October 12, 2022

Ropes & Gray's Investment Management Update August – September 2022

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

Risk Alert on Prospective Examinations Focused on the New Investment Adviser Marketing Rule

On September 19, 2022, the SEC Division of Examinations (the "Division") issued a Risk Alert titled *Examinations Focused on the New Investment Adviser Marketing Rule*. The Risk Alert's purpose is to inform SEC-registered investment advisers, "including advisers to private funds, about upcoming review areas during examinations focused on amended Advisers Act Rule 206(4)-1" (the "Marketing Rule"). The compliance date for the Marketing Rule is November 4, 2022.

The Division staff intends to conduct a number of specific national initiatives for compliance with the Marketing Rule that will include, but not be limited to, the following areas:

Marketing Rule Policies and Procedures

The staff will review whether investment advisers have adopted and implemented written policies and procedures with respect to the Marketing Rule. The Risk Alert notes that, in the adopting release for the Marketing Rule, the SEC stated its belief that "for these compliance policies and procedures to be effective, they should include objective and testable means reasonably designed to prevent violations of the final rule in the advertisements the adviser disseminates."

The Risk Alert notes that objective and testable means could include, but are not limited to, conducting an internal pre-review and approval of advertisements, reviewing a sample of advertisements based on risk and pre-approving templates.

Substantiation Requirement

The Marketing Rule prohibits advertisements that "[i]nclude a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the [SEC]." Accordingly, the Risk Alert notes that the Division staff will review whether investment advisers have a reasonable basis for believing they will be able to substantiate material statements of fact in advertisements. Quoting the Marketing Rule adopting release, the Risk Alert states that investment advisers can demonstrate this reasonable belief by creating "a record contemporaneous with the advertisement demonstrating the basis for their belief" and that an adviser might also choose "to implement policies and procedures to address how this requirement is met."

Performance Advertising Requirements

The Division staff will review whether investment advisers are in compliance with performance advertising requirements contained in the Marketing Rule, including the prohibitions on including the following in an advertisement:

- gross performance, unless the advertisement also presents net performance;
- any performance results, unless they are provided for specific time periods (not applicable to the performance of private funds);
- any statement that the SEC has approved or reviewed any calculation or presentation of performance results;

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- if an advertisement includes the performance of portfolios other than the portfolio being advertised, performance results from fewer than all portfolios with substantially similar investment policies, objectives and strategies as the portfolio being offered in the advertisement, with limited exceptions;
- performance results of a subset of investments extracted from a portfolio, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio;
- hypothetical performance, unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the adviser provides certain additional information; and
- predecessor adviser performance, which is prohibited unless (i) the personnel primarily responsible for achieving the prior performance manage accounts at the advertising adviser and (ii) the accounts that were managed by those personnel at the predecessor adviser are sufficiently similar to the accounts that they manage at the advertising adviser.

Books and Records, Form ADV

The Risk Alert reminds investment advisers that, in connection with the Marketing Rule, the SEC amended Advisers Act Rule 204-2 (*i.e.*, required books and records) to require investment advisers to create and keep certain records (*e.g.*, records of all advertisements they disseminate, including certain internal working papers, performance-related information, and documentation for oral advertisements, testimonials and endorsements). The Division staff will review investment advisers for compliance with these recordkeeping requirements.

In connection with the Marketing Rule, the SEC also amended Form ADV to require advisers to provide additional information about their marketing practices. The Risk Alert reminds investment advisers of their obligations to accurately complete these questions in their next annual Form ADV amendment.

REGULATORY PRIORITIES CORNER

The following brief updates exemplify certain trends and areas of current focus of regulatory authorities.

