Investment Services Regulatory Update

November 2019

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes Rule Changes for Proxy Advisory Firms

On November 5, 2019, the SEC issued a release proposing amendments to the federal proxy rules that are intended to enhance the accuracy and transparency of information provided by proxy advisory firms to investors and investment advisers that vote proxies on behalf of their clients.

Rule 206(4)-6 under the Investment Advisers Act of 1940 requires registered investment advisers to adopt and implement policies and procedures reasonably designed to ensure that they vote proxies in the best interest of clients. Soon after Rule 206(4)-6 was adopted, the SEC staff issued two no-action letters—Egan-Jones Proxy Services (May 27, 2004) and Institutional Shareholder Services, Inc. (Sept. 15, 2004)—indicating that advisers could demonstrate proxies were voted in their clients' best interest by voting proxies based on a recommendation of an independent third party, subject to certain conditions. In response, many advisers engaged an independent proxy advisory firm to provide voting advice and recommendations. These no action letters were rescinded by the SEC staff prior to a proxy roundtable held in November 2018, but the practical effects of this rescission were minimal because most advisers were able to continue to rely on SEC Staff Legal Bulletin No. 20, issued in 2014, which contained similar guidance. In August 2019, the SEC staff issued interpretive guidance regarding advisers' proxy voting responsibility, including the view that a voting recommendation given by a proxy advisory firm generally constitutes a "solicitation" that is subject to the federal proxy rules.

Following the SEC staff's August 2019 proxy voting guidance, the SEC proposed amendments to the proxy rules related to the use of proxy advisory firms in November 2019. These proposed amendments include the following:

- **Definition of Solicitation.** The proposed amendments would codify the SEC staff's interpretation that voting advice given by a proxy advisory firm constitutes a "solicitation" within the meaning of Rule 14a-1 under the Securities Exchange Act of 1934. The practical consequence of this interpretation would be that proxy advisory firms generally would become subject to the information and filing requirements in the federal proxy solicitation rules unless an exemption is available.

For more information, see Vedder Price P.C.'s summary of the SEC staff's August 2019 proxy voting guidance, *SEC Issues Proxy Voting Guidance*, which is available here.

- **New Conditions for Reliance upon Proxy Solicitation Exemptions.** The proposed amendments would add two new conditions to the exemptions in Rule 14a-2 that are typically relied upon by proxy advisory firms.
  - **Conflict of Interest Disclosure.** To rely upon the exemptions, a proxy advisory firm would be required to prominently disclose any material conflicts of interest.
  - **Review by Registrant.** To rely upon the exemptions, a proxy advisory firm would be required to give the registrant whose shareholders are being asked to vote on a matter upon which the advisory firm has provided proxy voting advice an opportunity to review and provide feedback on that advice before the advice is delivered to clients. The purpose of this condition is to identify factual errors, incompleteness or methodological weaknesses in the advisory firm's analysis.
- **Antifraud Provisions.** The proposed amendments make it clear that proxy voting advice is subject to the antifraud provisions of Rule 14a-9 under the Exchange Act, which provides that a proxy solicitation may not contain a material misstatement or omission. To avoid a potential violation, a proxy advisory firm may need to disclose certain information, such as the methodology used to reach a recommendation, any third-party information used in its analysis and any material conflicts of interest. The proxy advisory firm would also be required to disclose any material differences between its use of standards that materially differ from standards or requirements established or approved by the SEC. For example, if a proxy advisory firm were to recommend against the election of a director on the basis of independence using proprietary standards developed by the proxy advisory firm, as opposed to the SEC's standards, it may be necessary for the advisory firm to state that its recommendation is based on

independence standards that differ from those of the SEC.

The SEC's proposing release is available here.

