Ballard Spahr LLP

Investment Management Update

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Below is a summary of recent investment management developments that affect registered investment companies, private equity funds, hedge funds, investment advisers, and others in the investment management industry.

REGULATION BI, FORM CRS, ADVISER OR ADVISOR, AND FIDUCIARY DUTIES OF ADVISER

In a flurry of proposed rulemaking that added up to more than 900 pages of reading material, the Securities and Exchange Commission (SEC) recently tried its hand at addressing the complicated issues involved in setting a standard of conduct for broker-dealers. This issue has been debated for years among stakeholders and has been studied numerous times by the SEC and other parties. Most recently, the issue was addressed by the Department of Labor (DOL) in the context of broker-dealers working with DOL-regulated IRAs and ERISA plans. In March 2018, the U.S. Court of Appeals for the Fifth Circuit vacated much of the DOL's so-called fiduciary rule, giving the SEC an opportunity to tackle the issue.

The SEC has proposed Regulation Best Interest (BI)—a new proposed standard of conduct that would apply to broker-dealers making investment recommendations to retail investors. In a related release, the SEC also proposed a new customer relationship summary (Form CRS) for advisers and broker-dealers. Form CRS is a highly prescribed disclosure document that would be delivered to retail investors at the time of engagement by an adviser or a broker-dealer.

In addition, the SEC proposed restrictions on the use of the term "adviser" or "advisor" in order to avoid confusion between broker-dealers and advisers. Finally, the SEC proposed to delineate the elements of an adviser's fiduciary duty. The following is a summary of these recently proposed rules and guidance.

Regulation Best Interest (BI)

The Securities Exchange Act of 1934 (the Exchange Act) does not contain a standard of conduct applicable to broker-dealers or their associated persons. FINRA rules require that broker-dealers make "suitable" recommendations to retail investors, and the SEC

IN THIS ISSUE:

Regulation BI, Form CRS, Adviser or Advisor, and Fiduciary Duties of Adviser 1

Form CRS 3

Confusion Between Advisers and Broker-Dealers and Use of the Title Financial Adviser 4

Distillation of an Adviser's Fiduciary Duty 5

Auditor Independence and Loans to Audit 6

New Math: Ares, KKR, and Choice of Entity in 2018 9

SEC Adopts Fund E-Delivery Rule 10

SEC Postpones the Compliance Dates for Certain Provisions of the Liquidity Rules 11

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proposed Regulation BI as a way of establishing a standard of conduct for those recommendations. Most agree that the standard in Regulation BI is a higher standard than suitability, but lower than a fiduciary standard. For ethical broker-dealers, complying with the standard probably is not a significant imposition. However, documenting compliance—and establishing processes and controls around it—will be burdensome to even the most ethical broker-dealers.

Reasons for Regulation BI

According to the SEC, Regulation BI will:

- Enhance the quality of investment recommendations because a best interest standard is a higher standard than mere suitability
- Impose a substantive conduct standard as opposed to requiring only disclosure
- Improve the disclosure about the scope and terms of a broker-dealer's relationship with its retail customers
- Enhance disclosure of material conflicts of interest, which should help retail customers

Under proposed Regulation BI, to discharge a broker-dealer's duty to retail investors, a broker-dealer must act in the best interest of retail investors at the time of an investment recommendation without placing the financial or other interest of the broker-dealer ahead of the retail investor. Regulation BI has three components: (1) a duty of care element; (2) a controls element requiring written policies and procedures around compliance with the rule; and (3) a disclosure obligation that identifies the relationship between the retail customer and the broker-dealer that is discharged through delivery of a Customer Relationship Summary (Form CRS).

Care in Making Recommendations

Under proposed Regulation BI, a broker-dealer or its associated person making an investment recommendation must exercise reasonable diligence, care, skill, and prudence to understand the potential risks and rewards associated with an investment recommendation and have a reasonable basis to believe that the investment recommendation could be in the best interest of at least some retail customers.

