Investment Management Regulatory Update

November 26, 2019

Rules and Regulations

SEC Proposes Amendments to Modernize the Advertising and Cash Solicitation Rules

On November 4, 2019, the Securities and Exchange Commission (the "**SEC**") proposed amendments to Rule 206(4)-1 (the "**advertising rule**") and Rule 206(4)-3 (the "**solicitation rule**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") in an effort to modernize two rules that have remained largely unchanged since their respective adoptions decades ago.

The proposed amendments to the advertising rule would replace many of the current rule's limitations with principles-based provisions, and would allow for the use of testimonials, endorsements and third-party ratings under certain conditions.

The proposed amendments to the solicitation rule would expand the rule's scope to cover non-cash solicitation arrangements and solicitors for private funds, among other changes.

Davis Polk has published a **client alert** discussing the proposed amendments and will publish a full client memorandum shortly.

SEC Proposes Rules to Regulate Proxy Advisory Firms and Shareholder Proposals

On November 5, 2019, at an open meeting, the SEC voted (3 to 2) to propose amendments to the proxy rules. The proposed amendments relate to regulating proxy advisory firms. The SEC also voted to propose amendments with regard to shareholder proposals, including eligibility standards for submission and resubmission.

Davis Polk has published a **client alert** and a **client memorandum** discussing the proposed amendments.

SEC Staff Extends No-Action Relief to Facilitate Cross-Border Implementation of the European Union's MiFID II Research Provisions

On November 4, 2019, the SEC staff issued a no-action letter (the "**Letter**") to extend the temporary no-action relief previously provided in a no-action letter to the Securities Industry and Financial Markets Association on October 26, 2017 (the "**Original Letter**"). The Original Letter addressed certain issues raised by cross-border implementation of the provisions relating to research in the European Union's Markets in Financial Instruments Directive II ("**MiFID II**") and related implementing rules and regulations. Under the temporary relief provided in the Original Letter, a broker-dealer may, without becoming subject to the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), provide research services to an investment manager that is required, either directly or by contractual obligation, to pay for such research services with MiFID II-compliant research payments. The no-action relief provided in the Original Letter, which was set to expire July 3, 2020, has been extended until July 3, 2023.

Davis Polk has published a **client memorandum** discussing the Original Letter.

- **See a copy of the Original Letter**
- **See a copy of the Letter**

SEC Proposes Amendments to Exemptive Application Procedures

On October 18, 2019, the SEC issued a release (the "**Release**") proposing amendments to Rule 0-5 under the Investment Company Act, which sets forth the procedures for applications for exemptive relief. The proposed amendments would, among other changes: (i) establish an expedited review process for routine exemptive relief applications that are substantially identical to recent precedents and (ii) implement a new rule to deem an application withdrawn if the applicant does not respond in writing to comments within 120 days. In addition, the Release announced that the SEC will begin publicly disseminating comments on exemptive applications through the EDGAR system and on its website. The Release noted that the proposed amendments are intended to improve efficiency and to "provide additional certainty and transparency in the application process." The SEC requested comments on various aspects of the proposed amendments, which will be due 30 days following the Release's publication in the Federal Register.

Background

Certain provisions of the Investment Company Act empower the SEC to issue orders granting exemptive relief from certain requirements of the Investment Company Act. For example, Section 6(c) gives the SEC authority to "conditionally or unconditionally exempt any person, security, or transaction . . . from any provision or provisions of [the Investment Company Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Investment Company Act]." According to the Release, the current review process consists of the following process: if a request "meets the applicable standards," the SEC publishes a notice in the Federal Register and on its website indicating its intent to grant the requested relief; "interested persons" then have an opportunity to request a hearing on the application; if the SEC does not receive such a request and does not otherwise order a hearing during the notice period, the SEC issues an order granting relief. For applications that do not initially satisfy the applicable standards, the SEC may issue comments "asking for clarification of, or modification to, an application to determine whether, or ensure that, the relief meets the [Investment Company] Act's standards." The Release noted that the majority of notices of applications and orders are issued by the SEC through SEC staff under delegated authority; alternatively, for applications for which the staff does not have delegated authority, the staff presents its assessment to the SEC.

