INVESTMENT MANAGEMENT UPDATE

JANUARY 2020

IN THIS UPDATE

Covering legal developments and regulatory news for registered funds, their advisers and industry participants through December 31, 2019.

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RULEMAKING AND GUIDANCE

SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments

On December 18, 2019, the Securities and Exchange Commission (SEC) proposed amendments to the definition of "accredited investor" in Rule 501(a) of Regulation D under the Securities Act of 1933 and to the definition of "qualified institutional buyer" under Rule 144A under the Securities Act of 1933. The proposed amendments would add additional means for individuals to qualify to participate in private securities offerings, including offerings such as hedge funds, venture capital funds and private equity funds.

Currently, accredited investor status is determined if a person meets an income or net worth threshold.

The proposed amendments would expand the pool of investors who can participate in private offerings by conferring accredited investor status on natural persons based on their professional knowledge, experience or certifications — even if they do not meet the current income or net worth threshold. The proposed amendments would also add new categories for entities, including a "catch-all" category for any entity owning in excess of $5 million in investments. In particular, the proposed amendments to the accredited investor definition would:

- add new categories to the definition that would permit natural persons to qualify as accredited investors based on certain professional certifications and designations, such as holding a Series 7, 65 or 82 license, or other credentials issued by an accredited educational institution
- with respect to investments in a private fund, add a new category based on the person's status as a "knowledgeable employee" of the fund
- add limited liability companies that meet certain conditions, registered investment advisers and rural business investment companies (RBICs) to the current list of entities that may qualify as accredited investors
- add a new category for any entity, including Indian tribes, owning "investments," as defined in Rule 2a51-1(b) under the Investment Company Act of 1940, as amended (1940 Act), in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered

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- add “family offices” with at least $5 million in assets under management and their “family clients,” as each term is defined under the Investment Advisers Act of 1940, as amended (Investment Advisers Act)

- add the term “spousal equivalent” to the accredited investor definition so that spousal equivalents may pool their finances for the purpose of qualifying as accredited investors.

The proposed amendments to the qualified institutional buyer definition in Rule 144A under the Securities Act of 1933 would add limited liability companies and RBICs to the types of entities that are eligible for qualified institutional buyer status if they meet the $100 million in securities owned and investment threshold in the definition. The proposed amendments would also add a “catch-all” category that would permit institutional accredited investors under Rule 501(a), of an entity type not already included in the qualified institutional buyer definition, to qualify as qualified institutional buyers when they satisfy the $100 million threshold.

No amendments were proposed to the current rule’s definition of how much net worth, income and total assets are required to meet the accredited investor definition. The current thresholds have remained unchanged since the 1980s.

The public comment period for the proposed amendments will remain open for 60 days following publication in the *Federal Register*.

The SEC’s proposed rule is available at https://www.sec.gov/rules/proposed/2019/33-10734.pdf.

SEC Proposes Rule to Modernize Use of Derivatives by Registered Investment Companies

On November 25, 2019, the SEC voted to propose new and amended rules and form amendments, designed to provide an updated, comprehensive approach to regulating the use of derivatives and certain other transactions by registered investment companies, including mutual funds, exchange-traded funds (ETFs) and closed-end funds, as well as business development companies. In particular, the proposal includes:

- new Rule 18f-4, which would impose a uniform set of conditions and provide certain exemptions from the 1940 Act

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- new Rule 15l-2 under the Securities Exchange Act of 1934 (Exchange Act) and new rule 211(h)-1 under the 1940 Act, which are designed to address specific considerations raised by leveraged and inverse funds and exchange-listed commodity or currency pools (leveraged investment vehicles)

- amendments to proposed Rule 6c-11 under the 1940 Act to allow certain leveraged or inverse ETFs to operate without obtaining an exemptive order.

Proposed Rule 18f-4

Derivatives Risk Management Program. Proposed Rule 18f-4 would impose a uniform set of conditions and provide certain exemptions from the 1940 Act. Rule 18f-4 would generally require that any fund that engages in derivatives transactions, including securities borrowing for short sales, adopt a written derivatives risk management program. The program would have to include risk guidelines, weekly stress testing, daily back testing, protocols for internal reporting and escalation, and a periodic review of the program no less frequently than annually.

In addition, a derivatives risk management program would be required to be administered by a derivatives risk manager who is an officer of the fund's adviser or sub-adviser and is approved by the fund's board of directors. The fund's derivatives risk manager would have to report to the fund's board on the derivatives risk management program's implementation and effectiveness to facilitate the board's oversight of the fund's derivatives risk management.

Limit on Fund Leverage Risk. Proposed Rule 18f-4 includes a limitation on fund leverage risk, based on value-at-risk (VaR). The leverage risk of the fund would be based on a relative VaR comparison of the fund's VaR to that of a "designated reference index." The fund's VaR would not be permitted to exceed 150 percent of the VaR of the fund's designated reference index. If the fund's derivatives risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of its portfolio would not be permitted to exceed 15 percent of the value of the fund's net assets.