Under proposed Regulation BI, a broker-dealer and its associated persons also must have a reasonable basis to believe that the investment recommendation is in the best interest of a particular client based on a retail investor's profile and the risks and rewards associated with the recommendation. Finally, regarding a series of investment recommendations, a broker-dealer and its associated person must have reasonable basis to believe that a series of recommended transactions are in the retail customer's best interest when viewed in isolation and are not excessive when viewed together in light of a retail investor's profile.

Controls Around Conflicts of Interest

Proposed Regulation BI also requires a broker-dealer to maintain internal controls related to conflicts of interest generally and specifically related to financial incentives. A broker-dealer would have to establish, maintain, and enforce written policies and procedures reasonably designed to identify—and disclose or eliminate—all material conflicts of interest associated with investment recommendations to retail customers, including but not limited to those arising from financial incentives for the broker-dealer.

Other Key Aspects of Regulation BI

If a broker-dealer were to violate Regulation BI, there would no private right of action for customers. Only the SEC can enforce compliance with Regulation BI, but no scienter would be required for the SEC to bring a claim.

When Does Regulation BI Apply?

Regulation BI's standard of conduct would apply at the time a broker-dealer makes an investment recommendation to a retail customer. At that time, the broker-dealer would be required to disclose material facts relating to the scope of the relationship with a retail customer. This disclosure is captured in Form CRS, which the broker-dealer will have to deliver when engaged by a retail investor.

What Does Acting in a Retail Client's Best Interest Mean?

The SEC chose not to specify what constitutes "acting in a retail client's best interests" and believes such a determination would require a facts-and-circumstances test. The SEC did clarify that Regulation BI does not prohibit:

- Charging commissions on transactions
- Receiving or providing compensation on sales of particular investment products
- Receiving compensation from third parties
- Recommending proprietary products or those of affiliates
- Recommending securities underwritten by the broker-dealer or an affiliate including those offered in an IPO
- Recommending transactions when acting as principal, such as buying securities from customers for the broker-dealer's own account
- Recommending complex products
- Allocating trades and research, including investment opportunities among different customers and between retail accounts and the broker-dealer's own account
- Considering the cost to the broker-dealer in effecting a strategy, such as illiquid securities
- Accepting a retail order contrary to the broker-dealer's recommended strategy
- Considering factors other than the lowest price in executing transactions, including liquidity, risk, financial incentives, and volatility
- Recommending a more expensive product or strategy compared to other alternatives even if such strategy or product results in fees to the broker-dealer subject to disclosure and monitoring duties

These activities, which all are part of a typical brokerage business, would continue to be permitted. However, these activities can create conflicts, and those conflicts would need to be disclosed and managed. Proposed Regulation BI is in the comment period through August 7, 2018, unless extended.

FORM CRS

At the same time that it proposed Regulation BI to establish a standard of care for broker-dealers and retail customers, the SEC also proposed a new rule that would require broker-dealers and investment advisers to deliver a disclosure document that summarizes the relationship between a broker-dealer or adviser and a retail customer. This Form CRS is a highly prescribed document with required detailed disclosures in a specific format mandated by the SEC.

The purpose of Form CRS is to clear up confusion among retail investors regarding the differences between an advisory relationship and a brokerage relationship. Form CRS would be given in addition to other disclosures already required under securities laws, such as the brochure delivery requirement under the Adviser's Act, prospectus delivery requirements under the Securities Act of 1933 and Investment Company Act of 1940, disclosures required under the Exchange Act, and FINRA rules for broker-dealers. The SEC claims that it is seeking to help retail investors comparison shop and foster dialogue between retail clients and financial professionals about the structure of their relationship given the different business models, compensation structures, and incentives available and the conflicts that can occur.

Form CRS would be filed electronically on the Investment Adviser Registration Depository (IARD) for advisers—and on EDGAR for broker-dealers—and would be subject to anti-fraud rules. Compliance with the form's requirements would not, in the SEC's view, create a safe harbor from claims or enforcement.

Form CRS must include eight specific items, should be written without technical legal or business jargon, and should be no longer than four pages with a standard font and margin width. Form CRS would be given to retail investors at the point of initial contact. Retail investors are defined as natural persons, including trusts whose beneficiaries are natural persons.

