VedderPrice

April 2018

Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes Changes to Fund Liquidity Disclosure Requirements

On March 14, 2018, the SEC issued proposed amendments to the disclosure requirements concerning certain fund liquidity information. Fund liquidity reporting relates to new Rule 22e-4 under the Investment Company Act of 1940, as amended (the Liquidity Rule), which requires each fund to adopt and implement a written liquidity risk management (LRM) program reasonably designed to assess and manage the fund's liquidity risk.[1] A fund's LRM program must include certain components, including, among other things, that a fund classify the liquidity of each portfolio investment into one of four categories (or "buckets"): highly liquid investments, moderately liquid investments, less liquid investments and illiquid investments. Form N-PORT[2]—for which the compliance date has not yet occurred—requires a fund to publicly report the aggregate percentage of its portfolio investments that falls into each of the four buckets.[3] The SEC's proposed rule would eliminate the foregoing public reporting requirement.

Specifically, if adopted, the proposals would do the following:

- rescind the requirement in Form N-PORT that funds publicly disclose aggregate liquidity portfolio classification information on a quarterly basis;
- require funds to "briefly discuss" the operation and effectiveness of the LRM program during the most recently completed fiscal year in the annual report in order to "provide investors with enough detail to appreciate the manner in which a fund manages its liquidity risk";[4]

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1 The SEC adopted the Liquidity Rule in October 2016. For a more detailed discussion of the Liquidity Rule, please see the Vedder Price White Paper, "SEC Adopts New Rules Mandating Open-End Fund Liquidity Risk Management Programs and Permitting Swing Pricing," published on October 28, 2016 and available at: http://www.vedderprice.com/SEC-Adopts-New-Rules-Mandating-Open-End-Fund-Liquidity-Risk-Management-Programs-and-Permitting-Swing-Pricing-10-28-2016/.

2 Form N-PORT requires mutual funds and exchange-traded funds (ETFs) to file with the SEC monthly portfolio investment information, including the liquidity classification assigned to each of the fund's portfolio investments. Position-level liquidity classification data is not publicly disclosed. The SEC has determined that data on individual securities is "necessary for our monitoring efforts, but not appropriate or in the public interest to be disclosed to investors or other market participants."

3 Currently, Form N-PORT requires this aggregate information to be disclosed to the public only for the third month of each fiscal quarter with a 60-day delay. Although the requirements of the Liquidity Rule and Form N-PORT are in effect, the compliance date has not yet occurred.

4 The proposing release suggests—as an example—that "as part of this new disclosure, a fund might opt to discuss the particular liquidity risks that it faced over the past year, such as significant redemptions, changes in the overall market liquidity of the investments the fund holds, or other liquidity risks, and explain how those risks were managed and addressed, and whether those risks affected fund performance." The proposing release also notes that no specific liquidity classification information—either security specific or in the aggregate—would be required, although a fund may provide such information if it wishes.

- make nonpublic the reporting about the percentage of a fund's highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, less-liquid derivatives transactions;
- allow funds the option of splitting a fund's holding into more than one liquidity bucket in three specified circumstances:

  (1) if portions of a position have differing liquidity features that justify treating the portions separately, such as when a fund holds a put option on a portion, but not all, of the fund's holding of the asset which significantly affects the liquidity characteristics of the portion of the asset subject to the put;

  (2) if a fund has multiple sub-advisers with differing liquidity views, such as where sub-advisers manage different sleeves of a fund and a single holding is held in multiple sleeves, a fund may report each sub-adviser's classification of the proportional holding it manages—effectively treating each portion as two separate and distinct securities—rather than putting the entire holding into one bucket, thus avoiding "the need for costly reconciliation";

  (3) if the fund chooses to classify the position through an evaluation of how long it would take to liquidate the entire position (rather than basing it on the sizes it would reasonably anticipate trading)—referred to as a "proportionality approach"; and
- require funds to publicly report holdings of cash and cash equivalents on a quarterly basis on Form N-PORT.

If the proposed amendments are adopted, the SEC expects to provide for a tiered set of compliance dates based on asset size. Specifically, the SEC proposes to align the compliance date for the proposed amendments with the revised compliance date previously adopted for Form N-PORT.[5]

The proposing release notes that, to further assist in providing investors with information about fund liquidity, the SEC staff expects to publish "aggregated and anonymized information about the fund industry's liquidity," similar to periodic reports issued by the staff about private fund industry data that is gleaned from Form PF filings.