A fund's designated reference index must be unleveraged and reflect the markets or asset classes in which the fund invests. The index must not be administered by an affiliate of the fund, its investment adviser or principal underwriter, or created at the request of the fund or its investment adviser, unless the index is widely recognized and used.

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Exception for Limited Users of Derivatives. Proposed Rule 18f-4 would provide an exception from the derivatives risk management program requirement and the VaR-based limit on fund leverage risk for a fund that either (1) limits its derivatives exposure to 10 percent of its net assets or (2) uses derivatives only to hedge certain currency risks. Such a fund would still be required to adopt and implement policies and procedures reasonably designed to manage the fund's derivatives risks. The policies and procedures required of a limited user of derivatives will not be required to be as robust as a derivatives risk management program.

Alternative Conditions for Certain Leveraged or Inverse Funds. Proposed Rule 18f-4 includes a set of alternative conditions for certain leveraged or inverse funds. A fund meeting the definition of a "leveraged/inverse fund" under proposed Rule 18f-4 would not be required to comply with the proposed VaR-based leverage risk limit so long as it (1) limits the investment results it seeks to 300 percent of the return (or inverse of the return) of the underlying index, (2) discloses in its prospectus that it is not subject to the proposed limit on fund leverage risk, and (3) is a fund to which the new proposed sales practices rules would apply, prohibiting a retail investor from trading through a broker-dealer or investment adviser unless the broker-dealer or investment adviser were to approve the investor's account for such trading.

A "leveraged/inverse investment vehicle" is a fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple, or to provide investment returns that have an inverse relationship to the performance of a market index, over a predetermined period of time.

Reverse Repurchase Agreements and Unfunded Commitment Agreements. The proposed derivatives rule would also permit a fund to enter into reverse repurchase agreements and similar financing transactions, as well as "unfunded commitments" to make certain loans or investments, subject to conditions tailored to these transactions. A fund would be permitted to engage in reverse repurchase agreements and similar financing transactions so long as it meets the asset coverage requirements under Section 18 of the 1940 Act. However, unlike reverse repurchase agreements, the proposed rule does not treat a fund's obligation to return securities lending collateral as a financing transaction similar to a reverse repurchase agreement, so long as the obligation relates to an agreement under which a fund engages in securities lending, the fund does not sell or otherwise use noncash collateral received for loaned securities to leverage the fund's portfolio, and the fund invests collateral solely in cash or cash equivalents.

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Proposed Sales Practice Rules and Amendments to Rule 6c-11

The proposed sales practice rules would establish a set of due diligence and approval requirements for broker-dealers and SEC-registered investment advisers with respect to trades in shares of certain leveraged investment vehicles.

Under the proposed rules, a firm would have to exercise due diligence in determining whether to approve a retail customer or client's account to buy or sell leveraged investment vehicles. A broker-dealer or investment adviser could only approve the account if it had a reasonable basis to believe that the customer or client is capable of evaluating the risks associated with these products.

Following on the heels of the SEC's recently proposed ETF Rule, which explicitly excluded leveraged and inverse products, the rules proposal would permit certain leveraged or inverse ETFs to rely on Rule 6c-11. The SEC proposes to rescind the exemptive orders previously issued to the sponsors of leveraged or inverse ETFs in connection with any adoption of the proposed amendments. This would have the effect of harmonizing the regulatory requirements for leveraged and inverse products and streamlining the process of getting these products to market.

Reporting Requirements

The proposal would require a fund to report confidentially to the SEC on a current basis on Form N-LIQUID (to be renamed "Form N-RN") if the fund is out of compliance with the VaR-based limit on fund leverage risk for more than three consecutive business days. The proposal also would amend Forms N-PORT and N-CEN to require funds that are currently required to file these forms to provide certain information regarding a fund's derivatives exposure and, as applicable, information regarding the fund's VaR. This information would be publicly available.

The public comment period for the proposed amendments will remain open for 60 days following publication in the *Federal Register*.

The SEC's proposed rule is available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

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SEC Issues Dear CFO Letter for Investment Companies and Creates Accounting Matters Bibliography

On November 22, 2019, the Staff of the Chief Accountant's Office in the SEC's Division of Investment Management disseminated a letter, intended for chief financial officers of the Division's registrants and other interested parties, to aid fund registrants, their independent public accountants and other stakeholders in addressing particular accounting, auditing, financial reporting or other related disclosure matters. In connection with the release of this "Dear CFO Letter," the Division of Investment Management also published an accounting matters Bibliography on its website, featuring both current Staff positions expressed in past Dear CFO Letters and updates on whether the Staff positions have been rescinded, modified or supplemented.

The Dear CFO Letter noted that the Staff previously released eight Dear CFO Letters from November 1994 through February 2001, but had more recently chosen to express accounting-related guidance and views through various other means. The Dear CFO Letter further noted that, by reviving the practice of issuing Dear CFO Letters, the Staff believed it could convey the current views of the Division of Investment Management to registrants in a consistent and transparent way.

