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Investment Management Update – September 2020

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Covering legal developments and regulatory news for funds, their advisers and industry participants through July 31, 2020.

RULEMAKING AND GUIDANCE

SEC Adopts Amendments to Exemptive Applications Procedures

On July 6, 2020, the U. S. Securities and Exchange Commission adopted rule amendments to establish an expedited review procedure for exemptive and other applications under the Investment Company Act of 1940, as amended, that are substantially identical to recent precedent, as well as a new informal internal procedure for applications that would not qualify for the new expedited process. According to the SEC, these actions are intended to create efficiencies and to provide transparency regarding the process.

The SEC states that granting appropriate exemptions from the 1940 Act can provide economic benefits to funds and their shareholders (i.e., make the applications process less expensive), foster financial innovation, and increase the diversity of opportunities for investors. The SEC provides as examples that exchange-traded funds have historically required an exemption in order to operate, and other funds have sought exemptive relief in order to operate in a more efficient and less costly manner.

Highlights:

Expedited Review Procedure for Routine Applications

- The amendments to rule 0-5 under the 1940 Act establish an expedited review procedure for routine applications that are substantially identical to recent precedent.
  - Expedited review will be available if the current application is substantially identical to two other applications for which an order granting the relief has been issued within three years of the date of the current application's initial filing.
  - Notice for an application filed under expedited review will be issued no later than 45 days from the date of filing unless the application is not eligible under the rules or additional time is necessary for appropriate SEC staff consideration.
  - An application for expedited review will be deemed withdrawn if the applicant does not respond to comments from SEC staff within 30 days.

Procedure for Other Applications

- The amendments to rule 0-5 under the 1940 Act will deem an application outside of expedited review withdrawn when the applicant does not respond to comments from SEC staff within 120 days.
- New rule 17 CFR 202.13 establishes an internal timeframe for SEC staff to take action on applications outside of expedited review. Under this new rule, SEC staff would take action on the application within 90 days of the initial filing and each of the first three amendments thereto, and within 60 days of any subsequent amendment. In addition, the SEC staff could grant 60 day extensions. The purpose of this new rule is not to grant enforceable rights to either the applicant or the SEC, but rather to provide informal, non-binding guidelines which the SEC staff intends to meet.

These new procedures will be effective 270 days following their publication in the Federal Register.

The SEC's final rule is available at: https://www.sec.gov/rules/final/2020/ic-33921.pdf.

Five Key Points About the DOL's New Fiduciary Rule

On June 29, 2020, the U.S. Department of Labor (DOL) announced a new proposed class exemption to certain prohibited transaction restrictions in the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the Code), entitled "Improving Investment Advice for Workers & Retirees." The proposed exemption is intended to help workers and retirees by preserving the wide availability of investment advice arrangements and products for retirement investors. The proposed exemption is expected to be well-received by "investment advice fiduciaries," because it is broader and more flexible than the DOL's pre-existing prohibited transaction class exemptions which generally provide relief for more discrete transactions. Here are five things you should know about the proposed exemption.

1. Background

In 1975, the DOL established a five-part test for fiduciary status under ERISA. The Code uses identical wording for the five-part test in its definition of fiduciary. Under both ERISA and the Code, a person is an investment advice professional if the person renders "investment advice" for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, OR has any authority or responsibility to do so.

Under the DOL's five-part test for advice to constitute "investment advice," a financial institution or investment professional who is not otherwise a fiduciary under another provision of the statute must –

1. render advice *to* the plan *as to the value* of securities or other property, *or make recommendations as to the advisability of* investing in, purchasing, or selling securities or other property,
2. on a *regular* basis,
3. *pursuant to a mutual agreement, arrangement, or understanding* with the plan, plan fiduciary or IRA owner, that
4. the advice will serve as a *primary basis for investment decisions* with respect to plan or IRA assets, and that
5. the *advice will be individualized based on the particular needs of the plan or IRA.* (emphasis supplied).

There are three consequences under the rule to a financial institution or investment professional that meets this five-part test, *and* receives a fee or other compensation, direct or indirect: that institution or professional (A) is an “investment advice fiduciary” under ERISA and the Code, (B) is subject to fiduciary duties with respect to an employee benefit plan (Plan) , and (C) is forbidden from engaging in certain “prohibited transactions” involving Plans and individual retirement accounts or annuities (IRAs) unless an exemption applies.