The proposing release requests comment on the proposed elimination of the aggregate liquidity profile public disclosure requirement of Form N-PORT, the proposed replacement with a requirement that funds add a narrative discussion of their LRM program to annual reports, and other elements of the proposed amendments. Comments are due by May 18, 2018.

The proposing release is available at: https://www.sec.gov/rules/proposed/2018/ic-33046.pdf

Submitted comments are available at: https://www.sec.gov/comments/s7-04-18/s70418.htm

[5] On December 8, 2017, the SEC adopted a temporary rule (the Temporary Rule) delaying by nine months the requirement that registered investment companies file reports on new Form N-PORT via the EDGAR system. Under the Temporary Rule, larger fund groups that previously would have been required to submit their first reports on Form N-PORT via EDGAR for the period ending June 30, 2018 (due no later than July 30, 2018) will submit their first reports on Form N-PORT via EDGAR by April 30, 2019. Smaller fund groups will begin submitting reports on Form N-PORT via EDGAR by April 30, 2020.

Public Statements, Press Releases and Testimony

SEC Division of Investment Management Director Dalia Blass Discusses Data Analytics, Board Outreach, ETFs and Index Providers at ICI Conference

In her keynote address at the Investment Company Institute's 2018 Mutual Funds and Investment Management Conference on March 19, 2018, SEC Division of Investment Management Director Dalia Blass discussed the Division's use of data analysis, the status of the Division's Board Outreach Initiative and various issues relating to exchange-traded funds (ETFs) and index providers.

Among other things, Director Blass discussed the Division's analytical work and its resources. For instance, she discussed "Monitoring and Analytics GUI for Investment Companies" (referred to as "MAGIC"), a tool developed by the Analytics Office (formerly known as the Division's Risk and Examinations Office) to assist Division staff in organizing and evaluating data submitted in SEC filings, noting the tool's broad functionality. She stated that MAGIC would help the Division "to implement a risk-based approach to reviewing disclosure that will improve the effectiveness and efficiency of [its] work." She further noted that MAGIC is dynamic and able to be extended to incorporate data gathered from new forms such as Form N-PORT, and that its abilities can be built upon, including, for example, the Analytics Office's recent addition of machine learning capabilities to the tool.

Director Blass also provided an update on the Division's Board Outreach Initiative, stating that over the previous few months Division staff members had met with fund boards, independent board members and their counsel, and independent auditors to learn about the challenges board members face and to obtain feedback about how board members view their role. She stated that fund board members had emphasized the importance of board involvement in matters that are of the greatest of concern to fund shareholders—fees and expenses, performance, investment process, etc.—but also stressed the importance of maintaining a separation between oversight and management, such as with valuation and the review of affiliated transactions. Director Blass stated that, in light of these discussions, the Division staff is working on updating its valuation guidance with a goal of developing recommendations to help boards perform their valuation duties in a manner that recognizes "evolution in the markets and the standards for accounting, auditing and reporting." She also stated that the Division staff compiled a list of board responsibilities that "blur the line between oversight and management," adding that the staff did not want to add to such responsibilities in future policy decisions.

In addition, Director Blass noted that ETFs, which in the aggregate represent over $3.5 trillion in assets, currently operate under more than 300 individually issued exemptive orders. She stated that the current situation was not ideal, expressing regret that a uniform ETF rule proposed in 2008 was not adopted and noting both the expense to new entrants to the ETF marketplace of obtaining the necessary exemptive relief and other negative outcomes

resulting from ETFs operating under long and non-uniform exemptive orders. Consequently, a uniform ETF rule is a high priority for the Division; Director Blass said that the staff is working to prepare such a proposal. Director Blass also noted that the term "ETF" is often used to describe other investment products, such as exchange-traded notes (ETNs) or commodity pools, that are not investment companies or even funds. She expressed concern that shareholders may not understand the differences in risks, strategies and investor protections applicable to these various products if the generic term "ETF" is used to describe them all and posed the question of whether a different approach should be used for exchange-traded product nomenclature.

Finally, Director Blass discussed the evolution of the market for index-based ETFs, noting that in the past most indices were broad and fairly well understood but that more recently funds have been developed to track a broad range of indices, including indices focusing on narrow strategies, indices with alternative weighting methods (e.g., "smart beta" indices), custom indices and indices from affiliated index providers. She asked whether it would make sense to revisit the status of certain index providers—which have historically relied on the "publisher's exclusion"—as investment advisers, noting that "recent developments appear to have moved certain index providers away from what we might think of as publishers." Specifically, Director Blass questioned the status of a provider of an index that is maintained for only one fund, a provider that takes significant input from the fund's sponsor or board in creating an index and an index provider that is an affiliate of the fund's sponsor, and emphasized that the status of providers of broad-based indices that are widely used need not be revisited. She further expressed concern that a fund that tracks a custom or narrowly focused index may not have adequate disclosure of its investment strategy.