The eight required items are: (1) introduction; (2) description of services offered; (3) standard of conduct;

(4) fees and costs; (5) comparison of brokerage and adviser services; (6) conflicts of interest; (7) where to find additional information and (8) key questions a retail investor should ask their financial professional. For more details on these requirements, click here.

Delivery, Updating, and Filing Requirements

For advisers, Form CRS would be delivered at or before the parties enter into an advisory agreement. For broker-dealers, it would be delivered at or before the first engagement of services by the broker-dealer for the retail investor. Form CRS could be delivered in paper or electronically, subject to the SEC's prior guidance on receiving client consent for e-delivery of disclosure documents to retail investors. Advisers and broker-dealers would have to maintain the form on a public website.

When there is material change in a relationship with a client, an updated form would have to be delivered. A material change in relationship would occur, for example, if a client rolled over an IRA or changed from a brokerage account to an advisory account requiring a CRS form delivery.

Like the requirement that an advisory firm's brochure must be amended within 30 days of a material change, Form CRS also would have to be updated within 30 days of a material change in a firm that made the form materially inaccurate. The firm would be required to provide an updated disclosure to retail clients.

Finally, advisers and broker-dealers would have to maintain Form CRS and all updates as part of a firm's books and records. These must be subject to review and examination by SEC staff upon request.

Proposed Form CRS currently is out for comments. Comments are due by August 7, 2018, unless extended.

CONFUSION BETWEEN ADVISERS AND BROKER-DEALERS AND USE OF THE TITLE FINANCIAL ADVISER

Because many retail clients often are confused about the difference between a broker-dealer and investment adviser the SEC proposed to regulate the use of names and titles such as "financial advisor" or "financial adviser," which have been used by both advisers and broker-dealer representatives for many years. The SEC believes that, although Form CRS would go a long way toward clearing up retail investors' understanding of the differences in services, compensation, and business models between broker-dealers and advisers, the SEC deems it important to restrict which professionals can use the title "adviser" or "advisor."

Accordingly, the SEC has proposed to prohibit a broker-dealer or an associated person of a broker-dealer when communicating with a retail investor from using as part of his or her name the words or title "adviser" or "advisor" unless the firm is registered as an investment adviser. Brokerage firms that are not dual registrants could not call their registered representatives financial "advisers" or "advisors," wealth "advisers" or "advisors," or trusted "advisers" or "advisors." These restrictions would apply to broker-dealers' communications with retail investors but would not apply to communications with institutional investors. The restrictions also would not prohibit a broker-dealer or its associated person from using the term "adviser" or "advisor" when acting on behalf of a bank or insurance company. Broker-dealers and their associated persons also may use the title "financial consultant" when communicating with retail investors. The SEC does not believe using the title "financial consultant" creates the same level of confusion with investment adviser representatives.

Prominent Disclosure of Regulatory Status

In another attempt to clear up confusion between advisers and broker-dealers, the SEC proposed that advisers and broker-dealers prominently disclose in print or in electronic retail communications (proposed Exchange Act Rule 15l-3(a) and proposed Adviser's Act

rule 211h-1(a)) that the firm is registered as a broker-dealer or investment adviser, as applicable. Registered associated persons of a broker-dealer or investment adviser similarly would have to state prominently that he or she is associated with a broker-dealer or adviser registered with the SEC. (proposed Exchange Act rule 15l-3(b) and proposed Advisers Act rule 211h-1(b)).

If a firm is a dual registrant, or a person is dually associated, the firm or the person must disclose such status. This disclosure would be required in print or electronic communications with retail investors to further clarify and to avoid confusion between the two types of financial professionals.

Comments on the SEC's proposed restrictions on use of the term "adviser" or "advisor" also are due by August 7, 2018, unless extended.

DISTILLATION OF AN ADVISER'S FIDUCIARY DUTY

The SEC provided a proposed interpretation of what it thinks constitutes an adviser's fiduciary duty.

The U.S. Supreme Court, in *SEC v. Capital Gains Research Bureau, Inc.* 375 U.S. 180 (1963), clarified that an investment adviser is a fiduciary held to the highest standard of conduct and must act in a client's best interest. The adviser has an affirmative duty of the utmost good faith and full and fair disclosure of all material facts. The SEC proposed its interpretation of the contours of an adviser's fiduciary duties to clients. In the SEC's view, an adviser's fiduciary duties are principally comprised of the duty of care and duty of loyalty. The SEC provided guidance on what those duties mean.