According to the Release, the application process "has been a significant and valuable tool in the evolution of the investment management industry, and sometimes is the origin of new rules under the

[Investment Company] Act." The Release also noted that applicants have "sought relief to implement innovative features or create new types of funds that do not fit within the regulatory confines" of the Investment Company Act, such as exchange-traded funds. However, according to the Release, applicants have expressed concern regarding the time required to obtain relief for both "routine and novel applications." The SEC has taken various steps over the years "aimed at improving the application process." According to the Release, in 1993, the SEC proposed amendments to Rule 0-5 to establish an expedited review for some routine applications, but the amendments were not adopted. In 2008, SEC staff implemented an internal target of providing comments on at least 80% of applications within 120 days, and in 2010, the SEC staff met this goal on 100% of applications and "has not dropped below 99% each year since." The Release noted that for applications received on or after June 1, 2019, the SEC staff has implemented a new target of providing comments "on both initial applications and amendments within 90 days."

Expedited Review

The proposed amendments to Rule 0-5 "would establish an expedited review procedure for applications that are substantially identical to recent precedent." The Release identified various potential benefits of the proposed amendments, including the SEC's ability to grant relief more quickly and to "devote additional resources to the review of more novel requests," as well as a less expensive application process for applicants.

According to the Release, under proposed Rule 0-5(d), an applicant may request expedited review if the application is "substantially identical" to two other applications for which an order granting relief has been issued within two years of the application's initial filing. Substantially identical applications would be defined as "those requesting relief from the same sections of the [Investment Company] Act and rules thereunder, containing identical terms and conditions, and differing only with respect to factual differences that are not material to the relief requested." The Release noted that the substantially identical requirement "would help to ensure that applicants use the [expedited] procedure only when they do not need to modify the terms and conditions of the precedent applications and are not raising new issues for the [SEC] to consider." The Release stated that certain types of applications, including those filed under sections 2(a)(9), 3(b)(2), 6(b), 9(c), and 26(c) of the Investment Company Act, are unlikely to qualify for expedited review because they are too fact-specific.

According to the Release, proposed Rule 0-5(e) would require an application submitted for expedited review to include the following additional information: (i) a notation on the cover page of the application prominently stating "EXPEDITED REVIEW REQUESTED UNDER 17 CFR 270.0-5(d)"; (ii) exhibits with marked copies of the application showing changes from the two precedents identified as substantially identical; and (iii) a cover letter identifying the two precedents and certifying that the applicant "believes the application meets the requirements of [the rule] and that the marked copies . . . are complete and accurate."

The Release stated that, under proposed Rule 0-5(f), a notice for an application for expedited review would be issued no later than 45 days from the date of filing, "unless the applicant is notified that (i) the application is not eligible for expedited review because it does not meet the criteria in Rule 0-5(d), or (ii) further consideration of the application is necessary for appropriate consideration of the application." The Release provided examples of when further consideration may be required, including: "cases where the [SEC] is considering a change in policy that would make the requested relief, or its terms and conditions, no longer appropriate" and "cases where [SEC staff] is investigating potential violations of [f]ederal securities laws that may be relevant to the request for relief." According to the Release, proposed Rule 0-5(f) would impose conditions on the operation of the 45-day period. The Release stated that the 45-day period would restart upon the filing of any amendment that the SEC or its staff did not solicit (although SEC staff may act before the end of the additional 45-day period "if the unsolicited amendment relates only to factual differences not material to the relief requested or to some other minor change"). In addition, the 45-day period would stop running upon: (i) any comment on the application by SEC staff, and would resume running on the fourteenth day after the applicant files an amended application responsive to such request; or (ii) any irregular closure of the SEC's Washington, D.C. office to the public for normal business hours, and would resume upon the reopening of the office.

According to the Release, under proposed Rule 0-5(f), if an applicant does not file an amendment responsive to SEC staff's request within 30 days of receiving such request, including the required marked copy and certification discussed above, the application would be deemed withdrawn and such withdrawal would be without prejudice.

Standard Review

The SEC has proposed a new rule to provide a time frame for all other applications filed under Rule 0-5 that do not qualify for the expedited review process, in order to "provide applicants with added transparency regarding the review of applications." According to the Release, under paragraph (a) of the proposed rule, SEC staff "should" take action on applications subject to standard review within 90 days of the initial filing and any amendments thereto. Taking "action" on an application or amendment could consist of: "(i) issuing a notice of application; (ii) providing the applicants with comments; or (iii) informing the applicants that the application will be forwarded to the [SEC], in which case the application is no longer subject to paragraph (a) of the rule." The Release stated that SEC staff may also grant 90-day extensions and applicants "should" be notified of such extensions. In addition, the Release noted that if SEC staff does not support the requested relief, it typically notifies applicants, giving applicants an opportunity to withdraw an application before a recommendation to deny relief is made.

According to the Release, the SEC has also proposed to amend Rule 0-5 to deem an application withdrawn if an applicant does not respond in writing to SEC staff comments within 120 days of the request. The Release stated that this procedure will allow the SEC to maintain "a clear record of pending applications, as well as provide the public, including potential new applicants, with a better sense of the applications that the [SEC] is actively considering at any given time." In addition, the Release noted that such withdrawals would be without prejudice.

