEC proposed amendments to the exemptive relief application process under the 1940 Act to establish an expedited review procedure for exemptive applications that are substantially identical to recent precedent and proposed adopting a new rule that establishes an internal timeframe for the SEC staff to review applications that do not qualify for the expedited review process. Additionally, the SEC stated that it intends to begin publicly disseminating SEC staff comments on applications and applicants' responses no later than 120 days following the final disposition of an application.

Expedited Review

Eligibility. The SEC is proposing to amend Rule 0-5 under the 1940 Act to establish an expedited review process for applications that are substantially identical to two other applications for which an order granting the requested relief has been issued within two years of the date of the application's initial filing. "Substantially identical" applications would be defined as "those requesting relief from the same sections of the Act and rules thereunder, containing identical terms and conditions, and differing only with respect to factual differences that are not material to the relief requested." The SEC stated that applicants requesting expedited review would not be able to "mix and match relief" of prior applications under the proposed rule, noting that "[e]ven small changes to the terms and conditions of an application, compared to a precedent application, may either raise a novel issue, or require a significant amount of time for the Staff to consider whether it raises such an issue."

Additional Information Required. An applicant seeking expedited review would be required to include the following information with its application:

- a notation on the cover page of the application that prominently states: EXPEDITED REVIEW REQUESTED UNDER 17 CFR 270.0-5(d);
- exhibits with marked copies of the application showing changes from the final versions of the two precedent applications; and
- an accompanying cover letter, signed, on behalf of the applicant, by the person executing the application, (1) identifying the two substantially identical applications that serve as precedent; and (2) certifying that the applicant believes the application meets the requirements of Rule 0-5(d) and that the marked copies required by Rule 0-5(e)(2) are complete and accurate.

Timeframe. Under the proposed amendments, a notice for an application submitted for expedited review would be issued no later than 45 days from the date of filing unless the applicant is notified that (1) the application is not eligible for expedited review under Rule 0-5; or (2) further consideration of the application by the SEC staff is necessary. Any comment on the application by the SEC staff would pause the 45-day period. The proposal includes certain other conditions and rules relating to the 45-day review period.

Applications Deemed Withdrawn. The proposed amendments provide that if an applicant does not file an amendment responsive to the SEC staff's request for modifications within 30 days of receiving such request, the application will be deemed withdrawn.

Standard Review

Timeframe. Under the proposed amendments, the SEC staff would take action on any application subject to standard review within 90 days of the initial filing and any amendments thereto. The SEC notes that "action on an application or amendment" would consist of (1) issuing a notice of application; (2) providing the applicants with comments; or (3) informing the applicants that the application will be forwarded to the SEC, in which case the application is no longer subject to the standard review timeframe.

Applications Deemed Withdrawn. The proposed amendments provide that if an applicant has not responded in writing to a request for clarification or modification of an application within 120 days after the request, the application will be deemed withdrawn.

Comments on the proposed amendments were due November 29, 2019.

See the proposing release.

SEC Expands 'Testing the Waters' Communications to All Issuers

On September 26, 2019, the SEC adopted new Rule 163B and related amendments under the Securities Act of 1933 (Securities Act) to expand the permitted use of "testing-the-waters" communications to all companies regardless of size or reporting status, including BDCs and other registered investment companies (together, "funds"). The new rule enables any issuer, including those that are not an emerging growth company or any person authorized to act on the issuer's behalf, to make oral and written offers to qualified institutional buyers and institutional accredited investors before or after the filing of a registration statement to gauge investors' interest in an offering.

Use of Rule 163B in the Fund Context

In the final rule release, the SEC noted that although funds would be eligible to use test-the-waters communications under Rule 163B, they are less likely to use Rule 163B due in part to certain considerations under the 1940 Act and associated market practices. The release noted that funds contemplating registered offerings often file a single registration statement under both the Securities Act and the 1940 Act to take advantage of certain efficiencies. In comment letters submitted in response to proposed Rule 163B, industry participants expressed their concern that absent an exemption from 1940 Act registration requirements, most funds would continue to file a single registration statement under both acts and therefore would not take advantage of the prefiling benefits of proposed Rule 163B. The SEC, however, declined to provide a new exemption under the 1940 Act to allow a fund that would otherwise be required to register under Section 8 of the 1940 Act to avoid this registration requirement while it engages in communications under Rule 163B. The SEC explained that an exemption from registration and from the substantive requirements of the 1940 Act could allow funds potentially to engage in activities that are contrary to the substantive requirements of the 1940 Act that protect investors and apply outside of a registered fund's offering. The SEC stated, "Given the need to consider these matters further, we are not adopting an exemption under the Investment Company Act at this time."

