June 9, 2021

Ropes & Gray's Investment Management Update April – May 2021

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

SEC ESG DEVELOPMENTS – Chair Gensler to Prioritize Climate-Related Risk Disclosure – Commissioner Lee Dispels "Myths" Surrounding SEC's Authority to Mandate ESG-Specific Corporate Disclosures

On May 6, 2021, for the first time as Chair of the SEC, Gary Gensler testified before the House Committee on Financial Services (video available here). He was invited by the Committee to testify about the significant price volatility and trading volume of certain so-called meme stocks in January 2021 (*e.g.*, GameStop Corp.). Chair Gensler was asked whether he intended to prioritize climate-related risk disclosure from issuers. He responded that he would prioritize rulemaking covering climate-related risk disclosure because, at the core of our market structure, are (i) disclosures and (ii) investors who decide which risks to incur based on those disclosures. At present, he stated, climate-related risk is something that investors want to better understand as they make their investment decisions. Chair Gensler stated that the SEC can provide consistency and comparability regarding climate-related risk disclosure, and he encouraged interested parties to submit comments in response to then-acting Chair Allison Lee's March 15, 2021 public statement soliciting public input on disclosures related to climate change by mid-June.

On May 24, 2021, Commissioner Allison Lee delivered a speech titled "Living in a Material World: Myths and Misconceptions about 'Materiality.'" Ms. Lee's speech was intended to show that the SEC has legal authority to mandate various ESG disclosures, even if the ESG disclosures were not "individually material to the bottom line of every public company." After providing her arguments that the SEC's rulemaking authority extends to mandating ESG disclosures, Ms. Lee urged that "we continue the important debate on how best to craft a rule proposal on climate and ESG risks and opportunities."

On May 26, 2021, in the prepared portion of his testimony before the House Appropriations Committee's Subcommittee on Financial Services and General Government, Chair Gensler stated that he looked "forward to staff recommendations on proposing rules regarding issuer disclosure of climate risks and human capital, and that he anticipated "that this will be the initial steps in our broader efforts to update our disclosure regime for modern markets."

These public statements are not surprising and reinforce the fact that a majority of the SEC commissioners – consisting of Chair Gensler and Commissioners Lee and Caroline Crenshaw – are seen as willing to implement climate-related risk disclosure requirements for operating companies and, perhaps, mandatory disclosure requirements regarding ESG issues, as well.

- On April 9, 2021, the SEC Division of Examinations issued a Risk Alert regarding observations from recent exams of firms offering ESG products and services (the "ESG Risk Alert"). In Ropes & Gray's April 13, 2021 Alert discussing the ESG Risk Alert, we summarized developments since January 2020, noting that the SEC's focus on ESG investing had been apparent for more than a year.
- However, our Alert highlighted that Commissioners Hester Peirce and Elad Roisman have maintained that the SEC's "enhanced focus" on climate and ESG-related matters amounted to nothing new, and questioned whether "these announcements represent a change from current Commission practices or a **continuation of the status quo with a new public relations twist**." (Emphasis added).

Therefore, prospective rulemaking on climate-related risk disclosure and ESG investment practices is likely to be based upon 3-2 votes by the SEC commissioners. That said, among other examples, the October 2020 SEC adoption of Rule 18f-4 (registered funds' use of derivatives, described in this Ropes & Gray Alert), the August 2020 SEC amendments to the definition of "accredited investor" (described in this Ropes & Gray Alert) and the August 2019 SEC releases on the proxy-voting responsibilities of investment advisers (described in this Ropes & Gray Alert) also were 3-2 rulemakings.

SEC Terminates Certain COVID-19 Exemptive Relief and No-Action Letters; In-Person Meeting Relief Remains in Effect

In March 2020, the SEC issued a conditional exemptive order (the "Order") permitting registered open-end investment companies (except money market funds) and insurance company separate accounts registered as unit investment trusts to obtain short-term funding by borrowing from affiliated persons or under an interfund lending facility (even if the funds involved in the transaction did not have an interfund lending order). By its terms, the Order was terminable upon two weeks' public notice from the SEC staff.

