August 9, 2018

Ropes & Gray's Investment Management Update – June-July 2018

The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

SEC Adopts Changes to Liquidity Risk Management Disclosure Items

At its June 28, 2018 meeting, the SEC published a release (the "Release") adopting amendments to portions of the disclosure requirements associated with Rule 22e-4 under the 1940 Act. The SEC proposed similar amendments in a March 2018 proposing release (described in this Ropes & Gray Update). The adopted amendments, which are largely as proposed in March, make the following changes.

1. ***Rescind Quarterly Public Disclosure of Aggregate Liquidity Classifications and Replace with Narrative Disclosure.*** The SEC rescinded the requirement, in Form N-PORT, that a fund publicly disclose, on an aggregate basis, the percentage of its investments allocated to each of the four liquidity classification categories under Rule 22e-4. This rescinded item is replaced by new Item 27(d)(7)(b) in Form N-1A that requires a brief description, in a fund's annual or semi-annual report to shareholders, of the operation and effectiveness of a fund's liquidity risk management program ("LRM program") following a fund board's periodic review of the fund's LRM program pursuant to Rule 22e-4(b)(2)(iii).

   If a fund's board reviewed the written report prepared, pursuant to Rule 22e-4(b)(2)(iii), by the LRM program administrator during the fund's most recent fiscal half-year, the brief description of the operation and effectiveness of the fund's LRM program over the past year must be included in the annual or semi-annual report to shareholders that includes the most recent fiscal half-year. If a board reviews a fund's LRM program more frequently than annually (as required by the Rule), the fund may choose to include the description of the LRM program's operation and effectiveness over the past year in either the fund's annual report or semi-annual report.

   - The March 2018 proposing release would have required a fund's annual report to include, in its Management's Discussion of Fund Performance ("MDFP"), the discussion of the operation and effectiveness of the fund's LRM program over the past year. The Release moves this discussion to a new subsection (titled, "Statement Regarding Liquidity Risk Management Program") of the fund's annual or semi-annual report.

   - Nevertheless, the Release notes that a fund's MDFP must discuss factors that materially affected performance of the fund during its most recently completed fiscal year, and that liquidity events may materially affect a fund's performance. Therefore, the Release states, to the extent a liquidity event has such an effect, it must be discussed in the fund's MDFP.

   The Release also provides that a fund should have at least one full year's experience with its LRM program before including the required brief description in the fund's shareholder report. Therefore, the compliance date of the addition of new Item 27(d)(7)(b) in Form N-1A requiring a brief discussion of a LRM program's operation and effectiveness in an annual or semi-annual report is December 1, 2019.[1] This is one year after the December 1, 2018 compliance date for funds to establish an LRM program.

Separately, because the amendments eliminate public disclosure of a fund's aggregate liquidity classification information, the SEC has moved a portion of Form N-PORT – containing the percentage of a fund's highly liquid investments that are earmarked to cover or pledged to satisfy margin requirements in connection with derivatives that are classified as less than highly liquid investments – from the public portion to the non-public portion of Form N-PORT.

2. ***Allocating Investments into More than One Liquidity Category.*** The amendments permit a fund, in three specific circumstances, to allocate its holdings of a particular instrument among more than one liquidity classification category.

- The first circumstance is when a fund has a portfolio holding that is nominally a single security, but portions of the holding have different liquidity-affecting features that justify treating the holding as two or more separate investments for liquidity classification purposes. As an example, the Release cites a fund holding an asset that includes a put option on a portion, but not all, of the fund's holding of the asset.

- The second circumstance is when sub-advisers managing sleeves of a fund have differing views regarding the appropriate liquidity classification of the same holding.

- The third circumstance would be available to a fund that, for internal risk management purposes, classifies its holdings proportionally across the four liquidity classifications, based on assumed proportional sales of entire positions to meet redemptions. For a fund employing this internal practice, the SEC believes that reporting of fund holdings proportionally across liquidity categories on Form N-PORT would be more efficient and less costly.