The SEC stated that it continues to believe that certain funds may be able to rely on Rule 163B to engage in prefiling communications. The SEC noted that BDCs, because they are not required to register under the 1940 Act, may be more likely to engage in prefiling communications under Rule 163B when contemplating a registered offering close in time to the fund's inception. The SEC also noted that funds that initially conduct exempt offerings — including certain registered closed-end funds and BDCs — may rely on Rule 163B if they are contemplating a subsequent registered offering.

Rule 163B became effective December 3, 2019.

For a detailed description of Rule 163B, see our September 27, 2019, client alert, "SEC Expands 'Testing-the-Waters' Communications to All Issuers."

District Court Dismisses Excessive Fee Claim Against Calamos Following Two-Week Bench Trial

On September 27, 2019, Judge Edgardo Ramos of the U.S. District Court for the Southern District of New York, following a two-week bench trial, issued an opinion and order dismissing an action brought by two shareholders of the Calamos Growth Fund against Calamos Advisors LLC, the fund's investment adviser (Calamos), alleging that the adviser breached its fiduciary duty under Section 36(b) of the 1940 Act by charging the fund excessive investment advisory fees.

To prevail on a Section 36(b) claim, the plaintiffs must prove by a preponderance of the evidence that the advisory fee that Calamos charged to the fund during the relevant period was "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The court applied the *Gartenberg* standard to determine whether a fee is "so disproportionately large," and at issue in the trial were four *Gartenberg* factors: (1) the nature and quality of services provided to the fund and its shareholders; (2) the profitability of the fund to the adviser; (3) comparative fee structures; and (4) the care and conscientiousness of the fund's board in evaluating the adviser's compensation. (In September 2018, the court granted partial summary judgment to Calamos on two of the six *Gartenberg* factors: fall-out benefits and economies of scale.)

Here, the court ultimately concluded that the plaintiffs failed to prove that Calamos breached its fiduciary duty under Section 36(b). The court's findings regarding four remaining *Gartenberg* factors are summarized below.

Nature and Quality of Services: The plaintiffs contended that the fund's performance was "exceptionally poor" and that the independent trustees offered only "fig-leaf responses" to the adviser's "continued poor performance" in managing the fund. The court found that the fund did underperform for most of the relevant period but stated this only "weakly" supports the plaintiffs' contention that the advisory fees were excessive. The court noted, "Investors and boards are typically more concerned with future performance, which necessarily entails some speculation; and past performance, whether poor or exceptional, is a weak and unreliable indicator of future performance." The court also found that the adviser's "substantial efforts to improve performance and the Fund's more recent uptick in performance further lessens the importance of the Fund's struggles with performance during the relevant period."

Profitability of the Fund to the Adviser: The court found that the profitability of the fund to Calamos did not support a conclusion that the advisory fees charged to the fund were excessive. The court stated, "As the credible evidence at trial revealed (1) no estimate of Calamos' profitability is excessive; (2) an adviser's choice of cost allocation methodology, if reasonable (as is Calamos' average AUM methodology) does not meaningfully affect whether an advisory fee is excessive; (3) Calamos' calculation of its profitability as to the Fund necessarily involves the exercise of reasonable discretionary accounting judgments, as Calamos' judgments were; and (4) because there are a range of reasonable and acceptable judgments and methodologies that can be used, and which all will produce a range of different but equally reasonable results, there is no one 'true' profitability figure."

Comparative Fee Structures: The court disagreed with the plaintiffs' contention that the advisory fee charged to the fund was excessive based upon a comparison of (1) annual investment advisory fees charged to the fund versus fees charged by investment advisers at comparable funds; and (2) annual investment advisory fees charged to the fund versus fees charged to Calamos' subadvised and institutional clients. On the comparison of fees charged by peer mutual funds, the court concluded that while the fund's fee was "above its peer group

and category medians each year that the Independent Trustees approved the [advisory agreement]," such comparisons did not support a finding that the fees charged to the fund "were so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." On the comparison of fees charged to other Calamos accounts, the court found that the fees charged to Calamos' subadvised and institutional funds were "inapt comparators" to the fund's fees since the "higher fees charged to the Fund … reflected the greater services and risks that Calamos experienced in managing the Fund when compared to its [other accounts]—particularly in areas such as legal, regulatory, and compliance; fund governance; fund administration services; oversight of third-party service providers; portfolio management; and client/shareholder services."

In rejecting the plaintiffs' comparative fees argument, the court made the novel finding that subadvisory fees provide an inapt comparator for advisory fees even where certain subadvised clients demand more "extreme" services than a typical subadvised client. The plaintiffs' comparative fees argument focused on a subadvised client that required "extensive individualized service" from Calamos. While the court acknowledged that the level of services Calamos provided to that particular subadvised client was atypically high, the court rejected the plaintiffs' fee comparison as unpersuasive in light of the credible testimony that those demands represented the "exception to the rule" that subadvisory services were substantially less demanding than advisory services. The court's rejection of the plaintiffs' comparative fees argument is also notable insofar as it credited testimony that one of the fund's subadvised clients made the decision to pay the advisory fee in exchange for Calamos' full suite of services. Specifically, the court found persuasive "credible evidence ... that some institutional clients were not dissuaded by the Fund's advisory fee and instead voluntarily chose to pay the fee and park their money in the Fund."

