October 15, 2019

Ropes & Gray's Investment Management Update August-September 2019

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

SEC Claims Adviser Failed to Disclose Conflicts Arising from Revenue-Sharing Payments

On August 1, 2019, the SEC filed a complaint in the U.S. District Court for the District of Massachusetts against Commonwealth Equity Services, LLC ("CES"), alleging that CES had breached its fiduciary duty to its advisory clients by failing to disclose its receipt of certain revenue-sharing payments. The SEC alleged that CES relied on a third-party broker, National Financial Services, LLC ("NFS"), to serve as its clearing broker, to execute its advisory clients' orders and to maintain custody of the investments held in the advisory clients' accounts. NFS offered a "no transaction fee" ("NTF") program, through which CES advisory clients could transact in fund shares without a transaction fee. NFS also offered a "transaction fee" ("TF") program, through which CES advisory clients could transact in shares from a different set of mutual funds and, for which, NFS charged a transaction fee. Sponsors of mutual funds paid NFS fees to make their funds available on the NTF platform, and NFS paid CES a portion of these fees as revenue sharing (based upon CES advisory clients' investments in the mutual funds). NFS also paid CES, as revenue sharing, a portion of the transaction fees within the TF program that NFS charged CES's advisory clients.

According to the SEC's complaint, CES disclosed in its Form ADV that it received revenue-sharing payments with respect to investments in mutual funds within the NTF program offered by NFS. However, the SEC alleged, CES failed to disclose its conflicts of interest arising from incentives to invest its advisory clients in more expensive mutual funds and in more expensive share classes, for which NFS made greater revenue-sharing payments. With respect to the mutual fund transactions within the TF program, the SEC alleged that CES failed to disclose to its advisory clients that it received revenue-sharing payments from NFS.

The SEC alleged that (i) CES's failure to disclose its conflicts of interest constituted a negligent breach of its fiduciary duty to its advisory clients in violation of Section 206(2) of the Advisers Act and (ii) by failing to adopt and to implement reasonably designed written policies and procedures for identifying and disclosing these conflicts of interest, CES violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

In CES's answer to the SEC complaint, CES offered a range of affirmative defenses. CES asserted that the SEC complaint failed to allege facts showing that CES's disclosure was insufficient. According to CES, while the level of detail in CES's disclosure regarding its receipt of revenue-sharing payments expanded over time, the conflict disclosures were at all times sufficient and appropriate when made. In addition, CES asserted that the SEC's claim – that CES had an obligation to make more specific disclosures regarding particular aspects of its receipt of revenue-sharing payments – deprived CES of fair notice under the Due Process Clause. CES maintained that the SEC could have imposed such a requirement by formal rulemaking under the Administrative Procedures Act, but the SEC had not done so. According to CES, the SEC "cannot fill this void by bringing fraud charges to retroactively impose uncabined duties to disclose particular line items that *ex post* appear to be sound." CES also asserted several other defenses, including that the SEC's new claims should be barred by an earlier settlement reached between the parties.

Observations: In its complaint, the SEC claimed that CES's disclosures were insufficient because CES described its conflicts of interest as merely potential and acknowledged only that it "may" have incentives to select more expensive investments based on its compensation, while CES had an *actual* conflict that did create the incentives. This claim echoes the SEC's recent statement in its June 2019 release, *Commission Interpretation Regarding Standard of Conduct for Investment Advisers* (the "Conduct Interpretation"):

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> To illustrate what constitutes full and fair disclosure, we are providing the following guidance on . . . the appropriate level of specificity, including the appropriateness of stating that an adviser "may" have a conflict . . . [D]isclosure that an adviser "may" have a particular conflict, without more, is not adequate when the conflict actually exists.[1]

CES asserts that its conflicts disclosure during the relevant period tracked long-standing industry practice, and that the SEC is unfairly imposing a new "informed consent" disclosure standard after-the-fact via enforcement action. This position finds support in the public statements of at least one commissioner. At the April 2018 meeting at which the SEC proposed the Conduct Interpretation, Commissioner Peirce stated that "the proposed interpretation makes new law . . . The informed consent requirement is new; the only Commission basis is a mention in an instruction to Form ADV."[2]

Indeed, prior statements about the adequacy of conflicts disclosure have not addressed such "may" language or suggested it was inadequate.[3] Whether an adviser has provided full and fair disclosure has focused on disclosure of material facts, assessed in the total mix of information.[4] To underscore this point, in the disclosure context, federal courts have dismissed assertions of a difference between "will" and "may" as a "semantic quibble" and not, by itself, a material omission.[5]

CES's defense that the SEC seeks unlawfully to apply retroactively a new test regarding the adequacy of disclosure is worth close attention. We will continue to monitor the *SEC v. Commonwealth Equity Services* litigation closely.