Duty of Care

The SEC believes an adviser's fiduciary duty of care involves three key elements: (1) the duty to act and to provide advice that is in the best interest of a client; (2) the duty to seek the best execution for a client's trades when an adviser has assumed responsibility for transaction execution; and (3) the duty to provide advice and monitoring over the course of the adviser-client relationship.

An adviser's duty to provide advice in a client's best interest is, in the view of the SEC, the duty to make a reasonable inquiry regarding a client's financial condition, level of financial sophistication, investment experience, and investment objectives. The adviser should profile a client and tailor suitable personalized advice accordingly. The amount of inquiry considered reasonable is a facts-and-circumstances test and would depend on the nature of the services and complexity of the client's profile and investment objectives. The SEC believes an adviser must update the profile as circumstances change. Life changes, such as having children, aging, changes in tax or other laws, divorces, job changes, college expenses, and other factors, all could necessitate an update to a client profile.

To tailor suitable investment advice, an adviser must engage in a level of diligence into the client's situation that identifies the client's investment objectives and risk tolerance. Among many factors an adviser must consider in tailoring an investment strategy are the costs of the strategy, liquidity, volatility, and performance in varying market conditions. The SEC observed that an adviser need not recommend the lowest cost product all of the time, but if there are identical products and one is available at a cheaper price and the other provides a fee to the adviser, the adviser must provide a full and fair disclosure and get client consent to recommend the higher cost product that pays the adviser.

An adviser also owes the client a duty to perform a reasonable investigation into the investment strategy or product to make sure the adviser is not recommending the strategy or product based on materially inaccurate or incomplete information.

An adviser's duty to seek best execution is set forth in guidance under Section 28(e) of the Exchange Act. In essence, the adviser's goal is to maximize value for the client under the circumstances. The adviser is not obligated to choose the lowest price broker-dealer to execute transactions. The adviser can—and

should—weigh a full range of factors, including quality of a broker-dealer's services, the value of any research, the capacity of the broker-dealer to execute the trades required, and the responsiveness and financial responsibility of the broker-dealer. Seeking the best execution must be re-examined periodically. An adviser cannot perform the analysis once and fail to examine execution service again.

A third aspect of the duty of care is acting and providing advice and monitoring over the course of the relationship. The frequency of actions and monitoring must be in the best interests of a client. On one hand, an adviser cannot set up an automatic investment program, leave it on auto-pilot for years, and continue to collect an asset-management fee. On the other hand, an adviser cannot micro-manage a client account and excessively churn a client's account. The adviser must provide appropriate actions and frequent monitoring appropriate for the client and the investment strategy.

Duty of Loyalty

The second pillar of an adviser's fiduciary duty is the duty of loyalty. Simply put, this means that the adviser must always put the client's interests ahead of the adviser's. An adviser cannot favor his or her own interests or the interests of one client over another. An adviser cannot treat one set of clients better than another. This comes up often in the allocation of investment opportunities. In an initial public offering or other investment where there are a limited number of shares that can be purchased for client accounts, the adviser need not always follow a *pro rata* formulaic allocation. Rather, an adviser can allocate investment opportunities using his or her best judgment based on the client's investment objectives, risk profile, and similar factors. Allocation policies must be fair. If there is a conflict of interest—for example, if an affiliate of the adviser is involved in the investment strategy or product—the conflict must be fairly disclosed and the client must consent.

An adviser must provide full and fair disclosure of the facts relating to an adviser client relationship. An adviser also must seek to avoid conflicts of interest and make a full and fair disclosure of any conflicts that cannot be avoided. Disclosure must be sufficiently specific so that a client can make an informed choice whether or not to provide consent. It is not adequate to state that there "may" be a conflict of interest with respect to a particular investment strategy or product when, in fact, there *is* a conflict of interest. For example, it is not sufficient to disclose that an adviser *may*, in fact, receive compensation from a fund, brokerage firm, or insurance carrier when the adviser knows it will receive a fee. In that circumstance—as with any conflict of interest—the adviser must provide disclosure of all material facts fully and fairly so that the client can make an informed decision. Absent such disclosure, the client's consent is not valid in the SEC's view.