In 2016, the DOL had tried to update and modernize the 1975 rule[1] but a 2018 decision of the U.S. Court of Appeals for the Fifth Circuit vacated the attempt. Effective immediately, the DOL reinstated the 1975 five-part test to determine whether a retirement investment adviser is acting as a fiduciary. The DOL has now issued a revised Proposed Exemption.

2. Proposed Exemption

The proposed exemption would apply to registered investment advisers, broker-dealers, banks, insurance companies, and their employees, agents, and representatives that are considered investment advice fiduciaries under the reinstated five-part test.

Practice Point

The trigger for the application of the proposed exemption is that the investment advice fiduciary is already a regulated entity in the form of an RIA, registered broker dealer, bank or insurance company and their employees, agents and representatives. Apparently, a “country squire” who is not associated with one of these entities cannot avail themselves of the exemption.[2]

The proposed exemption would permit investment advice fiduciaries to receive compensation as a result of providing fiduciary investment advice, including advice to roll over assets from a Plan to an IRA and other similar rollover recommendations (e.g., IRA to IRA).

It would also permit investment advice fiduciaries to engage in “principal transactions” in which they could sell or purchase certain securities and other investments from their own inventories to or from Plans and IRAs.

Practice Point

Note that even though the DOL has provided an exemption for “principal transactions,” the investment adviser must still run the gauntlet of Section 206(3) of the Investment Advisers Act of 1940, as amended, which generally prohibits principal trades unless very specific procedures are followed, including (1) disclosing in writing to the client before completion of such transactions the capacity in which the adviser is acting, and (2) obtaining the consent of the client to such transaction. Further, the SEC has always taken the position that Section 206 applies to all investment advisers, including those not registered as advisers with the Commission.

The proposed exemption would require fiduciary investment advice to be provided in accordance with the “Impartial Conduct Standards” announced in Field Assistance Bulletin (FAB) 2018-02 (discussed in footnote 1). The Impartial Conduct Standards have three components: (1) a best interest standard (i.e., advice is prudent and loyal); (2) a reasonable compensation standard; and (3) a requirement to make no misleading statements about investment transactions and other relevant matters.

The proposed exemption also includes certain additional protective conditions designed to protect the interests of Plans, participants and beneficiaries, and IRA owners – (1) disclosure of fiduciary status to retirement investors, (2) policies and procedures requiring mitigation of conflicts of interest, and (3) an annual retrospective compliance review.

Unlike the overturned exemption, the proposed exemption is designed to align with existing conduct standards issued by other regulators, such as the SEC.

Investment advice fiduciaries could lose access to the proposed exemption for 10 years for certain criminal convictions in connection with the provision of investment advice to retirement investors, or for egregious conduct with respect to compliance with the class exemption.

3. Rollovers from Plans to IRAs

In the preamble to the proposed exemption, the DOL explains that the decision to roll over Plan assets to an IRA is potentially a very consequential financial decision, because amounts accrued in Plans can represent a lifetime of savings, and often comprise the largest sum of money a worker has at retirement. The DOL takes the position that advice to take a distribution of assets from a Plan is advice to sell, withdraw, or transfer investment assets currently held in the Plan, and therefore may be covered by the five-part test to determine whether a retirement investment adviser is a fiduciary.

All five prongs of the five-part test must apply for a financial institution or investment professional to be an investment advice fiduciary when making a rollover recommendation. Accordingly, advice to take a distribution from a Plan and roll over the assets to an IRA provided in an isolated and independent transaction (*in contrast with advice as part of an ongoing relationship or an anticipated ongoing relationship* with the advice provider) would fail to meet the regular-basis prong of the five-part test.

4. Robo-Advice Arrangements

The proposed exemption would not cover advice arrangements that rely solely on automated investment advice that involves computer models that utilize portfolio management algorithms (i.e., robo-advice). Those advice arrangements are covered by separate statutory exemptions in ERISA and the Code. The proposed class exemption would, however, cover “hybrid” robo-advice arrangements which involve advice generated by computer models in connection with additional advice from an investment professional.

Practice Point

The proposal does not further elaborate on hybrid "robo-advice arrangements," but presumably an investment professional who consults a computer model and then relays that conclusion as part of an ongoing advice relationship will not be considered a "robo-advice arrangement."