Care and Conscientiousness of the Independent Trustees' 15(c) Review: The court found that "the weight of credible trial evidence makes clear that the Independent Trustees were fully informed, conscientious and careful in approving [the investment adviser's] annual advisory fee" and consequently, "substantial deference to the Independent Trustees' decision is warranted." The court reached two notable conclusions in granting substantial deference to the fund's board. First, the court agreed with the *Kennis v. Metropolitan West Asset Management, LLC* decision that a fund's board of trustees "does not have a duty to negotiate" advisory fees or obtain fee reductions. *Id*. Second, the court rejected the plaintiffs' argument that the fund's board was "required to calculate, estimate, or otherwise reduce to a number the litigation risks faced by Calamos as a consequence of advising the Fund." The court held that Section 36(b) does not require advisers to "provide a cost breakdown that quantifies in dollars and cents all of the different services and risks entailed in managing a mutual fund as compared to an institutional or sub-advisory account."

See the opinion.

Second Circuit Affirms Dismissal of Shareholder Breach of Contract Claims That Mutual Fund Violated the 1940 Act

On September 9, 2019, in *Edwards v. Sequoia Fund, Inc.*, the Second Circuit affirmed the dismissal of claims brought by a putative class of shareholders against a mutual fund alleging that the fund breached a contractual obligation not to "concentrate" its investments in a single industry. The plaintiffs alleged that the statement of additional information of the mutual fund's registration statement constituted an enforceable contract with shareholders that required the fund to observe an investment policy to not "concentrate" its investments in a single industry, as "concentrate" is defined in the 1940 Act. The plaintiffs claimed that the fund thus breached its concentration policy at least three times in 2015 when, due to increases in the value of the fund's health care assets, the value of those assets came to exceed 25% of the fund's overall assets. The court assumed, without deciding, that the registration statement, including the statement of additional information, was a contract, but agreed with the fund that the alleged instances where its investments in a particular industry exceeded 25% did not violate the fund's policy.

For more information about *Edwards v. Sequoia Fund, Inc.*, see our November 2019 client alert, "Inside the Courts — An Update From Skadden Securities Litigators."

Securities Class Action Against Mutual Fund Reaches Partial Settlement

On December 18, 2019, in *Sokolow v. LJM Funds Management, Ltd.*, Judge Robert Dow Jr. of the U.S. District Court for the Northern District of Illinois approved a partial settlement between the parties.

In their complaint, the plaintiffs argued that the defendants made false and misleading public statements regarding the cautious investment strategy of the fund while actually investing in leveraged options, thus overexposing it to the risk of volatility and a down market. In early February 2018, after a drop in the stock market and an increase in volatility, the fund lost 80% of its value and failed to post its NAV on February 5. The fund subsequently announced it would be liquidated and dissolved. The defendants filed a motion to dismiss in February, and the case was stayed pending settlement negotiations in May.

In August, several of the parties entered into the partial settlement agreement that the court finalized on December 18. The parties to the settlement agreement include all of the defendants — including the at-issue investment trust, distributors and trustees — except the adviser and the two portfolio managers. All claims against the settling defendants were resolved for $12.85 million.

District Court Dismisses Investors' Sections 11 and 10(b) Claims Against ETF Issuer

On January 3, 2020, in *In re ProShares Trust II Securities Litigation*, Judge Denise Cote of the U.S. District Court for the Southern District of New York dismissed claims brought by a putative class of shareholders against an issuer of ETFs alleging that the issuer failed to disclose certain risks associated with a particular inverse ETF. The inverse ETF was designed to deliver the opposite performance of a short-term futures index (VIX) that consists of futures contracts tied to the S&P 500 index (the SVXY Fund). The plaintiffs primarily alleged that the registration statement for the SVXY Fund was misleading because the statement omitted that the fund's own daily rebalancing through the purchase and sale of VIX futures contracts could itself drive up the price of VIX futures contracts and the level of market volatility and thus drive down the value of SVXY shares.

The court concluded that the plaintiffs failed to adequately allege a material misstatement or omission. The court noted that "[r]eading the Registration Statement 'cover-to-cover,' the disclosures and representations 'taken together and in context' could not have misled a reasonable investor about the nature of the SVXY Fund and the risks associated with this complex financial product." The court stated that the registration statement adequately disclosed that "substantially all" of the SVXY Fund's assets were invested in futures contracts, which can be "highly volatile," and that the large positions in these contracts that the fund could acquire increases the risk of illiquidity and the risk of "large losses when buying, selling or holding such instruments." The court thus determined these disclosures would have put a reasonable investor on notice that "the Fund's own conduct in purchasing and selling VIX futures contracts could affect market liquidity and drive down the value of SVXY shares."