In all three circumstances, a fund splitting its holdings of a particular instrument into more than one classification category would be required to disclose on Form N-PORT which of the three circumstances led the fund to split the classification.

3. ***Report of Cash and Cash Equivalents.*** Form N-PORT currently does not require a fund to report the amount of cash and cash equivalents held by the fund. The amendments make additions to Form N-PORT to include information about a fund's holdings of cash and cash equivalents. The SEC will disclose this information publicly each quarter following a 60-day delay.

The compliance date for the N-PORT amendments is June 1, 2019, with the first SEC filing, containing month-end June 30 data, due July 30, 2019. As noted above, the compliance date of new Item 27(d)(7)(b) in Form N-1A affecting disclosure in annual or semi-annual reports to shareholders is December 1, 2019.

SEC Requests Comments on Intermediary Fees for Forwarding Fund Materials

With its June 5, 2018 release adopting Rule 30e-3 (described in this Ropes & Gray Alert), the SEC also published a release soliciting public comment (the "Fee Release") seeking input on the regulatory framework under which intermediaries charge fees for distributing non-proxy disclosure materials to fund investors, including shareholder reports and prospectuses ("Fund Materials"). These fees are ultimately borne by the fund and, therefore, the fund's investors.

Background. Currently, under Exchange Act Rules 14b-1 and 14b-2, broker-dealers and banks must distribute Fund Materials to their customers who are beneficial owners of the fund's shares only if the broker-dealers and banks are

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[1] This is the compliance date for "larger entities," which are funds that, together with other investment companies in the same "group of related investment companies," have net assets of $1 billion or more as of the end of the most recent fiscal year of the fund. The compliance dates for other funds is June 1, 2020.

assured reimbursement of their "reasonable expenses" from the fund. The SEC has not determined what constitutes "reasonable expenses" and, instead, has left that determination to the NYSE and FINRA. Registered funds reimburse the vast majority of intermediary firms that distribute Fund Materials to their customers based on the NYSE fee schedule rates because most intermediaries are NYSE members or members of FINRA (which has a rule that is similar to the NYSE's rules).

Broker-dealers and banks typically outsource their Fund Materials delivery obligations to a third-party service provider, which contracts with the intermediary and also acts as billing and collection agent for the intermediary for the amounts charged to funds.

Request for Comment. The Fee Release stated that, with the adoption of Rule 30e-3, a number of industry participants have expressed concerns with respect to the regulatory framework, which was designed principally for the delivery of operating company proxy materials, when applied to Fund Materials. The Fee Release solicits input on a broad variety of topics, including the following:

- Whether the current NYSE and FINRA rules regulating fees for distributing operating company materials to beneficial owners should apply to Fund Materials and, more broadly, whether Rules 14b-1 and 14b-2 are sufficiently tailored to the distribution of Fund Materials.

- Whether FINRA should determine the level of processing fees for funds, especially in view of the NYSE's observation that the NYSE "may not be best positioned to take on the regulatory role in setting fees for mutual funds."

- Whether there is parity between the fees that third-party service providers charge their intermediary clients for distribution of Fund Materials and the fees these service providers bill funds on behalf of the intermediaries.

- In a similar vein, whether there is parity between the fees that third-party service providers charge their intermediary clients for distribution of Fund Materials and the costs that a fund incurs for distributing the same Fund Materials to investors whose shares are registered directly with the fund's transfer agent.

- With respect to financial intermediaries that have entered into "sub-transfer agent" or "sub-accounting" service arrangements with funds, whether fund payments under the NYSE and FINRA rules are duplicative of fund payments for the same services under existing sub-transfer agent/sub-accounting service arrangements.

Responses to the questions raised in the Fee Release must be received by the SEC no later than October 31, 2018.