5. Significance of the Proposed Exemption for Investment Advisers and Plan Fiduciaries

The proposed exemption is significantly broader and more flexible (i.e., it does not identify specific transactions that are covered) than the DOL's pre-existing prohibited transaction class exemptions for investment advice fiduciaries. Those pre-existing exemptions provide relief for more discrete transactions, and have not been amended to provide relief for compensation arrangements that developed over time (e.g., commissions, 12b-1 fees, revenue sharing, etc.). Investment advisers could choose to comply with pre-existing exemptions or the proposed exemption, based on their needs and business models.

Plan fiduciaries now have certainty that the five-part test should be applied to determine if an investment adviser is acting in the capacity of an investment advice fiduciary for purposes of ERISA and the Code. Provided the proposed exemption is finalized, Plan fiduciaries will want to understand whether investment advice fiduciaries are complying with pre-existing exemptions or the new exemption.

Comments on the proposed exemption were due in August. The exemption, if granted, is expected to be available 60 days after the date of publication of the final exemption in the Federal Register. The temporary enforcement policy announced in FAB 2018-02 remains in place.

Links

- Notice of Proposed Class Exemption
- Technical Amendment
- Fact Sheet
- News Release

SEC Still Observing Deficiencies Involving Private Fund Fees and Expenses and Conflicts Disclosure

On June 23, 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert highlighting the following three general areas of deficiencies OCIE identified in examinations of private fund advisers: (1) conflicts of interest; (2) fees and expenses; and (3) policies and procedures relating to material nonpublic information (MNPI). OCIE hopes this latest risk alert will assist private fund advisers in reviewing and enhancing their compliance programs, and also will provide investors with information concerning private fund adviser deficiencies.

General Areas Deficiencies	Specific Practices Observed

	• Multiple clients investing in the same portfolio company • Undisclosed financial relationships (e.g., investors making seed investment or providing credit) between investors and or clients and the adviser • Preferential liquidity rights to certain investors through side letters • Private fund adviser interests in recommended investments (e.g., preexisting ownership interests or other financial interests, such as referral fees or stock options in the investments) • Undisclosed process, and failure to follow disclosed process, for allocations of co-investments • Service providers (e.g., advisers with incentives for portfolio companies to use certain service providers, such as incentive payments from discount programs, but failed to disclose the incentives and conflicts to investors) • Inadequate disclosures on fund restructurings and stapled secondary transactions • Cross-transactions (e.g., advisers had established the price at which securities would be transferred between client accounts in a way that disadvantaged one of the clients)
Fees and Expenses	• Inaccurate allocation of fees and expenses (e.g., broken-deal, due diligence, annual meeting, consultants, and insurance costs, among the adviser and its clients, including private fund clients, employee funds, and co-investment vehicles) • Misleading investors about who would bear the costs associated with operating partners’ services and potentially causing investors to overpay expenses • Inappropriately over-valuing client assets causing clients to overpay management fees • Undisclosed monitoring, board and deal fees, and inaccurate management fee offsets

	• Code of Ethics Rule (e.g., unenforced trading restrictions; undefined policies and procedures for adding securities to, or removing securities from, restricted lists; unenforced gifts and entertainment policies; failures to require submission of timely transactions and holdings reports timely or preclearance requests; and failure to identify correctly certain individuals as "access persons")
MNPI Policies and Procedures	• Section 204A (e.g., policies and procedures did not address, or were not enforced with respect to, interactions with insiders of publicly traded companies, "expert network" firms, investors who are corporate insiders, access to MNPI in connection with PIPEs, and access to office space or systems that possess MNPI)

Déjà vu?

This is not the first OCIE guidance reminding private fund managers to review their policies and procedures to avoid these types of deficiencies. Shortly after the initial round of exams following the Dodd-Frank wave of private fund manager registrations in 2012, OCIE observed a high rate of deficiencies involving private fund manager fees and expense allocations. Since 2015, OCIE has often included in its annual exam priorities roster private fund fees and expenses, disclosure of conflicts of interest, as well as actions that appear to benefit the adviser at the expense of investors.[3]

The SEC followed through on its exam priorities. The SEC has initiated multiple actions against private fund managers since 2015 on violations such as expense allocation, undisclosed fees, and undisclosed conflicts of interest, including with respect to broken deal expenses, accelerated monitoring fees, and affiliated consulting fees.[4]

OCIE has similarly reminded advisers to review compliance programs for MNPI deficiencies. In February 2017, OCIE published a risk alert listing the five most frequent compliance topics identified on investment adviser examinations completed within the past two years — Code of Ethics rule violations made the list. Representative violations of the Code of Ethics Rule centered on the advisers' failure to satisfactorily provide information about the advisers' codes of ethics. Among other things, the staff observed that advisers failed to comprehensively identify their "access persons," neglected to timely disclose information pertaining to holdings and transactions reports, and failed to properly describe their codes of ethics in Form ADV filings.

