August 13, 2019

Ropes & Gray's Investment Management Update – June-July 2019

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

SEC No-Action Letter Provides More Flexibility Under Manager-of-Managers Orders

On July 9, 2019, the SEC staff issued a no-action letter to the BNY Mellon Family of Funds ("BNY Mellon") in which the staff provided its assurance that an adviser with an existing manager-of-managers order could rely on the relief provided under the Carillon Order (described below) with respect to subadvisory agreements with affiliated advisers (in addition to wholly-owned subadvisers and unaffiliated subadvisers), without having to amend its existing manager-of-managers order. The no-action position was conditioned on BNY Mellon's compliance with the conditions in the Carillon Order (the "Carillon Conditions").

Background. On May 29, 2019, the SEC issued an order to Carillon Series Trust (the "Carillon Order") that expanded the scope of exemptive relief available under a pre-existing manager-of-managers exemptive order. The Carillon Order allows (i) the Carillon Series Trust and its investment adviser, without the approval of fund shareholders, to enter into or amend a subadvisory agreement with a subadviser ("Subadviser Voting Relief"), including any subadviser that is an affiliated person of the investment adviser (an "Affiliated Subadviser"),[1] and (ii) the Carillon funds to disclose the advisory fees paid to subadvisers on an aggregate, rather than individual, basis.

In prior manager-of-managers orders (each a "Prior Multi-Manager Order"), including the order amended by the Carillon Order, the SEC exemptive relief applied solely with respect to subadvisers that were either wholly-owned by the principal adviser or its parent or unaffiliated with the principal adviser.

The Carillon Order modified certain conditions that frequently have been included in Prior Multi-Manager Orders:

a. Eliminating the condition that the principal adviser provide the fund board, no less frequently than quarterly, with information about the profitability of the adviser with respect to each subadvised fund;

b. Eliminating a prohibition on trustee and officer ownership of an interest in a subadviser (although any such ownership would still make a trustee an interested person of the fund);

c. Expanding the findings that must be made by the fund board to cover potential material conflicts of interest when considering a proposed subadviser change or reviewing an existing subadvisory agreement as part of the annual contract renewal process; and

d. Requiring the adviser to provide the fund board with information related to material conflicts of interest each year during the annual contract renewal process, including (i) any material interest the adviser has in the subadviser and any material impact the subadvisory agreement may have on that interest, (ii) any arrangement or understanding in which the adviser is a participant that may materially affect, or be materially affected by, the subadvisory agreement, (iii) any material interest in a subadviser by an officer or trustee of the fund or officer or board member of the adviser, and (iv) any other information that may be relevant to the board in evaluating potential material conflicts of interest with respect to the subadvisory agreement.

The BNY Mellon No-Action Letter. In the BNY Mellon no-action letter, the SEC staff stated that it would not recommend enforcement action under Section 15(a) of the 1940 Act if the BNY Mellon applicants, without amending

[1] An Affiliated Subadviser is any investment subadviser that is not a wholly owned subadviser, but is an "affiliated person" (as defined in Section 2(a)(3) of the 1940 Act) of a subadvised fund or the principal adviser for reasons other than serving as investment subadviser to one or more of the funds.

their Prior Multi-Manager Order, deemed their Prior Multi-Manager Order amended in the same manner as the Carillion Order and subject to the Carillon Conditions ("Multi-Manager Relief"). In this regard, the SEC staff stated:

We would not expect a fund or investment adviser that relies on this position to comply with the conditions of their Prior Multi-Manager Order. A fund that wishes to rely on its Prior Multi-Manager Order with respect to an Affiliated Subadviser not covered by the Prior Multi-Manager Order, must comply with the [Carillion] Conditions, *including obtaining shareholder approval to operate as a fund using Multi-Manager Relief for Affiliated Subadvisers*, with respect to any existing or future subadviser going forward. (Emphasis added).

The SEC staff also stated that a fund that wishes to rely on its Prior Multi-Manager Order solely with respect to the type(s) of subadvisers covered by the Prior Multi-Manager Order (which would exclude Affiliated Subadvisers), "may choose to comply with the [Carillon] Conditions, in their entirety, instead of the conditions in its Prior Multi-Manager Order, provided the fund does so with respect to all existing and future subadvisers going forward. If a fund's Prior Multi-Manager Order provides only Subadviser Voting Relief, our no-enforcement position extends only to that relief."

In sum, the BNY Mellon no-action letter provides greater flexibility to funds operating under a Prior Multi-Manager Order in that it permits funds (i) to expand the scope of existing manager-of-managers relief to include Affiliated Subadvisers without amending the Prior Multi-Manager Order, provided the Carillion Conditions are observed and, (ii) even without expanding the relief to include Affiliated Subadvisers, to choose to operate under the Prior Multi-Manager Order's conditions or the Carillion Conditions, whichever are less burdensome.