See the opinion.

1940 Act, Section 36(b) Wrap-Up

Just a few cases remain from the most recent wave of Section 36(b) litigation, which was centered on the "subadvisory" or "reverse-manager-of-managers" theory of excessive fee liability and which courts have uniformly rejected.

1. *In re BlackRock Mut. Funds Adv. Fees Litig*. — the first trial rejecting that theory and one of the largest mutual fund cases ever — was appealed in March 2019 and is tentatively set for oral argument in January 2020. For more information about *BlackRock*, see our February 2019 client alert, "Court Rules in BlackRock's Favor in Excessive Fee Trial, One of Largest Mutual Fund Cases Ever."
2. *In re Davis New York Venture Fund Fee Litig.* was appealed in June 2019, and the plaintiffs filed their opening brief in October 2019. For more information about *Davis New York*, see our July 2019 client alert, "SDNY Rules in Favor of Mutual Fund Adviser, Dismisses Excessive Fee Claim."
3. *Kennis v. Metropolitan West Asset Management, LLC* was appealed in August 2019, and the plaintiffs filed their opening brief in November 2019. For more information about *MetWest*, see our August 2019 client alert, "Another Mutual Fund Adviser Prevails at Trial in Excessive Fee Case."
4. *Obeslo v. Great-West Capital Mgmt., LLC* is scheduled to begin trial in January 2020 before Judge Christine Arguello of the U.S. District Court for the District of Colorado.

SEC Adopts New ETF Rule

On September 26, 2019, the SEC adopted new Rule 6c-11 and related form amendments under the 1940 Act that "are designed to create a consistent, transparent, and efficient regulatory framework for ETFs that are organized as open-end funds and to facilitate greater competition and innovation among ETFs." Under Rule 6c-11, ETFs that are organized as open-end funds that satisfy certain conditions will be permitted to operate within the scope of the 1940 Act without obtaining an individual exemptive order from the SEC. In the press release announcing the rule, the SEC noted that these changes "will replace hundreds of individualized exemptive orders ... and level the playing field among most ETFs."

Scope of Rule 6c-11. Rule 6c-11 will be available to ETFs organized as open-end funds and provides exemptions for index-based ETFs and actively managed ETFs. Rule 6c-11 will not be available to ETFs organized as unit investment trusts (UITs), leveraged or inverse ETFs, ETFs structured as a share class of a multiclass fund, and nontransparent ETFs.

Conditions for Reliance on Rule 6c-11. ETFs seeking to rely on Rule 6c-11 will be subject to certain conditions, including the following:

- Transparency: An ETF will be required to provide daily portfolio transparency on its website.
- Custom basket policies and procedures: An ETF relying on Rule 6c-11 will be permitted to use baskets that do not reflect a pro-rata representation of the fund's portfolio or that differ from the initial basket used in transactions on the same business day (custom baskets) if the ETF adopts and implements written policies and procedures setting forth detailed parameters for the construction and acceptance of custom baskets that are in the best interests of the ETF and its shareholders. An ETF will be required to comply with certain recordkeeping requirements, including preserving and maintaining copies of all written agreements between an authorized participant and the ETF that allow the authorized participant to purchase and redeem creation units.
- Website disclosure: An ETF will be required to disclose certain information on its website in order to inform investors about the costs of investing in ETFs and the efficiency of an ETF's arbitrage process.

Rescission of Prior Exemptive Relief. One year after the effective date of Rule 6c-11, the SEC will rescind "those portions of our prior ETF exemptive orders that grant relief related to the formation and operation of an ETF, including certain master-feeder relief." The SEC will not rescind exemptive relief of UIT ETFs, leveraged/inverse ETFs, share class ETFs and nontransparent ETFs and will not rescind relief it has provided to ETFs from Section 12(d)(1) and Sections 17(a)(1) and (a)(2) under the 1940 Act related to fund of funds arrangements involving ETFs.

Amendments to Form N-1A, Form N-8B-2 and Form N-CEN. The SEC adopted amendments to Forms N-1A, N-8B-2 and N-CEN to reflect new Rule 6c-11.

Exemptive Relief for Broker-Dealers. In conjunction with new Rule 6c-11, the SEC issued an order granting exemptive relief to broker-dealers and certain other persons that engage in transactions with ETFs relying on Rule 6c-11 from certain requirements of the Exchange Act and the rules thereunder.

Rule 6c-11 was effective December 23, 2019.

See the final rule and the exemptive order.

