GODFREY & KAHN S.C.

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Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS

SEC Rule Proposal Designed to Enhance ESG Disclosure

Overview

On May 25, 2022, the Securities and Exchange Commission (SEC) published a rule proposal which would improve disclosures by funds and investment advisers that take Environmental, Social, and Governance (ESG) factors into consideration when making investing decisions. The proposal, which would apply to registered investment advisers, advisers exempt from registration, registered investment companies, and business development companies (BDCs), is intended to mitigate the risk of exaggerating ESG practices stemming from the lack of specific disclosure requirements tailored to ESG investing. The proposal requires additional specific disclosures regarding ESG strategies in fund registration statements, the management discussion of fund performance in fund annual reports (MD&P), and adviser disclosure brochures.

This rule proposal aims to prevent potential "greenwashing," which is an exaggeration of ESG strategies to attract business. Interestingly, however, the SEC has chosen not to define the term "ESG." The proposal was approved by the SEC in a 3-1 vote along party lines, with Commissioner Peirce dissenting, and will remain open for public comment until August 16, 2022.

Fund Disclosure

For registered funds and BDCs, the proposal distinguishes among funds based on the extent to which they consider ESG factors in their investment processes. In this regard, the proposal places funds into one of three categories, as follows:

- ***ESG-Integration Funds***, which are funds that consider one or more ESG factors alongside other, non-ESG factors, as part of their investment selection process, such that ESG factors may not be dispositive with respect to any particular investment. An ESG-integration fund would be required to provide fewer new disclosures than the other two categories of funds. Such funds would be required to describe, in a few sentences in the summary prospectus, how ESG factors are incorporated into the investment process, including the ESG factors considered, with a more detailed description provided later in the statutory prospectus. In addition, ESG-integration funds that consider greenhouse gas (GHG) emissions as part of the investment process would be required to describe, later in the statutory prospectus, how the fund considers the GHG emissions of its portfolio holdings, including the methodology that the fund uses as part of its consideration of portfolio company GHG emissions.

- ***ESG-Focused Funds***, which are funds for which ESG factors are a significant or main consideration in selecting investments or in engaging with portfolio companies (e.g., a fund that applies a screen to include or exclude investments in particular industries based on ESG factors or has a policy of voting its proxies to encourage ESG practices or outcomes). Additionally, to help ensure that any fund that markets itself as ESG provides sufficient information to investors to support the claim, the proposed definition of an ESG-focused fund explicitly includes (i) any fund that has a name including terms indicating that the fund's investment decisions incorporate one or more ESG factors, and (ii) any fund whose advertisements indicate that the fund's investment decisions incorporate one or more ESG factors by using them as a significant or main consideration in selecting investments. An ESG-focused fund would be required to include a standardized ESG "strategy overview table" in the summary prospectus which provides an overview of the fund's ESG strategy, a summary of how the fund incorporates ESG factors into its investment decisions, and a description of how the fund votes proxies and/or engages with companies about ESG issues, with additional disclosure required if the fund's engagement with portfolio companies on ESG issues (either by voting proxies or otherwise) is significant. Such funds would be required to provide a more detailed description of each of these items later in the statutory prospectus.

- ***ESG-Impact Funds***, which are a subset of ESG-focused funds that seek to achieve a specific ESG impact or impacts (e.g., a fund that invests with the goal of seeking current income while also furthering the fund's disclosed goal of financing the construction of affordable housing units). In addition to the disclosure requirements applicable to ESG-focused funds, an ESG-impact fund would be required to disclose, as part of the ESG "strategy overview table," how the fund measures progress towards its stated impact (including the key performance indicators the fund analyzes), the time horizon employed for measuring that progress, and the relationship between the impact the fund seeks to achieve and the fund's financial returns, with more detailed information provided later in the statutory prospectus. An ESG-impact fund would also be required to disclose in its *investment objective* the ESG impact that the fund seeks as a result of its investments.

