December 13, 2018

Ropes & Gray's Investment Management Update – October-November 2018

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

SEC Announces Exam Initiatives Focused on Specific Types of Funds/Advisers

On November 8, 2018, the SEC's Office of Compliance Inspections and Examinations (the "OCIE") published a Risk Alert announcing the OCIE's risk-based examination initiatives of mutual funds (including ETFs) and their advisers that fall within one or more of six categories:

1. Index funds that track custom-built indexes;
2. Smaller ETFs and/or ETFs with little secondary market trading volume;
3. Mutual funds with higher allocations to certain securitized assets;
4. Funds with aberrational underperformance relative to their peer groups;
5. Advisers relatively new to managing mutual funds; and
6. Advisers who provide advice to both mutual funds and private funds that have similar strategies and/or are managed by the same portfolio managers.

With the exception of the last category (side-by-side management), all of the Risk Alert's examination initiatives appeared in the OCIE's *Examination Priorities for 2018* (published in February 2018). The Risk Alert describes the OCIE's rationale for focusing on funds and advisers within each examination initiative category, as well as the information sought by the OCIE from funds and advisers within each category. Funds and advisers that fall within a category and their CCOs should carefully review the Risk Alert's descriptions of the information that will be requested by the OCIE.

SEC Issues Risk Alert on Adviser Compliance with the Cash Solicitation Rule

On October 31, 2018, the OCIE published a Risk Alert summarizing the most common deficiencies that the OCIE staff cited in recent examinations of advisers' compliance with Rule 206(4)-3 under the Advisers Act (the "Cash Solicitation Rule").

The Cash Solicitation Rule generally prohibits registered investment advisers from paying a cash fee, directly or indirectly, to any person who solicits clients for the adviser (a "solicitor"), unless the arrangement complies with certain conditions, including (i) the cash fee is paid pursuant to a written solicitation agreement and (ii) the solicitor is not subject to certain enumerated disqualifications. Additional conditions apply if a solicitor is not a partner, officer, director or employee of the adviser or its affiliates (a "third-party solicitor"), including requirements that a prospective client is provided with, and acknowledges receipt of, certain specified disclosures regarding the solicitation arrangement. The adviser must also make a bona fide effort to determine whether the third-party solicitor has complied with the written solicitation agreement.

The Risk Alert listed the following as "some of the most frequent deficiencies" that the OCIE staff has identified concerning compliance with the Cash Solicitation Rule:

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- Third-party solicitors that did not provide the required solicitor disclosure documents to prospective clients or provided documents that did not contain all information required by the Cash Solicitation Rule.
- Advisers that did not receive signed and dated client acknowledgements of receipt of required disclosure documents.
- Advisers that paid cash fees to solicitors without a solicitation agreement in place or pursuant to an agreement that did not contain provisions required by the Cash Solicitation Rule.
- Advisers that did not make a bona fide effort to ascertain whether third-party solicitors complied with the solicitation agreement.

SEC Opinion Provides Guidance on CCO Liability

On October 29, 2018, the SEC issued an opinion in *In the Matter of the Application of Thaddeus J. North* that provides helpful guidance regarding whether sanctions for compliance violations should be imposed on CCOs of FINRA member firms. The decision arose from an appeal from a FINRA disciplinary action involving Mr. North, former CCO of a FINRA member. Among other things, the SEC affirmed FINRA's determination that North had violated NASD Rule 3070(a)(9)[1] by failing to report a business relationship between an associated person of his firm and a person he knew was subject to "statutory disqualification," as defined in Exchange Act Section 3(a)(39).

As a basis for appeal, North argued that he could not be held liable for a violation of NASD Rule 3070, because the rule applied only to the firm and not to him personally. In rejecting this argument, the SEC made a number of statements about the standards that apply to the conduct of CCOs in performing their duties:

> [Our prior] decisions reflect the principle that, in general, good faith judgments of CCOs made after reasonable inquiry and analysis should not be second guessed. In addition, indicia of good faith or lack of good faith are important factors in assessing reasonableness, fairness and equity in the application of CCO liability.
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> While matters involving the determination of CCO liability are facts and circumstances specific, there are matter types where determinations of individual liability generally are straightforward. For example, absent unusual mitigating circumstances, when a CCO engages in wrongdoing, attempts to cover up wrongdoing, crosses a clearly established line, or fails meaningfully to implement compliance programs, policies, and procedures for which he or she has direct responsibility, we would expect liability to attach. In contrast, disciplinary action against individuals generally should not be based on an isolated circumstance where a CCO, using good faith judgment makes a decision, after reasonable inquiry, that with hindsight, proves to be problematic. When the facts and circumstances of matters fall outside these relatively clear examples of where liability should or should not attach, liability determinations will require matter-specific analysis and informed judgment.