Comments on the SEC's proposed distillation of an adviser's fiduciary duties are due by August 7, 2018, unless extended.

While not binding *per se*, we believe the SEC's proposed interpretative guidance will be influential on the courts and the industry.

AUDITOR INDEPENDENCE AND LOANS TO AUDIT

In May, the SEC proposed to amend Rule 2-01 of Regulation S-X, its auditor independence rules concerning loans to audit firms (the Loan Provision). The proposed rule would have the effect of slightly relaxing the inquiry when an auditor is in a lending relationship with certain shareholders of an audit client. Because of the proliferation of omnibus accounts in the name of various financial services companies and funds, the SEC's proposed rule would permit an accounting firm to look solely at beneficial ownership rather than record and beneficial ownership, replace the existing 10 percent bright-line shareholder ownership test with a "significant influence" test, add a "known through reasonable inquiry" standard with respect to identifying beneficial owners of the audit client's equity securities, and amend the definition of "audit client" for a fund under audit to exclude certain funds that would be considered affiliates of the audit client.

The proposed rulemaking followed a no-action letter that the commission granted to Fidelity Management & Research Company in June 2016. It was extended in June 2017 to permit Fidelity's audit firm to continue to audit certain Fidelity funds notwithstanding noncompliance with the Loan Provision because the audit firm concluded it could be objective and impartial.

Current Summary of the Loan Provision of Regulation S-X

Under current Rule 2-01 of Regulation S-X, an audit firm cannot be independent if an audit firm or its covered persons—which generally means the audit engagement team and those in the chain of command and such persons' immediate family members—are in a lending relationship with an audit client, its officers and directors, or the record or beneficial owners of more than 10 percent of the equity securities of the audit client, unless an exception applies. The SEC believes that a debtor-creditor relationship between an auditor and audit client could create conflicts in which the auditor's obligation to serve investors' interests could be impaired.

The reason that the SEC applied the rule not only to the audit client, but to the record or beneficial owners of more than 10 percent of the audit client's equity securities, is to capture shareholders of the audit client that could have a special and influential role with the audit client. A 10 percent bright-line test was deemed appropriate.

The definition of "audit client" included affiliates of the entity being audited, and the definition of "affiliate" is the familiar test that an affiliate of the audit client include entities that control, are controlled by, or are under common control with the audit client.

This means that an accounting firm is not independent if it has a lending relationship with an entity that has a record or beneficial ownership of more than 10 percent of the equity securities of the firm's audit client or any entity that that is a parent, subsidiary, or entity under common control of the audit client. In a fund complex, if an accounting firm has a lending relationship with an entity that has a record or beneficial ownership of more than 10 percent of any fund within the complex, the accounting firm is not independent of any of the funds, regardless of the specific fund it is auditing.

The SEC recognized that financial intermediaries often are the "record" holder of equity securities in registered and unregistered investment companies, pooled investment vehicles, and other affiliated funds of fund complexes. Affiliates of those financial intermediaries often are financial institutions that act as lenders to audit firms. Consequently, that may result in audit clients having beneficial ownership of more than 10 percent of a fund subject to audit. But because the financial intermediary is only the record owner and not the beneficial owner, the financial intermediary does not really control more than 10 percent of the audit client, and the auditor's objectivity and independence with respect to the audit client is not impaired.

The SEC also observed that, in the case of open-end funds, record ownership percentages fluctuate greatly within a given time period for reasons that are beyond the control or knowledge of a lender to an audit firm that also is the fund shareholder of record. The financial intermediary in whose name the mutual fund shares are titled is acting on behalf of many—in some cases thousands—of beneficial owners, and the lender/intermediary has no ability to influence the fund or affect the auditor of the fund. Because a mutual fund must be available for continuous purchasing and redemptions, the ownership percentages of the beneficial owners will fluctuate and may cross 10 percent without the auditor, financial intermediary, or audit client knowing until after the fact.