SEC Proposes Amendments to Shareholder Proposal Rule

On November 5, 2019, the SEC issued a release proposing amendments to Rule 14a-8 under the Securities Exchange Act of 1934, which is the rule that governs the process through which shareholders may submit proposals to be included in a company's proxy statement. If adopted, the proposal would amend Rule 14a-8 as follows:

- **Share Ownership Requirement.** At present, Rule 14a-8 requires that a shareholder must have owned at least $2,000 in market value, or 1 percent, of a company's securities in order to submit a shareholder proposal for inclusion in the company's proxy statement. The proposal sets forth a three-tiered ownership requirement structure, under which shareholders who own a smaller dollar amount of securities would be required to own those securities for a longer period of time before submitting a shareholder proposal.
- **Written Statements.** The proposal would add requirements that a shareholder provide the company with written statements to the effect that the shareholder intends to continue to hold the requisite amount of securities through the date of the shareholder meeting and that the shareholder will be available to discuss the proposal with the company between 10 and 30 days of submission.
- **One Proposal.** Rule 14a-8 currently provides that each shareholder may submit no more than one proposal to a company for a particular shareholder meeting. The current rule would be narrowed so that a single person may submit only one proposal for a particular meeting, whether submitted directly as a shareholder or indirectly as a shareholder representative.
- **Resubmission.** The proposal would also raise the levels of shareholder support that a previous proposal must have received in order to be eligible for resubmission at the same company's future shareholder meeting and would add a new provision that would allow companies to exclude proposals under certain circumstances in which shareholder support for the matter declines year over year.

The SEC requested comments as to whether special provisions should be considered for the amendment to Rule 14a-8 that would require shareholders to reaffirm proposals for open-end funds (which typically do not hold annual shareholder meetings) after some passage of time or, absent reaffirmation, allow the proposals to expire.

Comments on the SEC's proposal are due 60 days after publication of the proposal in the Federal Register.

The SEC's release is available here.

SEC Proposes Expedited Review Process for Exemptive Applications

On October 18, 2019, the SEC issued a release proposing amendments to Rule 0-5 under the Investment Company Act of 1940 that would expedite the review process for certain applications for exemptive relief under the 1940 Act. The proposed amendments would also result in an application under standard review being deemed withdrawn if the applicant fails to respond to SEC comments within 120 days. In addition, the SEC proposed a new informal procedural rule that would establish a more transparent, informal review process for applications not qualifying for expedited review.

The three primary changes prescribed by the release are:

- **Expedited Review for Routine Exemptive Applications.** Under the proposed amendments to Rule 0-5, expedited review would be available for applications for exemptive relief that are substantially identical to two other applications that have been granted relief similar to that requested within two years of the date on which the application is initially filed. As proposed, an applicant requesting expedited review would submit an application with an identifying notation, cover letter and copies of the two applications relied upon as precedent. The SEC would be required to issue notices for all applications submitted for expedited review within 45 days from the date of filing. The 45-day period would pause if the applicant were to request a modification to the application or upon any irregular closure of the SEC's Washington, D.C. office. Under the proposal, if an applicant undergoing expedited review were to fail to respond to SEC comments within 30 days of receiving notice, the application would be deemed withdrawn without prejudice.

- **Application Deemed Withdrawn after 120 Days.** In addition, the proposed amendments to Rule 0-5 would establish a 120-day window for applicants applying for exemptive relief outside the expedited review process to respond in writing to SEC comments. Failure to meet this deadline would result in an application for exemptive relief being deemed withdrawn; however, the withdrawal would be without prejudice and the applicant could refile.

- **New Internal Time Frame for Standard Review.** Applications for exemptive relief that are not eligible for expedited review would continue to be subject to the standard review process. Under a proposed informal procedural rule, 17 C.F.R. § 202.13, the SEC would adopt a non-binding guideline under which the staff would take action on applications under standard review within 90 days of the initial filing or the filing date of any amendment, subject to the ability of the SEC to grant 90-day extensions.

Additionally, the SEC announced its intention to publicly release staff comments on applications, and responses to those comments, no later than 120 days after the final disposition of each application.

The SEC's release is available here.

SEC Proposes Amendments to Modernize Adviser Advertising and Solicitation Rules

On November 4, 2019, the SEC proposed significant amendments to the rules under the Investment Advisers Act of 1940 governing investment adviser advertisements and compensating solicitors.