In the Dear CFO Letter, the Staff commented that federal securities laws had evolved and existing rules and regulations had changed since the first Dear CFO Letter was published in 1994, meriting both a review of past Staff statements, including other Dear CFO Letters, and the publication of the Bibliography. The Staff further commented that modifications to accounting principles and auditing standards pertaining to funds by the Financial Accounting Standards Board and the Public Company Accounting Oversight Board, in addition to changes arising out of the Staff's disclosure review process, have impacted certain Staff positions as articulated in previous Dear CFO Letters, leading to the updated positions contained in the November 2019 Dear CFO Letter and Bibliography. Notably, the Dear CFO Letter and Bibliography also included the addition of a new Staff position related to distributions under Section 19(a) of the 1940 Act.

The Dear CFO Letter is available at https://www.sec.gov/files/industry-comment-letter-112219.pdf.

The Bibliography is available at https://www.sec.gov/investment/accounting-matters-bibliography.

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Exchanges File Rules With SEC Aimed at Spurring ETF Market

Three U.S. stock exchange operators — Cboe Global Markets, Nasdaq Inc. and Intercontinental Exchange Inc.'s NYSE Arca — have each submitted filings with the SEC that, if approved, would reduce or remove barriers to launching new ETFs, including by lowering the costs and speeding up the process.

These filings come shortly after the SEC's Division of Investment Management's September 2019 harmonization of its own rules on ETFs, which eliminated the exemptive relief requirement for most ETFs. The new ETF rule allows most ETFs to register using the same process as traditional open-end mutual funds.

For additional background information on ETFs, view Pepper Hamilton's presentation on the new ETF rule, *An Overview Of The Sec's Recently Adopted Exchange-Traded Funds (ETF) Rule*, available at https://www.pepperlaw.com/events/an-overview-of-the-secs-recently-adopted-exchange-traded-funds-etf-rule-2019-11-15/. See also, Pepper Hamilton's article on this topic in our October 2019 Investment Management Update, available at https://www.pepperlaw.com/publications/investment-management-update-2019-10-22/.

The exchange operators' November 2019 proposals to the SEC look to create efficiencies in connection with ETF launches, seeking, among other things, "blanket approvals" for ETFs covered by the new rule to have the ability to automatically list on an exchange and a lowering of the required minimum shares outstanding that funds need to gain before launching. The proposals also look to eliminate certain quarterly reports that ETFs must file with the SEC highlighting issues with the funds. Generally, it is expected that the new ETF rule, coupled with these proposed changes, will further expand ETFs' enormous popularity in the investment company industry.

A copy of the Cboe BZX Exchange, Inc. proposal is available at: https://www.sec.gov/rules/sro/cboebzx/2019/34-87560.pdf.

A copy of the Nasdaq Stock Market LLC proposal is available at: https://www.sec.gov/rules/sro/nasdaq/2019/34-87559.pdf.

A copy of the NYSE Arca proposal is available at: https://www.sec.gov/rules/sro/nysearca/2019/34-87542.pdf.

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OCIE Risk Alert: Top Compliance Topics Observed in Examinations of Investment Companies and Observations from Money Market Fund and Target Date Fund Initiatives

The SEC's Office of Compliance Inspections and Examinations (OCIE), published its latest Risk Alert on November 7, 2019. The Risk Alert provides information on the most common deficiencies and weaknesses OCIE observed during nearly 300 examinations of registered investment companies over a two-year period.

The Risk Alert notes that the most common deficiencies involved problems with investment companies' compliance programs, disclosure to investors, the investment advisory agreement renewal process under Section 15(c) of the 1940 Act, and investment companies' codes of ethics.

Compliance. Investment companies are required to adopt and implement written policies and procedures reasonably designed to prevent violations of the securities laws. OCIE observed several problems related to compliance obligations. These include a failure to implement procedures to ensure funds did not violate their investment limitations and guidelines, or outright failures to follow or enforce compliance policies and procedures. OCIE also observed repeated failures by investment companies to provide oversight on their service providers.

Disclosure to Investors. OCIE noted the most frequent deficiencies in shareholder disclosure involved providing incomplete or potentially materially misleading information in prospectuses and statements of additional information regarding actual fund practices, such as payment of fees to service providers. OCIE noted other examples of deficiencies included identifying certain strategies and principal investment strategies, even though a fund had not implemented such strategies at all.

Section 15(c) Process. OCIE observed repeated failures by fund boards of directors, which have responsibility for evaluating and approving annually the funds' investment advisory agreements with their investment advisers, pursuant to Section 15(c) of the 1940 Act. Some of the deficiencies OCIE noted include failures by fund boards to request or consider information pertinent to the Section 15(c) process. Similarly, OCIE identified failures by fund boards to adequately discuss the basis of approving an investment advisory agreement under Section 15(c).

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Fund Code of Ethics. An investment company is required to adopt a written code of ethics reasonably designed to prevent certain personnel from engaging in any fraudulent, deceptive or manipulative acts in connection with the purchase and sale of securities held or to be acquired by an investment company. OCIE observed several failures or deficiencies by investment companies related to this requirement. These include failures to actually implement a code of ethics or to adequately follow or enforce existing codes.