Adviser Prevails in "Subadviser" Excessive Fee Suit

In a recent decision by the U.S. District Court for the Southern District of New York, *In re Davis N.Y. Venture Fund Fee Litigation*, the court granted the defendants' motion for summary judgement in a case in which the plaintiffs alleged that the fees charged by a registered mutual fund's adviser were excessive and, therefore, constituted a violation of Section 36(b) of the 1940 Act.

The decision is among a group of Section 36(b) suits in which plaintiffs assert a theory that the plaintiffs' bar has developed. Specifically, in these "subadviser" suits, plaintiffs try to establish that the fees charged a mutual fund by its adviser are excessive because the fees that the adviser charged third-party funds in its capacity as subadviser were substantially less than the fees the adviser charges its own fund despite allegedly providing similar services. In granting summary judgment, the Davis court rejected the notion that such fee comparisons on their own are adequate to bring a case to trial.

The plaintiffs, shareholders of the Davis New York Venture Fund, alleged that Davis Advisers charged the Fund excessive fees, as evidenced by the lower fees it charged to third-party subadvised funds with similar investment strategies, the allegedly poor performance experienced by the Fund during the relevant time period, the allegedly high profit margins that Davis Advisers experienced during the same period (73-81%) and the Fund board's allegedly deficient process.

Board's Process. The plaintiffs criticized the Fund board's process in light of the board members' allegedly "deep ties to the financial industry," alleged failure to negotiate a lower advisory fee during the relevant time period and alleged lack of interest with respect to issues plaintiffs contended were important, as well as the adviser's alleged withholding of information from the board, including (i) an accurate description of the services Davis Advisers provided to the subadvised funds; (ii) an explanation of the services provided under the advisory agreement with the Fund compared to those provided under the subadvisory contracts; and (iii) an estimate of the profits the adviser would have earned if it had charged the Fund at the same rates it charged the subadvised funds. The court found none of these complaints raised a genuine issue of material fact and found that the board's decision to approve the Fund's contract with Davis Advisers was entitled to substantial deference. The court based this conclusion on various factors, including:

- It was undisputed that six of eight board members were "disinterested" as defined under the 1940 Act, and that the requisite majority voted to approve the Fund's advisory agreement annually.

- It was undisputed that matters relevant to the approval were considered at board meetings, including comparisons of advisory fee rates and expense ratios of the Fund and other "peer" funds selected by Lipper and Morningstar, as well as fees paid to Davis Advisers by other third-party funds for which Davis Advisers was the primary adviser.

- The board retained independent counsel with whom the board members met frequently and separately.

- Evidence that board members were informed that Davis Advisers provided shareholder services and administrative services under agreements separate from the advisory agreement, and that the fees paid by the Fund under those separate agreements did not cover all of Davis Advisers' expenses in performing those services.

"Gartenberg" Analysis. After finding that the board's decision to approve the Fund's contract with the adviser was entitled to substantial deference, the court concluded that the U.S. Supreme Court's *Jones* decision required the court to "apply" the *Gartenberg* factors.

> ***Comparative Fees.*** Years before the relevant litigation period, Davis Advisers had entered into advisory agreements with unaffiliated third-party sponsored funds. Finding that these funds, which were governed by an entirely separate board of trustees, had engaged in fee negotiations at arm's-length with Davis Advisers, the court held that the plaintiffs did not provide evidence showing that a comparison of the Fund's total advisory fee with the total advisory fee of the unaffiliated third-party sponsored funds – whose fee structures were nearly identical to that of the Fund – was inappropriate. Therefore, because there was actual evidence of a similar advisory fee resulting from a demonstrably arm's length negotiation with a third-party sponsor, the plaintiffs could not demonstrate that Davis Advisers charged the Fund an advisory fee beyond the range of what could have been bargained at arm's length. In light of this finding, the court did not have to address the comparability of the Fund to the subadvised funds and their respective fees central to the plaintiff's allegations.

> ***Fund's Performance.*** Recognizing that a fund's investment performance is not a *Gartenberg* factor *per se*, the court nonetheless addressed it as part of the holistic analysis provided under *Jones*. The court found that plaintiffs did not provide sufficient evidence that the Fund's deviation from its benchmark was particularly dramatic or unusual such that it should weigh strongly in favor of liability.

> ***Profitability.*** The parties generally agreed that Davis Advisers' before tax profit margin from the Fund ranged from 73.3% to 81.4% during the relevant time period. In a fairly brief analysis, the court noted that the 1940 Act was not intended to enable courts to set fees, and found that the plaintiffs had not provided sufficient evidence that Davis Advisers' profits were out of proportion to the services rendered. In doing so, the court cited to T. Rowe Price's Prime Reserve Fund's 77% margin rate as "approved" by the *Schuyt* court in 1987.

Conclusion. The court held that the board followed a conscientious advisory contract process, warranting substantial deference to the board's decision to approve the contract. The plaintiffs failed to provide sufficient evidence to support a rational conclusion that (i) Davis Advisers' performance was so deficient and its profits so great that its fees were disproportionate to its services, or (ii) the fees paid by the Fund were outside of the range that could have been produced through arm's-length bargaining. Accordingly, the court found that Davis Advisers was entitled to judgment as a matter of law.

