June 14, 2022

Ropes & Gray's Investment Management Update April – May 2022

On May 25, 2022, the SEC published two releases containing proposals affecting the mutual fund/investment management industry, each of which we covered in a separate client Alert. These two Alerts are summarized below with a hyperlink to the full text of each Alert.

SEC Proposes Changes to the Fund Names Rule

The SEC issued a release containing proposed changes to the names rule, Rule 35d-1 under the 1940 Act (the "Names Rule"), and related form amendments. If adopted as proposed, these changes would substantially expand the Names Rule's applicability and require funds to amend their prospectus disclosure. See Ropes & Gray's June 1, 2022 Alert.

SEC Proposes ESG-Related Disclosures by Registered Funds and Investment Advisers

The SEC issued a release containing proposed rule and form amendments under both the Advisers Act and the 1940 Act that, if adopted as proposed, would require specific disclosure regarding environmental, social, and governance ("ESG") strategies and methodologies in fund registration statements, fund annual reports, and adviser brochures. See Ropes & Gray's June 7, 2022 Alert.

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

SEC Settles Fraud Matter with Adviser and Provides Temporary Relief to Section 9(a)'s Bar to the Adviser and Its Affiliated Persons

On May 17, 2022, the SEC issued an order (the "Order") settling an administrative matter against a registered investment adviser (the "Adviser") that arose from a complex options trading strategy (the "strategy") that the Adviser marketed and sold to approximately 114 institutional investors in 17 unregistered private funds (the "Private Funds"). On the same day, the U.S. Department of Justice also announced that the Adviser had agreed to plead guilty to one count of criminal securities fraud arising from the same facts that underlie the Order. The misconduct alleged in both matters principally concerned the actions of the three portfolio managers that managed the options strategy. According to a Department of Justice press release issued on the same day as the Order, two of the portfolio managers pled guilty to securities fraud changes, and the third portfolio manager was indicted for securities fraud.

The Order alleges that, beginning on or before January 2016 and continuing through March 2020 (the "Relevant Period"), the Adviser, through the actions of the three portfolio managers, misled investors regarding the significant downside risk faced by the Private Funds, which included misrepresentations and omissions made in connection with the purchase and sale of the Private Funds' securities. More specifically, the Order alleges that during the Relevant Period, the three portfolio managers:

- Manipulated reports and other information provided to or created for certain investors on an *ad hoc* basis to conceal the magnitude of the strategy's downside risk, including the placement of hedging positions in the Private Funds;
- Did not consistently implement a tailored risk mitigation program that the Adviser had agreed to with the largest client in the Private Funds;
- Misrepresented to investors that the strategy had a specified capacity limit for certain funds when, at times, the Private Funds exceeded that amount;

- In March 2020, following that month's COVID-related market volatility, engaged in multiple efforts to conceal their misconduct from the SEC staff; and

- Caused the Private Funds to ultimately lose several billion dollars in value during the market dislocations caused by COVID-related market volatility.

As a result of the conduct described above, the Order asserts that the Adviser violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as anti-fraud provisions under Section 206 of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.

The Settlement. In settlement of the proceeding, the Adviser agreed (a) to being censured by the SEC, (b) to pay to the SEC disgorgement of $315.2 million plus prejudgment interest of $34.0 million for a total of $349.2 million, which is to be deemed satisfied by a forfeiture and restitution ordered pursuant to a guilty plea and settlement of the parallel criminal charge against the Adviser and (c) to pay a civil money penalty of $675 million (including restitution to Private Fund investors).

On the same day that the SEC issued the Order, the Adviser and various affiliated persons of the Adviser filed an application with the SEC seeking an order providing exemption from Section 9(a) of the 1940 Act with respect to the Adviser's guilty plea. In the plea agreement, the Adviser pled guilty to one count of securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In the application:

- The Adviser requested a time-limited exemption for the sole purpose of providing the Adviser with sufficient time to transition certain U.S.-registered fund advisory relationships to other service providers. Upon the expiration of the time-limited exemption, the Adviser's guilty plea will disqualify the Adviser from engaging in the fund servicing activities, including advisory services activities, identified in Section 9(a).

- The Adviser's affiliated persons (the "Continuing Fund Servicing Applicants") requested a temporary exemption from Section 9(a) until the SEC takes final action on an application for a permanent order (the "Permanent Order"). The temporary order (the "Temporary Order") would provide the time-limited exemption to the Adviser and a temporary exemption to the Continuing Fund Servicing Applicants pending SEC action on the Permanent Order. The Permanent Order, if granted, would provide a permanent exemption to the Continuing Fund Servicing Applicants from Section 9(a).