In addition to the new prospectus disclosures that would be required under the rule proposal, new disclosures would also be required to be made in the MD&P section of a fund's annual report. Namely:

- ESG-impact funds would be required to briefly summarize the fund's progress on achieving its specific impacts in both qualitative and quantitative terms during the reporting period, and the key factors that materially affected the fund's ability to achieve the specific impacts, on an annual basis in the annual report;

- Funds for which proxy voting is a significant means of implementing their ESG strategy would be required to disclose certain information regarding how the fund voted proxies on ESG issues during the reporting period, and funds for which engagement with issuers on ESG issues through means other than proxy voting is a significant means of implementing their ESG strategy would be required to disclose certain information about their engagement practices (including the number or percentage of issuers with whom the fund held ESG engagement meetings): and

- ESG-focused funds that consider environmental factors as part of their investment strategies would be required to disclose the carbon footprint and the weighted average carbon intensity of the fund's portfolio (i.e., the aggregated GHG emissions of the portfolio).

The rule proposal also includes amendments to Form N-CEN that are designed to collect additional census-type information about a fund's use of ESG factors, including its use of ESG service providers. The proposed amendments would collect information on the ESG strategy a fund employs (i.e., integration, focused or impact), the ESG factors it considers, the method it uses to implement its ESG strategy, and whether the fund considers ESG-related information or scores provided by a service provider. To further increase investors' ability to locate relevant information, the proposal states that all ESG-related disclosures would be required to be in a machine-readable XBRL format.

Adviser Disclosure

For registered investment advisers, the proposal would amend Form ADV Part 2A (the disclosure brochure) to include information about the adviser's ESG practices. These amendments are similar, in many respects, to the requirements in the proposal for funds, and include the following:

- Advisers would be required to provide a description of the ESG factors considered for each significant investment strategy or method of analysis for which the adviser considers any ESG factor, and disclose how they incorporate those factors when providing investment advice, including when recommending or selecting other investment advisers.
- Using definitions for ESG-integration, ESG-focused and ESG-impact strategies which are similar to the proposed definitions of these terms for registered funds, the proposal would require advisers to provide an explanation of whether and how the adviser incorporates a particular ESG factor (i.e., E, S, or G) and/or combination of factors, and whether and how the adviser employs ESG-integration and/or ESG-focused strategies and, if ESG-focused, whether and how the adviser also employs ESG-impact strategies.
- If an adviser employs, for any significant strategy, criteria or a methodology to select or exclude investments based on the consideration of ESG factors, the proposal would require the adviser to describe the criteria and/or methodologies and how it uses them including, but not limited to, (i) any internal methodology, third-party methodology or combination of both; (ii) any inclusionary or exclusionary screen, including an explanation of the factors the screen applies; and (iii) any index, including the name and description of the index and an explanation as to how the index utilizes ESG factors in determining its constituents.
- An adviser would also be required to disclose any relationship or arrangement that is material to its advisory business or its clients that the adviser or any of its management persons have with any related person that is an ESG consultant or service provider.
- For advisers with proxy voting authority, the proposal would require such advisers that have specific voting policies or procedures that include ESG considerations when voting client securities to include a description of which ESG factors they consider and how they consider them.
- Advisers that sponsor wrap fee programs would be subject to additional disclosure requirements.

To complement the proposed client-facing disclosures, the proposal includes amendments to Form ADV Part 1A designed to collect information about an adviser's use of ESG factors in its advisory business. These proposed amendments would expand the information collected about the advisory services provided to separately managed account clients and private fund clients. For separately managed account reporting, the new disclosures only would apply to investment advisers registered or required to be registered with the SEC, and for private fund reporting, the new disclosures would apply to those advisers as well as exempt reporting advisers.

Compliance Policies and Procedures and Marketing

The SEC noted in the rule proposal that it has observed a range of compliance practices that do not appear to fully address a fund's or adviser's incorporation of ESG factors into its investment processes. As a result of this, as well as the comprehensive nature of the proposed ESG-related amendments to required disclosures, the rule proposal reaffirms existing obligations under the applicable Investment Company Act and Advisers Act compliance rules when funds and advisers incorporate ESG factors into their investment processes. In particular, the proposal states that funds' and advisers' compliance policies and procedures should address (i) the accuracy of ESG disclosures made to clients, investors, and regulators, and (ii) the portfolio management processes to help ensure portfolios are managed consistently with the ESG-related investment objectives disclosed by the funds and/or adviser. Moreover, the rule proposal notes that current regulations seek to prevent false or misleading advertisements by advisers, including greenwashing, by prohibiting material misstatements and fraud. Therefore, the release states that it generally would be materially misleading for an adviser to overstate in an advertisement the extent to which it utilizes or considers ESG factors in managing client portfolios.

