GODFREY & KAHN S.C.

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# Investment Management Legal and Regulatory Update

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## LATEST DEVELOPMENTS: FUNDS

### SEC Issues Risk Alert Relating to Examination Initiatives Focused on Registered Investment Companies

The SEC's Division of Examinations (Division) issued a risk alert on October 26, 2021 sharing its observations from recent examinations of mutual funds and exchange-traded funds (ETFs) with respect to industry practices and regulatory compliance in certain areas that may have an impact on retail investors (RIC Initiatives).

Under the RIC Initiatives, the Division conducted examinations of more than 50 fund complexes – covering more than 200 funds and/or series of funds – and nearly 100 advisers. The initiative focused on the effectiveness of the compliance policies and procedures of the funds and their advisers, disclosures by the funds to investors, and fund governance practices. Below is a summary of the more frequent deficiencies and weaknesses identified in the risk alert to assist funds and their advisers in developing and enhancing their compliance programs and policies.

#### Compliance Programs

Funds and their advisers did not establish, maintain, update, follow or appropriately tailor their compliance programs to address various business practices, including portfolio management, valuation, trading, conflicts of interest, fees and expenses, and advertising. Inadequate policies and procedures were noted in the following areas:

*Compliance Oversight of Investments and Portfolios*

- Monitoring for portfolio management compliance, including monitoring compliance requirements regarding trade aggregation, trade allocation and best execution, and senior securities and asset segregation.
- Monitoring for compliance with a fund's specific investment restrictions, such as investment concentration restrictions, limitations on alternative investments or restrictions on lower-rated securities.
- Monitoring portfolios for compliance with the "Fund Names Rule."
- Addressing the administration of a fund's liquidity risk management program and providing appropriate oversight of third-party vendors providing liquidity classifications of holdings.
- Providing appropriate oversight of the viability of smaller or thinly-traded ETFs.

*Compliance Oversight of Valuation*

- Maintaining an adequate compliance program for valuation of portfolio securities, including processes and controls that provide for due diligence and oversight of pricing vendors.
- Maintaining appropriate policies, procedures and controls for valuation of portfolio securities, including provisions that address potential conflicts, such as where portfolio managers are permitted to provide input as voting members of the valuation committee.

*Compliance Oversight of Trading Practices*

- Addressing appropriate trade allocation among client accounts so that all clients are treated fairly, including instances where trades for fund clients are aggregated with trades for other client accounts.
- Preventing prohibited principal transactions and joint transactions with affiliates.
- Identifying cross trades and preventing violations of the legal requirements for cross trading and principal trading.
- Addressing sharing of soft dollar commissions among clients to assess whether any client is disadvantaged.

*Compliance Oversight of Conflicts of Interest*

- Addressing advisers' conflicts of interest with funds and their service providers.
- Reviewing index providers and the services they provide for, among other things: (1) conflicts of interest with advisers, such as when they share personnel, are affiliated or have business arrangements (e.g., marketing support payments or revenue sharing payments); and (2) the sharing, or the potential misuse, of material non-public information.

*Compliance Oversight of Fees and Expenses*

- Monitoring allocation of expenses between funds and their advisers, subject to any fee waivers by the adviser.
- Reviewing fee calculations for any inconsistencies between a fund's contractual expense limitation and its disclosures regarding expenses included in operating expenses, subject to the expense cap.

*Compliance Oversight of Fund Advertisements and Sales Literature*

- Reviewing and filing fund advertisements and sales literature, including review of fee and expense disclosures to determine whether they are fair, balanced and not misleading.

**Board Oversight of Fund Compliance Programs**

The staff observed issues with fund policies and procedures for board oversight of fund compliance programs. For example, the staff observed that funds did not:

- Have appropriate policies, procedures and processes for monitoring and reporting accurate information to the board, such as: (1) fees paid by funds to financial intermediaries and other service providers for providing shareholder services; (2) the type of services provided by service providers; and (3) pricing exceptions under the funds' valuation policies and procedures.
- Provide appropriate processes as part of the board's annual review and approval of the fund's investment advisory agreement under Section 15(c) of the Investment Company Act regarding the board's consideration as to whether the adviser has any financial condition that is reasonably likely to impair its ability to meet its contractual commitments to clients. For example, the board's considerations may include a review of the adviser's responses to a 15(c) questionnaire.

- Complete required annual reviews of a fund's compliance program that address the adequacy of policies and procedures and effectiveness of their implementation.
- Ensure that the annual report from the fund's chief compliance officer addressed the operation of the policies and procedures of the fund's adviser, including whether the adviser had policies and procedures in specific risk areas.