SEC Division of Investment Management Publishes FAQs Regarding Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation

On October 18, 2019, the staff of the SEC's Division of Investment Management published answers to frequently asked questions on compensation arrangements and financial conflicts and related disclosure obligations arising from an investment adviser's fiduciary duty and Form ADV. The staff noted that while the FAQs discuss disclosure obligations in the context of certain types of compensation that investment advisers receive (*i.e.*, 12b-1 fees and revenue sharing), these principles and disclosure obligations also apply to other forms of compensation. Accordingly, the staff encouraged investment advisers to be proactive in reviewing their practices concerning the compensation that they, their affiliates or their associated persons receive in connection with the investments they recommend and related services they provide to identify conflicts of interest.

Disclosures of Conflicts of Interest Related to Compensation That an Investment Adviser, Its Affiliates or Its Associated Persons Receive in Connection With Investment Recommendations

The FAQs state that, in order to meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. An adviser must also eliminate or disclose all conflicts of interest that might incline it to render advice that is not disinterested.

The FAQs note that an adviser that receives, directly or indirectly, compensation in connection with its investment recommendations has a financial incentive to make recommendations that result in the receipt of that compensation, which can give rise to conflicts relating to, for example, the types of investments, the fund families, the particular funds and the share classes of individual funds that the adviser recommends, as well as the extent of trading it recommends. These conflicts must be disclosed in Form ADV.

The FAQs remind advisers that:

- An adviser's fiduciary duty and the Form ADV instructions require the adviser to disclose conflicts of interest that result when it receives compensation, directly or indirectly, in connection with its investment recommendations.
- Where such conflict exists, an adviser must also disclose how it addresses the conflict.
- An adviser may also be required to make disclosures to clients that are in addition to those required in Form ADV.
- The Form ADV brochure is designed to promote effective communication between an adviser and its clients and should be written in plain English and appropriate to the level of financial sophistication of the adviser's clients.

Disclosure of Material Facts Related to Recommendations of Investments or Services With Different Compensation Structures

The FAQs state that an adviser must disclose conflicts of interest when more than one mutual fund share class is available to a client and the adviser receives, directly or indirectly, compensation based on the share class it recommends. The FAQs provide some examples of material facts that an adviser should disclose about its practices relating to recommendations of investments or services with different compensation structures:

- The existence and effect of different incentives and resulting conflicts
  - The fact that different share classes are available and that different share classes of the same fund represent the same underlying investments.

- How differences in sales charges, transaction fees and ongoing fees would affect a client's investment returns over time.
- The fact that the adviser has financial interests in the choice of share classes that conflict with the interests of its clients.

- The nature of the conflict
  - For example, whether the conflict arises (1) as a result of differences in the compensation the adviser and its affiliates receive; or (2) from the existence of any incentives shared between the adviser and the clearing broker or custodian (such as offsets, credits, or waivers of fees and expenses).
  - Whether there are any limitations on the availability of share classes to clients that result from the business of the adviser or the service providers that the adviser uses.
  - Whether an adviser's practices with regard to recommending share classes differs when it makes an initial recommendation to invest in a fund as compared to (1) when it makes recommendations regarding whether to convert to another share class; or (2) when it makes recommendations to buy additional shares of the fund.
- How the adviser addresses the conflict
  - The circumstances under which the adviser recommends share classes with different fee structures and the factors that the adviser considers in making recommendations to clients.
  - Whether the adviser has a practice of offsetting or rebating some or all of the additional costs to which a client is subject (such as 12b-1 fees and/or sales charges), the impact of such offsets or rebates, and whether that practice differs depending on the class of client, advice or transaction.

Form ADV Disclosure Requirements Related to an Adviser's Receipt of Revenue-Sharing Payments

The FAQs state that under Item 14.A of Part 2A of Form ADV, if someone who is not a client provides an economic benefit to an adviser for providing investment advice or other advisory services to its clients, the adviser must generally describe the arrangement, explain the conflicts of interest, and describe how it addresses the conflicts of interest.

Material Facts Relating to Revenue-Sharing Arrangements

The FAQs provide the following examples of material facts that an adviser should disclose about its practices and conflicts:

- The existence of any incentives provided to the adviser or shared between the adviser and others (*e.g.*, clearing brokers, custodians, funds' investment advisers or service providers).
- As with the receipt of 12b-1 fees, an adviser disclosing that it "may" have a conflict as the result of receiving revenue-sharing payments is not adequate when the conflict actually exists. (For more information regarding the SEC's position with respect to "may" disclosures, see the discussion titled "SEC Adopts Rules and Interpretations Related to Standards of Conduct for Broker-Dealers and Investment Advisers" in our September 2019 Investment Management Update.)