Robust 15(c) Process Does Not Prevent 36(b) Case from Proceeding to Trial

On June 13, 2018, in *In re Blackrock Mut. Funds Advisory Fee Litig.*, the U.S. District Court in New Jersey denied the defendants' motion for summary judgment in a case alleging excessive fees under Section 36(b) of the 1940 Act with respect to two funds advised by BlackRock and its affiliates; namely, the BlackRock Global Allocation Fund and the BlackRock Equity Dividend Fund (the "Funds"). As described by the court, the plaintiffs' claims were based on a "reverse manager of managers" theory that alleged BlackRock's fee was "excessive because it is substantially higher than the subadvisory fee [it] charges to perform substantially the same services as a subadviser for an independent third-party fund."

In the first part of the decision, the court made two key findings regarding the board of the Funds: (i) the 15(c) review process conducted by the board was robust and (ii) BlackRock had not misled the board or provided it with false or incomplete information. Among other factors, the court noted that the board received "extensive information" prior to its 15(c) meetings, asked follow-up questions of BlackRock and received additional information in response, and "negotiated to obtain fee concessions in favor of shareholders" twice during the relevant period (for the Equity Dividend Fund).

The court then focused on what it called the “the crux of Plaintiffs’ excessive fee claim” – the allegation that, “although BRIM [Blackrock Investment Management] provides substantially the same services for the [unaffiliated] Subadvised Funds that BRA [BlackRock Advisors] provides to the Funds, BRA’s Advisory Fee is more than double the rate of BRIM’s Subadvisory Fee.” The defendants opposed the plaintiffs’ contention and argued that “a comparison of BRA’s Advisory Fee to BRIM’s Subadvisory Fee is inapt because the scope and scale of the services that BRA provides the Funds are vastly different from the services that BRIM provides the Subadvised Funds.” Specifically, the defendants argued that, in addition to portfolio management services, BRA provided a broad range of “Support Services” to the Funds in exchange for the advisory fee. Those Support Services included services related to: (i) fund accounting, (ii) compliance programs, (iii) supporting the board in performing its duties, (iv) hiring and overseeing service providers, including the accountant, custodian and transfer agent of the Funds, (v) ensuring compliance with the Funds’ regulatory reporting and financial disclosure requirements, (vi) overseeing distribution partners and the distribution of the Funds’ shares through various distribution channels, (vii) managing dividend requirements, (viii) managing tax issues and (ix) recordkeeping.

Although the court signaled an uphill battle for plaintiffs at trial, the court ultimately held that at the pretrial stage, it could not determine “that Plaintiffs’ comparison between the [Funds’] Advisory Fee and the Subadvisory Fee is inapt as a matter of law.”

The court also found that disputes of material fact with respect to plaintiffs’ allegations concerning economies of scale and profitability precluded summary judgment. In this regard, the plaintiffs offered the testimony of Dr. Ian Ayres as an expert witness. According to Dr. Ayres, the BlackRock Funds enjoyed economies of scale as their AUM increased and costs did not increase as rapidly. The court held that evaluating the testimony of the plaintiffs’ expert witness required testimony at trial and stated “in light of the substantial disputes regarding the services that BRA actually performs for the Funds, it necessarily follows that a dispute exists regarding the ultimate question on profitability in this case – whether BRA’s profitability from the Funds is disproportionate to the services rendered.” The court also declined to endorse at summary judgment the argument that BlackRock’s profitability was within the range accepted by other courts, noting that “Section 36(b) requires a totality of the circumstances approach, and thus, a profit margin that is not excessive upon certain facts may be excessive under another.”