### Disclosure to Investors

Below are examples of common deficiencies identified by the staff with respect to fund disclosures to investors in fund filings, advertisements, sales literature and other shareholder communications.

*Deficiencies in Fund Filings*. Funds had inaccurate, incomplete and/or omitted disclosures in their filings. Examples include:

- Omitted disclosures regarding principal investment strategies and risks of investing in the funds, potential conflicts associated with allocation of investment opportunities among overlapping investment strategies, and changes in the broad-based indexes used for comparison of fund performance.
- Inconsistent or inaccurate disclosure concerning a fund's net assets and net expense ratios, contractual expense limitations and operating expenses subject to the contractual expense limitation.
- Failure to disclose in the fund's SAI required information concerning standing committees of a fund's board and accurate information regarding the number of accounts and total assets managed by the fund's portfolio managers.

*Deficiencies in Advertising and Sales Literature*. Funds had inaccurate, incomplete or omitted disclosures on a variety of advertising and sales literature-related topics, including: (1) investment strategies and portfolio holdings; (2) fund expenses, contractual expense limitations, or expense ratios; (3) average total returns; (4) performance information not disclosed with the required legends; (4) methodologies for calculating the performance of the benchmark index; and (5) composition of the index used for performance comparisons.

### Staff Observations Regarding Compliance and Disclosure Practices

Below is a list of sample practices with respect to fund and adviser compliance programs, board oversight of fund compliance programs and disclosure practices that funds and their advisers may find helpful in their compliance oversight practices.

- Funds and their advisers adopted and implemented compliance programs that provided for the following:
  - Review of compliance policies and procedures for inconsistency with practices.
  - Conducting periodic testing and reviews for compliance with disclosures (e.g., review whether funds are complying with their stated investment objectives, strategies and restrictions) and assess the effectiveness of compliance policies and procedures in addressing conflicts of interest.
  - Ensuring compliance programs adequately address the oversight of key vendors, such as pricing vendors.
  - Adopting and implementing policies and procedures to address: (1) compliance with applicable regulations; (2) compliance with the terms and conditions of applicable exemptive orders and any disclosures required to made under the order; and (3) undisclosed conflicts of interest, including potential conflicts between funds and advisers and their affiliated service providers.

- Fund boards provided oversight of fund compliance programs by assessing whether:
  - The information provided to the board was accurate, including whether a fund and its adviser were accurately disclosing to the board: (1) the fund's fees, expenses and performance; and (2) the fund's investment strategies, any changes to the strategies, and the risks associated with the respective strategies.
  - The fund was adhering to its processes for board reporting, including an annual review of the adequacy of the fund's compliance program and effectiveness of its implementation.
- Funds adopted and implemented policies and procedures concerning disclosure, such as those that required:
  - Review and amendment of disclosures in a fund's prospectus, SAI, shareholder reports or other investor communications consistent with the fund's investments and investment policies and restrictions.
  - Amendment of disclosures for consistency with actions taken by the fund's board.
  - Update of the fund's website disclosures concurrently with new or amended disclosures in the fund's prospectus, SAI, shareholder reports or other client communications.
  - Review and testing of fees and expenses disclosed in the fund's prospectus, SAI, shareholder reports or other client communications for accuracy and completeness of presentation.
  - Review and testing of the fund's performance advertising for accuracy and appropriateness of presentation and applicable disclosures.

*Source: Division of Examinations Risk Alert: Observations from Examinations in the Registered Investment Company Initiatives (Oct. 26, 2021), available here.*

# LATEST DEVELOPMENTS: ADVISERS

## SEC Issues Risk Alert on Advisory Fee Calculations

The Division issued a risk alert about a national initiative focused on advisory fees charged to retail clients, which assessed how advisers charge fees for their services, as well as the adequacy of the fee disclosures and accuracy of fee calculations. The staff conducted 130 examinations of SEC-registered advisers under the initiative and identified deficiencies related to advisory fees during most of the examinations.

The staff examined adviser compliance policies, procedures and practices related to advisory and other fees charged and related disclosures provided to clients. The staff also reviewed policies and procedures related to the valuation of unique or hard-to-value assets.