Transition Period and Compliance Dates

The SEC is proposing a one-year transition period, from the effective date of any final rulemaking, with respect to compliance with the prospectus disclosure requirements, the regulatory reporting on Form N-CEN, and the disclosure and regulatory reporting on Form ADV Parts 1A and 2A, and a longer, 18-month transition period, for annual report disclosure obligations.

Sources: Environmental, Social and Governance Disclosures for Investment Advisers and Investment Companies, Release Nos. IC-34594, IA-6034 (May 25, 2022), available here; SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies about ESG Investment Practices, SEC Press Release 2022-92 (May 25, 2022), available here; SEC Fact Sheet, ESG Disclosures for Investment Advisers and Investment Companies (May 25, 2022), available here.

LATEST DEVELOPMENTS: FUNDS

SEC Proposal to Modernize Fund "Names Rule"

Overview

The same day that the SEC published the rule proposal to enhance ESG disclosures by funds and advisers, the SEC published a separate rule proposal which would modernize the SEC's "names rule." Rule 35d-1 under the Investment Company Act, also known as the "names rule," has not been amended since the Rule's adoption over 20 years ago. Since that time, the SEC staff, members of the fund industry, and investor advocacy groups have identified a number of challenges regarding the application of the Rule that could have investor protection implications. These concerns prompted the SEC to publish a Request for Comment on Fund Names in March 2020 seeking public comment on the framework for addressing fund names, particularly given market and other developments. In light of the comments received, the SEC's proposed amendments to the Rule are intended to ensure that a fund's name accurately reflects its investments and related risks, and provide clarity and transparency to investors on the nature of a fund's investments.

Under the proposal, funds that consider ESG factors in connection with their investment practices would be subject to new requirements. In addition, the proposal would (i) expand the Rule's applicability to commonly used fund names that focus on investment strategies instead of specific investments, (ii) enhance prospectus disclosure requirements for terminology used in fund names, (iii) update the Rule's notice requirements, (iv) establish recordkeeping requirements, and (v) add a new requirement for funds to report on Form N-PORT regarding compliance with the Rule. The Rule currently applies to registered investment companies (both open-end and closed-end funds), and under the proposed amendments, would also apply to BDCs. The proposal was approved by the SEC in a 3-1 vote along party lines, with Commissioner Peirce dissenting, and will remain open for public comment until August 16, 2022.

80% Investment Policy Requirement

Name Suggesting an Investment Focus. The proposal would expand the scope of the Rule's current 80% investment policy requirement to apply to fund names that "include terms suggesting that the fund focuses on investments that have, or whose issuers have, particular characteristics." For example, fund names with terms such as "growth" or "value," or terms indicating that the fund's investment decisions incorporate one or more ESG factors, such as "sustainable," would be captured under the Rule. With respect to the latter category, given the increasingly common use of ESG or similar terminology in a fund's name, the proposed amendments would make the use of such terminology a violation of the Rule if the identified ESG factors do not play a central role in the fund's strategy. Moreover, ESG-integration funds (as defined above) would be prohibited from using ESG terminology in their name altogether.

In addition, the proposal seeks to bring naming standards in line with market practices by requiring funds investing in various types of derivatives to use a derivative instrument's notional amount, rather than its market value, for the purpose of determining compliance with the 80% requirement. The proposed amendments would also apply to other fund names that historically may have not been subject to the 80% requirement, depending on the context, such as fund names that include the terms "global," "international," or "intermediate term (or similar) bond." The SEC's stated aim in expanding the scope of the Rule is to help ensure that fund names that suggest to investors that the fund focuses its investments in a particular way are addressed by the Rule. Funds with names that suggest a focus on a particular type of investment or industry, or in particular countries or geographic regions, or those that suggest certain tax treatment, would continue to be subject to the Rule's existing 80% investment policy requirement.