The SEC affirmed FINRA's determination that North plainly knew of the business relationship between an associated person of his firm and a person whom North knew was subject to a statutory disqualification, but failed to inquire into the relationship or to report the relationship to FINRA. The SEC noted that North was responsible for reporting the relationship regardless of whether the relationship involved misconduct.

[1] NASD Rule 3070 required members to report to FINRA "not later than 10 business days after the member knows or should have known" that one of its associated persons was "associated in any business or financial activity with any person who is subject to a 'statutory disqualification.'" FINRA Rule 4530, effective July 1, 2011, superseded NASD Rule 3070.

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SEC Proposes Variable Products Summary Prospectus and "Notice and Access" for Underlying Fund Prospectuses – May Implicate Fund Prospectus Delivery Generally

In an October 30, 2018 proposing release (the "Release"), the SEC proposed Rule 498A under the Securities Act to permit, for the first time, the use of a summary prospectus to satisfy prospectus delivery obligations under Section 5 of the Securities Act for variable life and variable annuity contracts ("variable contracts") issued by an insurer's separate account.

- Rule 498A, along with other rule and form amendments in the Release, also would permit mutual funds that are investment options offered under variable contracts to satisfy prospectus delivery obligations by relying on an optional "notice and access" framework.

- The Release may represent the first steps towards a notice-and-access delivery framework to satisfy mutual fund prospectus delivery obligations more generally.

A discussion of the Release follows.

Proposed Summary Prospectuses

A. Variable Contract Summary Prospectuses. Variable contracts are generally securities under the federal securities laws. A "separate account" established by the sponsoring insurance company is the legal entity that registers these securities. Most separate accounts are organized as a unit investment trust. A unit investment trust registers its securities with the SEC (each such registrant, a "UIT") either on Form N-4 (variable annuity contracts) or Form N-6 (variable life contracts).[2] A UIT is further divided into subaccounts, each of which invests in the shares of a mutual fund that is an "investment option" offered under a variable contract.

As issuers of variable contracts, UITs currently maintain their offering documents by filing annual post-effective amendments to Forms N-4 and N-6 and supplementing (or stickering) their prospectus or SAI, as necessary. This regime is similar to mutual funds' Form N-1A practices. After an annual update, a variable contract issuer generally sends the new statutory prospectus to all variable contract holders accompanied by prospectuses for the mutual funds that serve as underlying investment options.

The Release, including Rule 498A and related rule and form amendments, contemplates two types of variable contract summary prospectuses: (i) an "initial summary prospectus" to be provided to first-time variable contract investors and (ii) an "updating summary prospectus" to be provided to existing investors.[3]

1. An initial summary prospectus would be limited to a description of a single variable contract offered under the related statutory prospectus, and would contain specific key information about the variable contract, including the contract's most salient components, risks and benefits. The initial summary prospectus would be "sent or given no later than the time of the carrying or delivery of the contract security" to satisfy prospectus delivery obligations.

[2] According to the Release, in 2017, there were (i) five variable annuity separate accounts registered as management investment companies on Form N-3, (ii) 435 variable annuity separate accounts registered as UITs on Form N-4 and (iii) 238 variable life insurance separate accounts registered as UITs on Form N-6. Because most separate account registrants are UITs, the discussion that follows is limited to UITs.
[3] Use of either type of summary prospectus to satisfy a variable contract issuer's prospectus delivery obligations would be optional.

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2. An updating summary prospectus would normally contain a short description of certain changes to the variable contract(s) effected during the previous year, along with a subset of the information in the initial summary prospectus. An updating summary prospectus would be permitted to describe one or more variable contracts offered under the related statutory prospectus.

Both an initial summary prospectus and an updating summary prospectus would be required to have an appendix that provides summary information about the mutual funds that are underlying investment options offered under a variable contract, including each fund's adviser and subadviser, expense ratio and average annual total returns over the past one-year, five-year and 10-year periods, along with a hyperlink to a website where contract holders can find the prospectuses and other information about the mutual funds that serve as underlying investment options.

Reliance on Rule 498A would also be conditioned on (i) public availability of the variable contract's current initial summary prospectus, updating summary prospectus, statutory prospectus and SAI at a website address hyperlinked to, or identified on, the cover page or beginning of a related summary prospectus and (ii) the ability of any recipient of a variable contract summary prospectus to request and receive, either on paper or electronically, the variable contract's statutory prospectus and SAI.

