September 7, 2021

# Ropes & Gray's Investment Management Update June – July 2021

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

## Fund of Funds Arrangements FAQs

The staff of the Division of Investment Management (the "DIM") recently prepared responses to questions related to the implementation of Rule 12d1-4 under the 1940 Act (the "FAQs"). The questions and responses in the FAQs, which are summarized below, concern fund of funds "investment agreements." Fund of funds have until January 19, 2022 to comply with Rule 12d1-4, as described in Ropes & Gray's October 14, 2020 Alert.

The FAQs confirm that the trigger point for an acquiring fund to enter into an investment agreement with an unaffiliated acquired fund is immediately prior to its crossing any one of the statutory limits of Section 12(d)(1)(A) of the 1940 Act – *i.e.*, the 3-5-10% limits. The FAQs also confirm that (i) no findings under Rule 12d1-4(b)(2)(i) would be required, as long as the acquiring fund does not exceed the 3% limit with respect to a specific acquired fund, (ii) the fund of funds investment agreement with such acquired fund would not have to include "any material terms" concerning the findings otherwise required under Rule 12d1-4(b)(2)(iv)(A) because no such terms exist and (iii) the same analysis applies if the acquiring fund is a unit investment trust ("UIT").

The FAQs also clarify Rule 12d1-4's operation for an acquiring fund that holds acquired funds below the statutory limits of Section 12(d)(1)(A) that subsequently makes an acquisition in *another* fund in excess of those limits in reliance on Rule 12d1-4. In this case, the acquiring fund must enter into a fund of funds investment agreement with an acquired fund before the acquiring fund acquires securities of such acquired fund in reliance on Rule 12d1-4, but an acquiring fund is not required to enter into investment agreements with acquired funds in which it had invested prior to relying on Rule 12d1-4.

## SEC Issues Risk Alert Regarding Fixed Income Principal and Cross Trades

On July 21, 2021, the SEC Division of Examinations (the "Division") issued a Risk Alert (the "Alert") concerning the most common compliance issues observed by the Division staff regarding principal and agency cross trades under the Advisers Act. The Alert supplements the staff's observations made in a 2019 Risk Alert by providing greater detail on certain compliance issues and focusing on examinations of SEC-registered investment advisers' cross trades and principal trades of fixed income securities. The Alert then describes practices that the Division staff has observed and believes are effective compliance practices.

## Effective Practices

***Compliance Programs.*** The Alert provides the following as characteristics of effective compliance programs:

- Specific and detailed definitions regarding what constitutes a principal trade, cross trade, or both were more likely to be consistently followed.
- While nearly all of the investment advisers had adopted applicable written compliance policies and procedures, the better examples included *all* of the following standards.
    - Transactions were required to be fair and equitable to all participating client accounts with prescribed pricing methodologies used to execute the transactions.

- Periodic evaluations of the quality of execution were performed with periodic reporting to the adviser's legal or compliance departments.
- Clients received written information regarding the capacity in which the adviser acted.
- Portfolio managers or traders received advanced written approval from senior management or compliance personnel in order to execute cross trades.

- Placing conditions, qualifications, or restrictions on the execution of principal trades, cross trades, or both within clients' accounts, including the following:
    - The securities must only be purchased by or sold to another client when there is a need and securities meet each participating client's investment objectives.
    - The client accounts involved in these trades are not ERISA accounts.
    - The adviser, its affiliated persons, and its supervised persons may not receive commissions or any other compensation with respect to these trades.

***Written Disclosure Programs.*** The Alert provides the following as characteristics of effective disclosure programs:

- Clients provided with full and fair disclosure of all material facts surrounding principal and cross trades, covering the following topics:
    - How the adviser addresses the conflicts of interest that were identified, and the circumstances under which the adviser may engage in these transactions.
    - Any costs associated with these transactions, including the pricing methodologies used by the adviser to value the securities transactions, as well as the total amount of all commissions or remuneration received by the adviser or any affiliated persons.
    - For agency trades, the option for clients to revoke their written blanket consent to execute agency cross trades without penalty at any time by written notice to the adviser and, for principal trades, the total number of principal trades entered into during the period (since the date of the last statement or summary).
- Clients provided with disclosure regarding principal and cross trading practices in multiple documents, including Form ADV Part 2As, advisory agreements, separate written communications to clients and/or private fund offering documents.