The proposal notes that there would continue to be certain fund names that would not be captured under the amended Rule because they do not suggest an investment focus, including fund names that (i) reference characteristics of the fund's portfolio as a whole, such as a name indicating that the fund seeks to achieve a certain portfolio "duration" or that the fund is "balanced;" (ii) reference elements of an investment thesis without specificity as to the particular characteristics of the component portfolio investments, such as "long/short;" (iii) suggest a possible result to be achieved, such as "real return;" or (iv) reference a retirement target date. Nevertheless, pursuant to Rule 38a-1 under the Investment Company Act and regardless of whether a fund is required to adopt an 80% investment policy under the Rule, a fund would be required to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, which include Section 35(d) and Rule 35d-1.

Departures from the 80% Investment Requirement. Under the current formulation of the Rule, the 80% investment policy requirement applies "under normal circumstances" (which is not defined by the Rule) and is determined at the time a fund makes an investment. The proposed amendments would eliminate the "under normal circumstances" concept and, instead, establish a limited time frame and specific circumstance under which a fund would be permitted to depart temporarily from the 80% requirement. Temporary departures would be permitted only: (i) as a result of market fluctuations or other circumstances unrelated to the purchase or sale of an investment by a fund; (ii) to address unusually large cash inflows or unusually large redemptions; (iii) to take a defensive position in cash and cash equivalents to avoid a loss in response to adverse market, economic, political, or other conditions; or (iv) to reposition or liquidate a fund's assets in connection with fund launches, reorganizations, or changes to the fund's 80% investment policy. A fund generally would have to bring its investments back into compliance with the 80% requirement within thirty (30) days, except that a fund would have sixty (60) days to reposition its portfolio following notice to investors of a change to its 80% investment policy or 180 days in connection with its initial launch. In all cases, a fund would have to come back into compliance as soon as reasonably practicable.

Unlisted Closed-End Funds and BDCs. If a fund is a registered closed-end investment company or a BDC that does not have shares that are listed on a national securities exchange, the proposal would require the fund's 80% policy to be a fundamental investment policy. As a result, the policy could not be changed without shareholder approval.

Materially Deceptive or Misleading Name. Under the proposal, a new provision would be added in the Rule which states that a fund's name may be materially deceptive or misleading even if the fund adopts an 80% investment policy and otherwise complies with the Rule's requirement to adopt and implement the policy. The SEC explained that the Rule's 80% investment policy requirement is not intended to create a safe harbor for fund names, and the proposed amendments, if adopted, would codify this view to make clear that a fund's name may be materially deceptive or misleading even where the fund complies with its 80% investment policy. This could occur if, for example, a fund complies with its 80% investment policy but makes a substantial investment that is antithetical to the fund's investment focus (e.g., a "fossil fuel-free" fund making a substantial investment in an issuer with fossil fuel reserves). Similarly, a fund's name could be materially deceptive or misleading if the fund invests in a way such that the source of a substantial portion of the fund's risk or returns is different from those that an investor reasonably would expect based on the fund's name (e.g., a short-term bond fund using the 20% basket to invest in highly volatile equity securities that introduce significant volatility into a fund that investors would expect to have lower levels of volatility associated with short-term bonds).

Prospectus Disclosure

The proposed amendments would require a fund that is subject to the 80% investment policy requirement to include in its prospectus disclosure that defines the terms used in its name, including the specific criteria the fund uses to select the investments that the term describes, if any. Such new information would be required to be in a machine-readable XBRL format. For purposes of the proposed disclosure requirements, "terms" would mean any word or phrase used in a fund's name, other than any trade name of the fund or its adviser, related to the fund's investment focus or strategies. The proposed amendments are designed to help investors better understand how the fund's investment strategies correspond with the investment focus that the fund's name suggests, as well as to provide additional information about how the fund's management seeks to achieve the fund's objective.

Notice Requirement

The proposed amendments to the Rule, like the current Rule, would require that unless the 80% investment policy is a fundamental policy of the fund, notice must be provided to fund shareholders at least sixty (60) days before any change in the fund's 80% investment policy. The proposed amendments would incorporate some modifications to the current notice requirement that are designed to better address the needs of shareholders who have elected electronic delivery and to incorporate additional specificity about the content and delivery of the notice. As an additional modification, the proposed amendments would require notices to describe not only a change in the fund's 80% investment policy, but also a change to the fund's name that accompanies the investment policy change.

Recordkeeping

The proposed amendments would require funds to maintain certain records depending on whether the fund would be required to adopt an 80% investment policy. Funds subject to that requirement would be required to maintain certain records documenting their compliance with the Rule. Conversely, funds that do not adopt an 80% investment policy would be required to maintain a written record of their analysis that the 80% investment policy is not required under the Rule.