DRAO Issues Two Accounting and Disclosure Information Notices

On September 9, 2019, the Division of Investment Management's Disclosure Review and Accounting Office ("DRAO") issued ADI 2019-08, *Improving Principal Risks Disclosure* ("ADI 2019-08") describing certain shortcomings observed by the SEC staff in disclosures of principal risks in mutual fund summary prospectuses. Among other things, ADI 2019-08 encouraged funds to list their principal risks in order of importance and stated that funds that, instead, list their principal risks *alphabetically* "could obscure the importance of these key risks." The staff recognized that listing principal risks based on importance "requires subjective determinations." Therefore, the staff stated, funds were best positioned to make "these judgments of relative importance" and, in general, the staff would not comment when a fund ordered its principal risks by importance.

Note: *ADI 2019-08 did not acknowledge that Form N-1A merely requires a fund to "summarize the principal risks of investing in the [f]und" and contains no obligation to list principal risks in any particular order. The tenor of DRAO's observations regarding the order in which principal risks are listed is consistent with comments that the SEC disclosure staff has been giving to registered funds and an October 2018 speech by Dalia Blass, Director of the Division of Investment Management.*

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[1] Rel. No. IA-5248 (June 5, 2019).

[2] Statement at the Open Meeting on Standards of Conduct for Investment Professionals, Comm. Hester M. Peirce (Apr. 18, 2018) *available at* www.sec.gov.

[3] *See Amendments to Form ADV*, Rel. No. IA-3060, (Jul. 28, 2010) ("An adviser must deal fairly with clients and prospective clients, seek to avoid conflicts with its clients and, at a minimum, make full disclosure of any material conflict or potential conflict."); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) ("Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts.'").

[4] *See Amendments to Form ADV, supra*, at note 35:

> The standard of materiality under the Advisers Act is whether there is a substantial likelihood that a reasonable investor (here, client) would have considered the information important. See *SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992). *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988); *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 445, 449 (1976). This is a facts and circumstances test, requiring an assessment of the 'total mix of information,' in the characterization of the Supreme Court.

[5] *See Benzon v. Morgan Stanley Distributors, Inc.*, 420 F.3d 598, 612 (6th Cir. 2005); *Lubbers v. Flagstar Bancorp Inc.*, 162 F. Supp.3d 571, 581 (E.D. Mich. 2016); *In re AIG Advisor Group Sec. Litig.*, 2007 WL 1213395 at n.15 (E.D.N.Y.); *In re RAC Mortgage Investment Corp. Sec. Litig.*, 765 F. Supp. 860, 864 (D. Md. 1991).

In addition, ADI 2019-08:

- Observed that some fund groups do not tailor their principal risk disclosure for each fund within the fund group but, instead, rely on "generic, standardized, risk disclosures across funds."
- Encouraged funds to consider disclosing that a fund may be inappropriate for certain types of investors.

On October 2, 2019, DRAO issued ADI 2019-09, *Performance and Fee Issues*, describing shortcomings observed by the SEC staff regarding disclosure of fund performance and fee information. The shortcomings, among others, included funds that fail to (i) reflect sales loads in their average annual return tables, (ii) disclose acquired fund fees and expenses appropriately and (iii) tag their risk/return summaries in XBRL.

REGULATORY PRIORITIES CORNER

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

SEC Issues Risk Alert on Principal and Agency Cross Trading Compliance Issues

On September 4, 2019, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert (the "Alert") summarizing the most common issues identified by OCIE staff concerning investment advisers' compliance with Section 206(3) of the Advisers Act and Rule 206(3)-2 thereunder, which regulate securities transactions between an investment adviser, acting as principal or as agent, and its advisory clients. For example, the Alert notes that OCIE staff had observed advisers effect principal transactions between advisory clients and an affiliated pooled investment vehicle, where the adviser failed to recognize that the adviser's greater-than-25% ownership of the pooled investment vehicle would subject the transactions to Section 206(3) (referencing the Gardner Russo & Gardner no-action letter). The Alert does not address principal and agency cross transactions with a registered fund under Sections 17(a) and 17(e) of the 1940 Act.