Regulatory Priorities Corner

The following brief updates exemplify trends and areas of current focus of relevant regulatory authorities:

OCIE Issues Risk Alert Regarding Advisers’ Best Execution Obligations

On July 11, 2018, the SEC’s Office of Compliance Inspections and Examinations (the “OCIE”) published a Risk Alert summarizing the most common deficiencies that the OCIE staff had cited in recent examinations of advisers’ compliance with the Advisers Act obligation to seek best execution for their clients. The Risk Alert stated that an adviser has a fiduciary duty to execute securities transactions for clients in such a manner that the client’s total costs or proceeds in each transaction are the most favorable to the client under the circumstances. Under well-established guidance, an adviser is required to “periodically and systematically” evaluate the execution quality of the broker-dealers it selects to execute transactions and consider “the full range and quality of a broker-dealer’s services including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser.” The adviser’s assessment of best execution may also be impacted by the adviser’s receipt of brokerage and research services under Section 28(e) of the Exchange Act.

According to the Risk Alert, the most frequent best execution issues cited by the OCIE staff in adviser examinations were:

- Advisers that did not perform best execution reviews.

- Advisers that did not consider materially relevant factors during best execution reviews, including qualitative factors such as a broker-dealer's execution capability, financial responsibility and responsiveness to the adviser.
- Advisers that did not solicit and review input from the adviser's traders and portfolio managers.
- Advisers that did not conduct comparisons of services available from other broker-dealers.
- Advisers that did not fully or accurately disclose their best execution practices.
- Advisers that did not provide full and fair disclosure in Form ADV of their soft dollar arrangements.
- Advisers that did not properly administer mixed-use allocations.
- Advisers that had inadequate compliance policies and procedures or internal controls regarding best execution.
- Advisers that did not follow their best execution policies and procedures.

SEC Requests Comment on Fund Retail Investor Experience and Disclosure

In a June 5, 2018 request for comment, the SEC solicited public comments from investors regarding how mutual funds, exchange-traded funds and other types of registered funds could enhance their disclosures documents to help investors make informed investment decisions.

- ***Fund Disclosure Content.*** The SEC is seeking comments on whether the existing disclosure regime for registered funds is useful to investors, whether investors actually rely upon the currently required disclosure documents, whether investors would like to see additional or different required content and whether investors would like the SEC to provide more tools to help compare investment choices.

- ***Fund Disclosure Delivery.*** The SEC is soliciting suggestions regarding how the delivery of fund disclosure documents can be improved to optimize when investors receive these documents relative to their investment decisions and how investors receive fund disclosure documents to ensure that an investor can easily find, access, and compare the information at a time when the information is useful to the investor. The SEC is seeking comment on (i) timing questions (*e.g.*, what fund information is helpful to an investor before an investment is made and what information is helpful after the investment), (ii) whether it is easy for investors to find and access a fund's prospectus and SAI before the purchase of shares, or do investors rely upon a financial adviser to obtain fund disclosure documents and (iii) whether the SEC should consider requiring "point-of-sale" disclosures.

  The SEC is also interested in public comments concerning the extent to which investors rely on the electronic delivery of investment and fund-related information, including whether there is still sufficient demand to retain paper delivery as the default delivery mechanism. More generally, the SEC is interested in understanding investor preferences regarding electronic updates of newly available fund disclosure documents and the promotion of electronically available information.

- ***Fund Disclosure Design.*** The SEC is requesting investor feedback on all aspects of improving how fund information is presented to investors and improving this presentation to assist investors make informed investment decisions. Among other things, the SEC seeks comments on the effectiveness of the existing summary prospectus for mutual funds and ETFs and whether a similar, layered disclosure framework might improve other fund disclosures.

Responses to the questions raised by the SEC must be received by the SEC no later than October 31, 2018.

Other Developments

Since the last issue of our Investment Management Update, we have also published the following separate Alerts of interest to the investment management industry:

2018 Proposed ETF Rulemaking – Summary and Analysis
July 10, 2018
This Alert summarizes and analyzes the SEC's recent rule proposal relating to the organization and operation of ETFs. The SEC's proposal seeks to create a consistent, transparent, and efficient regulatory framework for ETFs and to facilitate greater competition and innovation among ETFs. If adopted as proposed, the proposed rule would significantly alter the regulatory landscape for ETFs and level the playing field for both existing ETF sponsors and new entrants in the ETF market.