B. Prospectuses of Underlying Mutual Fund Investment Options. The Release, including Rule 498A and related rule and form amendments, also provides for a mutual fund that is an investment option offered under a variable contract to satisfy its prospectus delivery obligations.

As proposed, a mutual fund's prospectus delivery obligations would be satisfied if (i) an initial summary prospectus is used for each currently offered variable contract within the UIT's registration statement, (ii) a summary prospectus is used by the mutual fund, (iii) the mutual fund's summary and statutory prospectuses, SAI and most recent shareholder reports under Rule 30e-1 of the 1940 Act are available online at a website address hyperlinked to, or identified on, the cover page or beginning of the variable contract's summary prospectus and (iv) any recipient of a variable contract summary prospectus may request and receive, either on paper or electronically, the items listed in (iii).

C. Format and Contents of Variable Contract Summary Prospectus. Along with a hyperlink to the Release, the SEC website contains both a Hypothetical Initial Summary Prospectus and a Hypothetical Updating Summary Prospectus (both hypothetical documents also appear as appendices in the Release). The Release proposes changes to Forms N-3, N-4 and N-6 to implement Rule 498A's summary prospectus framework, and these forms, with proposed amendments, are also available on the SEC website (Form N-3, Form N-4 and Form N-6).

Comment Period

In the Release, the SEC requested public comments on a broad variety of topics. Comments must be received by the SEC no later than February 15, 2019.

Observations

Variable contract prospectuses are frequently lengthy and complex, and industry practice is to bundle the summary prospectuses of mutual funds that serve as underlying investment options with the variable contract prospectus. Consequently, the disclosure documents delivered to first-time variable contract purchasers and annually thereafter are often voluminous. The Release's proposals would streamline variable contract disclosure for investors.

Separately, the proposed approach to satisfy a mutual fund's prospectus delivery obligations is noteworthy because, as the Release stated, it "incorporates aspects of the 'access equals delivery' framework." The SEC also stated in the Release:

In proposing new rule 498A, we are considering approaches that could affect, and raise the possibility of future amendments to, certain parallel provisions of rule 498 and certain of our registration forms applicable to other types of registered investment companies.

The SEC's statement comes against the backdrop of recently adopted Rule 30e-3 under the 1940 Act, applicable to fund shareholder reports, which follows a notice-and-access delivery approach. In fact, in the Rule 30e-3 adopting release, the SEC stated that it "may consider in the future an electronic or notice and access delivery framework for documents other than shareholder reports."

Whether the SEC contemplates amending Rule 498 to permit a notice-and-access framework for the delivery of funds' summary prospectuses in other contexts is unknown. The most that can be said is that the Release may represent the first steps towards such a framework.

SEC Adopts Safe Harbor for Broker-Dealers' Research of Registered Funds, BDCs and ETPs

In a November 30, 2018 adopting release, the SEC adopted Rule 139b under the Securities Act to create a safe harbor for independent broker-dealers participating in a securities offering of a "covered investment fund" to publish or distribute a "covered investment fund research report." If the conditions of Rule 139b are satisfied, a broker-dealer's publication or distribution of such a report will not be deemed to constitute an offer to sell the covered investment fund's securities for purposes of Sections 2(a)(10) and 5(c) of the Securities Act, even if the broker-dealer is participating in a registered offering of the covered investment fund's securities. A discussion of the Rule, which will become effective January 14, 2019, follows.

Rule 139b and Its Requirements

Rule 139b is a result of the Fair Access to Investment Research Act of 2017 (the "FAIR Act"), which directed the SEC to adopt rule amendments to extend the safe harbor in existing Rule 139. Rule 139 permits the publication or distribution of research reports concerning one or more issuers by a broker-dealer participating in a registered offering of one of the covered issuers' securities.[4] The FAIR Act also specified that the rule amendments shall be "upon such terms, conditions, or requirements" as the SEC may determine necessary or appropriate.

Rule 139b defines covered investment fund to include (i) registered investment companies (including a series or class thereof), (ii) investment companies that have filed an election to be treated as a business development company ("BDCs") and (iii) certain commodity- or currency-based trusts or funds.[5] A covered investment fund research report must be published by an independent broker-dealer and, therefore, is defined as a research report published or distributed by a broker-dealer about a covered investment fund (or its securities), excluding a research report published or distributed by (i) the covered investment fund or any affiliated person of the covered investment fund or (ii) a broker-dealer that is the investment adviser, or an affiliated person of the investment adviser, for the covered investment fund.