Again, on April 12, 2018, OCIE released a risk alert identifying the most frequently cited compliance deficiencies relating to fees and expenses charged by SEC-registered investment advisers to their clients. In particular, the 2018 risk alert highlighted OCIE's observation of fund managers misallocating marketing expenses, regulatory filing fees, and travel expenses to fund clients instead of the adviser, in contravention of the applicable advisory agreements, operating agreements, or other disclosures. OCIE's stated objectives in issuing the risk alert were to encourage advisers to assess their advisory fee and expense practices and related disclosures to ensure that they are complying with the Investment Advisers Act, the relevant rules, and their fiduciary duty, and review the adequacy and effectiveness of their compliance programs.

We have already observed recent private fund exam document request letters lasering in on these issues and anticipate more to come. If history has its way and repeats itself, we may be in store for another round of private fund enforcement actions related to expense allocation, undisclosed fees, and undisclosed conflicts of interest.

Compliance Takeaways

Private fund managers should take heed of OCIE's guidance and assess their advisory fee and expense practices, related disclosures, and MNPI policies and procedures. In particular, firms should consider the following takeaway tips for reviewing these compliance matters:

- Review your firm's current compliance policies and procedures to confirm consistency with the terms of your fund governing documents and Form ADV disclosure.
- Review your general ledgers to confirm expenses have been properly allocated as between the adviser and the funds you advise. A best practice is to have the fund governing documents expressly enumerate the line items allocated to the fund.
- Periodically test to confirm the fees charged were properly calculated and the expenses allocated to the fund were authorized under the fund documents.
- Review breach logs to ensure any detected violations are remediated and procedures updated to prevent future violations.
- Confirm your fund investors are on the same page as you about fund fees and expenses (particularly any management fee based on values) by making periodic disclosures to your LPAC/investors about the fees and expenses paid by the fund.
- Check out our recent client advisory discussing the "Do's and Don'ts" of insider trading/MNPI issues while working from home.

For more information on private fund fees and expenses, please check out this podcast on fund fees and expense trends, as well as the article "Fund Fees and Expenses-A Tale of Four Surveys: Trends 2014-2018", by Julia D. Corelli of Troutman Pepper. The field surveys for the 2020 Fees and Expenses Benchmarking Survey sponsored by our firm, Private Equity International, Withum, and PEF Services are complete and the results will be released in the fall. Please email Brian Dolan (brian.dolan@troutman.com) if you want to receive the results once they are available.

SEC Extends Relief for Virtual Meetings of Fund Boards and Announces Termination of Other COVID-19 Related Relief

On June 19, 2020, the SEC issued an order (the Order) stating that it was extending specific aspects of its March 25, 2020 order which granted exemptions from certain provisions of the 1940 Act and certain rules under it, in response to the far-ranging effects of COVID-19. Specifically, the Order extended relief from in-person voting requirements for fund boards that was included in the March 25, 2020 order. Under the Order, the relief from in-person voting requirements will now extend at least through December 31, 2020. The SEC noted that the extension is designed to provide flexibility to boards of registered funds and business development companies (BDCs) that continue to encounter challenges meeting in person due to COVID-19. Notably, the Order did not extend other portions of the March 25, 2020 order, including relief with respect to fund prospectus delivery requirements. Additionally, relief from the requirements for in-person board action imposed under Sections 15(c) and 32(a) and Rules 12b-1(b)(2) and 15a-4(b)(2)(ii) under 1940 Act continue to be conditioned on the following circumstances, first set forth in the March 25, 2020 order:

- Reliance on the relief is necessary or appropriate due to circumstances related to current or potential effects of COVID-19;
- The votes required to be cast at an in-person meeting are instead cast at a meeting in which directors may participate by any means of communication that allows all directors participating to hear each other simultaneously during the meeting; and
- The board of directors, including a majority of the directors who are not interested persons of the registered

investment company or BDC, ratifies the action taken pursuant to this exemption by vote cast at the next in-person meeting.

The SEC's order is available at: https://www.sec.gov/rules/exorders/2020/ic-33897.pdf.