Proposed ETF Rule Seeks to Expand the ETF Market and Streamline the Requirements for Launching and Operating ETFs
July 3, 2018
As expected, the proposed ETF rule (the "Rule") codifies many aspects of the exemptive relief necessary to form and operate an ETF. The Rule also makes substantial progress toward other Staff goals, including leveling the regulatory landscape for ETF sponsors and bolstering the efficient operation of the arbitrage mechanism that supports an ETF's shares trading at a market price approximating the shares' net asset value. This Alert is a summary of certain key aspects of the Rule and some preliminary observations.

SEC Adopts Rule Permitting Notice-and-Access "Delivery" of Shareholder Reports
June 26, 2018
In a June 5, 2018 Release, the SEC adopted new Rule 30e-3 under the 1940 Act (the "Rule"). Subject to conditions, the Rule will permit registered funds to satisfy their obligations to transmit annual and semi-annual reports to shareholders by making them accessible at a website address specified in a written notice mailed to shareholders. Funds are already permitted to rely on similar "notice-and-access" rules to furnish proxy statements to shareholders and statutory prospectuses to holders of summary prospectuses.

The Rule's effective date is January 1, 2019. However, the Rule specifies a minimum two-year transition period. Any fund that seeks to rely on the Rule prior to January 1, 2022 (*i.e.*, the end of the extended transition period) must satisfy additional conditions.

SEC Director Hinman's Remarks Confirm that Ether and Bitcoin Are Not Securities
June 18, 2018
On June 14, 2018, speaking at the Yahoo Finance All Markets Summit: Crypto event in San Francisco, William Hinman, Director of the SEC's Division of Corporation Finance, made news when he definitively stated that neither bitcoin (BTC) nor ether (ETH) are securities, and that offers and sales of these cryptocurrencies are not securities transactions. He also indicated that even though the initial issuance of a digital asset may have represented a securities offering, once the asset is no longer controlled by a central authority or used primarily to purchase goods or services on a functioning network, it may not make sense to regulate the digital asset as a security.

Director Hinman provided a series of factors to be used to analyze whether any particular digital asset offering should be considered an "investment contract" under the test outlined in *SEC v. W.J. Howey Co.* and, therefore, his remarks provide clear criteria for when a digital asset offering may not involve a security.

Separately Managed Accounts – SEC Resolves One "Inadvertent Custody" Ambiguity
June 13, 2018
On June 5, 2018, the SEC's Division of Investment Management supplemented its Staff Responses to Questions About the Custody Rule to respond to a significant ambiguity in its prior custody guidance for investment advisers to separately managed accounts. Specifically, in its response to new Question II.11 (the "Response"), the SEC staff clarified that, when an adviser does not have a copy of a client's custody agreement and does not know, or have

reason to know, whether the agreement would give the adviser inadvertent custody, the Division would not recommend enforcement under Rule 206(4)-2 of the Advisers Act (the "Custody Rule"), provided the adviser did not recommend, request or require that a client engage the client's custodian.

However, the Response does not address the questions raised in the SEC staff's prior guidance concerning whether all investments must settle on a "delivery versus payment" basis in order to rely on the "authorized trading" exemption from the Custody Rule.

GDPR and the Funds Industry
June 1, 2018
In this Alert, Ropes & Gray's investment management and cybersecurity initiative examines the impact of the GDPR on the funds industry, with a focus on the regulation's effect on non-EU-based funds and advisers. Given that one of the express aims of the GDPR is to broaden the territorial scope of the European privacy regime, processing activities of funds and advisers are covered if the fund or adviser (1) offers goods and services to individuals in the EU or (2) monitors the behavior of EU-located individuals.

If you would like to learn more about the developments discussed in this Update, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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