The transcript of Director Blass's remarks is available at: https://www.sec.gov/news/speech/speech-blass-2018-03-19

Litigation and Enforcement Actions and Initiatives

SEC ENFORCEMENT ACTIONS

Advisers Settle SEC Administrative Proceeding Regarding Securities Lending Practices

Pursuant to an order dated March 8, 2018 (the Order), the SEC settled an administrative proceeding against investment advisers Voya Investments, LLC and Directed Services LLC (the Voya Advisers) alleging that the Voya Advisers engaged in the practice of recalling securities on loan ahead of the dividend record date in order to provide tax benefits to their insurance affiliates to the detriment of fund investors. Pursuant to the settlement, the Voya Advisers were assessed a civil monetary penalty of $500,000, among other remedies.

According to the Order, the Voya Advisers served as investment advisers to a complex of insurance-dedicated mutual funds available to holders of variable annuity, variable life and group annuity contracts offered through

insurance companies affiliated with the Voya Advisers (the Insurance Affiliates). As described in the Order, at the direction of the Voya Advisers, the mutual funds engaged in securities lending activities whereby the funds loaned portfolio securities to qualified financial institutions in order to obtain additional income.

The Order alleges that, for a fourteen-year period between 2003 and 2017, the Voya Advisers would recall securities on loan before the dividend record date, allowing the Insurance Affiliates to claim a dividend received deduction. According to the Order, the structure of the mutual funds was such that the Insurance Affiliates were the shareholders of the funds "and, accordingly, could claim the [dividend received deduction] for any portion of the dividends the Funds received" after the recall, which otherwise would have gone to the securities borrower, resulting in a tax benefit to the Insurance Affiliates. However, according to the Order, recalling the loaned securities ahead of the dividend record date resulted in lost securities lending income to the mutual funds and, ultimately, the insurance contract holders.

The Order stated that these securities lending practices resulted in a conflict of interest that was never disclosed in the funds' prospectuses, which were made available to the insurance contract holders. The Order alleged that "[t]he Voya Advisers knew and understood that there was a connection between recalling securities for the dividend record date and net earnings from securities lending by the mutual funds, and understood that the recall practice benefitted the Insurance Affiliates," yet never disclosed the conflict. According to the Order, this omission rendered the prospectuses "materially misleading" in violation of Sections 206(2) and 206(4) of the Investment Advisers Act of 1940, as amended.

In addition to the $500,000 civil monetary penalty, the SEC ordered the Voya Advisers to pay over $3 million in disgorgement and prejudgment interest and enjoined the Voya Advisers from committing or causing any future violations.

The Order is available at: https://www.sec.gov/litigation/admin/2018/34-82837.pdf

SECTION 36(b) LITIGATION

U.S. District Court for the Northern District of Illinois Grants Summary Judgment in Section 36(b) Excessive Fee Suit

Summary

On March 13, 2018, the U.S. District Court for the Northern District of Illinois granted a motion for summary judgment in a suit brought against Harbor Capital Advisors, Inc. (the Adviser) under Section 36(b) of the Investment Company Act of 1940, as amended (the 1940 Act), by shareholders of the Harbor International Fund and the Harbor High Yield Bond Fund (together, the Funds).

The Adviser employs a "manager-of-managers" business model, using sub-advisers selected and paid by the Adviser and approved by the Board of Trustees fo the Funds (the Board) to make day-to-day investment decisions.

The Adviser pays the sub-adviser's fees from the management fees it receives from the Funds. The plaintiffs' theory of liability, according to the Court, was that "the revenue [the Adviser] collects from the Funds compared to the costs it incurs for the services it purportedly provides is so disproportionately large that its fees bear no reasonable relationship to the services rendered and could not have been the product of arm's length negotiations." In this regard, the plaintiffs contended that only those advisory services directly performed by the Adviser should be considered when determining whether its fees were excessive and those provided by the sub-advisers retained by the Adviser should be excluded. The Court disagreed.

Background

Under Section 36(b) of the 1940 Act, investment advisers owe a fiduciary duty with respect to the compensation they receive for providing investment advisory services to registered funds, and fund shareholders have an express private right of action to enforce this duty against investment advisers and their affiliates that receive compensation from funds. In such cases, plaintiffs have the burden of proof to show, by a preponderance of the evidence, that investment advisory fees are excessive, i.e., "that the fees are 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."