SEC Settles Administrative Action with Adviser Regarding Proxy Voting, Draws Commissioners' Dissents

On September 20, 2022, by a 3-2 vote, the SEC issued an order (the "Toews Order") settling an administrative proceeding arising from an investment adviser, Toews Corporation ("Toews"), casting proxy votes in connection with more than 200 shareholder meetings on behalf of the registered investment companies (the "Funds") that it managed without taking any steps to determine whether the votes were cast in the Funds' best interests, and without implementing policies and procedures reasonably designed to ensure that Toews voted proxies in the Funds' best interests. Specifically, the SEC asserted that, over a multi-year period beginning in 2017 through January 2022:

- In its Form ADV brochures, Toews disclosed that "[a]s an adviser to our mutual fund programs and the Fund, we act as a fiduciary. We will vote proxies in the best interests of our clients."
- Toews' written policies and procedures stated the following:

> As to each Fund . . . Toews exercises its proxy voting rights with regard to the companies in that Fund's investment portfolio, with the goals of maximizing the value of the Fund's investments, promoting accountability of a company's management and board of directors to its shareholders, aligning the interest of management with those of shareholders, and increasing transparency of a company's business and operations.

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- Notwithstanding the statements in Toews' Form ADV and policies and procedures, Toews directed a third-party service provider to vote all of the Funds' portfolio securities in favor of the proposals put forth by the issuers' management and against any shareholder proposals. The service provider followed this standing instruction without exception.
- According to the Toews Order, Toews never deviated from the standing instruction and never reviewed the proxy materials for any of the more than 200 shareholder meetings as to which it cast votes in the described manner. The Toews Order stated that Toews did not take steps to ascertain whether the proxy votes were being cast in the Funds' best interests or implement any policies and procedures reasonably designed to ensure that it did so.

Based on these facts, the SEC concluded that Toews had violated provisions of the Advisers Act and Rule 206(4)-6 thereunder. Without admitting or denying the SEC's findings and allegations, Toews agreed to be censured and to pay a civil penalty of $150,000.

Commissioners' Dissent

On September 20, 2022, Commissioners Hester Peirce and Mark Uyeda issued a joint statement (the "Dissent") explaining the reasons for their dissent from the Toews Order.

Contradiction of Prior SEC Guidance. The Dissent noted that the Toews Order said that Toews "has revised its proxy voting policies and procedures to address the issues raised by the facts described." The Dissent stated that, based on this language, the Toews Order "might be read to imply that Toews' prior proxy voting practices were *per se* improper and violate the Advisers Act and the proxy voting rule" (*i.e.*, Rule 206(4)-6). The Dissent went on to assert that this implication would be contrary to the SEC's 2019 release that stated "[a] client and its investment adviser may agree that the investment adviser should exercise voting authority pursuant to specific parameters designed to serve the client's best interest," including voting each proxy consistent with the voting recommendations of management of the issuer.[1] The Dissent highlighted that:

- An adviser and its client – consistent with the adviser's fiduciary duties and Rule 206(4)-6 – "can agree that a 'standing instruction' approach to proxy voting is in the best interest of the client."
- The cost of "reviewing and analyzing individual matters may outweigh any corresponding increase in the value of the issuers' securities" and the Rule 206(4)-6) adopting release "recognizes that the adviser may take cost into account when determining how to satisfy its fiduciary duties." Moreover, the adopting release stated that, at times, "refraining from voting a proxy [may be] in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client."
- The Toews Order did not make any findings that (i) Toews' clients would have been financially better off if Toews had voted the proxies in a different manner and (ii) any of the votes cast resulted from a conflict of interest.

Cost Impact on Small Advisers. The Dissent stated that the costs "incurred by smaller investment advisers to review and analyze each matter submitted for a shareholder vote likely will be passed on to clients." The Dissent noted that Toews is a small adviser with 17 employees who perform investment advisory functions and approximately $1.25 billion in assets under management. The Dissent further noted that, in view of the fact that a majority of investment advisers are small

[1] The Dissent cites *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, Rel. No. IA-5325 (Aug. 21, 2019), available here.

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advisers, "incorrect implications drawn from the [Toews] Order potentially could have wide-ranging consequences" for other small advisers.[2]

SEC Settles Administrative Actions Involving Failures to Retain Text Messages

On September 27, 2022, the SEC issued a press release announcing that it had settled eleven administrative actions against fifteen broker-dealers and, in one of those actions, an affiliated investment adviser, for "widespread and longstanding failures by the firms and their employees to maintain and preserve electronic communications." All of the firms are well known Wall Street names.