SEC No-Action Letter – Diversified Index Fund that Becomes Non-Diversified Due to Market Action

On June 24, 2019, the SEC staff issued a no-action letter stating that it would not recommend enforcement action against a diversified broad-based index fund that, without obtaining shareholder approval, no longer complied with the diversification requirements in Section 5(b)(1) of the 1940 Act due solely to market movements in the capitalization of the issuers constituting the fund's broad-based index. The SEC staff's no-action position was subject to various conditions, as described below, and applies to any registered open-end fund or ETF that seeks to track a broad-based index produced by an independent index provider.

Background

For a fund to qualify as a "diversified company" under Section 5(b)(1), generally with respect to 75% of its total assets, the fund cannot invest greater than 5% of its total assets in one issuer or hold more than 10% of an issuer's outstanding voting securities. During the past year, the top constituents of certain broad-based, large-cap U.S. equity growth indices (*e.g.*, the S&P 500 Growth Index) each have grown to represent more than 5% of the relevant broad-based index and, in the aggregate, more than 25% of that index.[2]

Section 13(a)(l) of the 1940 Act prohibits a fund from changing its sub-classification from a diversified fund to a non-diversified fund, unless the change is authorized by the vote of a majority of the fund's outstanding voting securities. Section 34(b) of the 1940 Act prohibits any person from making any untrue statement of a material fact in a fund registration statement.

In the underlying incoming letter, the applicant requested no-action assurance with respect to enforcement action under Sections 13(a)(l) and 34(b) to the extent necessary to allow the fund to approximate the composition of the fund's broad-based index. The incoming letter emphasized that, provided appropriate disclosure is made to investors and shareholders, the request (i) was consistent with the expectations of investors in a broad-based index fund, (ii) would avoid costs arising from disruption of the fund's portfolio, and (iii) would benefit shareholders by permitting the fund to avoid the expenses associated with holding a shareholder vote.

The No-Action Letter

The SEC staff stated that it would not recommend enforcement action under Sections 13(a)(1) and 34(b) against a diversified broad-based index fund that exceeded Section 5(b)(1)'s limits solely due to market movements among the issuers constituting the broad-based index that the fund intends to track. The staff approvingly repeated the applicant's arguments in the incoming letter (summarized above), but made its no-action position contingent upon the following conditions:

1. The fund would update the principal investment strategy disclosure in its prospectus to address the possibility that the fund has or may become non-diversified due to fluctuations in market capitalization or index weighting of the issuers comprising the broad-based index tracked by the fund.

2. The fund's prospectus would disclose as a principal risk factor the risks associated with any periods of non-diversification.

3. The fundamental investment policy regarding diversification within the fund's statement of additional information would be revised to disclose the fund's intention to be diversified in approximately the same proportion as the relevant broad-based index.

4. The fund would provide shareholders with a prospectus supplement or other communication on a separate document that clearly disclosed the fund's updated principal investment strategy and related risks, as well as the fact that shareholder approval would not be sought when the fund crosses from diversified to non-diversified

[2] As of June 30, the top four issuers within the S&P 500 Growth Index – Microsoft (8.1%), Apple (6.5%), Amazon (6.3%) and Alphabet (5.1%) – collectively represented approximately 26% of that index.

status due solely to fluctuations in market capitalization or index weighting of the issuers comprising the broad-based index tracked by the fund.

5. The fund would make its revised diversification policy available on its website.

In addition, the SEC staff's no-action position required that the fund's broad-based index must be created by an index provider that is not an affiliated person of the fund, its investment adviser or principal underwriter, or an affiliated person of such persons, and must not be created solely for the fund or its affiliated persons.

Delaware Court Rules that Activist Investor May Run Its Slate of Directors After Closed-End Funds' Board "Overstepped" Its Bylaws Authority

On June 27, 2019, the Court of Chancery of the State of Delaware issued a memorandum opinion in *Saba Capital Master Fund, Ltd. v. Blackrock Credit Allocation Income Trust* in which the court held that the (identical) board of trustees of two closed-end funds had overstepped its authority under the funds' bylaws by:

- including in a questionnaire to a dissident shareholder's board nominees a substantial number of questions that were unrelated to the board-member qualifications set forth in the funds' (identical) bylaws, and
- seeking to enforce a strict five-day deadline for the nominees to respond to the questionnaire.

Accordingly, the court held that (i) the board of trustees was barred from invalidating the shareholder's nominations on the grounds that the nominee questionnaires were returned in an untimely manner and (ii) votes in favor of the shareholder's nominees must be counted at the funds' annual meetings.