Additionally, in March 2020, the Division of Investment Management (the "DIM") issued two no-action letters addressed to the Investment Company Institute concerning the ability of certain affiliates to purchase (i) securities from a money market fund (available here), and (ii) debt securities from a mutual fund (available here). Each of the two letters stated that it would cease to be effective upon public notice from the SEC staff.

Following public notice by the SEC staff in late March 2021, the relief provided by the Order terminated, and the two no-action letters were withdrawn, effective April 30, 2021.

Separately (as described in this Ropes & Gray IM Update), the SEC's extension of its order providing an exemption from the requirements – arising under Sections 15(c) and 32(a) of the 1940 Act and Rules 12b-1(b)(2) and 15a-4(b)(2)(ii) under the 1940 Act – that votes of the board of directors of either the registered management investment company or business development company be cast in person – remains in effect.

SEC Staff Identifies Senior Securities No-Action Letters to Be Withdrawn Following Rule 18f-4's Transition Period

In October 2020, the SEC adopted Rule 18f-4 (the "Rule"), which will dramatically change the regulation of the use of derivative instruments and certain related transactions by mutual funds (other than money market funds), exchange-traded funds, closed-end funds and business development companies (collectively, "funds"). The Rule is discussed in Ropes & Gray's Alert.

Rule 18f-4's effective date was February 19, 2021. The Rule's adopting release provided for an 18-month transition period following the Rule's effective date (*i.e.*, until August 19, 2022) for funds to prepare to come into compliance with the Rule. In addition, the Rule's adopting release stated that Release 10666 will be rescinded on August 19, 2022, and that certain no-action letters and guidance addressing derivatives transactions and other transactions covered by proposed rule 18f-4 will be withdrawn in connection with the final rule. However, the Rule's adopting release *did not* provide a list of the no-action letters and guidance that will be withdrawn.

On March 30, 2021, the DIM published an Information Update titled *Withdrawal and Modification of Staff Letters Related to Rulemaking on Use of Derivatives and Certain Other Transactions by Registered Investment Companies and Business Development Companies*. The Information Update lists ten no-action letters (identified as "Withdrawn") plus an additional 28 no-action letters (virtually all identified as "Modified. Statements related to section 18 are withdrawn"), all of which will be withdrawn on August 19, 2022.

Additionally, on March 30, 2021, the Chief Accountant of the DIM announced that, effective August 19, 2022, the DIM will withdraw the 1997 Dear CFO letter.

NYSE Proposes and Withdraws Limits on Closed-End Funds' Investments in Private Funds

On April 9, 2021, New York Stock Exchange LLC (the "NYSE"), pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder, filed with the SEC a notice of proposal (the "Proposal") to amend Section 102.04(A) of the NYSE Listed Company Manual. Currently, Section 102.04(A) does not expressly restrict the types of investments in which a NYSE-listed closed-end fund may invest.

The Proposal's amendments to Section 102.04(A) would have established limits on NYSE-listed closed-end funds' investments in entities that rely on either Sections 3(c)(1) or 3(c)(7) of the 1940 Act to avoid being deemed an

"investment company" under Section 3(a) of the 1940 Act ("private funds"). Specifically, as proposed to be amended, Rule 102.04(A) would have barred the NYSE initial listing of a closed-end fund if the closed-end fund had invested more than 15 percent of its net asset value in private funds or greater than five percent of its net asset value in any single private fund. Moreover, these limits would have to be included in the fundamental investment limits of (i) any newly listed closed-end fund that intends to invest in private funds and (ii) any closed-end fund that is already listed on the NYSE that wants to invest private funds.