The press release states that, from January 2018 through September 2021, the firms' employees "routinely communicated about business matters using text messaging applications on their personal devices" while the firms "did not maintain or preserve the substantial majority of these off-channel communications, in violation of the federal securities laws." The failures to maintain these records "involved employees at multiple levels of authority, including supervisors and senior executives."

The SEC Order Involving an Investment Adviser

In the SEC order that included an investment adviser (as well as a two affiliated broker-dealers), the SEC claimed that employees of the broker-dealers communicated internally and externally "by personal text messages or other text messaging platforms" and sent and received text messages "that related to the business of the broker-dealers and registered investment adviser."

The SEC order explains that rules adopted under Section 204 of the Advisers Act, including Advisers Act Rule 204-2(a)(7), require investment advisers to preserve in an easily accessible place originals of all communications received and copies of all written communications sent relating to, among other things, any recommendation made or proposed to be made and any advice given or proposed to be given. The SEC order, however, does not appear to address the activities of the investment adviser's personnel. Instead, the order provides several examples of the activities of the broker-dealers' personnel. Thus, the SEC order does not explicitly address the conduct of the adviser's personnel that gave rise to the adviser's inclusion in the order and also does not contain any analysis of which provisions of Rule 204-2(a)(7) were violated.

While the SEC order concluded that the investment adviser had violated Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder and had failed to reasonably supervise its employees with a view to preventing or detecting certain of its employees' aiding and abetting violations of Section 204 of the Advisers Act and Rule 204-2(a)(7) thereunder within the meaning of Section 203(e)(6) of the Advisers Act, the order does not provide specific insight into the types of questions that investment advisers might face regarding text messages and other non-email electronic communications.

SEC Settles Administrative Action Regarding Affiliated Service Provider Fees

On September 12, 2022, the SEC issued an order settling an administrative proceeding arising from the alleged failures of two affiliated investment advisers ("Adviser A" and "Adviser B" and, together, the "Advisers") to disclose that a portion of Adviser B's fees charged to the funds advised by Adviser A included a Cost Component (as defined below). The SEC made the following allegations in the order:

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[2] The Dissent cites a 2022 survey by the Investment Adviser Association that found that more than 88% of investment advisers have 50 or fewer employees, and two-thirds of investment advisers with 50 or fewer employees have less than $1 billion in assets under management.

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Background

- The private funds' limited partnership agreements (the "LPAs") granted Adviser A authority to provide services to the funds either directly or indirectly. Adviser B provided services to the private funds in exchange for certain fees, and Adviser B's provision of these services was detailed in the LPAs and in service agreements between Adviser B and the private funds.
- Adviser B charged fees to the funds for "ancillary and underwriting services" (the "Ancillary Services") based on an hourly billing rate and a 10% cost-plus margin. Adviser B is a limited a partnership, and its limited-partner owners pay tax on income paid through to them by Adviser B. The fees paid by the private funds for the Ancillary Services included a component to cover the limited-partner owners' tax on income passed through to them (a "Cost Component"). The Advisers did not disclose that the fees Adviser B charged the private funds included a Cost Component.
- From at least 2005 through 2017, Adviser B's fees for the Ancillary Services were calculated without disclosing the Cost Component as a separate line item. Instead, each year, a Cost Component was included in the calculation of Adviser B's fee rates for the Ancillary Services that Adviser B charged the private funds. In aggregate, approximately $54.6 million charged to the private funds was attributable to the Cost Components.

Alleged Non-Disclosures

In the order, the SEC alleged that during at least 2005 through 2017:

- The LPAs, Adviser B's service agreements, and the private funds' disclosure documents failed to disclose that Adviser B calculated its fees by including the Cost Component in its Ancillary Services fees.
- The Advisers disclosed in the private funds' annual audited financial statements the total amount of Ancillary Services fees charged to the funds, but did not disclose the Cost Component portion within that total in the audited financial statements, due diligence questionnaires, in meetings with the private funds' Limited Partnership Advisory Committees (the "LPAC") or in other disclosures to the private funds' investors.