### Advisory Fee Calculation Errors

Several advisers charged advisory fees inaccurately due to a variety of errors, such as:

- *Using inaccurate percentages to calculate advisory fees*. For example, advisers charged fees that were different from contractually agreed-upon rates, used the incorrect fee schedule, failed to convert all clients to their updated or new fee schedule, and had errors in fee percentages manually entered into their portfolio management systems.
- *Double-billing advisory fees*, typically due to oversights, such as not updating a system following a change in billing practices.
- *Incorrectly calculating breakpoint or tiered billing rates or improperly householding accounts*.
- *Using incorrect client account valuations*. For example, advisers included in their account valuations: (1) assets that disclosures stated would be excluded from the fee calculations; (2) stale account balance information as a result of the loss of data during transitions of portfolio management systems; (3) incorrect valuation dates for client billings; and (4) inaccurate account values due to timing differences in cash and dividend transactions in electronic custodial feeds compared to the available balance at the custodian.

### Failure to Credit Certain Fees Due to Clients

Several advisers either failed to refund prepaid fees on terminated accounts or failed to assess fees for new accounts on a pro rata basis.

### Fee-Related Disclosure Issues

Issues were identified related to incomplete or misleading Form ADV brochure disclosures and other disclosures, including disclosure that: (1) failed to reflect current fees charged or whether fees were negotiable; (2) failed to accurately describe how fees were calculated or billed; and (3) was inconsistent across advisory documents.

### Missing or Inadequate Policies and Procedures

Advisers failed to maintain written policies and procedures addressing advisory fee billing, monitoring of fee calculations and billing, or both. While some advisers had informal or unwritten practices in these areas, the staff considered such issues to be relevant to the operations of the adviser, and thus should be captured in written policies and procedures. Below are some examples of the staff's observations:

- *Policies and procedures that specifically address fee calculations*. Advisers had generic policies and procedures and failed to address specifics related to the processes for computing, billing, and testing advisory fees. Some advisers had no policies for testing or monitoring fee calculations.
- *Policies and procedures to address material advisory fee components*. Adviser policies and procedures omitted a variety of critical advisory fee components relevant to the firm's business, including: (1) valuation of illiquid or difficult-to-value assets included in the assets for the calculation of advisory fees; (2) fee offsets, such as those offered for 12b-1 fees; (3) fee reimbursements for terminated accounts, where the client prepaid fees; (4) prorating fees for additions or subtractions of assets in accounts; and (5) family account aggregation or the application of breakpoints for fee calculations.

### Staff Observations Regarding Industry Practices

The staff shared the following examples of observed policies and practices to assist advisers with compliance:

- Adopt and implement written policies and procedures addressing advisory fee billing processes and validating fee calculations.
- Centralize the fee billing process and validate that the fees charged to clients are consistent with compliance procedures, advisory contracts, and disclosures.
- Ensure resources and tools established for reviewing fee calculations are utilized.
- Properly record all advisory expenses and fees assessed to and received from clients, including those paid directly to advisory personnel.

*Source: Division of Examinations Risk Alert: Division of Examinations Observations: Investment Advisers' Fee Calculations (Nov. 10, 2021), available here.*

## SEC Staff Issues Statement on Form CRS Disclosures

The SEC's Standards of Conduct Implementation Committee (Committee) issued a statement on December 17, 2021 relating to its review of Form CRS relationship summaries filed by advisory firms and observed how firms have implemented the content and format requirements of Form CRS with a view to evaluate whether the relationship summary is fulfilling its intended purpose. The Committee is comprised of staff from the SEC's Division of Investment Management, the Division of Examinations, the Division of Trading and Markets and the Office of Investor Education and Advocacy. The Committee made the following observations:

***Use of Technical Language, Including Disclaimers***. Relationship summaries must be concise and direct and use plain English, taking into consideration retail investors' level of financial experience. Firms must avoid legal jargon, citing specific SEC rules and highly technical business terms unless clearly explained, such as "in arrears," "markups" and "markdowns." The staff observed some relationship summaries that included disclaimers and hedging language that are neither required nor permitted.

***Omission of Required Information***. Firms must generally include all required headings, conversation starters and prescribed language.

***Lack of Specific References to More Detailed Information***. Firms must include specific references to more detailed information as specified in the instructions, such as to the firm's Form ADV brochure, in the relationship summary sections describing the firm's services, fees and costs, and conflicts of interests. A relationship summary that is posted on a firm's website or otherwise provided electronically must provide a means of facilitating access to any information that is referenced in the relationship summary if the information is available online. Some relationship summaries did not include these required references. Rather, some relationship summaries posted on firms' websites simply stated that retail investors could find more detailed information in the firm's Form ADV brochure, but did not provide a hyperlink to the brochure.