## REGULATORY PRIORITIES CORNER

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

### SEC Announces Annual Regulatory Agenda; Commissioners Peirce and Roisman Release Dissenting Statement

The Office of Information and Regulatory Affairs publishes the "Unified Agenda of Regulatory and Deregulatory Actions" of the various federal agencies. The Unified Agenda is updated semi-annually, and includes the SEC's Current


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Agenda, which reflects only the *priorities of SEC Chair Gary Gensler* and does not necessarily reflect the views and priorities of any other Commissioner.

Published in early June, the spring 2021 SEC Current Agenda contained the three new items in the first table below, each accompanied by this statement: "First time published in the Unified Agenda."

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| **Pre-Rule Stage** | ***Third-Party Service Providers*** (The DIM is considering recommending that the SEC seek public comment on the role of certain third-party service providers, such as index providers and model providers, and the implications for asset management industry). |
| **Proposed Rule Stage** | ***Rules Related to Investment Companies and Investment Advisers to Address Matters Relating to Environmental, Social and Governance Factors*** (The DIM is considering recommending that the SEC propose requirements for investment companies and investment advisers related to environmental, social and governance factors, including ESG claims and related disclosures). |
| **Proposed Rule Stage** | ***Open-End Fund Liquidity and Dilution Management*** (The DIM is considering recommending that the SEC propose changes to regulatory requirements relating to open-end fund's liquidity and dilution management). |

The SEC Current Agenda also contained the three items in the table below, each identified as within the Proposed Rule Stage. Each of these three items appeared in the fall 2020 SEC Unified Agenda as a "Long-Term Action" (*i.e.*, "items under development but for which the agency does not expect to have a regulatory action within the 12 months after publication of this edition of the Unified Agenda").

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| **Proposed Rule Stage** | ***Amendments to Rule 17a-7 Under the Investment Company Act*** (The DIM is considering recommending that the SEC propose amendments to Rule 17a-7 under the 1940 Act concerning the exemption of certain purchase or sale transactions between an investment company and certain affiliated persons). |
| **Proposed Rule Stage** | ***Amendments to the Custody Rules for Investment Advisers*** (The DIM is considering recommending that the SEC propose amendments to existing rules and/or propose new rules under the Investment Advisers Act to improve and modernize the regulations around the custody of funds or investments of clients by investment advisers). |
| **Proposed Rule Stage** | ***Money Market Fund Reforms*** (The DIM is considering recommending reforms relating to the regulation of money market funds). |



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In response to Chair Gensler's re-opening of rulemakings they deemed finalized (including proxy-voting advice, not shown in the tables above) in the spring 2021 SEC Current Agenda, Commissioners Hester Peirce and Elad Roisman issued a joint public statement titled *Moving Forward or Falling Back? Statement on Chair Gensler's Regulatory Agenda*, in which they claimed that Chair Gensler was engaged "in an effort to reverse course on a series of recently completed rulemakings." In addition, the two commissioners stated, "the Agenda is missing some other important rulemakings, including rules to provide clarity for digital assets, allow companies to compensate gig workers with equity, and revisit proxy plumbing" and "[w]hile we will keep an open mind on each proposal, it is hard to see how the Commission could change course on such complex matters before the Commission's latest actions have fully taken effect."

## SEC Issues Risk Alert Regarding Advisers Managing Accounts in Wrap Fee Programs

On July 21, 2021, the SEC Division of Examinations issued a Risk Alert (the "Wrap Fee Alert") based on its examinations of advisers associated with wrap fee programs (collectively, "examined advisers"). Following the typical format of Risk Alerts from the Division, the Wrap Fee Alert describes the most common deficiencies observed by the Division staff and provides examples of commendable policies and practices in each category.

**Commendable Policies and Practices**

***Fiduciary Duty and Recommendations Made in Clients' Best Interest***

- Conducting reviews of wrap fee programs – both initially and periodically thereafter – to assess whether the wrap programs recommended to clients are in the best interests of clients. This process includes periodically reminding clients to report any changes in their personal situations.

- When recommending that clients should convert from non-wrap fee accounts to wrap fee programs, providing clients with information regarding investing through wrap fee program accounts, especially the differences associated with such account strategies (*e.g.*, assessments of the fees, expenses, and other costs involved).

***Disclosures***

- Making full disclosure regarding the advisers' conflicts of interest related to transactions executed within the wrap fee programs (*e.g.,* advisers receive compensation from wrap fee program sponsors, advisers have financial incentives to not migrate infrequently traded wrap fee accounts to brokerage or non-wrap advised accounts).