Release of Comments

According to the Release, the SEC plans, through the EDGAR system and on its website at **www.sec.gov**, to "publicly disseminate [SEC staff] comments on applications, and responses to those comments, no later than 120 days after the final disposition of an application." The public distribution of comments is intended to "expand the transparency of the applications process, so that the public can benefit from greater transparency into the applications process without the delay or burden of submitting [Freedom of Information Act] requests." This change would apply to both standard and expedited review of applications. The effective date of this new process will be announced in a subsequent adopting release.

- **See a copy of the Release**

Industry Update

SEC Enforcement Division Issues Report on Priorities and FY 2019 Results

On November 6, 2019, the Division of Enforcement of the SEC (the "**Enforcement Division**") issued a report (the "**Annual Report**") highlighting its priorities for the upcoming year and reviewing the enforcement actions it brought during the 2019 fiscal year.

According to the Annual Report, five core principles guided the Enforcement Division's decision making in 2019: focusing on retail investors' interests, focusing on individual accountability, keeping pace with technological change, imposing remedies that most effectively further enforcement goals and constantly assessing resource allocation within the Enforcement Division.

The Annual Report also summarizes the Enforcement Division's enforcement results for fiscal year 2019. According to the Annual Report, the Enforcement Division brought 862 enforcement actions during 2019, which led to more than $4.3 billion in disgorgement and penalties and about $1.2 billion returned to investors. These enforcement actions also resulted in the suspension of trading in the securities of 271 companies and the barring or suspension of 595 individuals.

According to the Annual Report, 526 of the 862 enforcement actions were standalone actions, of which 36% concerned investment advisory and investment company issues, 21% concerned securities offerings, and 17% concerned issuer reporting/accounting and auditing matters. Other major categories included market manipulation, insider trading, and broker-dealer issues, each of which constituted 6-7% of the total number of standalone actions.

Davis Polk has published a **client memorandum** discussing the Annual Report.

- **See a copy of the Annual Report**

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

On November 7, 2019, the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") issued a risk alert (the "**Risk Alert**") outlining (a) information on the most common deficiencies observed by OCIE staff during recent examinations of registered investment companies and (b) the staff's observations from national examination initiatives focusing on money market funds and target date funds.

Compliance Observations from Examinations of Registered Investment Companies

According to the Risk Alert, the most often cited deficiencies and weaknesses for registered investment companies ("**funds**") were those related to the fund compliance rule, disclosure to investors, the board approval process involving advisory contracts, and the fund code of ethics rule. The most common deficiencies and weaknesses in these areas noted in the Risk Alert included:

Fund Compliance Rule

- *Compliance programs that did not take into account the nature of the funds' business activities* – For instance, some funds lacked policies and procedures reasonably designed to prevent funds from violating their own investment limitations and guidelines. Some funds also lacked policies and procedures to review the appropriateness and accuracy of methods used for pricing securities, or to ensure that disclosures made in advertisements or other sales materials were accurate and not materially misleading.
- *Policies and procedures not followed or enforced* – For instance, some funds failed to follow or enforce policies and procedures requiring the fund's board to approve or ratify fair valuations determined by the valuation committee. Some funds also failed to follow policies and procedures regarding the funds' obligations to obtain multiple broker quotes with respect to cross trades to allow the funds' boards to evaluate compliance with relevant exemptions under the affiliated transaction rule.
- *Inadequate service provider oversight* – For instance, certain fund policies and procedures did not provide for ongoing monitoring and due diligence of providers' services relating to pricing of portfolio securities and fund shares. Some funds also failed to obtain board approval of the policies and procedures of the funds' subadvisers.
- *Annual reviews were not performed, or did not address the adequacy of the funds' policies and procedures* – For instance, some funds failed to conduct annual reviews or lacked supporting documentation to demonstrate that annual reviews were completed. In some cases, annual

reviews did not address the adequacy of the funds' policies and procedures or the effectiveness of their implementation.

Disclosure to Investors

- *Incomplete or potentially materially misleading information in fund prospectuses, statements of information, or shareholder reports when compared to the funds' actual activities* – For instance, some funds failed to disclose the payment of fees made to service providers or a change to an investment strategy, or identified strategies as the fund's principal investment strategies when the fund had not implemented, and did not expect to implement, such strategies.