Unprompted Remedial Measures

The order acknowledged that, in 2018, prior to any contact with the SEC staff, the Advisers undertook an internal review of fee practices and related disclosures. In December 2018, the Advisers ended the Cost Component practice, effective January 1, 2018.

- In the fall of 2020, the private funds were reimbursed for the portion of the Ancillary Services fees attributable to the aggregate Cost Components. This reimbursement, totaling $64.7 million, included $54.6 million as a tax component with 10% margin and $10.1 million in interest. Adviser A disclosed the reimbursement in an LPAC meeting in December 2020 and again in audited financial statements for the private funds in March 2021.
- The internal review, the decision to end the Cost Component practice and the reimbursements occurred prior to any contact with the SEC's staff in the investigation underlying the SEC order.
- In August 2022, the Advisers made additional disclosures to investors and an additional $3.8 million in interest was paid to the private funds.

SEC Conclusions and Penalties

The SEC concluded that the Advisers (i) were negligent during the period from 2005 through 2017 in failing to disclose each year's Cost Component to the private funds' investors, (ii) failed to implement written policies or procedures

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reasonably designed to prevent violations of the Advisers Act or its rules and (iii) had violated various provisions of the Adviser's Act and the rules thereunder.

Without admitting or denying the SEC's findings and allegations, the Advisers agreed to pay, jointly and severally, a civil penalty of $11.2 million.

SEC Settles Administrative Actions with Various Advisers Regarding the Custody Rule and Form ADV

On September 9, 2022, the SEC issued a press release announcing that it had settled nine administrative proceedings with investment advisers that had allegedly failed to comply with requirements of Advisers Act Rule 206(4)-2 (the "Custody Rule") and/or to timely update their SEC Forms ADV to reflect the status of audits of financial statements for the private funds they advised.

- In eight of the nine orders, the SEC alleged that an investment adviser failed (i) to have audits performed or to distribute audited financials to investors in certain private funds it advised in a timely manner and/or (ii) to update its Form ADV promptly to reflect that it had received audited financial statements after having initially reported that it had not yet received the audit reports (*i.e.*, the adviser had checked "Report Not Yet Received" in Form ADV, Section 7.B.23.(h) in its Form ADV filing and had not updated it after that date when it had received the report).
- The SEC concluded that, in these eight cases, the adviser had violated Section 206(4) of the Advisers Act and the Custody Rule and/or Section 204(a) and Rule 204-1(a) thereunder, which required the investment adviser to update certain information about its private fund audits in its Form ADV.
- In the remaining order (of the nine orders), the SEC alleged that the private funds' investment adviser, in its Form ADV, stated "Report Not Yet Received" in response to the question, "Do all of the reports prepared by the auditing firm for the private fund since your last updating amendment contain unqualified opinions?" The SEC claimed that the investment adviser had received audit opinions for the funds but did not update or revise its Form ADV until its next annual updating amendment (approximately twelve months after receiving the audit opinions). The SEC concluded that the investment adviser had violated Section 204(a) of the Advisers Act and Rule 204-1(a) thereunder.

Without admitting or denying the SEC's findings and allegations, the advisers included in the nine orders agreed to be censured and to pay civil penalties that, combined, totaled more than $1 million, and ranged from $50,000 to $330,000 among the advisers.

In the SEC's press release, the Director of the SEC's Enforcement Division, Gurbir S. Grewal, stated that "[n]on-compliance with the Custody Rule creates significant risks for the safety and security of client assets" and that these nine actions "show that the [SEC] expects private fund advisers to meet their obligations to secure client assets and will pursue those who fail to do so." In addition, the press release noted that private fund investment advisers "are reminded that per the instructions to Form ADV, Part 1A, Schedule D, Section 7.B.23.(h), "[i]f you check 'Report Not Yet Received,' you must promptly file an amendment to your Form ADV to update your response when the report is available."

SEC Staff Issues TIPS Funds Advertising Guidance

On August 17, 2022, the SEC Division of Investment Management's Disclosure Review and Accounting Office published Accounting and Disclosure Information ("ADI-12") titled *SEC Yield for Funds That Invest Significantly in TIPS* ("TIPS Funds").