The Risk Alert is available at https://www.sec.gov/files/Risk%20Alert%20-%20Money%20Market%20Fund%20and%20Target%20Date%20Fund%20Initiatives.pdf.

SEC Proposes Rule Amendments to Improve Accuracy and Transparency of Proxy Voting Advice

On November 5, 2019, the SEC proposed amendments to its rules governing proxy solicitations intended to enhance the quality of the disclosure about material conflicts in the proxy voting advice industry. The proposal would also provide an opportunity for a period of review and feedback through which issuers would be able to identify errors in proxy voting advice.

Highlights of the proposal include the following:

- **Rule 14a-1(l).** The proposal would amend Exchange Act Rule 14a-1(l) to specify that a person who furnishes proxy voting advice is deemed to be engaged in a "solicitation" subject to the proxy rules.

- **Rules 14a-2(b)(1) and 14a-2(b)(3).** The proposal would revise the exemptions from the information and filing requirements provided by Exchange Act Rule 14a-2(b) such that proxy voting advice businesses relying on these exemptions would be subject to the following conditions:

  - They must include disclosure of material conflicts of interest in their proxy voting advice.

  - Registrants and certain other soliciting persons must be given an opportunity to review and provide feedback on proxy voting advice before it is issued (with the length of the review period dependent on the number of days between the filing of the definitive proxy statement and the date of the shareholder meeting).

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  - Registrants and certain other soliciting persons may request that proxy voting advice businesses include in their voting advice a hyperlink or analogous electronic medium directing the recipient of the advice to a written statement that sets forth the registrant's or soliciting person's views on the proxy voting advice.

- **Rule 14a-9.** The proposal would modify Exchange Act Rule 14a-9 to include examples of when the failure to disclose certain information in the proxy voting advice could, depending on the particular facts and circumstances, be considered misleading within the meaning of the rule.

The public comment period for the proposed amendments will remain open for 60 days following publication in the *Federal Register*.

The SEC's proposed rule is available at https://www.sec.gov/rules/proposed/2019/34-87457.pdf.

SEC Proposes Amendments to Modernize Shareholder Proposal Rule

On November 5, 2019, the SEC proposed amendments to modernize Rule 14a-8 of the Exchange Act. Rule 14a-8 provides a procedure for shareholder proposals to be included in a company's proxy statement. In a press release issued in connection with the proposed amendments, the SEC noted that the proposed amendments were based on the SEC Staff's extensive experience reviewing shareholder proposals and related no-action requests. The SEC stated that, in 2018 alone, almost 5,700 proxy materials were filed with the SEC, and the Staff in the Division of Corporation Finance received more than 250 no-action requests relating to shareholder proposals. The proposed amendments are part of the SEC's ongoing focus on improving the proxy process and the ability of shareholders to exercise their voting rights. It was also noted by the SEC that the shareholder proposal rule had not been updated in more than 20 years.

Rule 14a-8 sets forth guidelines regarding when a company must include a shareholder's proposal in its proxy statement in connection with an annual or other shareholder meeting. The proposed amendments would revise the eligibility requirements under Rule 14a-8(b), the one-proposal limit under Rule 14a-8(c), and the resubmission thresholds under Rule 14a-8(i)(12).

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Rule 14a-8(b). Rule 14a-8(b) currently sets forth who is eligible to submit a proposal and the means of demonstrating eligibility to submit the proposal. If adopted, Rule 14a-8(b) would be amended as follows: The current requirement that a shareholder submitting a proposal hold at least $2,000 or 1 percent of a company's securities for at least one year to be eligible to submit a proposal would be revised to eliminate the 1 percent threshold altogether and, instead, provide three revised thresholds, any one of which a shareholder could satisfy to be eligible to submit a proposal:

- continuous ownership of at least $2,000 of the company's securities for at least three years;
- continuous ownership of at least $15,000 of the company's securities for at least two years; or
- continuous ownership of at least $25,000 of the company's securities for at least one year.

The proposed amendments to Rule 14a-8(b) would further require that a shareholder-proponent, who elects to use a representative to submit a shareholder proposal, provide documentation to make it clear that the representative is authorized to act on the proponent's behalf and to provide a meaningful degree of assurance as to the proponent's identity, role and interest in a proposal that is submitted for inclusion in a company's proxy statement.

Additionally, each shareholder-proponent would be required to state that he or she is able to meet with the company, either in person or via teleconference, no fewer than 10 calendar days nor more than 30 calendar days after submission of the shareholder proposal, and provide contact information as well as business days and specific times that the shareholder-proponent is available to discuss the proposal with the company.

Rule 14a-8(c). Rule 14a-8(c), which currently provides that a shareholder may submit no more than one proposal to a company for a particular shareholder meeting, would be amended under the proposed rules to replace "shareholder" with "person." The proposed change would preclude a shareholder submitting one proposal in his or her own name and simultaneously serving as a representative to submit a different proposal on another shareholder's behalf for consideration at the same meeting. Similarly, a representative would not be permitted to submit more than one proposal to be considered at the same meeting, though each proposal may be on behalf of different shareholders.