SEC Settles Enforcement Matter with Mutual Fund Advisers Concerning Disclosure of Securities Lending Practices

On September 16, 2019, the SEC issued an Order in settlement of proceedings brought against two investment adviser subsidiaries of an insurance company in which the SEC asserted that the advisers' securities lending activities violated provisions of the Advisers Act. The SEC's allegations arose from two practices by the advisers that occurred after the funds were reorganized in 2006 and converted, for federal tax purposes, from regulated investment companies to partnerships. The purpose of the reorganizations and changes in tax status was to provide the parent insurance company with tax benefits under the federal dividends received deduction ("DRD") for dividends received on securities held by the funds.

According to the Order, the reorganizations and actions by the advisers and other subsidiaries of the insurance company parent harmed the funds in two ways. First, the Order stated that the funds' affiliated administrator temporarily recalled securities that the funds had out on loan in advance of the securities' dividend record dates for the purpose of increasing the parent company's DRD on those shares. Recalling the securities allegedly caused the funds to forego securities lending revenue and investment income they otherwise would have earned had the administrator not recalled the securities. The Order stated that the advisers did not disclose to the funds' boards the conflict of interest between the insurance company and the funds in connection with the securities recalls. Second, the Order stated that the fund reorganizations subjected the funds to less favorable tax treatment in certain foreign jurisdictions, and the insurance company parent failed to reimburse the funds in a timely manner for this less favorable tax treatment, despite assurances by the advisers to the funds' boards that the insurance company would do so.

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Solely for the purpose of the SEC proceedings, and without admitting or denying the SEC's allegations in the Order, the advisers agreed to disgorge $27.6 million and to pay a civil money penalty of $5 million.

SEC Settles Two Enforcement Matters with Advisers Concerning Proxy Voting

On September 27, 2019, the SEC issued two similar orders in settlement of unrelated proceedings brought against two investment advisers. In the first order, the SEC alleged that Amadeus Wealth Advisors, LLC ("Amadeus") voted proxies with respect to client securities in multiple client accounts, notwithstanding the fact that Amadeus' Form ADV and advisory agreements represented that Amadeus did not accept proxy voting authority over client securities. In the second order, the SEC similarly alleged that Three Bridge Wealth Advisors, LLC ("Three Bridge") voted proxies for its client securities, notwithstanding the fact that Three Bridge represented in its Form ADV and advisory agreements that it did not accept proxy voting authority for client securities.

Note: *In the SEC's recent release,* Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers *(the "IA Release"), the SEC stated that "the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent." Therefore, according to the IA Release, an adviser and its client (subject to the persistent conditions of full and fair disclosure and informed consent) are free to define the scope of the proxy voting arrangements. These two enforcement matters underscore that the SEC is serious about holding an adviser to the bargain struck with clients concerning proxy voting.*

IRS PLR May Enhance Marketability of Some Annuities Products

On August 26, 2019, Allianz Life Insurance Company of North America ("Allianz") announced that it had received a favorable private letter ruling ("PLR") from the Internal Revenue Service concerning the federal tax treatment of advisory fees taken from non-qualified, fee-based annuities. According to the Allianz announcement, the PLR will permit the payment of advisory fees from fixed-index or variable nonqualified annuities (*i.e.*, sold outside a retirement account such as an IRA) without creating a taxable distribution event. Therefore, the Allianz PLR, which is similar to an August 6, 2019 PLR received by Nationwide, should enhance the marketability of these products by fee-based advisers.

ROPES & GRAY ALERTS AND PODCASTS SINCE OUR JUNE-JULY UPDATE

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:

2019 Final ETF Rulemaking – Summary and Analysis

October 15, 2019
The SEC recently adopted a final ETF rule, largely in the form proposed in June of 2018, but with several important changes in response to industry.

Credit Funds Report – The Road Ahead: Driving Success in 2020

October 3, 2019
The private credit industry grew by leaps and bounds over the past decade: AUM jumped to $769 billion as of June 2018, from $275 billion in 2009. In this thought leadership report, Ropes & Gray collected five articles from members of the firm's credit funds team that highlight key issues in the formation and operation of credit funds. These articles touch on the conflicts inherent in managing both credit and PE funds, the prevalence of key person terms, the intricacies of BDC regulation and value-based payment arrangements in the health care industry, and the potential changing landscape of foreign credit support.