Rule 139b requires that a covered investment fund research report be either an issuer-specific research report or an industry report.

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[4] Broadly speaking, Rule 139 is currently available only with respect to research reports covering an issuer that meets the requirements to offer securities on Form S-3. Typically, this means that the issuer has (i) outstanding voting and non-voting common equity held by non-affiliates with a market value of at least $75 million and (ii) filed all periodic reports required by the Exchange Act during the preceding 12 months.
[5] The commodity- or currency-based trust or fund must (i) be issuing securities registered under the Securities Act that are listed for trading on an exchange, (ii) have assets consisting primarily of commodities, currencies or derivative instruments that reference commodities or currencies and (iii) reflect in its registration statement that its securities may be purchased or redeemed, subject to conditions or limitations, for a ratable share of its assets.

A. ***Issuer-Specific Research Reports***

1. If the covered investment fund is a registered investment company, an issuer-specific research report must, as of the date of a broker-dealer's reliance on Rule 139b, concern a covered investment fund that has been subject to the reporting requirements of Section 30 of the 1940 Act for at least twelve calendar months and that has filed in a timely manner all required 1940 Act reports during the immediately preceding twelve calendar months.[6]

2. If the covered investment fund is not a registered investment company, the covered investment fund must have been subject to the reporting requirements of Sections 13 or 15(d) of the Exchange Act for at least twelve calendar months and filed in a timely manner all required Forms 10-K and 10-Q during the immediately preceding twelve calendar months.

3. At the time of the broker-dealer's initial publication or distribution of a research report on the covered investment fund (or re-initiation thereof), and at least quarterly thereafter:

    a. If the covered investment fund is a registered investment company or BDC, the aggregate market value of voting and non-voting common equity held by affiliated persons and non-affiliated persons – or, in the case of a registered open-end investment company (other than an ETF), its NAV (including the NAV of shares held by affiliated persons and non-affiliated persons) – must be at least $75 million.[7]

    b. If the covered investment fund is a commodity- or currency-based trust or fund, the aggregate market value of voting and non-voting common equity held by non-affiliated persons must be at least $75 million.

4. The broker-dealer must be publishing or distributing research reports in the regular course of its business and, in the case of a research report regarding a covered investment fund that does not have a class of securities in "substantially continuous distribution," the publication or distribution must not be (i) the initiation of publication of research reports about the covered investment fund or its securities or (ii) the re-initiation of publication following discontinuation of publication of such research reports.

    a. The "regular course of business" and initiation/re-initiation provisions are intended to reduce the possibility that covered investment fund research reports are used as a means to circumvent the prospectus requirements of the Securities Act.

    b. The FAIR Act prohibits Rule 139b from applying the initiation/re-initiation prohibition in the case of a covered investment fund with a class of securities in substantially continuous distribution. In the adopting release, the SEC stated that the test of whether a class of securities is in substantially continuous distribution will be based on an analysis of facts and circumstances. However, the SEC confirmed that "substantially continuous distribution" includes (i) traded registered closed-end investment companies and BDCs engaged in at-the-market offering programs over consecutive quarters pursuant to Securities Act Rule 415(a)(4) and (ii) other types of funds that are engaged in a "continuous" offering pursuant to Rule 415(a)(1)(ix).

[6] The relevant reports are Forms N-CSR, N-Q, N-PORT, N-MFP (if applicable) and N-CEN.
[7] The Rule refers to General Instruction I.B.1 to Form S-3. This amount is currently $75 million.

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B. ***Industry Reports***

1. An industry report must, as of the date of a broker-dealer's reliance on Rule 139b, concern a covered investment fund that is subject to the reporting requirements of Section 30 of the 1940 Act (*i.e.*, no twelve-month requirement). If the covered investment fund is not a registered investment company, then the fund must be subject to the reporting requirements of Section 13 or Section 15(d) of the Exchange Act (*i.e.*, no twelve-month requirement).

2. An industry report must contain (a) similar information with respect to a "substantial number of covered investment fund issuers of the issuer's type" (*e.g.*, money market funds, bond funds, balanced funds) or investment focus (*e.g.*, primarily the same industry or country or geographic region) or (b) a comprehensive list of covered investment funds currently recommended by the broker-dealer – excluding any covered investment fund that is advised by the broker-dealer (or by an affiliated person of the broker-dealer) and any covered investment fund that is an affiliated person of the broker-dealer.