Proposed Amendment to the Loan Provision

To address the complexities of the application of the Loan Provision and prevent disqualification of an audit firm when objectivity would not be impaired, the SEC has proposed to amend the Loan Provision to:

- Focus solely on beneficial ownership as opposed to record ownership
- Replace the 10 percent bright-line shareholder ownership test with a "significant influence" test

- Add a "known through reasonable inquiry" standard for identifying beneficial owners of an audit client's equity securities
- Amend the definition of "audit client" for a fund to exclude other funds in a fund complex not subject to audit

Beneficial Ownership Focus Rather Than Record Ownership

To recognize the prevalence of omnibus accounts and the fact that custodians, broker-dealers, banks, and other financial intermediaries often are the record holder of securities for clients, the proposed Loan Provision would apply only to *beneficial* ownership of an audit client's equity securities rather than *record* ownership. It is the beneficial owners who can influence or control an audit client rather than a financial intermediary that often is the record owner of equity securities for a number of investment fund audit clients.

Significant Influence Rather Than 10 Percent

The new Loan Provision would replace the current bright-line 10 percent equity ownership test with a new test that would prohibit an auditor from having a lending relationship with the beneficial owner of equity securities in audit client if such equity holder has significant influence over the audit client. The SEC believes that using a "significant influence" test would better capture risks that an audit client was under the control of a party that the auditor has a lending relationship with, as compared to a 10 percent bright-line test.

The SEC did not specifically define "significant influence" for this rule, but noted that an audit firm would have to assess whether a lender has the ability to exert significant influence over the audit client's operating and financial policies. Significant influence is referred to in the principles in Financial Accounting Standards Board's ASC Topic 323 "Investments-Equity Method and Joint Ventures" and other SEC accounting standards. Significant influence typically is indicated by:

- Representation on the board of directors
- Participation in policy-making processes
- Material intra-entity transactions
- Interchange of managerial personnel
- Technological dependency

There is no bright-line ownership test but consistent with ASC 323, 20 percent beneficial equity ownership would create a rebuttable presumption of significant influence over an audit client.

In the registered investment fund context, a lender to the audit client would have to be in a position to influence a fund's investment policies, day-to-day portfolio management processes, and the distribution of income and capital gains to have significant influence over the fund. Significant influence would not be present if the adviser simply has discretion to manage a fund's portfolio and the beneficial equity holder does not have the ability to influence portfolio management decisions. Likewise, a beneficial equity holder with the ability to vote on a *pro rata* basis to approve a fund's advisory agreement together with all of the other fund shareholders would not be deemed to have significant influence over the funds.

Reasonable Inquiry Compliance Threshold

Because of the difficulty in identifying beneficial ownership, including the fact that beneficial owners can object to the disclosure of their names, addresses, and securities position to the issuer, the SEC has proposed to amend the Loan Provision to require an audit firm or an audit client only to analyze beneficial owners of an audit client's equity securities who are known through "reasonable inquiry." This means that if an auditor or audit client does not know after a reasonable inquiry that a lender to the auditor also is a beneficial owner of the audit client's equity securities, even if that lender merely invests through financial intermediaries, then it is not likely that the auditor's objectivity and impartiality would be impaired by the relationship. Put another way, if neither the audit client nor the auditor knows that a lender is a beneficial owner of the audit client directly or indirectly through affiliates, the lender/beneficial owner is not having any influence, let alone significant influence, on the audit client.

Excluding Other Funds in a Fund Complex When an Audit Firm Audits a Fund

Finally, the SEC proposed to amend the definition of "audit client" under Rule 2-01 of Regulation S-X in the context of fund complexes and the application of the Loan Provision. The current definition of "audit client" generally includes all funds in a fund complex under the definition of affiliate. This can create difficulties for auditors that have lending relationships with banks that have relationships with funds in a fund complex. These interrelationships can cause independence issues for audit firms, even though the audit firm only audits one fund in a complex. Consequently, under the proposed new Loan Provision, the definition of "audit client" would be amended to remove other funds in a fund complex that otherwise would be considered an affiliate of the audit client.

Collectively, these revisions make it slightly easier for auditors, audit clients, and funds to comply and not risk independence issues.

The SEC is seeking comments on the rule until July 9, 2018, unless extended.