Form N-Port Disclosure

The rule proposal would amend Form N-PORT to include a new reporting item requiring registered funds (other than money market funds and BDCs) that are required to adopt an 80% investment policy to report on Form N-PORT: (i) the value of the fund's 80% basket, as a percentage of the value of the fund's assets; and (ii) if applicable, the number of days that the value of the fund's 80% basket fell below 80% of the value of the fund's assets during the reporting period. Funds subject to this reporting would be required to provide this information as of the end of the reporting period, and the information would be publicly available for the third month of each of the fund's fiscal quarters. The proposal also would amend Form N-PORT to include a new reporting item requiring a registered fund that is subject to the 80% investment policy requirement to indicate, with respect to each portfolio investment, whether the investment is included in the fund's 80% basket. This information would be publicly available for the third month of each of the fund's fiscal quarters.

Transition Period and Compliance Date

The SEC is proposing a one-year transition period, from the effective date of any final rulemaking, to provide time for funds to prepare to come into compliance with the proposed Rule amendments. Moreover, the rule proposal indicates that staff in the SEC's Division of Investment Management is currently reviewing its no-action letters and other statements addressing compliance with the Rule to determine which letters and other staff statements should be withdrawn in connection with any adoption of the rule proposal. Upon the adoption of any final Rule amendments, some of these letters and other staff statements would be moot, superseded, or otherwise inconsistent with the final Rule and, therefore, would be withdrawn.

Sources: Investment Company Names, Release No. IC-34593 (May 25, 2022), available here; SEC Proposes Rule Change to Prevent Misleading or Deceptive Fund Names, SEC Press Release 2022-91 (May 25, 2022), available here; Amendments to the Fund "Names Rule," SEC Fact Sheet (May 25, 2022), available here.

SEC Probes ETFs' Revenue-Sharing Agreements

The SEC's Division of Enforcement is conducting a sweep of ETF revenue-sharing practices and has requested that funds provide information regarding any compensation paid by an ETF or adviser to a financial intermediary based on assets held by the financial intermediary. The SEC has also requested information about payments based on the intermediary's activity and whether such payments come from the ETF or the adviser.

In recent years, the SEC has undertaken enforcement actions against brokers and advisers that have failed to properly disclose mutual fund revenue-sharing arrangements and the associated conflicts of interest, in particular whether lower cost funds that do not make revenue sharing payments are available. In a similar vein, the SEC is concerned about conflicts that may exist for intermediaries that receive revenue sharing fees from actively-managed ETFs but not passively-managed ETFs, as such arrangements may create an incentive for intermediaries to promote actively-managed ETFs over passively-managed ETFs.

Sources: David Isenberg, SEC Probes ETFs' Revenue-Sharing Agreements, IGNITES (Apr. 14, 2022), available by subscription; Greg Saitz, SEC Sweep Zeroes in on ETF Revenue Sharing, BoardIQ (Apr. 12, 2022), available by subscription.

LATEST DEVELOPMENTS: ADVISERS

SEC's Division of Examinations Issues Risk Alert on Code of Ethics and MNPI

The Division of Examinations (Division) issued a risk alert detailing deficiencies the staff observed during examinations of advisers related to Section 204A of the Advisers Act and Rule 204A-1 under the Advisers Act (Code of Ethics Rule).

Section 204A requires advisers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the misuse of material non-public information (MNPI) by the adviser or any person associated with the adviser (MNPI Requirement).

The Code of Ethics Rule requires advisers to adopt a "code of ethics" that sets forth the standards of business conduct expected from the adviser's "supervised persons" (e.g., employees, officers, partners, directors and other persons who provide advice on behalf of the adviser and are subject to the adviser's supervision and control). The Code of Ethics Rule requires certain supervised persons, called "access persons," to report their personal securities transactions and holdings to the adviser's chief compliance officer (CCO) or other designated persons. Deficiencies related to Codes of Ethics are among the most commonly observed by the Division.

Code of Ethics

Below are examples of deficiencies associated with the Code of Ethics Rule identified by the Division staff:

Identification of Access Persons. The staff observed advisers that did not identify and supervise certain employees as access persons in accordance with their Code of Ethics. In addition, some Codes of Ethics did not define "access person" or accurately reflect which employees are considered access persons.