If adopted, the amendments to Rule 206(4)-1 under the Advisers Act—the Advertising Rule—which has not been changed substantively since its adoption in 1961, would modernize the regulation of adviser advertising to account for technological developments, changing investor profiles and consumer habits by, for instance, permitting the use of testimonials, endorsements and third-party ratings, subject to certain conditions, and generally replacing broadly drawn limitations with a principles-based approach. Notably, the proposed amendments to the Advertising Rule would in some cases impose different requirements depending on whether an advertisement was intended for a retail investor or a non-retail investor. In addition, the SEC proposed amendments to Rule 206(4)-3—the Solicitation Rule—that are intended to respond to changed industry practices since that rule's adoption in 1979.

Members of Vedder Price's Investment Services group have separately published a summary of the proposed amendments to the Advertising Rule and the Solicitation Rule. That summary is available here.

SEC GUIDANCE

SEC Issues FAQs on Adviser Conflict Disclosure Practices

On October 18, 2019, the SEC's Division of Investment Management issued guidance in the form of Frequently Asked Questions that address certain matters regarding the disclosure of conflicts of interest involving the receipt by investment advisers of certain types of compensation, including 12b-1 fees, service fees, marketing support payments and other forms of revenue sharing by advisers and their affiliates and/or associated persons. The FAQs should be read in the context of the SEC's continued focus on conflicts of interest, particularly through the adoption of Form CRS and the SEC's recent focus on advisers' share class selection practices and receipt of 12b-1 fees through the Share Class Selection Disclosure Initiative. The FAQs address the conflicts of interest presented by these compensation arrangements and related disclosure obligations required under an adviser's fiduciary duties and Form ADV.

Key takeaways from the FAQs are as follows:

- Fiduciary duty principles and SEC guidance require an adviser to disclose in its Form ADV any compensation the adviser receives, directly or indirectly, in connection with its advisory activities.

- Compensation received by an adviser includes the receipt of payments as well as "the reduction or avoidance of expenses that an adviser incurs or otherwise would incur."

- If a conflict of interest exists, an adviser's fiduciary duties require the adviser to disclose the existence of the conflict, the nature of the conflict and how the adviser addresses the conflict.

- The SEC staff continues to caution against the use of the word "may" in situations in which a conflict actually exists or a business practice is actually followed. For example, in situations in which a conflict or practice applies only to a subset of clients, the adviser must specifically explain that a conflict exists and the circumstances that make the conflict applicable and identify the types of clients impacted. In this case, it would not be sufficient to note that the adviser "may" have a conflict of interest.
- Because market practices are constantly evolving, advisers are encouraged to proactively review their practices periodically to identify new or changing conflicts of interest.
- If an adviser materially amends or supplements its disclosures concerning share class recommendations or revenue-sharing arrangements, the adviser is required to highlight the amendments in Item 2 ("Material Changes") in its Form ADV Part 2.

The FAQs are available here.

SEC Extends Temporary Relief for MiFID II-Compliant Research Payments

On October 26, 2017, the SEC staff issued a no-action letter providing relief to broker-dealers that provide research that constitutes "investment advice" under the Investment Advisers Act of 1940 to investment managers subject to the prohibitions on soft-dollar use imposed by the European Union's amended Markets in Financial Instruments Directive (MiFID II), which took effect in January 2018. Under the relief, broker-dealers are able to receive payments for this research from investment managers paying their own money (i.e., "hard dollars"), from separate research payment accounts funded with client money or from a combination of the two. Absent this relief, a broker-dealer receiving these sorts of compensation for providing research that constitutes investment advice would be required to register as an investment adviser under the Advisers Act. The 2017 no-action relief was temporary and set to expire on July 3, 2020.

On November 4, 2019, the SEC staff extended for three additional years the temporary relief granted in the 2017 no-action letter. Accordingly, the relief will now expire on July 3, 2023 unless further action is taken. The SEC staff stated that the extension of the relief would allow the staff to further monitor and assess the effects of MiFID II on the market for research, including the effects of MiFID II on small- and mid-sized entities, and to consider whether additional guidance or recommendations are necessary. The SEC also noted that the additional time would enable EU regulators to evaluate the effects of MiFID II and consider modifications to their rules.

The SEC staff's October 26, 2017 no-action letter is available here.