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Rule 14a-8(i)(12). Rule 14a-8(i)(12) sets forth instances in which a company may exclude resubmitted proposals dealing with substantially the same subject matter or that have been included in the company's proxy materials within the previous five calendar years.

Currently, a company may exclude resubmitted proposals if the proposal received (1) less than 3 percent of the vote if proposed once within the preceding five calendar years; (2) less than 6 percent of the vote on its last submission to shareholders if proposed twice previously within the preceding five calendar years; or (3) less than 10 percent of the vote on its last submission to shareholders if proposed three or more times previously within the preceding five calendar years.

Under the proposed amendments, the 3 percent, 6 percent and 10 percent thresholds would be replaced with thresholds of 5 percent, 15 percent and 25 percent, respectively. Additionally, the proposed amendments would add a new provision that would allow for exclusion of a proposal that has been previously voted on three or more times in the last five years, notwithstanding having received at least 25 percent of the votes cast on its most recent submission, if the proposal (1) received less than 50 percent of the votes cast and (2) experienced a decline in shareholder support of 10 percent or more compared to the immediately preceding vote.

The public comment period for the proposed amendments will remain open for 60 days following publication in the *Federal Register*.

The SEC's proposed rule is available at https://www.sec.gov/rules/proposed/2019/34-87458.pdf.

SEC Proposes to Modernize Advertising and Cash Solicitation Rules for Investment Advisers

On November 4, 2019, the SEC proposed amendments to modernize Rule 206(4)-1 (the Advertising Rule) and Rule 206(4)-3 (the Cash Solicitation Rule) of the Investment Advisers Act. In a press release issued in connection with the proposed amendments, the SEC noted that the amendments were intended to reflect changes in technology, the expectations of investors seeking advisory services, and the evolution of industry practices. The Advertising Rule has not been significantly amended since its adoption in 1961. The Cash Solicitation Rule has not been significantly amended since its adoption in 1979.

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Advertising Rule

Under the proposed amendments to the Advertising Rule, the definition of an "advertisement" would be expanded to include any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes investment advisory services or that seeks to obtain or retain advisory clients or investors in any pooled investment vehicle advised by the adviser.

Certain communications would be excluded from the definition of advertisement, including (1) live, oral communications that are not broadcast; (2) responses to certain unsolicited requests for specified information; (3) advertisements, other sales materials or sales literature that is about a registered investment company or a business development company and is within the scope of other SEC rules; and (4) information required to be contained in a statutory or regulatory notice, filing or other communication. The revised definition for advertisement is intended by the SEC to be flexible enough to remain relevant and effective in the face of continuing advances in technology and evolving industry practices.

The amended Advertising Rule would prohibit certain specified advertising practices, including, among others, making an untrue statement of a material fact, or omission of a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading, and making a material claim or statement that is unsubstantiated.

The current Advertising Rule prohibits the use of "testimonials" altogether and is silent on the permissibility of endorsements and third-party ratings. The amended Advertising Rule would allow investment advisers to use testimonials, endorsements and third-party ratings, each subject to specified disclosures. It also contains specific prohibitions regarding the presentation of performance information in any advertisement, in addition to protections regarding the presentation of performance information in retail advertisements.

The proposed amendments would require advertisements to be reviewed and approved in writing by a designated employee before dissemination, except for advertisements that are (1) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle or (2) live, oral communications broadcast on radio, television, the internet or any other similar medium.

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Cash Solicitation Rule

The amended Cash Solicitation Rule would make several changes to the scope of the existing rule. As proposed, the Cash Solicitation Rule would no longer apply only to the payment of cash compensation; rather, it would apply regardless of whether an adviser pays cash or noncash compensation to a solicitor. Noncash compensation includes directed brokerage, awards or other prizes, and free or discounted services. The amended Cash Solicitation Rule would apply to the solicitation of current and prospective investors in private funds, rather than only to the solicitation of current and prospective clients of the adviser. It would also generally maintain the current rule's partial exemptions for solicitors that refer investors for impersonal investment advice and solicitors that are employees or otherwise affiliated with the adviser, while creating two new full exemptions for *de minimis* compensation to solicitors and for advisers that participate in certain nonprofit programs. The Rule also contains an expanded list of disciplinary events that would cause a person to be disqualified from acting as a solicitor, with limited exception.

The Cash Solicitation Rule would further require an adviser that compensates a solicitor for solicitation activities to enter into a written agreement with the solicitor, unless an exemption applies. Under the proposed Rule, the written agreement must include (1) a description of the solicitation activities and compensation; (2) a requirement that the solicitor perform its solicitation activities in accordance with certain provisions of the Investment Advisers Act; and (3) a requirement that the solicitor disclosure be delivered to investors. The current rule's requirement that the solicitor agree to deliver the adviser's Form ADV brochure and perform its solicitation activities consistent with the instructions of the adviser would be eliminated under the amended Cash Solicitation Rule.