3. The industry report's analysis of a covered investment fund may not be given materially greater space or prominence than that accorded any other covered investment fund in the publication.

4. The broker-dealer must be publishing or distributing industry research reports in the regular course of its business. In the case of an industry research report regarding a covered investment fund that does not have a class of securities in substantially continuous distribution, the broker-dealer must be including similar information about the covered investment fund in similar industry reports.

C. ***Presentation of Standardized Performance***

1. Any issuer-specific research report or industry report that presents performance information for a covered investment fund that is a registered open-end fund (or series or class thereof) must present the performance information in accordance with the presentment and timeliness requirements of Rule 482 under the Securities Act (*i.e.*, paragraphs (d), (e) and (g) of Rule 482).

2. Any issuer-specific report or industry research report that presents performance information for a covered investment fund that is a registered closed-end fund must present the performance information in accordance with instructions to Item 4.1(g) of Form N-2; provided, however, that other historical measures of performance may also be included if any other measurement is set out with no greater prominence than the measurement presented in accordance with the instructions to Item 4.1(g) of Form N-2.

Observations

Rule 139b should enhance the ability of broker-dealers to publish independent, third-party research during a registered securities offering by a covered investment fund, leading to better informed investors and markets. Covered investment funds are likely to benefit from greater independent broker-dealer coverage of their product offerings.

Additions to Investment Company Reporting Modernization FAQs

On November 14, 2018, the Division of Investment Management added several new FAQs to its website to respond to more questions arising under the SEC's Investment Company Reporting Modernization initiative adopted in October 2016 and revised in December 2017. Salient points from the new FAQs are summarized below.

- **Rule 22e-4-Related Phase-In (Form N-CEN).** Form N-CEN's compliance date for Item C.20 (lines of credit, interfund lending) and Item E.5 (an ETF's status as an In-Kind ETF) is December 1, 2018. However, a fund with a fiscal year-end that falls before December 1, 2018 that files a Form N-CEN on or after that date should not include a response to Items C.20 and E.5 in its report. Instead, the fund should begin responding to these two Form N-CEN items in its fiscal years that end on or after December 1, 2018.

- **Monthly Returns (Form N-PORT).** Item B.5(a) of Form N-PORT requires monthly total returns of the fund for each of the preceding three months to be reported in accordance with the methodologies outlined in the fund's registration statement (*e.g.*, Item 26(b)(1) of Form N-1A). The disclosures in registration statements are intended for annual reporting, while information provided on Form N-PORT will be reported monthly. The FAQ notes that, although both Forms N-1A and N-PORT require that sales loads and redemption fees must be deducted when calculating returns, there is no prescribed methodology for funds to pro-rate sales loads and redemption fees for purposes of reporting a net monthly result. Therefore, to assure consistency of the Form N-PORT monthly return information across funds responding to Item B.5(a), funds can report monthly returns without deducting sales loads and fees. Funds reporting returns without deducting sales loads and redemption fees should note this in Part E (explanatory notes to Form N-PORT).

- **Liquidated Funds (Forms N-PORT and N-CEN).** If a fund has liquidated, merged or is otherwise terminated and has no remaining investors or investments, but the registrant has not yet deregistered, the fund is not required to file reports on Form N-PORT. A new Form N-CEN FAQ (#6) discusses a registrant's filing obligations where the registrant (i) has filed, or intends to file, an application to deregister but has not yet deregistered or (ii) is a series of a multi-series registrant that was liquidated or otherwise terminated.

- **New Fund (Form N-PORT).** A new fund whose registration statement under the Securities Act has been declared effective or has become effective automatically, and whose shares have not yet been publicly offered, is not required to file reports on Form N-PORT. A new fund that publicly offers its shares for the first time is required to file its first report on Form N-PORT no later than 30 days after the end of the month of the first public offering, reflecting the fund's portfolio as of the end of that month.

- **Certain Derivatives (Form N-PORT).** The FAQs also explain in more detail Form N-PORT disclosures required by Article 12 of Regulation S-X with respect to certain derivatives for which the underlying asset is an index or custom basket of investments.

IM's Director Speaks on Division's Priorities and Perspectives

ICI Securities Law Developments Conference. On October 25, 2018, in the keynote address at the Investment Company Institute's Securities Law Developments Conference in Washington, D.C., Dalia Blass, Director of the SEC's Division of Investment Management (the "Division"), focused on three subjects: (i) fund disclosure, (ii) derivatives rulemaking and (iii) staff guidance.