Separately, in its complaint, the plaintiff alleged that amendments to one of the two funds' bylaws – requiring an affirmative vote by (i) a "majority of shares outstanding" to elect a trustee in a *contested* election and (ii) a plurality of shares represented at a meeting to elect a trustee at an *uncontested* election, without seeking shareholder approval, amounted to breaches of the trustees' fiduciary duties to have fair and reasonable nominating and voting procedures. However, the plaintiff did not seek preliminary injunctive relief with respect to this claim and the court has yet to rule on that claim. The bylaws of the other fund were not similarly amended.

The *Saba Capital* decision is discussed below.

Background. The plaintiff, Saba Capital Master Fund, Ltd. ("Saba"), is a Cayman Islands company and an activist shareholder-investor, including investments in the two BlackRock closed-end funds, which are organized as Delaware statutory trusts. Saba sought to elect its own candidates instead of the incumbent board members at the funds' upcoming annual meetings and, in accordance with the funds' bylaws, provided timely notices to the funds of its slate of nominees. As permitted by the funds' bylaws, the funds' board requested that Saba supplement the information about the candidates provided by Saba within five business days. The supplement consisted of a 47-page questionnaire (the "Questionnaire") containing nearly 100 questions.

After Saba missed the five-business-days deadline for returning the completed Questionnaire, the funds' board informed Saba that the Saba nominations were invalid and would not be counted at the funds' upcoming annual meeting. Shortly thereafter, both funds filed a preliminary proxy statement disclosing that the fund's board had determined that Saba's nominations were invalid because "Saba's hedge fund fail[ed] to comply with the Trust's By-laws."

With the annual meetings approaching, Saba sued and sought preliminary injunctive relief. Among other things, Saba alleged that each fund and its board violated the funds' bylaws by claiming that the Saba nominations were invalid because Saba had not responded to the Questionnaires within five business days. Saba asked the court to enter preliminary relief "to allow the nominations to be presented and votes to be counted."

The Decision. The court noted that both funds had set forth in their bylaws the various qualifications that trustees were required to satisfy (the "Trustee Qualifications").[3] Another portion of the bylaws governed the nomination of trustees, including nomination of trustee candidates by shareholders (the "Nomination Provisions"). The court noted that the Nomination Provisions required shareholders to "update and supplement" their nomination notices, "if necessary," to respond to a request from the fund's board for "any subsequent information reasonably requested" to determine that a proposed nominee met the Trustee Qualifications. Thus, the court reasoned, the bylaws imposed three restrictions on a fund's board to request updates and supplements to a shareholder nomination notice. Specifically, with respect to Saba, the court found that the requested information "must be (a) for the purpose of determining whether Saba's nominees met [the Trustee Qualifications], (b) 'reasonably requested' with that scope in mind, and (c) 'necessary' for the Boards' determinations."

At the court's request, both Saba and the defendants categorized the questions in the Questionnaire as related to the Trustee Qualifications or some other purpose. Saba claimed that only about one-third of the nearly 100 questions related to the Trustee Qualifications, while the defendants claimed that about two-thirds related to the Trustee Qualifications. The court found that, even by the defendants' count, approximately one-third of the questions were not related to the Trustee Qualifications. The court cited various examples of particular questions that did not appear to be related to the Trustee Qualifications, including:

- During the last two calendar years, have you knowingly engaged in an activity that meets the criteria for sanctions under the Iran Sanctions Act of 1996 or under the Comprehensive Iran Sanctions, Accountability and Divestment Act of 2010?
- Have you ever been disqualified, suspended, dismissed, placed on academic probation or otherwise subject to a disciplinary action at any academic institution?
- Have you ever been the subject of any allegation involving sexual assault, sexual harassment or sexual misconduct, irrespective of whether such allegation ultimately resulted in any formal or informal claims or litigation?

The court held that, while the Nomination Provisions authorized the board to ask for updates and supplements to determine whether the Saba nominees met the Trustee Qualifications, the defendants "went too far." By including in the Questionnaire so many questions that were unrelated to the Trustee Qualifications and seeking to enforce the strict five-day deadline to invalidate Saba's nominations, the court found that the board overstepped its updates-and-supplements authority under the bylaws, as described in the following excerpt from the opinion:

Defendants assert that the Questionnaire was broad because it is also designed to ensure that nominees satisfy federal regulations and requirements, as well as to elicit information the Boards would simply like to know about nominees. While those goals are understandable, the plain meaning of [the Nomination Provisions] only permits inquiries into [the Trustee Qualifications]. Defendants provide no reason why these additional and purportedly critical issues had to be dropped on Saba with a five-day deadline, when they could have been solicited through the already expansive [Nomination Provisions] and [Trustee Qualifications]. Including questions unrelated to [the Trustee Qualifications] made the Questionnaire, or even a targeted and appropriate subset of that Questionnaire, more burdensome to answer within the five-day deadline.

[3] For example, the Trustee Qualifications included requirements that (i) an individual nominated or seated as a "Non-Management Director" may not be an "interested person" of the fund, as defined under Section 2(a)(19), and (ii) an individual nominated or seated as a Director may not have been the subject of any of the ineligibility provisions contained in Section 9(a) of the 1940 Act. However, the Trustee Qualifications did not address many topics about which information normally is adduced in a trustee questionnaire.