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Flash Analysis: The Final ETF Rule

September 27, 2019
On September 26, 2019, the SEC announced that it had unanimously adopted Rule 6c-11 (the "ETF Rule"). The ETF Rule was adopted largely in the form proposed on June 28, 2018, but with several important changes in response to comments, including the elimination of the requirements (i) to publish the ETF's portfolio holdings prior to the acceptance of a creation or redemption order for that day, (ii) to include historical bid-ask spread information in an ETF's registration statement, and (iii) to make an interactive bid-ask spread calculator available on the ETF's website. At the same time, the SEC issued an exemptive order providing relief from certain rules under the Securities Exchange Act of 1934 ("Exchange Act"). The Exchange Act order may reduce regulatory complexity and eliminate inconsistencies applicable to most newly launched ETFs by eliminating the need for those ETFs to comply with the conditions of certain "class relief" letters.

Whitepaper: Retail Investments in Private Funds: Regulatory Obstacles and Opportunities

September 24, 2019
Over the past several years, regulators and market participants increasingly have called for the expansion of investment opportunities for retail investors and retirees. In this whitepaper, Ropes & Gray surveys the regulatory obstacles under the federal securities laws and ERISA that currently limit retail access to private funds, discusses the rationale for expanding retail access to private funds, and describes several potential models for doing so.

Podcast: Fund Subscription Facilities: Key Considerations for Limited Partners

September 24, 2019
In this Ropes & Gray podcast, asset management partner Isabel Dische and finance partner Patricia Lynch dove into the use of capital call facilities by private investment funds. Specifically, they went into detail on some of the pros and cons for limited partners of such subscription facilities, recent ILPA guidelines relating to their use, the market response to the ILPA guidelines, and their predictions for the future of the market following the adoption of these ILPA guidelines.

Podcast: Asset Management Regulatory Update: Reg BI, Form CRS, and SEC's Fiduciary Duty Interpretation

September 19, 2019
In this Ropes & Gray podcast, asset management counsels Brynn Rail and David Tittsworth discussed the SEC's new rules and interpretations that deal with standards of conduct for brokers and investment advisers. Specifically, they covered the topics of Regulation Best Interest (Reg BI), Form Customer Relationship Summary (Form CRS), and the SEC's fiduciary duty interpretation under the Advisers Act.

Second Circuit Affirms Dismissal of Mutual Fund Class Action, Applies SEC Guidance on Industry Concentration

September 11, 2019
In a decision ratifying the mutual fund industry's long-standing treatment of portfolio concentration, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a putative class action against the Sequoia Fund on September 9. In *Edwards v. Sequoia Fund, Inc.*, the shareholder-plaintiffs alleged that the Fund violated its industry concentration policy when healthcare stocks grew to comprise more than 25% of the Fund's assets in 2015, due to strong growth in the value of its holdings in Valeant Pharmaceuticals, Inc. The Fund's healthcare position grew to more than 25% due solely to increases in Valeant's share price, not because of any additional share purchases. Applying SEC guidance from 1983, the Second Circuit affirmed the trial court's holding that such "passive" increases in concentration cannot constitute a policy violation, defeating the plaintiffs' claims. The Fund is represented by a Ropes & Gray litigation team.

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Podcast: Federal Court Rejects Mutual Fund Fee Claims and Recognizes Market Realities

September 4, 2019
In this Ropes & Gray podcast, litigation & enforcement partners Amy Roy and Rob Skinner discussed the recent decision of a federal court in Los Angeles, rejecting claims of allegedly excessive mutual fund advisory fees against Metropolitan West Asset Management. They discussed the key arguments raised in the trial over the claims, and the evidence relied upon by the court in finding in MetWest's favor across the board.

SEC Issues Guidance to Clarify Investment Advisers' Proxy Voting Responsibilities and the Treatment of Proxy Advice Under the Proxy Rules

August 29, 2019
On August 21, 2019, the SEC published two releases: Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers (the "IA Release") and Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules (the "Proxy Release"). The releases were adopted in separate 3-2 votes, with Chairman Clayton and Republican Commissioners Peirce and Roisman forming the majority in both instances and Democratic Commissioners Jackson and Lee dissenting.

After years of debate, the IA Release and the Proxy Release represent a step towards greater SEC oversight of proxy advisory firms (each, a "Proxy Adviser") and investment advisers' reliance on Proxy Advisers. The oversight comes not by increased regulation of the Proxy Advisers themselves, but by providing detailed guidance to (and, thereby, possibly increasing the burdens on) investment advisers on how to monitor the advice they receive.

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