Regarding fund disclosure, Ms. Blass said that the first step to improve the experience of retail investors is to improve fund disclosure. She offered several suggestions for improvement, stating first that "a fund's prospectus and summary prospectus should tell the story of the fund." Ms. Blass questioned the usefulness of principal risk disclosure that is presented in alphabetical order. Ms. Blass also questioned the use of generic risk disclosures that are not tailored to a particular fund as another area for improving disclosure. She cited as an example a fund that includes lengthy derivatives risk disclosures but invests almost entirely in common stock although it "may" use derivatives under certain circumstances. She said the Division staff has brought to her attention similar problems with respect to "go anywhere funds" that have disclosures covering many types of securities, but actually invest in only one or a few of those asset classes or types of securities.

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Ms. Blass urged disclosure authors to "write clearly and concisely" and cited several examples of disclosure do not follow this principle, including (i) "summary" risk disclosure that is identical to the full-scale risk disclosure in the statutory prospectus and (ii) disclosure "so full of jargon that even [Division] staff – who review fund disclosures for a living – pull out the reference guides."

Ms. Blass also reported that the Division is working on a re-proposal of the SEC's 2015 derivatives rulemaking, but has not yet settled on an approach. Ms. Blass offered a list of a few of the questions with which the Division is grappling (*e.g.*, "How can we honor the policy of the 1940 Act while providing sufficient flexibility? Is there an approach that provides meaningful boundaries for the use of derivatives while recognizing the diversity of funds and the benefits derivatives can provide when used responsibly? What role should risk management play?").

Finally, Ms. Blass discussed SEC Chairman Jay Clayton's September 2018 statement to the effect that all statements by the SEC staff are nonbinding on the SEC and create no enforceable legal rights or obligations against the SEC or other parties. Ms. Blass said that she believed the Chairman's statement "reaffirmed what we all knew already."

2018 Fund Directors Conference. In an October 16, 2018 speech at the Independent Directors Council's Fund Directors Conference, Ms. Blass discussed some of the key lessons the Division has learned from its Board Outreach Initiative. Ms. Blass said that, based on her meetings with fund boards, she saw a striking amount of overlap regarding "what directors believe boards should be doing and where they believe existing requirements are not serving investors as well as they should." She highlighted three questions that directors consistently ask to help organize their oversight:

1. Are we seeing the quality of service we expect from the fund's service providers?
2. Are the costs of the fund reasonable?
3. Is the fund delivering the performance that investors would expect?

Ms. Blass then noted that directors are concerned about the line between oversight and management. She stated that the Board Outreach Initiative has revealed that directors want to focus their time on the inquiries that are more likely to reveal problems. She cited the requirement that boards make a quarterly determination that all cross-trades by a fund were made in compliance with compliance procedures adopted pursuant to Rule 17a-7. Ms. Blass stated that directors question the value of a board's trade-by-trade review. Instead, she said, directors want to focus on inquiries that are more likely to reveal problems (*e.g.*, "Why is a fund crossing? How does that compare to similar funds in the complex?"). In fact, Ms. Blass noted, directors believe the "right conversation" may go beyond specific legal requirements and require directors to track and discuss trends and developing issues that may affect funds in the context of quality, cost and performance.

Ms. Blass noted that the Board Outreach Initiative has shown that directors want clarity from regulators regarding their responsibilities, but not if clarity means sacrificing effectiveness. She said, "Directors want principles, not checklists." In particular, Ms. Blass noted, she has heard from directors that boards believe the flexibility provided by Rule 38a-1 is a good model because it "strengthens the hand of fund boards and compliance personnel in a way that is principles-based, allowing funds the flexibility to tailor compliance policies and procedures to the needs of that particular fund."

Ms. Blass next said that the Division has started to utilize what it has learned from the Board Outreach Initiative and has developed an internal framework that it will use as it develops a recommendation for board involvement when evaluating an existing obligation. The framework is based on the following four questions:

1. Should a given regulatory action require board engagement, and if so, what is the policy goal for the board's involvement?

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2. When the staff recommends board involvement, is it necessary to require a specific board action or can we instead focus on the goal and leave the means to the board?

3. Are the board responsibilities prescribed consistent with the board's oversight and policy role?

4. Are the board responsibilities clear, up-to-date and consistent with other regulatory actions?

She noted that the staff used this framework in connection with the issuance of a recent no-action letter (described in a prior Ropes & Gray Investment Management Update) that permits directors to rely on quarterly written representations from a fund chief compliance officer ("CCO"), instead of a board making determinations that fund transactions effected pursuant to exemptive Rules 10f-3, 17a-7 or 17e-1 under the 1940 Act complied with written procedures.