Based on the foregoing, the court held that the Questionnaire as a whole was not "reasonably requested" or "necessary" to determine whether Saba's nominees met the Trustee Qualifications. The court enjoined the defendants from applying the Nomination Provisions to invalidate Saba's nominations to the boards due to the tardy return of the Questionnaires and required the funds to count votes for the Saba nominees at the annual meetings.

Regulatory Priorities Corner

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

OCIE Risk Alert Regarding Investment Advisers Employing Persons with Disciplinary Events

On July 23, 2019, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert titled *Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest* (the "Alert"). The Alert is the result of OCIE's 2017 examination of more than 50 advisers that previously employed or were then employing persons with disciplinary histories. The purpose of the Alert is to encourage advisers, when designing compliance procedures, to consider risks posed by employing supervised persons who have disciplinary histories.

In General. According to the Alert:

- Nearly one half of the disclosure-related deficiencies of the advisers examined involved advisers providing insufficient information regarding disciplinary events in a Form ADV.
- Many examined advisers failed to introduce and follow compliance policies and procedures to address risks associated with hiring and employing individuals with prior disciplinary histories. For example, advisers lacked procedures reasonably designed to identify the completeness and accuracy of supervised persons' self-disclosures involving disciplinary events, reportable events or recent bankruptcies.

Additional OCIE Observations. According to the Alert, while certain deficiencies are commonly identified in OCIE examinations, these deficiencies were more frequently identified in the OCIE's examination of the advisers that hire and employ individuals with disciplinary histories. The Alert cited the following examples:

- Advisers that failed to oversee whether fees charged by their supervised persons were disclosed or determine whether the services for which clients paid were actually performed.
- Advisers that lacked advertising policies and procedures that offered appropriately specific guidance to supervised persons who prepared their own advertising materials and websites.
- Advisers that did not include reviewing the activities of supervised persons, including supervised persons with disciplinary histories, who worked remotely.
- Advisers that did not confirm that supervised persons responsible for performing certain compliance policies and procedures were satisfying their responsibilities.
- Advisers that had written policies and procedures that were inconsistent with actual business practices/disclosures.

Staff Observations on Improving Compliance. The Alert recommended the following supervisory policies and procedures for consideration by advisers that hire or employ persons with disciplinary histories:

- Adopting written policies and procedures that specifically address what must occur prior to hiring persons that have reported disciplinary events.

- Enhancing due diligence practices associated with hiring supervised persons to identify disciplinary events, and implementing heightened supervision of supervised persons with disciplinary histories.

- Adopting written policies and procedures addressing client complaints related to supervised persons (because advisers with such procedures were more likely to receive a report of a complaint related to their supervised persons).

- Including oversight of persons operating out of remote offices in compliance and supervisory programs.

SEC Settles Valuation Enforcement Matter with Adviser and Portfolio Manager

On June 4, 2019, the SEC agreed to settle an enforcement matter with Deer Park Road Management Company, LP ("Deer Park") and a Deer Park portfolio manager in which the SEC alleged that Deer Park and the portfolio manager had violated Section 206(4) of the Advisers Act and Rule 206-4(7) thereunder (the "Compliance Rule") by failing (i) to adopt and implement reasonably designed compliance policies and procedures relating to valuation of fund assets, and (ii) to ensure that the valuation policies it had adopted were, in fact, employed.

Background. The SEC's allegations focused on two aspects of Deer Park's valuation policies – the policies stated that securities must be valued in accordance with GAAP, and the policies contained a "90%/10%" pricing source protocol (the "Pricing Source Protocol"), described below, that prescribed various pricing sources to be used to value portfolio securities.

The SEC noted that GAAP requires that the methods used to measure the fair value of securities "shall maximize the use of relevant observable inputs and minimize the use of unobservable inputs" and, when models are used to assist in determining fair values, the "models must be calibrated to relevant observable market data, including transaction prices, to ensure they reflect current market conditions."

All of the SEC's allegations concerned the portfolio securities of a private fund that was not a registered investment company under the Investment Company Act of 1940.

Valuations Not Relying on a Third-Party Pricing Vendor. The SEC asserted that, over a three-year period, Deer Park's Pricing Source Protocol permitted Deer Park traders discretion to choose, on a monthly basis, whether to use a third-party vendor's price or Deer Park's internal valuations. This discretion was available to the Deer Park traders only with respect to securities that represented less than 25 basis points of the private fund's NAV and that, in the aggregate, represented no more than 10% of the private fund's NAV. The Deer Park traders submitted preliminary valuations, along with explanations, to the portfolio manager, who would review and adjust any valuations with which he disagreed. These valuations, as adjusted by the portfolio manager, became the final valuations used by Deer Park.