To determine whether an advisory fee is excessive, courts consider the fee in light of the factors initially set forth in the 1982 decision of the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, which were cited with approval by the U.S. Supreme Court in its 2010 decision *Jones v. Harris Associates, LP.*

The Court's Analysis of Deference Given to Board Decisions

In *Jones*, the Supreme Court said that a court should not "supplant the judgement of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's-length range." In this instance, the Court considered, in detail, evidence that the Board was independent, noting the qualifications of the Trustees, the quality of the Board's counsel, the volume of information considered by the Board in approving the Funds' investment advisory agreement and the Board's efforts to negotiate fees.

The Court concluded that the plaintiffs failed to point to admissible evidence to contest the process or independence of the Board and failed to show that the Board was uninformed or that the review process was tainted by the withholding of necessary information. Ultimately, the Court concluded that the plaintiffs' disagreement with the Board did not create a genuine issue of material fact as to whether the Board failed in its role as an "independent watchdog."

The Court's Application of the *Gartenberg* Factors

Applying the *Gartenberg* factors, the Court concluded the following:

- **Nature and Quality of Services:** In reviewing the nature and quality of services provided under an advisory agreement, all services provided under the agreement should be considered, including both services provided directly by the Adviser and services provided through a sub-contractual relationship (i.e., by a sub-adviser). Additionally, the plaintiffs failed to provide evidence "from which a reasonable jury could conclude"[6] that the Funds had not performed at least as well as, if not better than, comparable funds.

- **Comparative Fee Structures:** "[N]o reasonable trier of fact, viewing the undisputed facts in the light most favorable to plaintiffs, could find that [the Adviser's] fees fell outside the range of fees paid by comparable funds." On this point, the plaintiffs raised issues with respect to the reports from independent financial services firms that were reviewed by the Board, including (1) the use of the total expense ratio as a proper fee comparison measurement, (2) the sample sizes in the comparative expense groups, and (3) the comparability of the expense group constituent funds, among other things. The Court found that the plaintiffs' first argument was "well-taken," noting that the total expense ratio takes into account fees that are not part of the advisory fee and, as such, "may not provide a clear picture of what the actual bargaining range is for advisory fees alone." However, the Court pointed out that the data sets reviewed by the Board were not limited to total expense ratios. As to the size of the peer group, the Court said that plaintiffs failed to cite case law mandating larger data sets, noting that "the Seventh Circuit has affirmed a district court's finding that sample sizes of 10 or 11 peer funds is sufficient for a finding of comparable fees."

- **Profitability:** The plaintiffs failed to identify any case law supporting their contention that the Adviser should treat the fees it pays to the Funds' sub-advisers as "pass-through payments" and thus excluded from the Adviser's expenses in calculating profitability. In fact, the Court noted evidence in the record that the Board considered both profitability metrics—i.e., profitability both with and without the sub-adviser fees—and "rejected plaintiffs' preferred method as unhelpful or inappropriate."

- **Economies of Scale:** The Court agreed with the Adviser that the plaintiffs failed to raise any triable issues of fact regarding economies of scale. In this regard, the Adviser argued that the plaintiffs provided no "evidence that the total per-unit cost of servicing the Funds declined as the Funds grew in size" and thus did not carry their burden of proof to show whether economies of scale existed. Moreover, the Adviser asserted that the contractual breakpoints and fee waivers in place were adequate to share any realized economies of scale.

- **Fall-Out Benefits:** The plaintiffs failed to identify any evidence or articulate an argument for why the fees received by the Adviser's affiliates for distribution and transfer agent services, "which were known to and approved annually by, the Board, and paid directly by the Funds, militate towards a finding that the advisory fee charged by [the Adviser] is excessive." Consequently, "plaintiffs failed to raise a triable issue of fact as to this factor."

[6] References to a "reasonable jury" in the opinion are interesting since Section 36(b) generally is understood as "equitable" in nature, meaning plaintiffs are not entitled to a jury trial.

The order granting the motion to dismiss was issued under the captions *Zehrer v. Harbor Capital Advisors, Inc.*, Case No. 14 C 00789, and *Tumpowsky v. Harbor Capital Advisors, Inc.*, Case No. 14 C 07210.