The Cash Solicitation Rule, as proposed, would also modify the current solicitor disclosure to include additional information about a solicitor's conflicts of interest. Disclosure related to any financial interest for the solicitor in the client's choice of an investment adviser would remain, and advisers would no longer be required to obtain from each investor an acknowledgment of receipt of the disclosures. Similar to the current rule, the amended Cash Solicitation Rule would require that advisers using solicitors have a reasonable basis for believing that the solicitor has complied with the Rule's written agreement, including complying with the solicitor disclosure requirement.

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Review of Relevant Staff Guidance

The proposed Cash Solicitation Rule amendments noted that the Staff in the Division of Investment Management has issued a number of no-action letters and other guidance addressing the application of the current advertising and solicitation rules. The SEC's release accompanying the proposed amendments includes a list of the relevant letters and guidance. The Staff is reviewing these letters to determine whether any should be withdrawn in connection with any adoption of the proposed amendments.

The public comment period for the proposed amendments will remain open for 60 days following publication in the *Federal Register*.

The SEC's proposed rules are available at https://www.sec.gov/rules/proposed/2019/ia-5407.pdf.

Amendments to Procedures With Respect to Applications Under the Investment Company Act of 1940

The SEC issued a proposal on October 18, 2019 to amend Rule 0-5 under the 1940 Act to establish an expedited review procedure for exemptive relief applications that are substantially identical to recent precedent, as well as a new rule to establish an internal timeframe for review of applications outside of that expedited procedure.

The 1940 Act contains provisions that empower the SEC to issue orders granting exemptive relief from provisions of the 1940 Act. Rule 0-5 sets forth the procedure to be followed with respect to any application filed pursuant to any Section of the 1940 Act or any regulation or rule thereunder.

As proposed, expedited review would be available for an exemptive relief application that is "substantially identical" to two other applications for which an order granting the requested relief has been issued by the SEC within two years of the date of the application's initial filing, including that the requested relief is from the same sections of the 1940 Act and rules thereunder, contains identical terms and conditions, and differs only with respect to factual differences that are not material to the relief requested.

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Applicants may use the expedited procedure only when they do not need to modify the terms and conditions of the precedent applications, may not raise new issues for the SEC to consider, would not be able to combine portions or sections of different prior applications, and are not permitted to “mix and match” requested relief. The proposing release states in a footnote that co-investment applications, which generally seek relief to permit a business development company and certain closed-end management investment companies to co-invest in portfolio companies with each other and with other affiliated funds, would “usually not meet the standard for expedited review [because they] typically include different terms and conditions than those of precedent applications.”

Under the proposed rule, the SEC would have 45 days from the application filing date to comment on the application. For those applications that do not qualify for expedited review, the amendment would formalize the Staff’s current 90-day internal performance timeline. As proposed, the rule would permit the Staff to grant extensions and would set out the conditions for an amendment to be automatically withdrawn. Upon final disposition of an application, the Staff would disseminate the filings through EDGAR to make them publicly available, except for materials (or portions thereof) covered by confidential treatment requests.

The SEC believes the expedited review process will enable certain funds, such as ETFs or interval funds, to launch more quickly.

Comments to the rule proposal were due by November 29, 2019.

The SEC’s proposed rule is available at https://www.sec.gov/rules/proposed/2019/ic-33658.pdf.

SEC Releases FAQs on Disclosure of Certain Financial Conflicts Related to Investment Adviser Compensation

On October 18, 2019, the Staff of the SEC’s Division of Investment Management released frequently asked questions related to certain compensation arrangements and related disclosure obligations arising from both the investment adviser’s fiduciary duty and Form ADV. The FAQs address an investment adviser’s disclosure requirements related to (1) conflicts of interest as to compensation received by an investment adviser in connection with investments it recommends; (2) conflicts of interest regarding mutual fund share class recommendations; (3) revenue-sharing payments; and (4) material amendments to Form ADV. The FAQs are summarized below.

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Recommended Investments

An investment adviser that receives compensation, directly or indirectly, in connection with the investments it recommends has a financial incentive to make recommendations that result in the receipt of that compensation. With respect to disclosure of conflicts of interest related to compensation that they receive in connection with investment recommendations, the FAQs remind investment advisers that they must look to (1) their general disclosure obligations as a fiduciary and (2) the specific disclosure requirements in Form ADV.

As a fiduciary, an investment adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. An investment adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest that might incline it to render advice that is not disinterested.

The FAQs highlight a number of instructions to Form ADV that require disclosure of such conflicts, for example:

- General Instruction 3 for Part 2 requires that an investment adviser's client disclosures include "sufficiently specific facts" to allow clients to understand the investment adviser's conflicts and business practices and give informed consent or reject them.

- General Instruction 2 for Part 2 instructs investment advisers that, if a conflict or practice exists with respect to only certain classes of clients, advice or transactions, an investment adviser must "indicate as such rather than disclosing that [the investment adviser] 'may' have the conflict or engage in the practice."