Pre-Approval for Certain Investments. The staff observed access persons that purchased initial public offerings and limited offerings without requisite pre-approval. In addition, some Codes of Ethics did not require access persons to obtain pre-approval before directly or indirectly acquiring any interests in an initial public offering or limited offering.

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

- Could not produce evidence of supervisory review of holdings and transaction reports; or
- Did not assign the CCO's reporting to another member of the adviser – effectively permitting the CCO to self-review his or her own holdings and transaction reports.

In addition, some Codes of Ethics did not require access persons to:

- Submit reports;
- Include the specified content set out by the Code of Ethics Rule in their holdings and transaction reports; or
- Provide a written acknowledgement of their receipt of the code or any amendments.

The staff observed situations in which the holdings and/or transaction reports were not submitted by access persons or the reports were not submitted within the required timeframes and instances where supervised persons were not provided with a copy of the code or did not provide written acknowledgements.

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

Allocation of Investment Opportunities. The 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.

MNPI

Below are examples of deficiencies and weaknesses associated with the MNPI Requirement observed by the Division staff:

Policies and Procedures Related to Alternative Data. The staff observed advisers that used data from non-traditional sources (alternative data) (e.g., information gleaned from satellite and drone imagery of crop fields and retailers' parking lots, analyses of aggregate credit card transactions, social media and internet search data, geolocation data from consumers' mobile phones and email data obtained from apps and tools used by consumers) but did not adopt or implement reasonably designed written policies and procedures to address the potential risk of receipt and use of MNPI through alternative data sources. For example, advisers did not appear to:

- Adequately memorialize diligence processes or follow them consistently and instead engaged in ad hoc and inconsistent diligence of alternative data service providers;
- Have policies and procedures for assessing the terms, conditions or legal obligations related to the collection of alternative data, including when advisers became aware of red flags about the alternative data sources; or
- Consistently implement their policies and procedures related to alternative data service providers. Advisers:
  - Did not apply their due diligence process to all sources of alternative data;
  - Had an onboarding process for alternative data service providers, but did not have a system for determining when due diligence needed to be re-performed based on passage of time or changes in data collection practices; and
  - Could not demonstrate that their policies and procedures had been consistently implemented.

Policies and Procedures Related to "Value-Add Investors." "Value-add investor" refers to clients or fund investors that are corporate executives or financial professional investors who may have MNPI. The staff observed advisers that did not have or did not appear to 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. The staff observed advisers that:

- Did not have policies and procedures regarding MNPI risks posed by their value-add investors; or
- Maintained MNPI policies and procedures regarding value-add investors, but did not correctly identify all of the value-add investors or correctly identify and track their relationships with potential sources of MNPI.

Policies and Procedures Related to "Expert Networks." The staff observed advisers that did not appear to have or did not appear to implement adequate policies and procedures regarding their discussions with expert network consultants (i.e., professionals who are paid for their specialized information and research services) who may be related to publicly traded companies or have access to MNPI, including:

- Tracking and logging calls with expert network consultants;
- Reviewing detailed notes from expert network calls; and
- Reviewing relevant trading activity of supervised persons in the securities of publicly traded companies that are in similar industries as those discussed during calls.

The Division encouraged advisers to review their practices, policies, and procedures in this area and to ensure they comply with provisions of the Advisers Act and its rules.

Source: Division of Examinations Risk Alert: Investment Adviser MNPI Compliance Issues (Apr. 26, 2022), available here.

SEC Staff Publishes Bulletin on Standards of Conduct for Account Recommendations for Retail Investors

The SEC staff published a bulletin styled as questions and answers (Q&As) providing staff views on how broker-dealers, investment advisers and their associated persons can satisfy their obligations to retail investors when making account recommendations, including rollover recommendations. Below are some of the Q&As:

Factors to Consider Before Making an Account Recommendation

Both Regulation BI (Reg BI) and the fiduciary standard applicable to advisers (IA fiduciary standard) require firms to have a reasonable basis for an account recommendation, based on a reasonable understanding of the retail investor's investment profile and the account characteristics.