Section 15(c) Process

- *Reasonably necessary information to make a board decision was not requested or considered* – For instance, in evaluating fund investment advisory agreements, certain fund boards did not appear to consider relevant information such as the profitability of the fund to the adviser, economies of scale, or peer group comparisons for the advisory fee.
- *Inadequate discussion forming the basis of board approval* – In some cases, the staff observed a lack of adequate discussion in shareholder reports regarding the material factors and conclusions forming the basis for the fund board's approval of an investment advisory agreement, a failure to keep copies of the written materials the board considered in approving advisory contracts, or a lack of supporting documentation to demonstrate what information the boards requested and considered.

Fund Code of Ethics

- *Failure to implement the code of ethics or procedures reasonably necessary to prevent violations of the code of ethics* – For instance, some funds lacked adequate procedures to prevent access persons from misusing material non-public information (e.g., by designating a separate individual to review the Chief Compliance Officer's personal securities holdings and transactions reports), lacked procedures for determining or documenting that an access person was eligible for an exception, or failed to properly designate individuals as access persons.
- *Failure to follow or enforce the code of ethics* – For instance, some funds failed to collect and review personal securities holdings and transaction reports of access persons or failed to enforce the pre-clearance and holdings period restrictions in their code of ethics.
- *Code of ethics approval and reporting* – For instance, some funds failed to obtain initial board approval for their code of ethics, failed to provide fund boards with the required annual report regarding code of ethics violations and sanctions, or provided inaccurate reports.

Observations from Certain National Examination Initiatives — Money Market Funds ("MMFs")

According to the Risk Alert, OCIE staff examined MMFs for compliance with the amendments to the rules governing MMFs that became effective in October 2016. The staff observed instances of deficiencies or weaknesses related to MMF portfolio management practices, compliance programs, and disclosures, including:

- Some MMFs did not appropriately document one or more of the factors required to be considered when determining whether a security presents a minimal credit risk and is an eligible security under Rule 2a-7, adequately document periodic updates to files supporting the eligible security determination, or maintain records that adequately supported the determination that investments in repurchase agreements with non-government entities were fully collateralized by cash or government securities (in the case of Government MMFs).

- Some MMFs provided stress test results to their boards that did not include the required summary of significant assumptions used in the stress tests.
- Some MMFs had not adopted and implemented compliance policies and procedures reasonably designed to address certain requirements under Rule 2a-7 and other areas, such as:
    - periodic board oversight of the MMF's written guidelines and procedures under which the adviser, when delegated by the MMF's board, analyzes credit risks and makes minimal credit risk determinations;
    - periodic board oversight of certain MMF information, including the MMF's net asset value deviation methods and the amount of the deviation;
    - limiting investors in Retail MMFs to natural persons;
    - testing for issuer diversification to ensure that no more than 5% of the funds' assets were invested in any one issuer (other than government securities);
    - incorporating all required elements for considering, imposing and lifting liquidity fees and/or gates if the funds' weekly liquid assets were less than 30% of their assets;
    - filing accurate and timely information with the SEC, such as Form N-MFP; and
    - providing that the master fund make the fee and gate determinations in master/feeder fund arrangements.
- Some MMFs did not post on their websites all information required under Rule 2a-7, posted inaccurate information, or did not include all required legends in advertising materials.

Observations from Certain National Examination Initiatives — Target Date Funds ("TDFs**")**

The instances of deficiencies or weaknesses related to TDF disclosures and compliance programs noted in the Risk Alert included:

- Some TDFs had incomplete and potentially misleading disclosures in their prospectuses and advertisements, including disclosure regarding asset allocation (e.g., disclosure regarding asset allocation in marketing materials differed from prospectus disclosures), glide path changes and conflicts of interest (e.g., conflicts arising from use of affiliated funds and affiliated investment advisers).
- Many TDFs had incomplete or missing policies and procedures, including those for monitoring asset allocations, overseeing implementation of changes to their current glide path asset allocations, overseeing advertisements and sales literature, and monitoring whether disclosures regarding glide path deviations were accurate.

Conclusion

In the Risk Alert, OCIE staff encouraged funds to review their practices, policies, and procedures in these areas and to consider relevant improvements in their compliance programs.

- **See a copy of the Risk Alert**

Litigation

District Court Dismisses Excessive Fee Action Against Calamos Following Two-Week Bench Trial

On September 27, U.S. District Judge Edgardo Ramos issued an opinion and order, following a two-week bench trial, in which he dismissed claims that Calamos Advisors LLC ("**Calamos**") breached its duties under the Investment Company Act by charging excessive fees to the Calamos Growth Fund (the "**Fund**"), a mutual fund that Calamos managed.