OCIE Risk Alert – Examination Initiative: LIBOR Transition Preparedness

On June 18, 2020, the SEC's Office of Compliance Inspections and Examinations announced that it had identified registrant preparedness for the transition away from the London Interbank Offered Rate (LIBOR) as an examination program priority for FY 2020, and that OCIE had issued a Risk Alert to provide registrants with additional information about the scope and content of these examinations.

LIBOR is used extensively in the United States and globally as a "benchmark" or "reference rate" for various commercial and financial contracts, including corporate and municipal bonds and loans, floating rate mortgages, asset-backed securities, consumer loans, and interest rate swaps and other derivatives. The discontinuation of LIBOR, currently expected to occur after 2021, could have a significant impact on the financial markets and may present a material risk for certain market participants, including SEC-registered investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies (collectively, "registrants"). According to the OCIE Risk Alert, preparation for the transition away from LIBOR is essential to minimize any potential adverse effects.

OCIE stated in the Risk Alert that examinations may include a review of whether and how the registrant has evaluated the potential impact of the LIBOR transition on the organization's: (i) business activities; (ii) operations; (iii) services; and (iv) customers, clients, and/or investors (collectively, "investors"). Also, whether registrants have developed, and what steps they have taken, to prepare for the LIBOR discontinuation, including as applicable:

- The firm's and investors' exposure to LIBOR-linked contracts that extend past the current expected discontinuation date, including any fallback language incorporated into these contracts;
- The firm's operational readiness, including any enhancements or modifications to systems, controls, processes, and risk or valuation models associated with the transition to a new reference rate or benchmark;
- The firm's disclosures, representations, and/or reporting to investors regarding its efforts to address LIBOR discontinuation and the adoption of alternative reference rates;
- Identifying and addressing any potential conflicts of interest associated with the LIBOR discontinuation and the adoption of alternative reference rates; and
- Clients' efforts to replace LIBOR with an appropriate alternative reference rate.

OCIE provided an appendix to the Risk Alert with the types of information and documents that may be used in the OCIE examinations, and certain resources for registrants that may aid with the LIBOR transition.

The Risk Alert is available at:
https://www.sec.gov/files/Risk%20Alert%20-%20OCIE%20LIBOR%20Initiative_1.pdf.

SEC Staff No Action Letter: First Trust Senior Floating Rate Income Fund II – Omission of Shareholder Proposal from Saba Capital Management, LP

On June 17, 2020, the SEC staff issued a no-action letter that permits a listed closed-end fund – First Trust Senior Floating Rate Income Fund II— to omit from its proxy materials a non-binding proposal and supporting statement submitted by an institutional shareholder. The proposal was submitted by the shareholder pursuant to Rule 14a-8 under the Securities Act of 1934, which permits a shareholder to have proposals included in a fund's proxy materials, and, sets forth other applicable procedural and substantive requirements to do so. Rule 14a-8(b)(1) provides that to be eligible to submit a proposal, a shareholder must have continuously held at least $2,000 in market value, or 1%, of the company's securities *entitled to be voted on the proposal* at the relevant meeting for at least one year by the date the proposal is submitted.

The proposing shareholder sought to include in the fund's proxy materials a proposal to declassify the fund's board so that all trustees are elected on an annual basis. The fund, in seeking no-action relief, asserted that it could exclude the proposal pursuant to Rule 14a-8(b)(1) because the fund's Declaration of Trust only provided shareholders with the right to vote on certain enumerated matters, and that declassifying the fund's board is not included in the specific matters in the Declaration of Trust. In addition, the board's class structure was set forth in the fund's by-laws, which can only be amended by a vote of the board and not by shareholders.

The SEC's no-action letter is available at: https://www.sec.gov/investment/first-trust-senior-floating-rate-income-fund-ii-2020-06-17.

Division of Investment Management Issues Statement on Control Share Acquisition Statutes

On May 27, 2020, the staff of the SEC's Division of Investment Management issued a statement regarding the interplay of state control share acquisition statutes and the voting requirements of the 1940 Act. Specifically, the SEC staff withdrew its 2010 guidance issued to Boulder Total Return Fund, Inc.[5], in which it had stated that state control share statures are inconsistent with the requirements of Section 18(i) of the 1940 Act. The rescission of the Boulder letter paves the way for certain investment companies to use the protections against takeovers provided by state control share statutes.

State Control Share Statutes

Generally, state control share statutes provide a company with the right to prevent or restrict certain changes in corporate control by altering or removing voting rights when a person acquires, directly or indirectly, the ownership of, or the power to direct the vote of, control shares as defined in the specific state control share statute. Control shares are shares of stock that are equal to or exceed specified percentages of the company's total voting power.