Oddly, without seeming to understand the differences between the liquidity needs of closed-end funds and *mutual funds*, the Proposal noted that the SEC had amended Rule 22e-4 under the 1940 Act with respect to mutual funds to limit investments by mutual funds in illiquid investments, including private funds, to no more than 15 percent of the mutual fund's net assets. Accordingly, the Proposal stated, "[i]n light of this development in the SEC's regulation of mutual funds and the continuing interest demonstrated by issuers, the [NYSE] now proposes to amend Section 102.04(A) to provide for a limited ability of [NYSE-listed closed-end funds] to invest in private funds."[1]

In a May 12, 2021 notice, the NYSE withdrew the Proposal without explanation.

SEC Updates Form N-CEN FAQs

On April 21, 2021, the DIM updated its frequently asked questions ("FAQs") concerning investment company forms adopted in 2016 and amended in 2017 and 2019. The FAQs are marked to show changes to the FAQs (available here) since the 2019 amendments. In this instance, the DIM provided a detailed new question and a detailed answer concerning methodologies that a fund is permitted to employ to calculate the fund's "monthly average of the value of portfolio securities on loan" and the "monthly average net assets during the reporting period," as required to respond to Items C.6.f and C.19.a, respectively, of Form N-CEN.

REGULATORY PRIORITIES CORNER

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

SEC Staff Issues Statement on Funds Investing in the Bitcoin Futures Market

On May 11, 2021, the staff of the DIM issued a statement on registered funds investing in Bitcoin futures (the "Statement").

The Statement briefly highlighted five types of issues that are implicated by registered funds investing in digital assets, including cryptocurrencies or cryptocurrency-related investments that the DIM described in its 2018 letter titled Engaging on Fund Innovation and Cryptocurrency-Related Holdings (the "Cryptocurrency Holdings Letter"). The issues identified in the Cryptocurrency Holdings Letter concerned requirements regarding valuation, liquidity, custody, arbitrage mechanisms for exchange traded funds ("ETFs") and the potential manipulation and other risks associated with cryptocurrency-related markets.

The Statement observes that, since the Cryptocurrency Holdings Letter, the Bitcoin futures market has increased trading volumes and open-interest positions, and that the Bitcoin futures market "consistently has produced a reportable price for Bitcoin futures." In addition, the SEC staff observed that the Bitcoin futures market "has not presented the custody challenges associated with some cryptocurrency-based investing because the futures are cash-settled."

The Statement notes that some mutual funds are investing or seeking to invest in Bitcoin futures. Therefore, the Statement relates, the DIM, consulting with the Division of Economic and Risk Analysis and the Division of

[1] The SEC staff has informally taken a position that securities issued by a closed-end fund that is registered under the 1940 Act and the Securities Act and that invests more than 15 percent of its assets in private funds can be sold only to accredited investors. However, the SEC staff's informal position is not published or memorialized in any regulation or SEC guidance but, instead, has been communicated to closed-end fund registrants during the registration comment process.

Examinations, "will closely monitor the impact of mutual funds' investments in Bitcoin futures on investor protection, capital formation, and the fairness and efficiency of markets." In particular, the DIM expects to:

- Analyze the liquidity and depth of the Bitcoin futures market given regulatory requirements relating to mutual fund liquidity and derivatives risk management;
- Monitor funds' valuations of holdings in the Bitcoin futures market;
- Assess the ongoing impact of the potential for fraud or manipulation in the underlying Bitcoin markets and its possible influence on the Bitcoin futures market; and
- Consider whether the Bitcoin futures market could accommodate ETFs, which cannot prevent additional investor assets from coming into the ETF if the ETF becomes too large, or if the liquidity in the market starts to wane.

Separately, because closed-end funds do not present the same types of liquidity issues as open-end funds, the Statement "encourages any closed-end fund that seeks to invest in the Bitcoin futures market to consult with the staff, prior to filing a registration statement."