By pre-arrangement, the SEC provided the Temporary Order on the day application was filed. The portion of the application requesting the Permanent Order is still pending before the SEC.

Regulatory Priorities Corner

The following brief update exemplifies certain trends and areas of current focus of relevant regulatory authorities.

Division of Examinations Risk Alert on Investment Adviser MNPI Compliance Issues

On April 26, 2022, the SEC Division of Examinations (the "Division") issued a Risk Alert titled *Investment Adviser MNPI Compliance Issues* (the "Alert"). The Alert's purpose is to provide investment advisers and other market participants with information concerning "notable deficiencies" that the staff has cited related to Section 204A of the Advisers Act and Rule 204A-1 thereunder (the "Code of Ethics Rule"). According to the Alert, deficiencies related to Section 204A and the Code of Ethics Rule have been among the most commonly observed by Division staff.

The following is a summary of the deficiencies described in the Alert.

Section 204A-Releated Deficiencies

Policies and procedures related to Alternative Data. The Division staff observed advisers that used data from non-traditional sources ("alternative data"), but did not appear to adopt or implement reasonably designed written policies and procedures to address the potential risk of receipt and use of MNPI through alternative data sources. The Alert provided the following examples:

- Advisers did not appear to adequately memorialize diligence processes or follow them consistently. Instead they engaged in *ad hoc* diligence of alternative data service providers.
- Advisers did not appear to have policies and procedures regarding the assessment of the terms, conditions, or legal obligations related to the provision of the data, including when advisers became aware of red flags about the sources of such alternative data.
- Advisers did not appear to consistently implement their policies and procedures related to alternative data service providers.

Policies and procedures related to so-called "value-add investors." The Division staff observed advisers that did not implement adequate policies and procedures regarding investors (or in the case of institutional investors, key persons) who are more likely to possess MNPI, including officers or directors at a public company, principals or portfolio managers at asset management firms, and investment bankers.

Policies and procedures related to "expert networks." The Division staff observed advisers that did not implement adequate policies and procedures regarding their discussions with expert network consultants who may be related to publicly traded companies or have access to MNPI.

Compliance Issues Related to the Code of Ethics Rule

Identification of access persons. The Division staff observed advisers that did not identify and supervise certain employees as access persons in accordance with the Code of Ethics Rule. In addition, the Division staff observed adviser codes that did not define "access person" or accurately reflect which employees are considered access persons.

Access persons did not obtain required pre-approval for certain investments. The Division staff observed adviser access persons that purchased beneficial ownership in IPOs and limited offerings without requisite pre-approval.

Personal securities transactions and holdings. The Division staff observed deficiencies related to the required reporting of access persons' personal securities transactions and holdings. For example, the Division staff observed:

- Advisers that could not produce evidence of supervisory review of holdings and transaction reports, as well as advisers that did not have policies and procedures in place to assign the CCO's reporting to another member of the adviser and thereby effectively allowed the CCO to self-review his/her own holding and transaction reports.
- Situations in which the holdings and/or transaction reports were not submitted by access persons, the adviser's code of ethics did not include provisions requiring access persons to submit reports, or the reports were not submitted within the timeframes reflected in the Code of Ethics Rule.
- Advisers with codes that did not require access persons to include the specified content required by the Code of Ethics Rule in their transaction and holdings reports, including instances in which access persons did not include their investments in private placements.

Written acknowledgement of receipt of the code and any amendments. The Division staff observed instances where (i) supervised persons were not provided with a copy of the code or did not provide written acknowledgement of their receipt of the code or any amendments or (ii) the code did not contain provisions to reflect the written acknowledgment requirement of the Code of Ethics Rule.

Trading investments on restricted list. The Division staff observed instances where employees traded investments that were on the adviser's restricted list.

Allocation of investment opportunities. The Division staff observed situations where the adviser or its employees purchased securities at a better price, ahead of the adviser's clients, in contravention of the adviser's code.

Upcoming Compliance Dates

The following is a reminder of the upcoming compliance dates of significant SEC rulemakings.

August 1, 2022 – Closed-End Fund Inline XBRL Format Requirements. Closed-end funds that are eligible to file a short-form Form N-2 will be required to comply with Inline XBRL format requirements beginning August 1, 2022. All other closed-end funds must comply beginning February 1, 2023. See Ropes & Gray's April 27, 2020 Alert.