NEW MATH: ARES, KKR, AND CHOICE OF ENTITY IN 2018

H.R. 1, informally known as the Tax Cuts and Jobs Act (the Act), became law on December 22, 2017. The Act changed the corporate tax rate from a graduated rate at a maximum 35 percent to a flat 21 percent rate. This move has prompted many businesses, including asset management and private equity firms, to consider whether to remain pass-through entities or convert to C corporations. There have been some high-profile conversion decisions already. Ares Management announced in February that it would be converting to a corporation, and KKR & Co. announced its planned conversion in early May.

Speculation soon followed as to whether other firms would follow suit, such as recent suggestions that The Blackstone Group might convert as early as 2019, depending on valuation results for other firms. However, the appeal of conversion is driven by considerations that will be specific to each firm's situation. Key factors include:

- **Expanded Investor Base.** Both Ares and KKR were publicly traded partnerships, a structure that limited their potential investor base, particularly with respect to passive investors and investment products. As corporations, the firms hope to broaden their investor base and make it easier to invest, as KKR's co-founders and firm leaders Henry R. Kravis and George R. Roberts indicated in a statement.
- **Simplified Reporting.** Another advantage of the corporate structure is significantly simpler reporting for dividends, using 1099-DIV, than for pass-through income, which requires a more complex Form K-1. Pass-through income also can subject investors to multistate tax reporting. After conversion, the firms and their investors may anticipate reduced costs associated with this income reporting.
- **Increased Tax Cost.** Firms that derive a larger portion of their revenue from management fees than from performance fees are likely to have a greater incentive to convert. When organized as partnerships, firms would pay corporate taxes on the management fees charged to investors but generally would not pay taxes on performance fees. As C corporations, Ares and KKR will pay corporate taxes on all revenue, although at 21 percent rather than 35 percent. Ares indicated in a presentation that it "intends to retain performance fee earnings to fund future growth and for potential share repurchases," which would mitigate some of this downside.

In choosing to convert, firms are anticipating that increased value and share price for investors will outweigh the downside risk of an increased tax burden. That risk is reasonably palatable as long as the reduced 21 percent rate remains in place. Although the Act did not impose a sunset or expiration date on the corporate tax rate, whether such a low rate will remain permanent is unclear.

When making a decision whether to remain pass-through entities or convert to C corporations, asset managers should be wary that the corporate form is easy to get into and hard to get out of. Conversion from

a pass-through to a C corporation typically is possible on a tax-free basis, but conversion of a corporation to a pass-through entity is taxable. Likewise, once assets are in a C corporation, they generally cannot be distributed again without triggering a taxable event.

Because of these risks and the difficulty in reversing course once a change is made, it appears as if most asset management and private equity firms will continue to prefer pass-through structures over corporations. Regardless, each firm must consider the risks and benefits carefully, taking into account its own mix of income and investors. Ballard Spahr's Tax Group and Investment Management Group will continue to monitor trends in this area.

SEC ADOPTS FUND E-DELIVERY RULE

The SEC released on June 5, 2018, an Investment Company Disclosure and Delivery Rulemaking Package Fact Sheet. The fact sheet consisted of: (1) Adoption of an Optional Delivery Method for Fund Shareholder Reports; (2) Request for comment on enhancing fund disclosure to improve the investor experience; and (3) Request for comment on processing fees intermediaries charge for forwarding fund materials.[1]

Adoption of an Optional Delivery Method for Fund Shareholder Reports

The SEC adopted a new Rule 30e-3, which creates an optional "notice and access" method for electronic delivery of shareholder reports. Subject to conditions in the new rule, a fund may make its reports and other required materials publicly accessible at a specified website address, free of charge, and send investors a notice by mail of each report's availability. Funds will be permitted to satisfy their delivery obligations for shareholder reports by mailing the reports, delivering them electronically to investors who have chosen this method under the SEC's electronic-delivery guidance, providing notice and website accessibility, or any combination of those options. Investors who prefer to receive the full reports in paper may—at any time—choose that option free of charge.