The SEC alleged that Deer Park's policies and procedures for securities within this 10% "bucket" were not reasonably designed to prevent violations of the Advisers Act. The SEC asserted that, because the valuations determined by the Deer Park traders were made without reference to a third-party vendor price, the resulting valuations were contrary to the Deer Park valuation policies and procedures. Moreover, the preliminary valuations provided by the Deer Park traders disregarded market data and information, thereby failing to maximize observable inputs or properly calibrate their model-derived price in accordance with GAAP.

Valuations Relying on a Third-Party Pricing Vendor. The SEC also alleged that, during the three-year period, Deer Park's Pricing Source Protocol required that at least 90% of securities within the private fund's portfolio must be valued at or within a range of prices obtained from an external pricing source, including any securities representing more than 25 basis points of the private fund's NAV. According to the SEC, Deer Park's traders priced the securities in this bucket internally and subsequently obtained a price from a third-party pricing vendor. Deer Park then calculated a band ("Price Band") around the vendor's price and compared it to the value determined by the Deer Park traders. When the internally determined price fell within the Price Band, the internal price was used. If the internally determined price was outside the Price Band, Deer Park used the limit of the Price Band.

The SEC alleged that Deer Park's policies and procedures for securities within this 90% bucket were not reasonably designed to prevent violations of the Advisers Act. Specifically, the SEC claimed that Deer Park's valuation policies and procedures failed to sufficiently address the risk that the Deer Park traders would fail to maximize observable inputs or properly calibrate their model-derived valuations to observable trade data or information in accordance with GAAP.

Finally, the SEC asserted that the 90%/10% Pricing Source Protocol left the Deer Park traders with great discretion in using external prices, selecting pricing sources, and when and how to challenge prices. According to the SEC, Deer Park had inadequate controls to address the potential conflict of interest, and Deer Park lacked adequate oversight of its valuation process to ensure that valuations conformed with GAAP.

Outcome. Solely for the purpose of the enforcement matter, and without admitting or denying the findings in the SEC's order, Deer Park and the portfolio manager agreed to cease and desist from committing or causing any violations and any future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Deer Park and the portfolio manager also agreed to pay civil money penalties of $5 million and $250,000, respectively.

ICI Submits Recommendations Regarding Proxy System for Fund Shareholders

On June 11, 2019, the ICI submitted a comment letter to the SEC containing recommendations to improve the proxy system for funds and their shareholders. The ICI's letter revealed the following facts from a late 2018 survey to which 52 ICI member firms (representing about 71% of U.S. registered fund assets) responded:

- 43% of the respondents' proxy solicitations included 100,000 or more accounts, with almost 20% exceeding two million accounts.
- Nearly 80% of the respondents indicated that a majority (and in some cases, all) of their fund shareholders invested through intermediary omnibus positions.
- A majority of respondents (53%) reported that proxy solicitation processes took over 60 days, and 10% took more than 120 days.
- 37% of respondents reported that they had adjourned a shareholder meeting for lack of quorum and, of those that adjourned, 36% did so two or more times.
- 19 of 52 respondents indicated that the total costs of their proxy campaigns were $1 million or more, including five campaigns for which the costs exceeded $10 million.

The ICI letter recommended that the SEC consider a number of reforms to the current proxy system to address the problems revealed by the survey.

Other Developments

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

Second Circuit Finds an Implied Private Right of Action Under the Investment Company Act, Departing from the Third Circuit and Other Courts
August 12, 2019
In an August 5 holding that could open the door to a new breed of litigation claims involving mutual funds, the United States Court of Appeals for the Second Circuit ruled that the Investment Company Act of 1940 ("ICA") creates an implied private right of action that several other courts had previously declined to recognize. Section 47(b) of the ICA provides that "[a] contract that is made, or whose performance involves, a violation of [the ICA] . . . is unenforceable by either party." The Second Circuit concluded in *Oxford University Bank v. Lansuppe Feeder, Inc.* that Congress' intent in enacting Section 47(b) was to grant contracting parties a right to sue for rescission of a contract that allegedly violates the ICA. In recent years, most courts have interpreted the ICA as providing only one private right of action – a claim for excessive advisory fees against investment advisers and their affiliates expressly granted to mutual fund shareholders under Section 36(b). While an additional private right of action under the ICA raises the prospect of expanded litigation risk for advisers and funds, the scope of new litigation might be limited in practice by the requirement that the plaintiff be a *party* to the allegedly violative contract.

CFTC Staff Extends No-Action Relief from Certain Position Aggregation Requirements
August 9, 2019
The U.S. Commodity Futures Trading Commission's (the "CFTC") Division of Market Oversight recently issued CFTC Letter No. 19-19, which extends until August 12, 2022 the relief from certain position aggregation requirements it had granted previously in CFTC Letter No. 17-37. The relief was set to expire on August 12, 2019.