Judge Ramos ultimately concluded that plaintiffs had failed to prove that the compensation Calamos received was excessive in light of the six so-called "*Gartenberg* factors" courts use to determine whether a manger's fees are excessive under Section 36(b) of the Investment Company Act. *See Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.3d 293 (2d Cir. 1982). These factors include: (1) the nature and quality of the services provided to fund shareholders; (2) the profitability of the fund to the adviser; (3) fall-out-benefits -- i.e., collateral benefits accruing to the investment adviser due to the existence of the fund; (4) economies of scale; (5) comparative fee structures; and (6) the independence of the trustees and the care and conscientiousness with which the trustees performed their duties.

In September 2018, Judge Ramos ruled that plaintiffs had failed to raise triable issues of fact regarding *Gartenberg* factors 3 and 4 -- "fall-out benefits" to Calamos and economies of scale -- leaving only the remaining four other factors for trial. That trial commenced in November 2018 and lasted for two weeks; closing arguments were held in February 2019.

After canvassing the evidence and testimony presented at trial, Judge Ramos concluded that only one of the four remaining Gartenberg factors weighed in favor of finding Calamos's fees excessive.

First, with respect to factor 6 -- the independence and conscientiousness of the trustees' review -- Judge Ramos found that the trustees were fully informed, conscientious, and careful in their review. One of plaintiffs' key theories was that Calamos charged the Fund advisory fees greater than those that Calamos charged other accounts pursuing a similar strategy. Judge Ramos found that the trustees were fully informed about the disparity in fees charged to the Fund and other managed accounts and conscientiously evaluated information relevant to Calamos's fees.

Second, with respect to factor 5 -- comparative fee structures -- Judge Ramos concluded that even though the fees charged to the Fund were above the median in its peer group, comparison to other advisers' fees did not support a finding that the fees Calamos received were "so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." Similarly, Judge Ramos concluded that plaintiffs failed to show that differences in the services Calamos provided and risks Calamos bore by managing the Fund as opposed to other accounts could not explain why Calamos charged other managed accounts lower fees than it charged the Fund.

Third, with respect to factor 2 -- profitability -- Judge Ramos found that the profitability of the Fund to Calamos did not support a conclusion that Calamos's fees were excessive. The court reviewed a number of competing calculations of the Fund's profitability to Calamos and, after noting that the evidence demonstrated that there was "not one 'true' profitability figure" for the Fund, concluded that plaintiffs had failed to demonstrate that the Fund was so profitable as to suggest that Calamos was charging excessive fees.

Fourth, and finally, with respect to factor 1 -- the nature and quality of services provided to the Fund -- the Court concluded that the Fund's "often underwhelming" long-term performance history supported the contention that Calamos's fees were excessive. Judge Ramos found that the Fund generally performed worse than peer funds during the relevant time period, and Calamos witnesses admitted that the Fund had underperformed. On the other hand, Judge Ramos found that the Fund's performance only "weakly" supported the contention that Calamos charged excessive fees, in part because investors and fiduciaries "are typically more concerned with *future* performance, which necessarily entails some speculation."

Because only one of the *Gartenberg* factors supported plaintiffs' claim that Calamos charged excessive fees, Judge Ramos concluded that plaintiffs had failed to show that "Calamos received from the Fund an advisory fee so disproportionately large that it bore no reasonable relationship to the services rendered and did not reflect the product of arm's-length bargaining," and thus failed to show that Calamos breached its fiduciary duty under Section 36(b) of the Investment Company Act.

Judge Ramos's decision follows several other high profile victories for investment advisers in Section 36(b) litigation. Our **March 2019 Investment Management Regulatory Update** reported on a February 2019 decision dismissing Section 36(b) claims against BlackRock, and our **September 2016 Investment Management Regulatory Update** reported on an August 2016 decision in favor of AXA.

- **See a copy of the Calamos Opinion**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Nora M. Jordan	212 450 4684	**nora.jordan@davispolk.com**
James H.R. Windels	212 450 4978	**james.windels@davispolk.com**
John G. Crowley	212 450 4550	**john.crowley@davispolk.com**
Amelia T.R. Starr	212 450 4516	**amelia.starr@davispolk.com**
Leor Landa	212 450 6160	**leor.landa@davispolk.com**
Gregory S. Rowland	212 450 4930	**gregory.rowland@davispolk.com**
Michael S. Hong	212 450 4048	**michael.hong@davispolk.com**
Lee Hochbaum	212 450 4736	**lee.hochbaum@davispolk.com**
Sarah E. Kim	212 450 4408	**sarah.e.kim@davispolk.com**
Marc J. Tobak	212 450 3073	**marc.tobak@davispolk.com**