State control share statutes are anti-takeover statutes that are intended to force an acquirer to engage directly with an issuer's management, rather than obtaining significant voting power through market purchases of the corporation's shares. Generally, control share statutes do not apply to registered open-end funds, but do apply to closed-end funds. Approximately half of the states have control share statutes in effect.

Section 18(i) of the 1940 Act

Section 18(i) of the Investment Company Act states, in pertinent part, as follows:

"[e]xcept as . . . otherwise required by law, every share of stock hereafter issued by a registered management company… shall be a voting stock and have equal voting rights with every other outstanding voting stock . . ."

Congress adopted Section 18(i) to address the abuses of "various devices of control" by investment company insiders that were intended to effectively deny public shareholders "any real participation in the management of their companies." These devices often included placing voting control in a small group of stockholders, sometimes having relatively little economic investment in the fund, typically by means of special classes of stock with differential voting rights.

The Boulder Letter

In 2010, the SEC staff issued guidance in the form of a letter to Boulder Total Return Fund, Inc. regarding the interplay of the Maryland Control Share Acquisition Act (MCSAA) and Section 18(i). The guidance provided an in-depth analysis of Section 18(i), including the reasons for its adoption, and explanations of the "voting stock" requirement and the "equal voting rights" requirement. In conclusion, the SEC staff stated that a closed-end fund that opted in to the MSCAA would be acting in a manner inconsistent with Section 18(i) of the 1940 Act. It stated that this conclusion was supported by the wording of, and purposes underlying, Section 18(i) specifically and the 1940 Act generally.

May 2020 Staff Statement

On May 27, 2020, the SEC staff issued a statement rescinding the Boulder letter. The staff stated that in response to Chairman Clayton's instruction to review prior staff positions to ascertain whether they should be modified, rescinded, or supplemented in light of market or other developments, the staff considered recent market developments and statements from affected market participants.

It stated that the SEC staff would not recommend enforcement action to the SEC against a closed-end fund under section 18(i) of the 1940 Act for opting in to and triggering a control share statute, if the decision to do so by the board of the fund was taken with reasonable care on a basis consistent with other applicable duties and laws, and the duty to the fund and its shareholders generally.

In making this decision, a closed-end fund's board should consider: (1) the board's fiduciary obligations to the fund; (2) applicable federal and state law provisions; and (3) the particular facts and circumstances surrounding the board's action.

The SEC staff is seeking comments on whether additional staff action regarding state control statutes is warranted.

The Staff Statement on Control Share Acquisition Statutes is available at: https://www.sec.gov/investment/control-share-acquisition-statutes.

SEC Proposes to Modernize Framework for Fund Valuation Practices

On April 21, 2020, the SEC proposed new Rule 2a-5 under the 1940 Act to update the existing valuation framework for registered investment companies and business development companies. Proposed Rule 2a-5 appears to continue the SEC's initiative to modernize the responsibilities of fund boards in various ways. As part of Rule 2a-5, the SEC also proposed to rescind Accounting Series Releases 113 and 118, which provide guidance for determining fair value for restricted securities, and to rescind or withdraw additional SEC staff letters and other staff guidance addressing fund valuation matters.

Section 2(a)(41) of the 1940 Act, in relevant part, requires fund portfolio securities to be valued at their market value when market quotations for those securities are "readily available." When such quotations are not available, securities or other fund assets must be valued by using their fair value as determined in good faith by the fund's board. Recognizing, among other developments, the evolution in markets, fund investment and valuation practices, and available pricing information, Rule 2a-5 would allow for updated practices for fund boards to fulfill their duty of determining fair value in good faith under Section 2(a)(41) of the 1940 Act.

Under Rule 2a-5, determining fair value in good faith would require the following elements: (i) assessing any material risks associated with fair value determinations, including material conflicts of interest, and managing such risks; (ii) selecting, applying, and periodically reviewing fair value methodologies in a consistent manner; (iii) testing the appropriateness and accuracy of fair valuation methodologies used; (iv) overseeing and evaluating any pricing services used; and (v) adopting and implementing written, tailored fair valuation policies and procedures, and maintaining certain records, including documentation to support fair value determinations, and a copy of the written policies and procedures. The proposal includes specific questions for which they request comment concerning each of these proposed Rule requirements.