Court Rejects Mutual Fund Excessive Fee Claims Following Trial, Recognizing Important Fund Industry Market Conditions
August 6, 2019
In a decisive August 5 ruling that could be the final nail in the coffin for plaintiffs' efforts to compare advisory and subadvisory fees, a federal court in the Central District of California rejected claims of excessive mutual fund fees asserted against Metropolitan West Asset Management, LLC ("MetWest") following a bench trial. Finding in MetWest's favor across the board, U.S. District Judge George Wu held that the plaintiff-shareholder had failed to prove that MetWest charged excessive advisory fees to its flagship fund, the MetWest Total Return Bond Fund, which grew to become the world's largest actively managed bond fund. The court ruled that the plaintiff's proposed comparison of the Fund's advisory fee to lower subadvisory fees MetWest charged to external funds was "inapt," because MetWest "provides substantially different services and takes on substantially different risks" as adviser and sponsor of a proprietary fund. The court looked instead to mutual fund peer group fees as a more apt comparator, while also giving deference to the fee approval of the Fund's independent trustees following a robust review process. Judge Wu further rejected the plaintiff's theory that MetWest failed to share economies of scale merely because it did not implement breakpoints as the Fund grew in size. Throughout the decision, the court recognized important market conditions of today's mutual fund industry, including the stiff competition among fund advisers to both attract investor assets and retain talented professionals. MetWest is represented in the case by a team of Ropes & Gray litigators.

Upcoming Deadline for Form SHL – Foreign Ownership of U.S. Securities
July 23, 2019
Last month, the Department of the Treasury released the final instructions for the reporting requirements of the Treasury International Capital Benchmark Form SHL. Form SHL is filed every five years with the Federal Reserve Bank of New York, and requires U.S. resident entities to report information regarding foreign ownership of U.S. securities. Data is reported as of June 30, 2019 and must be submitted no later than August 30, 2019.

[Podcast: Private Fund Regulatory Update – Network and Cloud Storage]
July 22, 2019
In this Ropes & Gray podcast, asset management partners Laurel FitzPatrick and Joel Wattenbarger discuss the Risk Alert published on May 23, 2019 by the SEC's Office of Compliance Inspections and Examinations, which addresses the obligation to safeguard customer records and other information in cloud-based or network storage solutions.

[Podcast: European Green Finance and Sustainability Proposals – Impact for Asset Managers]
July 18, 2019
In this ESG-focused podcast, asset management partners Isabel Dische and Eve Ellis discuss the United Kingdom's recently published Green Finance Strategy, the European Union's Action Plan on Sustainable Finance and how these initiatives may impact asset managers.

[Recent CFTC Enforcement Action Against Non-U.S. Fund Manager for Violation of U.S. Position Limits Highlights Traps for Unwary]
July 15, 2019
On July 2, 2019, the United States Commodity Futures Trading Commission ("CFTC") issued an order (the "Order") filing and simultaneously settling charges against Elephas Investment Management Limited ("Elephas"), a hedge fund manager located in Hong Kong that is not registered with the CFTC, for violating speculative position limits on wheat futures. A simultaneous action was brought and settled by the Chicago Board of Trade ("CBOT"). The Order found that Elephas carried into the spot month a futures equivalent net long position of 1,680 December 2017 CBOT soft red winter wheat futures contracts, which exceeded the CFTC and CBOT spot month limit by over 1,000 contracts (180%). Elephas reduced its position below the limit the next day. As a result of the violation, Elephas was ordered to pay a civil monetary penalty to the CFTC of $160,000, a fine of $50,000 to the CBOT and a disgorgement of the $165,590 benefit it received in reduced losses. The actions against Elephas highlight the traps for unwary asset managers who trade futures, and options thereon, in U.S. markets.

[UK Financial Conduct Authority Reports on Enforcement Activity]
July 15, 2019
The latest enforcement statistics released by the UK Financial Conduct Authority ("FCA") show that the regulator is investigating more firms and individuals than ever in relation to an ever-expanding range of alleged misconduct.

[Regulatory Rollback: First Set of Volcker Rule Reforms Finalized]
July 11, 2019
On July 9, 2019, the five federal financial regulatory agencies issued a final rule (the "Rule") to, inter alia, revise the Volcker Rule's name-sharing restrictions applicable to bank-affiliated hedge funds and private equity funds and exclude certain community banks from the Volcker Rule. The Rule is consistent with the statutory amendments made pursuant to sections of the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA") and finalizes the changes as proposed in EGRRCPA in order to conform the regulations to the statutory revisions.

While the Rule will have a limited effect on the banking industry, other proposed revisions to the Volcker Rule regulations remain pending and, if adopted, would have a more significant impact on large banking institutions.

[SEC Issues Concept Release on Harmonization of Securities Offering Exemptions: Potential Opportunities for Both Private Funds and Registered Funds]
June 28, 2019
On June 18, 2019, the SEC published its Concept Release on Harmonization of Securities Offering Exemptions (the "Release") to solicit public comment on exemptions from registration under the Securities Act. The Release notes that, over time, there have been significant changes to the framework for exempt offerings, resulting in gaps and complexities. Therefore, the Release states, the SEC seeks comments on ways "to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate

investor protections." The Release is the most significant step that the SEC has taken to give effect to SEC Chairman Clayton's stated goal of broadening "main street" access to investments in private companies.