The SEC staff's November 4, 2019 letter extending the 2017 relief is available here.

LITIGATION AND ENFORCEMENT MATTERS

SECTION 36(b) LITIGATION

Court Dismisses Plaintiffs' Excessive Fee Claim against Mutual Fund Adviser Following Trial

On September 27, 2019, following a two-week bench trial, the U.S. District Court for the Southern District of New York dismissed an action brought by mutual fund shareholders under Section 36(b) of the Investment Company Act of 1940 against the fund's investment adviser alleging that the adviser breached its fiduciary duty to the fund by charging excessively high investment advisory fees. The court concluded that the plaintiffs failed to meet their burden to prove that the investment adviser breached its fiduciary duty under Section 36(b). Specifically at issue in the trial were four of the *Gartenberg* factors: (1) the nature and quality of services provided to the fund; (2) the profitability of the fund to the investment adviser; (3) comparative fees; and (4) the care and conscientiousness with which the independent trustees performed their duties, i.e., whether the board's approval of the advisory fee deserved substantial deference by the court. The court had previously granted partial summary judgment to the defendant with respect to the other two *Gartenberg* factors: fall-out benefits and economies of scale. The court's findings regarding the *Gartenberg* factors at issue were as follows:

- **Nature and Quality of Services.** The plaintiffs contended that the fund's performance was poor and that the independent trustees offered only "fig-leaf responses" to questions concerning the adviser's performance in managing the fund. In response, the court indicated that the independent trustees were "fully apprised of the fund's performance history and [the adviser's] efforts to improve performance." The court 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.** Although both parties presented competing profitability estimates, the court concluded that those estimates fell within the range of profitability that had been deemed by other courts not to be indicative of excessive fees and there was no other evidence indicating that the profit margins were excessive. The court also concluded that the adviser's methodology for calculating profitability, including its allocation of indirect costs on the basis of assets under management, was consistent with industry standards and accepted accounting principles, noting that "because there are a range of reasonable and acceptable judgments and methodologies that can be used [to calculate profitability], and which will all produce a range of different but equally reasonable results, there is no one 'true' profitability figure."
- **Comparative Fees.** The court disagreed with the plaintiffs' contention that the fee charged to the fund was excessive based upon a comparison of the fees charged with (1) fees charged to peer funds and (2) fees charged to the adviser's sub-advised and institutional clients. As to the peer comparisons, although the fund's fee was above its peer group and category medians, the court concluded that such comparisons did not support plaintiffs' argument that the adviser's fee was excessive and not reflective of arm's-length bargaining, noting that plaintiffs could not prevail by demonstrating solely that the fees are higher than those charged to peer funds and that "Section 36(b) does not require that a fund experiencing below-median performance must charge a below-median fee." The court also agreed with the adviser's expert witness that it made "economic sense" for investors to consider expense ratios. As to the other accounts, the court found that the fees charged to the adviser's other accounts are "inapt comparators" to the fund's fees since the adviser "provides substantially more services—and undertakes substantially more risks—in advising the Fund." The court acknowledged the greater extent of services and risks when serving as an adviser (as opposed to a sub-adviser) to a fund in areas such as legal (i.e., litigation risk), regulatory and compliance, and noted the adviser's ongoing responsibility for activities conducted through service providers.
- **Care and Conscientiousness of the Independent Trustees' 15(c) Review.** Contrary to the plaintiffs' allegation that the independent trustees were not properly apprised of the differences in services provided and risks undertaken by the adviser in advising the fund as compared to its institutional or sub-advisory clients, the court concluded that the independent trustees engaged in a "robust review" of these differences, citing, among other things, information provided to the independent trustees related to the 15(c) process throughout the year. 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 concluded that of the six *Gartenberg* factors, only one—the quality of services provided to the fund—"even marginally tends to support Plaintiffs' claim," with the other factors weighing decisively in the adviser's favor. Thus, the court concluded that the plaintiffs failed to prove that the adviser received an excessive investment advisory fee from the fund.

The case is *Chill v. Calamos Advisors LLC*, Case No. 15-cv-1014 (ER) (S.D.N.Y. Sep. 27, 2019).

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