- Under Item 5.E of the firm brochure (Part 2A of Form ADV), an investment adviser must disclose if it or its supervised persons accept sales compensation, including asset-based sales charges or service fees.

- Under Item 4.A(2), if an investment adviser's supervised person "receives commissions, bonuses or other compensation based on the sale of securities or other investment products, including as a broker-dealer or registered representative, and including distribution or service ('trail') fees from the sale of mutual funds, [the investment adviser must] disclose this fact" in its brochure supplement.

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An investment adviser's fiduciary duty and the instructions to Form ADV require an investment adviser to disclose any conflict of interest resulting from the receipt of compensation in connection with investment recommendations. Where such a conflict exists, an investment adviser must also disclose how it addresses the conflict. The FAQs emphasize that *longer* disclosures may not be *better* disclosures.

Share Class Recommendations

Following on a number of enforcement actions and a self-reporting initiative, the Staff provided FAQs regarding disclosure as to conflicts of interest arising from mutual fund share class recommendations.

In general, it is well-established that an investment adviser has a conflict of interest that it must disclose when more than one mutual fund share class is available to a client and the investment adviser receives compensation, directly or indirectly, based on the share class it recommends. While the Staff has observed a range of disclosure practices related to share class recommendations, it urged investment advisers to consider disclosure of the following items:

- *The existence and effect of different incentives and resulting conflicts.*
  - The fact that different share classes are available and that different share classes of the same fund represent the same underlying investments.
  - How differences in sales charges, transaction fees and ongoing fees would affect a client's investment returns over time.
  - The fact that the investment adviser has financial interests in the choice of share classes that conflict with the interests of its clients.
- *The nature of the conflict.*
  - For example, whether the conflict arises (1) as a result of differences in the compensation the investment adviser and its affiliates receive or (2) from the existence of any incentives shared between the investment adviser and the clearing broker or custodian (such as offsets, credits or waivers of fees and expenses).

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  - Whether there are any limitations on the availability of share classes to clients that result from the business of the investment adviser or the service providers that the investment adviser uses.

  - Whether an investment adviser's practices with regard to recommending share classes differ when it makes an initial recommendation to invest in a fund as compared to (1) when it makes recommendations regarding whether to convert to another share class or (2) when it makes recommendations to buy additional shares of the fund.

- *How the investment adviser addresses the conflict.*

  - The circumstances under which the investment adviser recommends share classes with different fee structures and the factors that the investment adviser considers in making recommendations to clients.

  - Whether the investment adviser has a practice of offsetting or rebating some or all of the additional costs to which a client is subject (such as 12b-1 fees and/or sales charges), the impact of these offsets or rebates, and whether that practice differs depending on the class of client, advice or transaction.

Revenue Sharing

The Staff highlighted Item 14.A of Part 2A of Form ADV, which requires disclosure of economic benefits provided to an investment adviser from someone who is not a client for providing investment advice or other advisory services to clients. In such cases, investment advisers should consider disclosure of the following material facts:

- The existence of any incentives provided to the investment adviser or shared between the investment adviser and others (*e.g.*, clearing brokers, custodians, funds' investment advisers or service providers). For example, any agreements to receive payments and/or expense offsets from a custodian for recommending that the investment adviser's clients maintain assets at the custodian.

- As with the receipt of 12b-1 fees, an investment adviser disclosing that it "may" have a conflict as the result of receiving revenue-sharing payments is not adequate when the conflict actually exists.

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Material Updates to Form ADV

The Staff pointed out that when an investment adviser materially amends or supplements its disclosures concerning share class recommendations or revenue-sharing arrangements in an annual update to its Form ADV, it is required to highlight the new disclosure in the summary of material changes.

Key Takeaways

An investment adviser must look to both its general disclosure obligations as a fiduciary and to the specific disclosure requirements in Form ADV. In particular, in seeking to meet its duty of loyalty as a fiduciary, an investment adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship. The examples provided in the FAQs were nonexhaustive, and disclosure should be tailored to an investment adviser's specific circumstances.

The FAQs are available at: https://www.sec.gov/investment/faq-disclosure-conflicts-investment-adviser-compensation.

ADI 2019-09 – Performance and Fee Issues

On October 2, 2019, the SEC's Division of Investment Management Disclosure Review and Accounting Office (DRAO) issued an Accounting and Disclosure Information (ADI) providing guidance and observations related to performance and fee information in certain registration statements reviewed by the DRAO. In the ADI, the SEC Staff reminded funds to verify the accuracy of performance and fee disclosures before filing them with the SEC and providing them to investors.

In particular, the ADI noted errors in the presentation of certain funds' performance, including the following: (1) funds that failed to reflect sales loads in their average annual returns table, resulting in the presentation of overstated performance; (2) showing negative performance as positive performance (in both the required bar chart and average annual return table); (3) transposing the presented performance of fund classes (such as showing Class A performance as Class B performance and vice versa); and (4) transposing the performance of different benchmark indices.