- When recommending wrap fee programs to clients, providing clear disclosure about whether certain services or expenses are not included in the wrap fee.

***Compliance Programs***

- Written compliance policies and procedures should include the factors to be evaluated to assess whether the investment recommendations made to clients in wrap fee programs are in the clients' best interests.

- The compliance programs should monitor and validate that the advisers sought best execution for clients' transactions.

- The compliance programs' policies and procedures should define what the advisers that recommend wrap fee programs to clients consider to be "infrequently" traded accounts and review such accounts to determine whether the wrap fee programs remain in the clients' best interests.

### Chair Gensler Addresses the Financial Stability Oversight Council

By statute, the Chair of the SEC is a voting member of the Financial Stability Oversight Council (the "FSOC"). On June 11, 2021, for the first time as Chair of the SEC, Gary Gensler attended a meeting of the FSOC and, in connection with the meeting, made a brief public statement titled *Money Market Funds Statement* (the "Statement").

In the Statement, Chair Gensler said that he believed in the FSOC's mission "to identify and respond to financial stability risks and to better promote market discipline." He stated that in the spring of 2020, there had been system-wide issues affecting critical parts of the U.S. short-term funding markets, including money market funds, commercial paper and the treasury repo markets. He noted that, in the fall of 2019, the U.S. treasury repo markets also experienced challenges.

Turning to money market funds, Chair Gensler stated that money market funds are "an important part of our markets and source of wholesale funding for many issuers." He noted that the SEC, in 2010 and 2014, sought to address structural issues faced by money market funds by issuing various reforms. Based on the events in the spring of 2020, he noted that the SEC, the FSOC and the President's Working Group have considered how to enhance the resiliency of money market funds. Chair Gensler noted that the events of the spring had called attention to prime money market funds and their relationship with investments in commercial paper and certificates of deposit. He noted that commercial paper and certificates of deposit "have limited liquidity in good times, and in critical weeks of stress last spring, virtually disappeared."

In view of the importance of ensuring money market funds' resiliency, Chair Gensler said, he was "directing SEC staff to look into these issues, in coordination with other federal agencies, and to consider any further reforms needed."

### NYSE Arca Rule Changed, Expanding Opportunities for Affiliated ETFs to Merge Without Shareholder Approval

The SEC recently issued a release approving a proposed rule change submitted by NYSE Arca, Inc. ("NYSE Arca"). The rule change amends NYSE Arca Rule 5.3-E to exempt certain registered investment companies, including ETFs that are currently listed on an exchange (collectively, "Covered Funds"), from having to comply with the shareholder approval requirement in NYSE Arca Rule 5.3-E(d)(9) in connection with the acquisition of the stock or assets of an affiliated Covered Fund in a transaction that (i) complies with Rule 17a-8 under the 1940 Act and (ii) does not otherwise require shareholder approval under the 1940 Act or the rules thereunder.

In the past, some ETFs have been liquidated by ETF sponsors rather than merged with other ETFs in part because of the shareholder-approval requirement. Therefore, the rule change may lead to mergers of affiliated ETFs instead of their liquidations.

Nasdaq and CBOE BZX, the other ETF listing exchanges, have similar shareholder approval requirements, but have not yet proposed similar rule changes.

### FINRA Reminder to Member Firms of Limitations on the Presentation of IRR in Retail Communications Concerning Private Placements

In 2020, FINRA published Regulatory Notice 20-21 (the "Notice") reminding member firms of their obligations in connection with marketing or sales communications regarding private placements that meet the definition of retail communication in Rule 2210(a)(5).

Among other things, the Notice informs member firms that, when marketing a program that has ongoing operations and, therefore, has a combination of realized and unrealized gains in its portfolio, FINRA interprets Rule 2210 to permit the inclusion of internal rate of return ("IRR") only if it is calculated in a manner consistent with the Global Investment

Performance Standards ("GIPS") adopted by the CFA Institute and includes additional GIPS-required metrics, such as paid-in capital, committed capital and distributions paid to investors. In addition, the Notice states, FINRA does not view as inconsistent with Rule 2210 those retail communications that provide an IRR for a specific investment in a portfolio, provided the IRR represents the actual performance of that holding.

Notwithstanding the Notice, there may be member firms that have not satisfied the Notice's requirements when presenting IRR in retail communications due to the difficulty of satisfying those requirements. However, there does seem to be movement toward compliance across the industry, and investment advisers, many of which rely on member firms to effect sales of interests in their funds to retail investors, are beginning to focus on determining how to calculate unrealized IRR in a manner consistent with GIPS.