***Shortcomings in Descriptions of Relationships and Services; Fees, Costs, Conflicts and Standard of Conduct***. Some relationship summaries failed to include required information or included impermissible, extraneous, or unresponsive disclosures. Shortcomings were most commonly observed in the following disclosures:

- *Monitoring*. Firms must explain whether *or not* they monitor retail investors' investments, and, if so, the frequency and any material limitations of that monitoring and whether or not the monitoring services are part of the firm's standard services.
- *Investment Authority*. Advisers that accept discretionary authority must describe those services, any material limitations on that authority and any specific circumstances that would trigger this authority. Advisers that offer non-discretionary services and broker-dealers must explain in their relationship summary that the retail investor makes the ultimate decision regarding the purchase or sale of investments.
- *Limited Investment Offerings*. Firms are required to disclose whether *or not* they make available or offer advice only with respect to proprietary products or a limited menu of products or types of investments. If so, the firm must describe these limitations. Some relationship summaries did not expressly state whether the firm has any product limitations, while others acknowledged limitations but did not describe them.
- *Principal Fees and Costs*. Firms must summarize the principal fees and costs that retail investors will be charged for the firm's services, including how frequently the fees and costs are assessed and the conflicts of interest they create. Some relationship summaries only included vague fee descriptions or failed to address the frequency with which those fees are assessed and billed. Other relationship summaries failed to address the associated conflicts of interest or incentives related to fees.
- *Wrap Fee Program Offerings and Fees*. Advisers that offer wrap free programs must describe the programs and fees. They are also encouraged to explain that asset-based fees associated with the wrap fee program will include most transaction costs, and therefore are higher than a typical asset-based advisory fee.
- *Extraneous Disclosures Regarding Standards of Conduct*. Firms are required to use the term "best interest" to describe their applicable standard of conduct. Some firms referred to themselves as "fiduciaries" or stated that they are subject to a "fiduciary duty" when describing the applicable standard of conduct rather than using the prescribed language of Form CRS.

- *Firm and Financial Professional Compensation Arrangements and Conflicts of Interests*. Firms must summarize how their financial professionals are compensated and disclose any potential conflicts of interest related to the firm's compensation practices. Some relationship summaries failed to explain the incentives created by certain conflicts of interest or suggested the firm "may" have a particular conflict without explaining when the conflict could exist. Further, rather than focusing on conflicts of interest, disclosure in some relationship summaries explained how the firm addresses or mitigates its conflicts. This type of disclosure is not permitted.

***Modification of the Disciplinary History Disclosure***. A firm must include in its relationship summary the heading: "Do you or your financial professionals have legal or disciplinary history?" and answer "yes" or "no." Some firms omitted or modified the heading or the conversation starters or provided extraneous language beyond the permissible yes or no response.

***Issues with Prominently Displaying Relationship Summary on Firm Website***. Firms that have a website are required to post the current version of their relationship summary prominently on their website in a location and format that is easily accessible for retail investors. In some cases, the staff could not locate a relationship summary on a firm's website or was only able to locate the relationship summary after an extensive search of the website.

***Use of Marketing Language***. The relationship summary is not designed to serve as marketing material. Some relationship summaries included marketing language, touted firms' abilities, or used superlatives or similar descriptors.

***Boilerplate***. Firms should not include vague and imprecise "boilerplate" explanations in their relationship summaries. Some relationship summaries failed to be tailored to the particular firm's services, fees, relationships, or conflicts. Some firms used boilerplate phrasing to suggest the firm "may" have a particular conflict. The boilerplate language used in many of these relationship summaries appeared to have been based on one or more widely shared templates without appropriate modification.

*Source: Staff Statement Regarding Form CRS Disclosures (Dec. 17, 2021), available here.*

# OTHER DEVELOPMENTS

## SEC Staff Statement on LIBOR Transition – Key Considerations for Market Participants

The SEC staff issued a statement on December 7, 2021 reminding investment professionals of their obligations when recommending securities or investments that use LIBOR as a benchmark (LIBOR-linked investments).

LIBOR's regulator, the Financial Conduct Authority, and administrator, ICE Benchmark Administration, Limited, had previously announced that the publication of one-week and two-month USD LIBOR maturities and non-USD LIBOR maturities will cease immediately after December 31, 2021, with the remaining USD LIBOR maturities ceasing immediately after June 30, 2023. In the U.S., the Secured Overnight Financing Rate (SOFR) has been identified as the preferred alternative reference rate by the Alternative Rates Reference Committee.