Disclosure of Material Changes to Share Class Recommendations or Revenue Sharing Arrangements

The FAQs note that an investment adviser that materially amends or supplements its disclosures concerning share class recommendations or revenue sharing arrangements in an annual Form ADV update must identify and discuss those changes (for example, on the cover page of the brochure, on the page immediately following the cover page or as a separate document accompanying the brochure).

See the FAQs.

ADI: Improving Principal Risk Disclosure in Mutual Fund Summary Prospectuses

On September 9, 2019, the Disclosure Review and Accounting Office staff of the SEC's Division of Investment Management issued an accounting and disclosure information (ADI) providing recommendations to mutual funds on improving principal risk disclosures in summary prospectuses.[1]

Ordering Risks by Importance

Among other things, the ADI "strongly encourage[s]" funds to "list their principal risks in order of importance, with the most significant risks appearing first." The ADI acknowledges that listing risks based on importance "requires subjective determinations." The ADI states that funds are in the best position to "make these judgments of relative importance" and that the staff would generally not comment when a fund orders its principal risks by importance.

Tailoring Risk Disclosures

The ADI encourages funds in fund groups to tailor risk disclosures for a particular fund rather than "rely on generic, standardized, risk disclosures across funds."

Disclosing That a Fund Is Not Appropriate for Certain Investors

The ADI encourages funds to consider disclosing that a fund may be inappropriate for certain investors. The ADI provides the following example: "[A] fund seeking to provide a defined return over a specific time period generally may not be appropriate for an investor that does not intend to hold the fund for the specified period. Highlighting this information may assist investors in making better informed investment decisions in line with their investment goals."

Other Reminders

The ADI provides three additional reminders regarding risk disclosure:

- The intent of the summary prospectus is to provide investors a concise summary of key information. More detailed information about principal risks should be presented elsewhere in the prospectus.
- Non-principal risks (and non-principal investment strategies) should be disclosed in a fund's statement of additional information rather than in the fund's prospectus.
- Funds should periodically review their risk disclosures, including the order of their risks, and consider whether the disclosures remain adequate in light of the fund's characteristics and market conditions.

See the principal risk disclosure ADI.

[1] The ADI is consistent with comments made by Dalia Blass, director of the Division of Investment Management, in an October 2018 keynote address given at the ICI Securities Law Developments Conference. See the keynote address.

ADI: Performance and Fee Disclosure in Fund Filings

On October 2, 2019, the Disclosure Review and Accounting Office staff of the SEC's Division of Investment Management issued an ADI providing guidance regarding certain performance and fee disclosure issues in fund filings.

Performance Presentations — Failing to Reflect Sales Loads: The staff has observed multiple funds that failed to reflect sales loads in their average annual returns table, resulting in overstating the performance of these funds compared to other funds. The staff notes that "the average annual returns table must reflect the deduction of the maximum sales load at the times, in the amounts, and under the terms disclosed in the fund's prospectus."

Performance Presentations — Additional Issues: The staff has also observed other performance presentation errors, including:

- Negative performance shown as positive performance in the bar chart and/or average annual return table
- Transposing the performance of fund classes
- Transposing the performance of multiple benchmark indices

Incorrectly Showing Net Expenses That Exceed Gross Expenses: The staff has observed some funds reflecting adviser expense recoupments as a positive fee waiver that causes their net expenses to be greater than their gross expenses. The ADI notes that this approach is not consistent with Form N-1A requirements, which allow two additional line items showing the waiver amount and net expenses only if there is a reduction in gross fees. Because recoupments are expenses to the fund, they should be reflected in the fee table as a separate line-item or included in "other expenses" and reflected in its gross expenses.

Failing to Disclose Acquired Fund Fees and Expenses: The staff has identified a number of funds that failed to reflect the appropriate amount of acquired fund fees and expenses in their fee table. The ADI notes that funds must ensure that the costs associated with their investments in other funds are appropriately reflected in their fee table and expense example.

Failing to Correctly Calculate the Expense Example: The staff has identified multiple funds that incorrectly calculate the expense example.

Failing to Correctly Tag the Risk Return Summary: The staff has observed that some funds incorrectly tag their information by using the wrong tags, enter the data incorrectly, or associate the tagged information with the wrong fund or class. The ADI reminds funds that the tagged data files carry the same liability as the related official filings.

See the performance and fee disclosure ADI.

OCIE Risk Alert: Top Compliance Topics Observed in Examinations of Investment Companies and Observations From Money Market Fund and Target Date Fund Initiatives

On November 7, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) published a risk alert to provide investment companies, investors and other market participants with information on the most often-cited deficiencies and weaknesses that the staff has observed in nearly 300 examinations of registered investment companies over a two-year period. The risk alert also includes the OCIE staff's observations from national examination initiatives focusing on money market funds (MMF) and target date funds (TDFs).