U.S. District Court Grants Defendants' Motion for Summary Judgment in Section 36(b) Excessive Fee Suit

Summary

On March 9, 2018, the U.S. District Court for the Southern District of Ohio (the Court) granted the defendants' motion for summary judgment in a suit brought under Section 36(b) of the Investment Company Act of 1940, as amended (the 1940 Act), against J.P. Morgan Investment Management Inc. (the Adviser) and J.P. Morgan Funds Management, Inc. (the Administrator) (together, the Defendants), the investment adviser and administrator, respectively, to the JPMorgan Funds. The plaintiffs, shareholders of various JPMorgan Funds, alleged that the Adviser breached its fiduciary duty by charging excessively high investment advisory fees to the Funds and that the Administrator breached its fiduciary duty to seven Funds by charging excessively high administrative fees to the Funds. The plaintiffs alleged that the fees the Adviser and Administrator charged the Funds violated Section 36(b) because such fees are higher than the fees the Adviser and Administrator charge for advisory and administrative services provided to other funds for which the Adviser and Administrator serve as sub-adviser and sub-administrator, respectively.

Background

Under Section 36(b) of the 1940 Act, investment advisers owe a fiduciary duty with respect to the compensation they receive for providing investment advisory services to registered funds, and fund shareholders have an express private right of action to enforce this duty against investment advisers and their affiliates that receive compensation from funds. In such cases, plaintiffs have the burden of proof to show, by a preponderance of the evidence, that investment advisory fees are excessive, i.e., "that the fees are 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."

To determine whether an advisory fee is excessive, courts consider the fee in light of the factors initially set forth in the 1982 decision of the U.S. Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, which were cited with approval by the U.S. Supreme Court in its 2010 decision *Jones v. Harris Associates, LP.*

The Court's Application of the *Gartenberg* Factors

Applying the *Gartenberg* factors, the Court concluded the following:

- **Comparative Fee Structures:** The plaintiffs failed to demonstrate that the fees the Defendants charged for advisory and administrative services to the Funds were so disproportionately large so as to be outside of the

range of what would have been negotiated at arm's length because the fee comparisons to funds sub-advised by the Adviser were not materially similar and the comparisons to fees charged by other administrators were not supported by sufficient evidence.

- **Economies of Scale:** The Court would not second-guess the benefits being shared with the Funds' investors based on amounts returned to investors through fee waivers, stating that there was no indication that the Funds' board could not have agreed to the fee waiver structure after good-faith negotiations.
- **The Funds' Fees and Performance:** The Adviser's services to the Funds, although similar in certain respects to the services provided to the sub-advised funds, require additional risk and scale. In addition, the comparative data reviewed by the Funds' board showed that the performance of all of the Funds was at least favorable, and the Defendants presented "undisputed evidence" that the Funds' fees fell within the range of those comparators. As such, the plaintiffs failed to meet their burden of showing that the nature and quality of the Defendants' services rendered the Funds' fees excessive.
- **The Board of Directors:** Despite the plaintiffs' argument that the decision-making process of the Funds' board should be discounted because the Defendants failed to provide complete or accurate information to the board, the board's approval of the Funds' agreements with the Defendants is entitled to considerable weight. No irregularities or deficiencies were identified in the board's decision-making, and the plaintiffs failed to provide facts to support the claim that the board did not engage in a good-faith process designed to guard against excessive fees when it reviewed the advisory and administration agreements.

The order granting summary judgment was issued under the captions *Goodman, et al. v. J.P. Morgan Investment Management, Inc., et al.*, Case No. 2:14-cv-414, and *Campbell Family Trust, et al. v. J.P. Morgan Investment Management, Inc., et al.*, Case No. 2:15-cv-2923.

Legislative Developments

House Passes Alleviating Stress Test Burdens to Help Investors Act, Which Would Exempt Mutual Funds and Investment Advisers from Dodd-Frank Stress Testing Requirements

On March 20, 2018, the U.S. House of Representatives passed a bill, referred to as the Alleviating Stress Test Burdens to Help Investors Act (the Bill), that would exempt non-bank financial companies not under the supervision of the Board of Governors of the Federal Reserve System from the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) stress-testing requirements, in an effort to relieve such entities of burdensome

requirements that are “structured and designed for banks and do not appropriately reflect risks to nonbanks.” If adopted, the Bill would amend the Dodd-Frank Act to remove a requirement that the SEC and the CFTC issue regulations to require nonbank financial companies subject to their respective jurisdictions, which includes mutual funds and investment advisers with respect to the SEC, with $10 billion or more in assets to conduct periodic stress tests. In addition, although it would no longer be required under the Dodd-Frank Act, the Bill would still allow the SEC and the CFTC to issue such regulations. The Bill will next go to the U.S. Senate for consideration.

The text of the Bill is available at:
https://www.congress.gov/bill/115th-congress/house-bill/4566/text

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