In the recent statement, the SEC staff noted that issuance or transaction documents for LIBOR-linked investments might not contain language intended to provide an alternative reference rate or otherwise address the permanent cessation of LIBOR (i.e., "fallback" language). In the SEC's view, if documents for these securities contain language contemplating only a temporary cessation of LIBOR, or fail to contain any fallback language, LIBOR-linked investments and their investment returns will experience material changes when LIBOR is discontinued. The staff also highlighted that valuation measurements that use LIBOR as an input may be potentially impacted. For example, unlike LIBOR, SOFR does not reflect perceived bank credit risk.

### Considerations for Advisers and Funds

Advisers should consider whether any LIBOR-linked investments they have recommended remain in their clients' best interest. Among other things, advisers should consider whether those investments or related contracts have robust fallback language providing for an alternative reference rate when LIBOR is discontinued. Where fallback language provides an alternative reference rate, advisers should consider whether any economic differences arising from the application of the alternative reference rate could cause the investment to depart from their clients' strategy or risk tolerance.

If a fund significantly invests in LIBOR-linked investments, it should disclose any material risks related to the discontinuation of LIBOR, as well as the potential impact (and expected timing of such impact) on those investments, including with respect to volatility, valuation and liquidity. Advisers and funds should also consider the impact to valuation inputs associated with the LIBOR transition and any impact to performance fees tied to LIBOR as a hurdle rate.

*Source: Staff Statement on LIBOR Transition – Key Considerations for Market Participants (Dec. 7, 2021), available here.*

## SEC Announces William Birdthistle as Director of Division of Investment Management

On December 21, 2021, the SEC announced the appointment of William A. Birdthistle as Director of the Division of Investment Management. Mr. Birdthistle will replace Ms. Sarah ten Siethoff who previously served as Acting Director for the Division of Investment Management. Prior to his appointment, Mr. Birdthistle served as a professor at Chicago-Kent College of Law, where he joined the faculty in 2006.

*Source: William Birdthistle Named Director of Division of Investment Management, SEC Press Release 2021-268 (Dec. 21, 2021), available here.*

## SEC Continues to Focus on Cryptocurrency

SEC Chair Gary Gensler spoke before the SEC Investor Advisory Committee on December 2, 2021 and shared his personal views on the cryptocurrency markets. Chair Gensler expressed his belief that there is a lack of investor protection with respect to the cryptocurrency markets, noting that investors are not provided with balanced and complete disclosure about crypto tokens or trading and lending platforms, which leaves cryptocurrency markets open to manipulation.

He further remarked that to the extent crypto tokens meet the definition of a security, they are required to be registered with the SEC. Mr. Gensler encouraged participants in the cryptocurrency markets to discuss challenges with respect to registration and compliance with the SEC staff. Following Mr. Gensler's comments, the SEC announced the appointment of Corey Frayer to Chair Gensler's executive staff to advise on SEC policymaking and interagency work in connection with the oversight of crypto assets.

*Sources: Remarks before the Investor Advisory Committee, Chair Gary Gensler (Dec. 2, 2021), available here; Chair Gensler Announces Additions to Executive Staff, SEC Press Release 2021-270 (Dec. 30, 2021), available here.*

## COMPLIANCE DATES FOR FINAL RULES

| Final Rule | Compliance Dates |
|---|---|
| New Fund of Funds Rule (Rule 12d1-4) and Related Amendments; Rescission of Rule 12d1-2 | Rule 12d1-4 became effective on January 19, 2021, but, in order to provide funds with a transition period, the compliance date for the amendments to Form N-CEN and the recission of Rule 12d1-2 and fund of funds exemptive orders is January 19, 2022. |
| Derivatives Risk Management Rule (Rule 18f-4) and Related Amendments; Rescission of Prior SEC Guidance (Release 10666) | Rule 18f-4 and related amendments to Forms N-CEN, N-PORT and N-LIQUID (to be renamed Form N-RN) became effective on February 19, 2021, and the compliance date is August 19, 2022. The SEC will rescind Release 10666 and related staff no-action letters and guidance effective August 19, 2022. |
| Fair Valuation Rules (Rules 2a-5 and 31a-4) | Rules 2a-5 and 31a-4 became effective on March 8, 2021, and funds will have until September 8, 2022 to come into compliance. |
| Advertising and Cash Solicitation Rule Amendments (Rules 206(4)-1 and 204-2) | The rule became effective on May 4, 2021 and advisers will have until November 4, 2022 to come into compliance. The current cash solicitation rule (Rule 206(4)-3) will be rescinded. However, until an adviser transitions to the amended marketing rule, the adviser should continue to comply with the previous advertising and cash solicitation rules. |