August 19, 2022 – Funds' Use of Derivatives. Rule 18f-4's effective date was February 19, 2021. The adopting release provides 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 Rule 18f-4. In addition, on that date, Release 10666 will be rescinded, and related no-action letters and other staff guidance (or portions thereof) will be withdrawn. On August 19, 2022, the SEC also will rescind the exemptive orders provided to leveraged/inverse ETFs, which will be permitted to rely on Rule 6c-11, as amended by the Rule 18f-4 adopting release. See Ropes & Gray's November 6, 2020 Alert.

September 8, 2022 – Good Faith Determinations of Fair Value. The effective date for Rules 2a-5 and 31a-4 was March 8, 2021. The compliance date is September 8, 2022. Funds have the option of complying with the Rules before the compliance date and after March 8, 2021. However, the adopting release states that any fund that elects to rely on Rules 2a-5 and 31a-4 before the compliance date may rely only on those rules, and may not also rely on other SEC guidance and staff letters and other guidance that will be withdrawn or rescinded on the compliance date. See Ropes & Gray's December 9, 2020 Alert.

Additional Ropes & Gray Alerts and Podcasts Since Our February – March Update

These Alerts and podcasts are in addition to the Alerts listed at the beginning of this Update.

Podcast: Pre-Approval of Liquidity Opportunities
June 13, 2022
In this Ropes & Gray podcast, asset management attorneys Lindsey Goldstein and Kevin White discussed some of the approaches taken to build authorities into fund limited partnership agreements to allow for future alternative liquidity opportunities. They discussed some considerations sponsors and investors should consider when negotiating these authorities, including what sponsors should keep in mind when determining whether to attempt to build in these authorities.

Podcast: Fully Invested: Co-Investments
June 8, 2022
This is *Fully Invested*, a podcast series from Ropes & Gray's global asset management practice that provides insight into essential considerations associated with current and emerging asset management topics. Given the still-growing popularity of co-investments—both from the perspective of fund sponsors and fund investors—Isabel Dische, Adam Dobson, Nicole Krea and Jessica Marlin provided an overview in this episode of the basic structures used for co-

investment transactions, as well as related issues that commonly arise in these deals. They also briefly touched on how the SEC's proposed private funds rules from earlier this year may shift the co-invest paradigm.

SEC Settles Enforcement Action Against Mutual Fund Adviser Challenging Funds' ESG Disclosure
May 26, 2022
The SEC announced settled cease and desist charges and a $1.5 million penalty against a mutual fund investment adviser on May 23, 2022 for alleged misstatements and omissions in fund disclosures regarding the adviser's incorporation of ESG factors into its investment process. The SEC alleged that the adviser represented that investments in the funds it advised had undergone an ESG quality review but in fact did not have ESG quality review scores for all investments held by the funds in question. The settlement marks the first enforcement action by the Division of Enforcement's Climate and ESG Task Force, formed in March 2021, and the first time in several years the SEC has brought an enforcement action based on ESG disclosures made by a registered fund.

Podcast: Impacts of the Russia/Ukraine Conflict on ETFs
May 13, 2022
In the latest installment of Ropes & Gray's ETF podcast series, asset management partner Brian McCabe and counsel Jessica Reece discussed the ongoing impacts of the Russia/Ukraine conflict on ETFs, including questions related to valuation and custody of Russian and Russian-related assets.

Podcast: Co-Investments and Fund Recapitalizations
May 3, 2022
In this Ropes & Gray podcast, asset management attorneys Isabel Dische, Adam Dobson, Jessica Marlin and Alex Chauvin discussed some of the issues sponsors, investors and secondary buyers will want to have in mind as they navigate the intersection of co-investment transactions and GP-led fund recapitalizations. They discussed some considerations for sponsors and investors at the time of the initial co-investment, preparing for the possibility of a future GP-led fund recapitalization, as well as considerations for secondary buyers contemplating a potential GP-led fund recapitalization involving co-investment positions.

2022 Investment Management Conference
April 21, 2022
Ropes & Gray's memorandum summarizes the 2022 Investment Management Conference sponsored by the Investment Company Institute. The Conference included sessions that discussed the following industry and regulatory developments, among others.

- Keynote Remarks by William A. Birdthistle, Director, Division of Investment Management, Securities and Exchange Commission and a discussion with senior Division of Investment Management personnel
- Trends in specialized products including ETFs, CEFs (including exchange-listed closed-end funds, interval funds and tender offer funds) and other investment vehicles
- The legislative outlook in an election year
- Innovations in financial offerings for retail investors
- A review of developments in mutual fund civil litigation
- Board practices and regulatory developments affecting fund directors

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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