Perhaps most notably, Rule 2a-5, as proposed, would permit a fund's board to assign the determination of fair value on any or all fund investments, pursuant to the previously discussed Rule requirements, to a fund's investment adviser (or sub-adviser), subject to ongoing active board oversight and specific additional requirements. These additional requirements would include: (i) relevant and tailored board reporting by the adviser consisting of both periodic reports detailing, at least quarterly, the adviser's evaluation of the adequacy and effectiveness of its process for determining fair value, including descriptions of material valuation risks and testing results among other information, and prompt reporting, in writing, of matters associated with the adviser's process that materially affect, or could have materially affected, the fair value of the assigned portfolio of investments; (ii) the adviser's specification of titles of adviser personnel responsible for determining fair value of investments, and reasonable segregation of duties among adviser personnel – the fair value process from portfolio management responsibilities, for example; and (iii) the retention of specific records related to the fair value determinations assigned to the adviser.

Noting that the 1940 Act and rules thereunder do not currently provide a definition of the term "readily available," Rule 2a-5 includes a proposed definition regarding what constitutes a "readily available" market quotation under Section 2(a)(41) of the 1940 Act.

Comments to the rule proposal were due by July 21, 2020.

The SEC's proposed rule is available at: https://www.sec.gov/rules/proposed/2020/ic-33845.pdf.

LITIGATION AND ENFORCEMENT

Decrease in 1940 Act Excessive Fee Lawsuits

Fewer lawsuits have been brought in recent years by plaintiffs' lawyers alleging that mutual fund companies have violated Section 36(b) of the 1940 Act by charging funds excessive fees. According to a recent ICI Mutual report, no new Section 36(b) excessive fee suits have been filed since 2018. Their analysis further suggests that this is the result of a downward trend in Section 36(b) cases over the past decade. Out of 29 such lawsuits filed since 2010, the vast majority of have settled or been dismissed, with only a few cases still pending. To date, none of the lawsuits have resulted in a favorable judgment for the plaintiffs.

The decreasing trend appears to reflect the high standard of proof for a successful Section 36(b) claim, and the reality that damages available to a successful plaintiff are limited to the "excess" portion of a fee paid starting one year before the commencement of the lawsuit. This also likely means that settlements that have been paid out to plaintiffs are relatively small, although most settlements are not publicly disclosed.

A few remaining Section 36(b) cases have not been settled or terminated. We will continue to follow such cases and their resolution.

SEC Charges Dually Registered BD/RIA with Providing Misleading Information to Retail Clients

On May 12, 2020, the SEC announced that Morgan Stanley Smith Barney LLC (MSSB) had agreed to settle charges that it provided misleading information to clients in its retail wrap fee programs regarding trade execution services and transaction costs. MSSB is a registered broker-dealer and investment adviser, and is an indirect, wholly-owned subsidiary of Morgan Stanley.

The SEC's order in this matter included that MSSB violated provisions of the Investment Advisers Act of 1940, imposed a $5 million penalty, and included a censure and a cease-and-desist order. The order also creates a Fair Fund to distribute the penalty paid by MSSB to harmed investors.

An SEC spokesperson stated, "Investment advisers are obligated to fully inform their clients about the fees that clients will pay in exchange for services. The SEC's order finds that MSSB failed to provide certain clients in its retail wrap fee programs accurate information about the costs they incurred for the services they received."

Wrap fee programs offer accounts in which clients pay an asset-based "wrap fee" that covers investment advice and brokerage services, including trade execution. According to the SEC's order, MSSB marketed its wrap fee accounts as offering clients professional investment advice, trade execution, and other services within a "transparent" fee structure, such that some of MSSB's marketing and client communications gave the impression that wrap fee clients were not likely to incur additional trade execution costs. During the relevant period from at least October 2012 until June 2017, the order found that some MSSB managers routinely directed wrap fee clients' trades to third-party broker-dealers for execution, which in some instances resulted in MSSB clients paying additional transaction fees that were not visible to them. As a result of MSSB's conduct, the order found that certain MSSB clients were unable to assess the value of the services received in exchange for the wrap fee paid to MSSB.

A copy of the SEC's order is available at: https://www.sec.gov/litigation/admin/2020/34-88856.pdf.