REGULATORY PRIORITIES CORNER

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

Adviser Allegedly Fails to Apply AUM Fee Discounts to Client Accounts

On November 19, 2018, the SEC issued an order announcing a settled enforcement matter involving an investment adviser. The SEC alleged that the adviser failed to apply advisory fee discounts to certain client accounts, contrary to the clients' advisory agreements and the adviser's representations to clients. Throughout an eight-year period, the SEC alleged that the adviser failed to aggregate its clients' assets under management in accounts held by the same client or clients in the same household, resulting in the adviser failing to apply the breakpoints reflected in the advisory agreements and overcharging 293 client accounts by approximately $304,000. The adviser refunded the clients all overcharged fees with interest.

The adviser retained a compliance consultant to conduct a review of its written compliance policies and procedures regarding advisory fees and Form ADV disclosures. The adviser also improved its billing automation. Without admitting or denying the SEC's allegations, in settling the matter, the adviser agreed to be censured and to pay a civil penalty of $50,000.

Cryptocurrency Developments

1. In a September 26, 2018 decision, the U.S. District Court for the District of Massachusetts denied My Big Coin Pay Inc.'s ("MBCI") and related defendants' motion to dismiss the CFTC's anti-fraud suit on the grounds that the CFTC failed to state a claim. The defendants argued that "My Big Coin" ("MBC"), the cryptocurrency involved in MBCI's alleged scheme, was not a "commodity" within the meaning of the Commodity Exchange Act (the "CEA") because "contracts for future delivery" are not "dealt in" (*i.e*., do not underlie) MBC. The court rejected this argument, reasoning that the CEA's definition of commodity was broader than any particular type or brand of a commodity. The court noted that Congress' approach to defining "commodity" showed its intent for courts to focus on categories when determining whether the CEA commodity definition's "dealt in" requirement is satisfied. The court held that, because another cryptocurrency, Bitcoin, already underlies futures contracts, other cryptocurrencies, including MBC, were commodities. The court stated that the CEA "only requires the existence of futures trading within a certain class (*e.g.* 'natural gas') in order for all items within that class (*e.g.* 'West Coast' natural gas) to be considered commodities."

2. On November 8, 2018, the SEC agreed to settle an enforcement action, *In the Matter of Zachary Coburn*, in which the SEC alleged that the respondent had been operating an unregistered "exchange" as defined by Section 3(a)(1) of the Exchange Act and Rule 3b-16 thereunder.

3. On November 16, 2018, the SEC's Divisions of Corporation Finance, Investment Management, and Trading and Markets issued a *Statement on Digital Asset Securities Issuance and Trading* (the "Statement"), summarizing SEC enforcement actions occurring at "the intersection of long-standing applications of our federal securities laws and new technologies." The Statement includes cryptocurrency developments discussed in Ropes & Gray's September 2018 Client Alert, including (i) *In the Matter of Crypto Asset Management, LP*, in which the SEC announced its first enforcement action against a hedge fund manager for allegedly violating provisions of the Securities Act, the Advisers Act and the 1940 Act in connection with the sale of interests in a private investment fund focused on digital assets and (ii) *In The Matter of TokenLot LLC*, the SEC's first enforcement matter involving an entity's status as an unregistered broker-dealer due to its alleged activities taking customer orders and funds for payments in both initial coin offerings ("ICOs") and digital token transactions on secondary markets.

The Statement also highlights the SEC's new FinHub website, which includes a link to the Cyber Enforcement Actions list of actions involving digital assets and ICOs.

ICI Files Comment Letter Calling for Changes to Processing Fee Framework

On October 31, 2018, the Investment Company Institute (the "ICI") filed a comment letter in response to the SEC's June 5, 2018 *Request for Comments on the Processing Fees Charged by Intermediaries for Distributing Materials Other Than Proxy Materials to Fund Investors*. The ICI expressed the view that the current regulatory framework – regulating fees that intermediaries charge funds for distributing certain disclosure materials to fund investors (*e.g.*, shareholder reports and prospectuses) – fails to address the conflict of interest that exists between intermediaries, who typically select the vendors that forward fund materials to their clients, and mutual funds, who pay the bills of those vendors. The ICI noted that the fee schedule contained in the New York Stock Exchange Rules sets forth the maximum rates that an intermediary can reasonably charge a fund for reimbursement. The ICI highlighted that it is common practice for the vendor to charge the maximum allowable rate to the fund and, then, to rebate a portion of the payment to the intermediary. Accordingly, the intermediary has no incentive to negotiate a lower fee for the benefit of shareholders, and intermediaries do not disclose these fees to their customers. The ICI also cited a recent ICI survey that found a fund typically pays three times the median cost (from its survey) in processing fees for mailing the same shareholder report to an intermediary-held account compared to an account held directly with the fund, and five times the survey median cost for a shareholder report that is emailed. To resolve the problems that arise from the conflict of interest, the ICI recommended that the SEC amend certain rules to allow funds, rather than intermediaries, to select the vendor and negotiate the fees that will be paid for distributing disclosure materials to fund investors.