SEC Issues Notice of Intent to Amend Rule 205-3's Definition of "Qualified Client" to Adjust for Inflation

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from entering into an investment advisory contract that provides for a performance fee – *i.e.*, compensation to the adviser based on a portion of the capital appreciation of a client's account. Rule 205-3 under the Advisers Act provides an exemption to the general prohibition in Section 205(a)(1) requiring, among other things, that any client entering into an advisory contract with a performance fee is a "qualified client," as defined in Rule 205(d)(1).

- Rule 205(d)(1) currently provides that a person is a qualified client if (i) the client has at least $1 million under management with the adviser immediately after entering into the advisory contract (the "AUM test") or (ii) the adviser reasonably believes, immediately prior to entering into the advisory contract, that the client has a net worth of more than $2.1 million (the "net-worth test").
- The Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 205(e) of the Advisers Act to provide that, every five years, the SEC must adjust for the effects of inflation the dollar-amount thresholds in the AUM test and the net-worth test, rounded to the nearest multiple of $100,000. The SEC last issued a Section 205(e) adjustment order in 2016.

On May 10, 2021, the SEC issued a notice (the "Notice") stating that it intends to issue an order making the required inflation adjustments to the dollar-amount thresholds in Rule 205(d)(1) – to increase the AUM test from $1 million to $1.1 and the net-worth test from $2.1 million to $2.2 – effective 60 days following the order. The Notice states that the SEC will issue the order making these adjustments unless the SEC orders a hearing.

Visually Impaired Investor Claims that Adviser's Website Violates Provisions of the Americans with Disabilities Act

On April 22, 2021, a visually impaired shareholder brought suit in the U.S. District Court for the Southern District of New York against the investment adviser to a family of registered investment companies. The complaint asserted that the investment adviser's website violated the plaintiff's rights under the Americans with Disabilities Act (the "ADA") and New York state law because the website was allegedly not fully accessible to, and independently usable by, the plaintiff and other blind or visually impaired people. The plaintiff sought a permanent injunction to cause a change in the investment adviser's corporate policies, practices, and procedures to assure that the website would become and remain accessible to blind and visually impaired consumers, as well as certification of a nationwide class action (under the ADA) and a New York sub-class action against the adviser.

Over the last several years, other fund complexes and financial services firms have settled similar lawsuits. This latest lawsuit in the Southern District is a reminder to fund complexes that maintain public websites to assure that these websites comply with the accessibility and usability requirements mandated for blind and visually impaired persons under the ADA, as well as requirements under applicable state laws.

ROPES & GRAY ALERTS AND PODCASTS SINCE OUR FEBRUARY–MARCH UPDATE

Podcast: Rated Note Feeder Structures
June 7, 2021
In this Ropes & Gray podcast, asset management partner Jason Kolman and finance partner Patricia Lynch discussed rated note feeder funds, new products that are becoming increasingly popular in the credit fund space. They discussed how these products meet the regulatory needs of insurance company investors, key differences compared to traditional feeder funds, and navigating the ratings agency process.

Podcast: Digital Assets: An Emerging Opportunity for Registered Funds
May 25, 2021
In this Ropes & Gray podcast, asset management partners Brian McCabe and Paulita Pike, and counsel Ed Baer, discussed digital assets and the ways these assets may be included in registered funds.

Podcast: The Rise of ESG ETFs
May 13, 2021
In part six of our ETF podcast series, Ropes & Gray partners Paulita Pike and Brian McCabe, and counsel Ed Baer, discussed the growth of ETFs that invest using ESG considerations.

Podcast: The DOL's Cybersecurity Guidance for Retirement Plan Sponsors, Service Providers and Participants
May 11, 2021
In this fourth episode of Ropes & Gray's podcast series addressing emerging issues for fiduciaries of 401(k) and 403(b) retirement plans to consider as part of their litigation risk management strategy, ERISA & benefits partner Josh Lichtenstein spoke with Ed McNicholas, co-chair of the data, privacy & cybersecurity practice, and David Kirchner, a principal in the benefits consulting group, about the U.S. Department of Labor's new cybersecurity guidance, which identifies steps that plan sponsors, service providers and participants should take for safeguarding retirement benefits and personal information.