## ROPES & GRAY ALERTS AND PODCASTS SINCE OUR APRIL–MAY UPDATE

A Step Closer Towards the New UK Capital Regime for Investment Firms
July 28, 2021
With less than six months to go until the new prudential regime for UK MiFID firms is due to come into effect, the FCA has published its second policy statement. This Alert considers the impact on UK sub-advisory firms and AIFMs with MiFID top-up permissions.

FTC Proposals Could Significantly Expand Registered Funds' Pre-Acquisition Notice Requirements Under the Hart-Scott-Rodino Act
July 19, 2021
February 1, 2021 was the Federal Trade Commission (the "FTC") closing date for public comments on two FTC proposals published in the Federal Register on December 1, 2020 – (i) Notice of Proposed Rulemaking and (ii) Advance Notice of Proposed Rulemaking (collectively, the "Proposals") – with respect to the Premerger Notification Rules (the "Rules") that implement the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSRA").

If adopted as proposed, the Proposals would require an investment adviser to aggregate the voting securities of any issuer held by the registered funds, private funds and other accounts it advises for purposes of the HSRA and the Rules' "notification threshold." This change would result in a significant increase in the number of premerger notification form (each, an "HSR Form") filings that advisers would be required to make with the FTC and the Department of Justice Antitrust Division. Investment advisers and, therefore, their clients, would have to bear very significant compliance costs. In addition, application of the Rules' 30-day waiting period, which commences after the filing of a completed HSR Form, would interfere with portfolio management.

Navigating State Regulation of ESG Investments by Investment Managers: A Rapidly Evolving and Contradictory Landscape
June 30, 2021
ESG integration by retirement plans has become front and center for regulators and political leaders across the world and in the U.S. over the last 12 months. As we await further developments from the U.S. Department of Labor (the "DOL") on ESG issues for private sector retirement plans, a number of states have taken steps to implement ESG regulatory frameworks for their pension systems. In particular, lines in the sand have been drawn for the fossil fuel, firearms and ammunition sectors. Some states seek to restrict their pension funds from investing in these sectors, while other states seek to penalize managers that exclude investments in or discriminate against these sectors. The landscape is rapidly evolving, with legislation adopted in the last few weeks in Maine and Texas. Bills are in various stages of progress in several other states.

Complicating things for asset managers, some of the laws take opposite stances. In addition, like state laws in many subject areas, the legislation in this area is loosely drafted, raising a host of questions and interpretive issues for both

managers and state officials. These laws therefore create challenges for managers to navigate in their ESG policies, marketing, funds and managed accounts.

This Alert describes the state laws adopted to date, as well as various pending state initiatives. We also discuss the current state of play of the DOL's ESG guidance.

Podcast: Pooled Employer Plans ("PEPs")—An Outsourcing Opportunity for Small and Larger Employers as well as Private Equity Sponsors to Reduce their ERISA Fiduciary Responsibilities
June 25, 2021
In this fifth episode of our Ropes & Gray podcast series addressing emerging issues for fiduciaries of 401(k) and 403(b) plans to consider as part of their litigation risk management strategy, David Kirchner and Jack Eckart, both from our benefits consulting group, discussed pooled employer plans ("PEPs"). PEPs allow employers to join a group retirement plan that is administered by third-party service providers who will assume the majority of the administrative and investment fiduciary responsibilities (and risks) of managing a defined contribution retirement plan. While the marketplace is just beginning to take shape, PEPs may potentially be an attractive option for small and larger employers, as well as private equity sponsors that oversee plans of multiple companies across their portfolio.

Podcast: Navigating the "New Normal" for Security-Based Swaps: Buy-Side Considerations for the SEC's Security-Based Swap Rules
June 17, 2021
With the SEC's rules governing security-based swaps under Title VII of the Dodd-Frank Act poised to take effect this year, Ropes & Gray derivatives & commodities attorneys Molly Moore and Andy Des Rault discussed issues that asset managers and other buy-side market participants will need to consider and steps they will need to take to prepare for this new regulatory regime.

2021 | 2022 SEC Rules' Effective and Compliance Dates
June 25, 2021
This two-page chart is a useful reminder of the upcoming effective and compliance dates of various significant SEC rulemakings that affect the registered fund (open-end and closed-end) industry.



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