Top Compliance Observations From Examinations of Investment Companies

The most often-cited deficiencies and weaknesses noted in the risk alert were those related to:

- The fund compliance rule
- Disclosure to investors
- The Section 15(c) board approval process involving advisory contracts
- The fund code of ethics rule

Fund Compliance Rule: The most often-cited deficiencies or weaknesses OCIE staff observed in connection with the fund compliance rule were:

- Funds' compliance programs that did not take into account the nature of funds' business activities or risks specific to the fund.
- Funds that did not follow or enforce their compliance policies and procedures.
- Funds that did not adopt and implement policies and procedures that were reasonably designed to oversee compliance by service providers.
- Funds that did not conduct annual reviews of their policies and procedures or whose lack of supporting documentation made it was unclear if the annual reviews were completed; certain funds also conducted annual reviews of their policies and procedures, but those reviews did not address the adequacy of the funds' policies and procedures and the effectiveness of their implementation.

Disclosure to Investors: The most often-cited deficiencies or weaknesses OCIE staff observed in connection with the funds' disclosures to investors were:

- Funds that provided incomplete or potentially materially misleading information in their prospectuses, statements of information or shareholder reports when compared to the funds' actual activities that the staff observed during examinations.

Section 15(c) Process: The most often-cited deficiencies or weaknesses OCIE staff observed in connection with the Section 15(c) process were:

- Fund boards that may not have requested or considered information reasonably necessary to evaluate the fund's investment advisory agreement and fund boards that received incomplete materials, but did not request the omitted information, such as performance data for the fund and other accounts managed by the adviser and profitability reports.
- Funds' shareholder reports that did not appear to discuss adequately the material factors and conclusions that formed the basis for the board's approval of an investment advisory contract. The OCIE staff also observed instances in which boards' advisory contract review process may not have complied with Section 15(c). The risk alert noted that in some instances, funds did not keep copies of written materials the board considered in approving advisory contracts, and in other instances, because of the lack of supporting documentation, such as board minutes, it was unclear what information fund boards requested and considered.

Fund Code of Ethics: The most often-cited deficiencies or weaknesses OCIE staff observed in connection with the fund code of ethics rule were:

- Funds that failed to implement procedures reasonably necessary to prevent violations of their codes of ethics.
- Funds that failed to use reasonable diligence to prevent violations of their codes of ethics.
- Funds that failed to comply with their approval and reporting obligations with respect to their codes of ethics.

National Examination Initiatives: Money Market Funds and Target Date Funds

Money Market Funds: The OCIE staff examined MMFs for compliance with amendments to rules governing MMFs that became effective in October 2016. The staff observed the following instances of deficiencies or weaknesses related to MMFs' portfolio management practices, compliance programs and disclosures:

- Some MMFs did not (1) document one or more of the factors required to be considered when determining whether a security presents minimal credit risks and is an "eligible security," as defined under Rule 2a-7 of the 1940 Act; (2) adequately document the periodic updates to their credit files to support the eligible security determination; and (3) maintain records that adequately supported their determination that investments in repurchase agreements with nongovernment entities were fully collateralized by cash or government securities (in the case of government MMFs).
- Some MMFs provided stress test results to their boards that did not include the required summary of significant assumptions used in the stress tests.
- Some MMFs had not adopted and implemented compliance policies and procedures reasonably designed to address certain requirements under Rule 2a-7 and other areas.
- Some MMFs did not post on their websites all information required under Rule 2a-7 and/or posted inaccurate information on their websites. In addition, some MMFs did not include all required legends in their advertising materials.

Target Date Funds: The OCIE staff examined over 30 TDFs to review whether their assets were invested according to the asset allocations stated in the funds' prospectuses, and whether the associated investment risks were consistent with fund disclosures (including those made in marketing materials). The staff observed the following instances of deficiencies or weaknesses related to TDFs' disclosures and compliance programs:

- Some TDFs had incomplete and potentially misleading disclosures in their prospectuses and advertisements, including disclosures regarding asset allocations, both current and prospective over time; glide path changes and the impact of these glide path changes on asset allocations; and conflicts of interest, such as those that may result from the use of affiliated funds and affiliated investment advisers.
- Many TDFs had incomplete or missing policies and procedures, including those for monitoring asset allocations, including ongoing monitoring; overseeing implementation of changes to their current glide path asset allocations; overseeing advertisements and sales literature, which resulted in advertising disclosures that were inconsistent with prospectus disclosures and were potentially misleading; and monitoring whether disclosures regarding glide path deviations were accurate.

See the risk alert.

OCIE Risk Alert: Investment Adviser Principal and Agency Cross-Trading Compliance Issues

On September 4, 2019, OCIE published a risk alert highlighting the most common compliance issues identified in investment adviser examinations relating to principal trading and agency cross-transaction provisions under Section 206(3) of the Advisers Act.