The federal securities laws, including Rule 482 under the Securities Act and Form N-1A, provide a standardized way for funds to calculate their current yield ("SEC Yield") for advertising purposes. SEC Yield approximates the current net

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income generated by a fund's portfolio over a historical 30-day period and is presented as an annualized percentage of a fund's offering price.

The Problem

ADI-12 notes that Treasury Inflation-Protected Securities ("TIPS") are U.S. Treasury notes and bonds that provide protection against inflation. The protection mechanism depends on an adjustment to the principal of a TIPS, which increases with inflation and decreases with deflation, and is intended to keep the principal constant on an after-inflation basis. If inflation occurs, the interest payment increases, and vice versa. ADI-12 states that TIPS' inflation-based adjustments to principal "may result in TIPS Funds disclosing exceptionally high SEC Yields during periods of rising inflation." Moreover, ADI-12 observes, the TIPS' principal adjustment "is not explicitly addressed in the SEC Yield calculation methodology," which was adopted before TIPS existed, resulting in funds

> adopting different treatments of the inflation adjustment to principal when calculating SEC Yield. Some TIPS Funds appear to exclude the inflation adjustment to principal from the yield calculation. Others appear to include this adjustment as income for purposes of the yield calculation. This diversity of practice among funds in how they calculate SEC Yield has led to significant differences in the yield advertised by similar TIPS Funds for the same periods.

ADI-12 suggests that TIPS Funds that choose to advertise their SEC Yield should evaluate which calculation methodology is most informative to investors.

- ADI-12 states that both excluding and including the TIPS inflation adjustment are approaches that are consistent with the required calculation methodology. However, excluding the inflation adjustment to principal as income "omits a key feature of TIPS and a potentially significant contributor to yield."
- ADI-12 goes on to state that the staff believes that TIPS Funds that include the inflation adjustment as income may need to provide additional disclosure during periods of rapidly changing inflation. Specifically, ADI-12 states that (i) the SEC Yield will be higher during periods of rising inflation and (ii) given that the SEC Yield calculation looks back only 30 days and is then annualized, the yield may vary significantly from month-to-month, particularly during periods of rapid change in the rate of inflation. Under certain circumstances, including in the recent market environment where inflation has been higher than in recent years, this may also cause the SEC Yield to be exceptionally high and may be unlikely to be repeated.

Staff Comments

To address these problems, ADI-12 states that:

- TIPS Funds that advertise their SEC Yield and that include a 30-day inflation adjustment may need to explain to investors that this adjustment may cause the yield to vary substantially from one month to the next.
- If a TIPS Fund's sales literature includes an exceptionally high SEC Yield, the sales literature should disclose that the yield is attributable to the rise in the inflation rate because the inflation adjustment to principal is treated as income.
    - The TIPS Fund should disclose that this 30-day inflation adjustment may cause the SEC Yield to vary substantially from one month to the next and might not be repeated.
    - These explanations should be tailored to the circumstances and current market conditions faced by the TIPS Fund rather than boilerplate disclosures.
- Alternatively, the staff will not object if, instead of including the inflation adjustment over the prior 30-day period and annualizing it, a TIPS Fund uses an inflation adjustment that looks back over the prior twelve-month

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period. However, to use the prior twelve-month period, a TIPS Fund would need to disclose that the SEC Yield reflects the impact of inflation over the prior twelve-month period, which is treated as income.

- Financial intermediaries that post the SEC Yield prepared by TIPS Funds should also include any accompanying disclosures prepared by the TIPS Funds.

SEC's Office of the Investor Advocate Releases Study on Fund Performance Benchmarks

The Office of the Investor Advocate (the "Office") was established at the SEC in 2014. Among its core functions are providing a voice for investors and studying investor behavior. On September 15, 2022, the Office published a study examining the impact of mutual fund performance benchmarks on investor decision-making and potential strategic behavior by firms in choosing benchmarks.

When displaying fund performance, Forms N-1A (for open-end funds) and N-2 (for closed-end funds) require a fund to present an "appropriate broad-based securities market index," and encourage the presentation of one (or more) "narrowly based indexes that reflect the market sectors in which the [f]und invests."