The conditions of new Rule 30e–3 include:

- **Report accessibility.** The shareholder report and the fund's most recent prior report must be publicly accessible and free of charge at a specified website.
- **Availability of quarterly holdings.** Quarterly holdings for the last fiscal year also must be publicly accessible at the website.
- **Format.** Funds must satisfy conditions designed to ensure accessibility of reports for shareholders, including format and location.
- **Notice.** Investors must receive a notice of the availability of each report that includes a website address where the shareholder report and other required information is posted as well as instructions for requesting a free paper copy or electing paper transmission in the future. The notice may include certain additional information, including instructions by which an investor can elect to receive shareholder reports or other documents by electronic delivery and additional content from the shareholder report.
- **Print upon request.** Funds must send a free paper copy of any of these materials upon request.
- **Paper reports.** At any time, an investor may elect to receive all future reports in paper by calling a toll-free telephone number or otherwise notifying the fund or intermediary.
- **Extended transition period.** During the extended transition period, the earliest that notices may be transmitted to investors in lieu of paper reports is January 1, 2021. In general, funds will be required to provide two years' notice to shareholders before relying on the rule, if relying on the rule before January 1, 2022.
- **Investor feedback.** The SEC is seeking public input, particularly from individual investors, on enhancing fund disclosures. It also is soliciting feedback on investor preferences for means of delivery and how to make better use of technology, including ways to make disclosure more interactive and personalized.
- **Processing fees for intermediaries.** The SEC is seeking public comment and additional data on the current processing fee framework for fees charged

1 https://www.sec.gov/news/press-release/2018-103.

by intermediaries for the distribution of disclosure materials other than proxy materials (e.g., shareholder reports and prospectuses) to fund investors. Their aim is to better understand the potential effects on funds and their investors.

SEC POSTPONES THE COMPLIANCE DATES FOR CERTAIN PROVISIONS OF THE LIQUIDITY RULES

The liquidity risk management program rule and related reporting and disclosure requirements (the Liquidity Rules) for mutual funds (except for money market funds) and open-end ETFs, which were adopted by the SEC in 2016, are due to take effect this December. The Liquidity Rules require that, among other things, a liquidity risk management program must be run at least on an annual basis and the assessment must use the same factors consistently.

The SEC announced in February that it would postpone the compliance dates for certain provisions of the Liquidity Rules by six months. The new compliance date will provide funds with additional time to complete the implementation of the Liquidity Rules' classification requirement, along with specified other elements that are tied to the classification requirement. Other provisions of the Liquidity Rules that provide important investor protection benefits, including the requirements to adopt a liquidity risk management program and to limit illiquid investments to 15 percent of the fund's portfolio, will go into effect as originally scheduled.

The compliance date for implementation of the classification and classification-related elements of the Liquidity Rules is June 1, 2019, for larger fund groups, and December 1, 2019, for smaller fund groups[2]. The other requirements will go into effect as originally scheduled: December 1, 2018, for larger fund groups, and June 1, 2019, for smaller fund groups.

The SEC also issued an additional set of FAQs related to the Liquidity Rules, focusing on questions that have arisen with respect to the liquidity classification process. In particular, the FAQs address sub-advised funds and ETFs that meet redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash (in-kind ETFs). The FAQs clarify that the liquidity risk management program administrator can delegate certain responsibilities to a fund's sub-adviser. The FAQs further clarify that an in-kind ETF may exclude from its calculation of its *de minimis* cash the amount of cash in its redemption proceeds that is proportionate to its uninvested portfolio cash. The FAQs make it clear that a fund or an ETF cannot delegate its responsibility under the Liquidity Rules to its adviser, sub-adviser, or the liquidity risk management program administrator.

Finally, the SEC anticipates considering in the future proposed amendments to Form N-PORT and Form N-1A related to disclosures of liquidity risk management for open-end management investment companies.

2 Under the Liquidity Rules, larger funds are those funds that, together with other funds in the same fund complex, have net assets of more than $1 billion as of the end of the most recent fiscal year. Smaller funds are those that, together with other funds in the same complex, have net assets of less than $1 billion as of the end of the most recent fiscal year.

CONTACTS

The above articles address the relevant investment management issues at a high level only. Please consult members of the Ballard Spahr Investment Management Group for further discussion.

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