Overview

Section 206(3) of the Advisers Act prohibits investment advisers from directly or indirectly selling any security to a client or purchasing any security from a client without disclosing to such client in writing before the completion of such transaction the capacity in which the investment adviser is acting. Additionally, Section 206(3) also prohibits an investment adviser that is, directly or indirectly, acting as broker for a person other than the advisory client from knowingly effecting any sale or purchase of any security for the account of that client, without disclosing to that client in writing before the completion of the sale or purchase the capacity in which the adviser is acting and obtaining the consent of the client to the sale or purchase (with certain limited exceptions).

Common Deficiencies or Weaknesses

Section 206(3) Requirements Not Followed: The OCIE staff has observed:

- Investment advisers that, acting as principal for their own accounts, had purchased securities from, and sold securities to, individual clients without recognizing that such principal trades were subject to Section 206(3) and therefore failed to make the required written disclosures to the clients or obtain the required client consents.
- Advisers that had recognized that they engaged in principal trades with a client, but did not meet all of the requirements of Section 206(3), such as failing to obtain appropriate prior client consent for each principal trade and failing to provide sufficient disclosure regarding the potential conflicts of interest and terms of the transaction.

Principal Trade Issues Related to Pooled Investment Vehicles: The OCIE staff has observed:

- Advisers that effected trades between advisory clients and an affiliated pooled investment vehicle, but failed to recognize that the advisers' significant ownership interests in the pooled investment vehicle would cause the transaction to be subject to Section 206(3); and
- Advisers that effected principal trades between themselves and pooled investment vehicle clients, but did not obtain effective consent from the pooled investment vehicle prior to completing the transactions.

Agency Cross Transactions: The OCIE staff has observed:

- Advisers that disclosed to clients that they would not engage in agency cross transactions, but in fact engaged in numerous agency cross transactions in reliance on Rule 206(3)-2; and
- Advisers that effected numerous agency cross transactions and purported to rely on Rule 206(3)-2, but could not produce any documentation that they had complied with the written consent, confirmation or disclosure requirements of the rule.

Policies and Procedures Related to Section 206(3): The OCIE staff has observed:

- Advisers that did not have policies and procedures relating to Section 206(3) even though the advisers engaged in principal trades and agency cross transactions; and
- Advisers that established but failed to comply with policies and procedures regarding principal trades and agency cross transactions.

See the OCIE risk alert.

LIBOR Updates

On September 5, 2019, the Financial Accounting Standards Board issued proposed accounting guidance to assist in the transition from the London interbank rate (LIBOR). The proposed guidance would "provide optional expedients and exceptions for applying generally accepted accounting principles to contract modifications and hedging relationships affected by reference rate reform [and] apply only to contracts or hedging relationships that reference LIBOR or another reference rate expected to be discontinued due to reference rate reform." Comments on the proposed guidance were due October 7, 2019. See the proposed guidance.

On October 9, 2019, the U.S. Department of Treasury and the Internal Revenue Service issued proposed regulations regarding federal income tax issues associated with changing the terms of debt, derivatives and other financial contracts to replace reference rates based on LIBOR with certain alternative reference rates. Comments on the proposed regulations were due November 25, 2019. See the proposed regulations.

New SEC Filing Fee Rate Effective October 1, 2019

On August 23, 2019, the SEC announced that in its fiscal year 2020, the fees that public companies and other issuers pay to register their securities with the SEC will be set at $129.80 per million dollars. The filing fee is calculated by multiplying the aggregate offering amount by 0.0001298. The new SEC filing fee rate went into effect on October 1, 2019.

SEC Announces Extension of Temporary Measure to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions

On November 4, 2019, the SEC staff issued an extension of an October 26, 2017, no-action letter, which provided temporary no-action relief to market participants regarding their U.S.-regulated activities as they engaged in efforts to comply with the provisions relating to research in the Markets in Financial Instruments Directive II (MiFID II) and related implementing rules and regulations. The staff stated in the extension letter that it will continue to not recommend enforcement action to the SEC against broker-dealers receiving payments in hard dollars or through research payment accounts from clients subject to MiFID II. The October 26, 2017, letter, which was set to expire July 3, 2020, was extended until July 3, 2023.

The SEC staff noted that the extension will (1) allow the staff to continue to monitor and assess the evolving impact of MiFID II and evaluate whether any additional guidance or recommendations to the SEC for regulatory actions are appropriate; (2) allow additional time for the authorities in the European Union or regulators in individual member states to continue their evaluation of the effects of MiFID II and potentially modify their rules; and (3) allow additional time for market-based solutions with respect to payments for research in the U.S. and Europe to evolve further, and for greater transparency regarding research payments and practices to develop.

See the November 4, 2019, no-action letter and the October 26, 2017, no-action letter.