ICI Recommendations to Enhance 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. In response, the ICI filed a comment letter on October 24, 2018 that included the following recommendations:

Summary Shareholder Reports. The ICI believes that the SEC should propose a new, optional summary shareholder report, which would contain key information, including instructions on how to access a full-length shareholder report. This recommendation expands upon the mandatory paper notice under recently adopted Rule 30e-3 that must be sent to an investor each time a current shareholder report is accessible. The ICI recommended that the notice also include instructions for how an investor could elect to prospectively receive either summary shareholder reports or full-length shareholder reports in paper, or make individual requests to receive particular reports, either in summary or full-length form.

"Notice and Access" Prospectus Delivery. In the Rule 30e-3 adopting release, the SEC stated that it "may consider in the future an electronic or notice and access delivery framework for documents other than shareholder reports." The ICI picked up on this point and recommended that the SEC adopt a similar approach for delivering funds' prospectuses and summary prospectuses as permitted by Rule 30e-3 for shareholder reports. Thus, firms would have the option of sending investors (i) a notice informing them that a summary prospectus and statutory prospectus are available (on-line or in paper form, if requested), (ii) a summary prospectus or (iii) a statutory prospectus.

SEC Rejects Certain Market Data Fees Charged by Exchanges

On October 16, 2018, the SEC issued an opinion in an appeal of an administrative law judge's decision rejecting challenges by the Securities Industry and Financial Markets Association ("SIFMA") to certain market data fees charged by two national securities exchanges, NYSE Arca, Inc. and Nasdaq Stock Market LLC. The SEC disagreed with the ALJ and held that the exchanges had not provided sufficient factual and legal support to continue to charge those fees and, therefore, failed to demonstrate that the challenged fees are fair and reasonable and not unreasonably discriminatory, as required under the Exchange Act.

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:

SEC Adopts Safe Harbor for Broker-Dealers' Research of Business Development Companies and Other Investment Funds

December 11, 2018

On November 30, 2018, the SEC adopted Rule 139b under the Securities Act of 1933, which establishes a non-exclusive safe harbor for independent broker-dealers participating in securities offerings of business development companies ("BDCs") and other "covered investment funds" that publish or distribute research reports on these investment funds, without the research reports being deemed offers to sell the investment funds' securities that otherwise could be in violation of the Securities Act. A discussion of the new rule, which will become effective 30 days after publication of the SEC's adopting release in the Federal Register, follows.

Declining to Follow *Northstar*, New York Federal Court Dismisses Breach of Contract Claim Against Mutual Fund for Purported Violation of Concentration Policy

October 24, 2018

In a victory for the mutual fund industry, a federal district court in New York rejected the attempt of fund shareholders to assert a breach of contract claim against the fund for a purported violation of an investment policy contained in part of the fund's prospectus. In doing so, Judge George B. Daniels of the U.S. District Court for the Southern District of New York in *Edwards v. Sequoia Fund, Inc.* declined to follow the Ninth Circuit's 2015 decision in *Northstar Financial Advisors, Inc. v. Schwab Investments*, holding that the terms of the concentration policy contained in Sequoia Fund, Inc.'s Statement of Additional Information cannot form the basis of a contractual obligation to the Fund's shareholders. Judge Daniels further ruled that even if shareholders could assert a breach of contract claim, the plaintiffs failed to allege a violation of the Fund's concentration policy.

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Deemed-Issuers Election under Section 817(h)

October 24, 2018

On October 16, 2018, the IRS issued guidance on the application of the Section 817(h) diversification test to specified agency-issued mortgaged-backed securities underlying annuity and life insurance contracts. Under Revenue Procedure 2018-54, taxpayers may elect to treat these mortgage-backed securities as being issued proportionately by the Federal Home Loan Mortgage Association ("Freddie Mac") and the Federal National Mortgage Association ("Fannie Mae") based on a ratio announced annually by the Federal Housing Finance Agency.

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