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The ADI also noted errors in the fee-related information presented by certain funds, including the following: (1) incorrectly showing net expenses that exceed gross expenses in a manner that is inconsistent with the requirements of Form N-1A; (2) prospectus fee tables that failed to reflect the appropriate amount of expenses associated with the fund's investments in other funds (*i.e.*, Acquired Fund Fees and Expenses); and (3) funds that incorrectly calculated the expense example (*i.e.*, the hypothetical calculation in the prospectus that shows the estimated expenses that an investor will pay for investing in a fund over different time periods).

Additionally, the ADI noted that some funds have incorrectly tagged their risk/return summaries in XBRL by using the wrong tags, entering the data incorrectly, or associating the tagged information with the wrong fund or class.

The SEC's ADI is available at https://www.sec.gov/investment/accounting-and-disclosure-information/performance/adi-2019-09-performance-and-fee-issues.

LITIGATION AND ENFORCEMENT

Calamos Prevails After Trial of 1940 Act Fee Case

A mutual fund adviser has won again on Section 36(b) claims. The U.S. District Court for the Southern District of New York issued a post-trial ruling on September 30, 2019 in *Chill v. Calamos Advisors LLC*, holding that the plaintiffs failed to meet their burden to show that Calamos Advisors charged excessive advisory fees to the Calamos Growth Fund in violation of Section 36(b) of the 1940 Act. The court concluded that, "of the six factors articulated in *Gartenberg* and reaffirmed in *Jones v. Harris Associates L.P.*, only one — the quality of services Calamos provided to the fund — even marginally tend[ed] to support Plaintiffs' claim. The other five factors weigh[ed] decisively in Calamos' favor." The court's opinion addressed each of the *Gartenberg* factors in detail.

Section 36(b) imposes a fiduciary duty on an investment adviser to a mutual fund with respect to the receipt of compensation, and gives mutual fund shareholders a private right of action to enforce that duty. The statute expressly assigns to any such plaintiff the burden of proof, and it has been supported by subsequent case law — that in order to demonstrate that a mutual fund investment advisor breached the "fiduciary duty with respect to the receipt of compensation for services," a mutual fund shareholder must show, as established in *Jones*, that the advisor charged "a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

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In deciding in favor of Calamos, the court paid particular attention to the credibility of the witnesses for Calamos. The court noted the conscientiousness and care of the independent trustees' 15(c) contract review. The court stated in its finding of fact that the weight of credible trial evidence made clear that the independent trustees were "informed, conscientious and careful" in approving Calamos' annual advisory fees under its investment management agreement for the relevant period, and that, therefore, a "substantial deference to the Independent Trustees' decision [was] warranted." The board's strong process was a prominent factor in the court's opinion.

The court's opinion and order are available at https://casetext.com/case/chill-v-calamos-advisors-llc-3.

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Pepper Hamilton LLP
Attorneys at Law

Pepper Hamilton's Financial Services Practice Group includes more than 45 lawyers and other professionals who focus their practices on issues affecting the financial services industry. Our Investment Management Group serves a wide range of businesses in the investment management community. Our practice involves three general areas: representation of registered investment companies and registered investment advisers, representation of alternative investment funds and investors in alternative products, and counseling regarding securities regulation, enforcement and litigation.

PEPPER HAMILTON'S INVESTMENT MANAGEMENT GROUP

INVESTMENT COMPANY & SEC REGULATORY MATTERS

Joseph V. Del Raso, Managing Partner | delrasoj@pepperlaw.com
John P. Falco, Partner | falcoj@pepperlaw.com
John M. Ford, Partner | fordjm@pepperlaw.com
Gregory J. Nowak, Partner | nowakg@pepperlaw.com
Todd R. Kornfeld, Of Counsel | kornfeldt@pepperlaw.com
Terrance James Reilly, Special Counsel | reillyt@pepperlaw.com
Theodore D. Edwards, Associate | edwardst@pepperlaw.com
Christopher M. Trueax, Associate | trueaxc@pepperlaw.com
Kyle F. Whiteman, Associate | whitemank@pepperlaw.com
Darlene Lee, Paralegal | leed@pepperlaw.com
Barbara H. Grugan, Senior Regulatory Compliance Specialist | gruganb@pepperlaw.com

SEC ENFORCEMENT & LITIGATION MATTERS

Jay A. Dubow, Partner | dubowj@pepperlaw.com
Jeremy D. Frey, Of Counsel | freyj@pepperlaw.com

FINANCIAL & SECURITIES REGULATORY MATTERS

Richard P. Eckman, Of Counsel | eckmanr@pepperlaw.com
Matthew M. Greenberg, Partner | greenbergm@pepperlaw.com

INVESTMENT COMPANY TAX MATTERS

W. Roderick Gagné, Partner | gagner@pepperlaw.com
Morgan Klinzing, Associate | klinzingm@pepperlaw.com

ERISA MATTERS

Michael J. Crumbock, Partner | crumbockm@pepperlaw.com
Rebecca Alperin, Of Counsel | alperinr@pepperlaw.com