SEC AND SRO NEWS

Changes at the SEC

Rumor that Jay Clayton May Leave Chairmanship of SEC

In a press release on June 19, 2020, U.S. Attorney General William P. Barr announced that President Trump intended to nominate Jay Clayton, currently the chairman of the SEC, to serve as the next U.S. Attorney for the Southern District of New York. The press release indicated that Mr. Clayton had accepted the nomination. In testimony before the U.S. House of Representatives Financial Services Committee on June 25, 2020, Mr. Clayton confirmed that he had engaged in initial conversations with officials in the Trump Administration to be appointed to the U.S. Attorney position. During the hearing, Mr. Clayton also confirmed that he did not have immediate plans to leave his position at the SEC. Mr. Clayton has served as SEC Chairman since May 2017, and was previously a lawyer in private practice.

Hester M. Peirce Nominated and Confirmed for Second Term on SEC

Hester Peirce, a Commissioner of the SEC, was nominated for another term in June 2020. Ms. Peirce was unanimously confirmed by the Senate on August 6. Her new term extends until June 5, 2025. First sworn in as a commissioner on January 11, 2018, Commissioner Peirce has developed a reputation for focusing on the growing cryptocurrency industry and its regulatory framework. Commissioner Peirce has had a lengthy tenure with the SEC, including as a staff attorney in the Division of Investment Management.

Commissioner Peirce was sworn in for her second term on August 17.

Caroline A. Crenshaw Nominated and Confirmed to SEC

Caroline Crenshaw was nominated in June 2020 by President Trump to become a Commissioner of the SEC. Ms. Crenshaw was unanimously confirmed by the Senate on August 6. Commissioner Crenshaw fills a term that expires on June 5, 2024. She will fill the seat previously held by Commissioner Robert Jackson Jr., who left the SEC in February 2020. Commissioner Crenshaw has served as a staff member in Mr. Jackson’s office, and she previously worked for former Commissioner Kara Stein. She has also served in positions across the SEC, including in OCIE and the Division of Investment Management.

Commissioner Crenshaw was sworn in as a Commissioner on August 17.

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[1] In 2016, the DOL tried to make significant changes to the 1975 rules when it replaced the long-standing five-part test with a revised fiduciary regulation, granted two new prohibited transaction class exemptions – the Best Interest Contract Exemption and the Class Exemption for Principal Transactions in Certain Assets Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs – and amended several pre-existing prohibited transaction class exemptions. In 2018, the U.S. Court of Appeals for the Fifth Circuit issued an opinion vacating the 2016 rulemaking. Later in 2018, the DOL issued a temporary enforcement policy for investment

advice fiduciaries, announced in Field Assistance Bulletin (FAB) 2018-02. In the FAB, the DOL stated that it would not pursue prohibited transactions claims against investment advice fiduciaries who worked diligently and in good faith to comply with "Impartial Conduct Standards" for transactions that would have been exempted in the new exemptions, or treat the fiduciaries as violating the applicable prohibited transaction rules. The Impartial Conduct Standards have three components: (1) a best interest standard (i.e., advice is prudent and loyal); (2) a reasonable compensation standard; and (3) a requirement to make no misleading statements about investment transactions and other relevant matters. Since 2018, other regulators, such as the Securities and Exchange Commission (SEC), state regulators and standards-setting bodies have issued their own conduct standards for investment professionals to address conflicts of interest. Retirement investment advisers have been waiting for additional guidance from the DOL since 2018.

[2] This type of limitation is not without precedent – for example, the DOL's famous prohibited transaction class exemption for Qualified Professional Asset Managers (PTE 84-14) has as its first requirement that the person attempting to avail itself of the exemption must be a registered investment adviser.

[3] See, http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf; https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf; and https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.

[4] See, http://www.sec.gov/litigation/admin/2016/ia-4493.pdf; http://www.sec.gov/litigation/admin/2015/ia-4219.pdf; http://www.sec.gov/litigation/admin/2015/ia-4131.pdf; http://www.sec.gov/litigation/admin/2015/ia-4253.pdf; https://www.sec.gov/litigation/admin/2018/ia-5079.pdf; https://www.sec.gov/litigation/admin/2016/ia-4529.pdf; http://www.sec.gov/litigation/admin/2014/ia-3927.pdf; http://www.sec.gov/litigation/admin/2016/ia-4494.pdf; http://www.sec.gov/litigation/admin/2015/34-74828.pdf; http://www.sec.gov/litigation/admin/2014/33-9551.pdf; https://www.sec.gov/litigation/admin/2015/ia-4258.pdf and https://www.sec.gov/litigation/admin/2020/ia-5485.pdf.

[5] Boulder Total Return Fund, SEC No-Action Letter (Nov. 15, 2010).

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