Key findings of the study include:

- Investors respond to benchmarks. In particular, subjective attractiveness ratings were much lower when study participants viewed fund performance accompanied by a single benchmark that outperforms the fund. This decrease in attractiveness also occurs, to a lesser extent, when investors viewed two benchmarks, where one outperforms and the other underperforms the fund.
- The distinction between broad-based and narrow benchmarks and the narrative descriptive text about the benchmarks do not have a different impact beyond the position of the benchmarks.
- Using data from the Morningstar Direct database, there was variation among funds' chosen benchmarks within a given sector, as well as variation regarding whether to present a secondary benchmark. This raised the possibility that a fund could pick a secondary benchmark that satisfies the requirements for permissible benchmarks, but that has performed poorly relative to other permissible benchmarks. This would put the fund's relative performance in a more positive light, which may affect investors' evaluations and investment decisions.

ADDITIONAL ROPES & GRAY ALERTS AND PODCASTS SINCE OUR JUNE – JULY UPDATE

Emerging Legal Questions for the Post-Merge Ethereum Network
October 10, 2022
On September 15, 2022, the Ethereum blockchain transitioned from a proof-of-work (PoW) consensus mechanism to proof-of-stake (PoS) consensus by merging the Ethereum Mainnet with the PoS Beacon Chain. This event, commonly referred to as the "Merge," is a historic moment for Ethereum, as well as a monumental development for the broader blockchain space. The Merge dramatically reduced the Ethereum network's energy consumption, which has long been a salient criticism against the mainstream adoption of the largest programmable blockchain. The introduction of PoS consensus to Ethereum is the first step in a phased plan to increase the network's efficiency, security, and scalability. This Alert is an overview of the Merge and its implications for investors and developers with respect to the Ethereum ecosystem.

Podcast: The Rise of the Single-Stock ETF
September 28, 2022
In the latest installment of Ropes & Gray's ETF podcast series, asset management counsels Ed Baer and Jennifer Choi discussed one of the hottest trends in the ETF space—single-stock ETFs.

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[Podcast: Fully Invested: SEC Requests]
September 13, 2022
In this episode of *Fully Invested*, Ropes & Gray asset management attorneys Nicole Krea, Jessica Marlin, and Nicole Horowitz, and litigation & enforcement attorney Matt McGinnis introduced listeners to the contours and typical lifecycles of SEC examinations for registered investment advisers. They also discussed how these advisers can prepare for examinations in advance, which includes leveraging internal and external resources and preparing materials on an ongoing basis.

[PErspectives: Private Equity Navigates Shifting Fundraising Dynamics]
August 30, 2022
In Issue No. 8 of *PErspectives*—Ropes & Gray's periodic publication featuring news, trends and legal developments in the private equity industry—we examined the driving forces behind a sharp decline in PE fundraisings in the first half of 2022 after a record-setting 2021. We also looked at the macroeconomic and geopolitical headwinds facing the market.

[SEC and CFTC Propose to Amend Form PF Reporting Requirements to Include New Asset Subclass for "Digital Assets"]
August 22, 2022
The SEC and Commodity Futures Trading Commission (the "CFTC") have jointly issued a release proposing amendments to Form PF, a confidential reporting form for certain SEC-registered investment advisers to private funds, that would require covered investment advisers to report on certain digital asset investments for the first time.

[CFTC Staff Further Extends No-Action Relief from Certain Position Aggregation Requirements]
August 19, 2022
The CFTC's Division of Market Oversight issued CFTC Letter No. 22-09, which further extends until the earlier of August 12, 2025 or the effective date of any codifying rulemaking the relief from certain position aggregation requirements it had granted previously in CFTC Letter No. 17-37 and extended in CFTC Letter No. 19-19. The relief was set to expire on August 12, 2022. As a result, market participants will continue to enjoy relief from many of the requirements under CFTC Rule 150.4, including:

- Relief from the advance notice filing requirement applicable to persons relying on certain aggregation exemptions;
- Streamlined notice filings for persons relying on the owned entity aggregation exemption;
- An expanded scope of entities that qualify as independent account controllers; and
- The limited application of the aggregation requirement for "substantially identical trading strategies."

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