Podcast: Co-Investments in the Age of Fund Recapitalizations
May 7, 2021
In this Ropes & Gray podcast, asset management partners Isabel Dische and Adam Dobson discussed points that investors should consider when negotiating terms of co-investments in light of the dramatic growth in the fund recapitalization market.

Podcast: *Anderson v. Intel* – A Test Case Regarding the Prudence of Adding Alternative Investments to Defined Contribution Plan Menus
April 15, 2021
In this third episode in a series of Ropes & Gray podcasts addressing emerging issues for fiduciaries of 401(k) and 403(b) plans to consider as part of their litigation risk management strategy, litigation & enforcement partner Amy Roy and benefits consultant Aneisha Worrell discussed some key takeaways from *Anderson v. Intel Corp. Investment Policy Committee*, the first case to date to address the prudence question under ERISA of including private equity and hedge fund investments on a defined contribution plan menu.

Podcast: Private Fund Regulatory Update: 2021 SEC Enforcement Priorities
April 14, 2021
In this Ropes & Gray podcast, asset management partner Joel Wattenbarger and counsel Nicole Krea discussed the new developments in the SEC during the changeover of administrations, including the recent release of a report from the Division of Examinations concerning their 2021 priorities. The Private Fund Regulatory Update is a series of podcasts

discussing key issues of interest and updates in the regulatory and compliance space, focusing in particular on private fund managers.

SEC Staff Issues Risk Alert on ESG Investing
April 13, 2021
On April 9, 2021, the Division of Examinations issued a Risk Alert "to highlight observations from recent exams of investment advisers, registered investment companies, and private funds offering [environmental, social, and governance ('ESG')] products and services" (collectively, "firms").

- The Risk Alert followed the Division of Examinations' standard format by describing, based upon examinations of firms, staff observations of (i) deficiencies and internal control weaknesses and (ii) commendable practices and reasonably designed internal controls.
- The Division of Examinations staff's observations are summarized in this client Alert.

PErspectives: Private Equity Industry Insights | Spring 2021
April 9, 2021
This is the Spring 2021 issue of PErspectives – Ropes & Gray's periodic publication featuring news, trends and legal developments in the private equity ("PE") industry. In this issue, we looked at 2021 and beyond as we explore the state of PE in a post-pandemic world and in the wake of significant political developments across the globe.

With a view to how markets are impacting PE stakeholders in a variety of industries and geographies, our contributors examined these and other probing questions:

- What should PE investors and portfolio companies expect as markets settle into a new normal post-COVID?
- How will the new U.S. administration and Brexit shape the global PE landscape?
- How are the U.S. financing markets faring after months of upheaval?
- What key trends are emerging in the telehealth sector?
- Why should asset managers consider long-hold investment strategies?
- What are some key risks and benefits from using IP in tech deals?

Podcast: Creating a Competitive Advantage Through Long-Term Ownership
April 7, 2021
In this Ropes & Gray podcast, asset management partners Arthur Andersen and John Ayer discussed the private equity industry's increasing interest in long-hold investment structures, along with the emergence of sponsors' ability to offer such structures as an important competitive advantage. They discussed how innovations in the industry have created more flexible arrangements for sponsors considering longer duration investments.

Podcast: Do Fund Sponsors Need a Secondary Buyer for a Fund Recap?
April 6, 2021
In this Ropes & Gray podcast, asset management partners Adam Dobson, Isabel Dische and Lindsey Goldstein discussed fund recapitalization transactions and a recent trend by some sponsors toward pursuing these transactions without a lead secondary buyer, and certain key risks for both fund sponsors and secondary buyers.

If you would like to learn more about the developments discussed in this Update, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Asset Management group listed below.

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