This Alert should be of interest to sponsors of private funds because the Release suggests that the SEC is willing to consider expanding investment opportunities in private equity funds and venture capital funds to retail investors.

EU Adopts New Rules on Marketing Investment Funds
June 27, 2019
The EU has now adopted supplementary rules on how funds are marketed to professional investors in the EU that the European Parliament voted on in April this year. The new rules adopted earlier this month aim to create more consistency in how different EU countries interpret certain concepts under the existing legislation. However, while the changes will provide a more harmonized approach, questions remain as to whether this will have a positive impact on fund managers.

SEC Adopts Rule Change to Address Funds' Auditor Independence Problem
June 25, 2019
In a June 18, 2019 release, the SEC adopted amendments to the "Loan Rule," a part of the SEC's auditor independence rule, Rule 2-01 of Regulation S-X. The amendments, which were proposed in 2018, should virtually eliminate the problems that led to the SEC staff's 2016 no-action letter regarding the application of the Loan Rule to an investment company complex.

SEC Adopts Regulation Best Interest and Issues Interpretive Release on the "Solely Incidental" Exclusion
June 21, 2019
On June 5, 2019, the SEC adopted two rules and published two interpretations "designed to enhance the quality and transparency of retail investors' relationships with investment advisers and broker-dealers." This Alert discusses the Regulation Best Interest adopting release and the SEC interpretive release regarding the "solely incidental" prong of the broker-dealer exclusion from the Advisers Act. Separate Ropes & Gray Alerts discuss the SEC release on the standard of conduct for investment advisers and the SEC adoption of Form CRS.

UK Financial Services Regulators Lay Down a Marker on Money Laundering in the Capital Markets
June 18, 2019
In a report published on June 10, 2019, the Financial Conduct Authority has set out its assessment of the money laundering risks and vulnerabilities in the capital markets. The report recognizes that this is an area that historically may not have been specifically addressed by firms' systems and controls. Although it is aimed at helping firms with developing appropriate compliance arrangements rather than formally assessing or criticizing firms' systems and controls, it identifies some areas in which the FCA has found a lack of awareness of risks and provides firms with clear reminders of their obligations under UK financial services and wider anti-money laundering ("AML") legislation. Some of the FCA's largest fines to date have been imposed for AML-related shortcomings in relation to wholesale markets' activity. The report reminds firms and individuals in all sectors that enforcement in this area is a priority.

SEC Adopts Form CRS (Client Relationship Summary) for Advisers and Broker-Dealers
June 14, 2019
On June 5, 2019, the SEC adopted Form CRS ("relationship summary"), along with new and amended rules and forms, to improve retail investors' understanding of the different investment-related services provided by registered broker-dealers, registered investment advisers and dually registered firms.

Joint Audit Committee's Regulatory Alert Potentially Affecting Separately Managed Account IMAs
June 13, 2019
On May 14, 2019, the Joint Audit Committee (the "JAC"), a representative committee consisting of U.S. derivatives exchanges and clearing houses and the National Futures Association, issued a Regulatory Alert concerning the JAC's interpretation of CFTC Regulation 1.56(b) ("Prohibition of Guarantees Against Loss").

SEC Releases Final Interpretation on Adviser Conduct Standard and Fiduciary Duty
June 12, 2019
On June 5, 2019, the SEC held an open meeting and issued a long-awaited final interpretation entitled "Commission Interpretation Regarding Standard of Conduct for Investment Advisers" (the "Final Guidance"). The Final Guidance provides clarifications that address comments received following the SEC's April 18, 2018 proposed guidance related to the standard of conduct for investment advisers under the Advisers Act.

Podcast: Credit Funds: Replacing LIBOR – Steps to Consider Taking Now
June 10, 2019
In this podcast, Jill Kalish Levy and Joel Wattenbarger discuss the impending cessation of LIBOR at the end of 2021 and its proposed replacement, SOFR, and how they differ. Market participants are already taking different approaches to the replacement of LIBOR from the documentation and logistical perspectives. This podcast explains the pros and cons of the various approaches, including the advantages and challenges associated with the "amendment approach" and the "hardwired approach" in documentation, and what actions credit fund managers may want to consider taking in 2019 to begin the transition away from LIBOR.

Podcast: Ropes & Gray's PEP Talk: General Solicitation by Private Equity Funds Under 506(c)
June 3, 2019
This new Ropes & Gray podcast series, *The PEP Talk, Ropes & Gray's Private Equity Podcast*, focuses on legal issues of interest to the private equity industry. In the first episode of the series, asset management partners Peter Laybourn and Debra Lussier are joined by Keith Higgins, chair of the firm's securities and governance practice and former SEC director of corporation finance, to discuss the opportunity for private equity funds to engage in general solicitation during fundraising under Rule 506(c) of Regulation D of the Securities Act.

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 Asset Management group listed below.

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