Q: *What are examples of investor characteristics I should consider to have a reasonable basis to believe the recommendation is in the retail investor's best interest?*

A: *(in part) As part of establishing a reasonable understanding of the retail investor's investment profile, the staff believes that you should consider, without limitation, the retail investor's: financial situation (including current income) and needs; investments; assets and debts; marital status; tax status; age; investment time horizon; liquidity needs; risk tolerance; investment experience; investment objectives and financial goals; and any other information the retail investor may disclose to you in connection with an account recommendation. The staff also believes that you should consider, without limitation, the retail investor's: anticipated investment strategy (e.g., buy and hold versus more frequent trading); level of financial sophistication; preference for making their own investment decisions or relying on advice from a financial professional; and the need or desire for account monitoring or ongoing account management.*

The staff continues with additional Q&As addressing how to handle situations where investor information is not available and examples of account characteristics to consider.

Consideration of Costs in Account Recommendations

Q: *Are costs always a relevant factor to consider when making account recommendations?*

A: *(in part) Yes, you must always consider cost as a factor when making an account recommendation. While Reg BI and the IA fiduciary standard do not always obligate you to recommend the least expensive type of account, both require you to have a reasonable basis to believe that the account recommendation is in the retail investor's best interest and does not place your or your firm's interests ahead of the retail investor's interest… if you recommend a higher cost account, you must have a reasonable basis to believe the account recommendation is nonetheless in the retail investor's best interest based on other factors and in light of the particular situation and needs of the retail investor.*

The staff continues with additional Q&As regarding consideration of costs, including examples of costs that should be considered (account fees, commissions and transaction costs, tax considerations, indirect costs and fees associated with investment products) and other factors to consider (e.g., investor's need for certain services or anticipated composition of investments in the account).

Retirement Account Rollover Recommendations

The staff notes that in addition to Reg BI and the IA fiduciary standard, rollovers also are subject to regulation by the Department of Labor (DOL) and advises firms to review Prohibited Transaction Exemption (PTE) 2020-02.

Q: *Are there additional factors that I should consider when making a rollover recommendation in order to have a reasonable basis to believe the recommendation is in the retail investor's best interest?*

A: *(in part) Yes; the staff believes that there are specific factors potentially relevant to rollovers that you should generally consider when making a rollover recommendation to a retail investor. These factors include, without limitation, costs; level of services available; features of the existing account, including costs; available investment options; ability to take penalty-free withdrawals; application of required minimum distributions; protection from creditors and legal judgments; and holdings of employer stock.*

As with account recommendations more generally, relevant factors should be considered in light of, among other things, the retail investor's investment profile to develop a reasonable belief that the retirement account or rollover recommendation is in the retail investor's best interest.

Q: *When considering a rollover recommendation, do I have to consider the option of leaving the retail investor's investments in the employer's plan?*

A: *(in part) [Yes.] To evaluate any recommendation to transfer assets out of an employer's plan, or between IRAs, you would need to obtain information about the existing plan, including the costs associated with the options available in the investor's current plan.*

Retail Investor Preferences

Q: *If a retail investor expresses a preference for a particular type of account, would making an account recommendation on the basis of that preference satisfy the standards?*

A: *(in part) No… Where a retail investor expresses a preference for a particular type of account, the staff believes that factor should be considered. You would not, however, be relieved of the obligation to consider reasonably available alternatives and recommend an account you reasonably believe is in the retail investor's best interest…*

In the staff's view, however, if the retail investor ultimately directs you to open an account that is contrary to your recommendation, you would not be required to refuse to accept the investor's direction.

Documentation of Account Recommendations

The staff addresses the need for firms to document the basis for account recommendations, which is required for rollover recommendations by PTE 2020-02 as well. Remember that beginning July 1, 2022, PTE 2020-02 requires firms to provide in writing the specific reasons why a rollover recommendation is in the best interest of the retirement investor.

Conflicts of Interest

The SEC staff also gives the following examples of practices that can assist firms in addressing conflicts of interest associated with account recommendations:

- Avoid compensation thresholds that disproportionately increase compensation through openings of certain account types;
- Adopt and implement policies and procedures reasonably designed to minimize or eliminate incentives, including both compensation and non-compensation incentives, for employees to favor one type of account over another;
- Implement supervisory procedures to monitor recommendations that involve the roll over or transfer of assets from one type of account to another (such as recommendations to roll over or transfer assets in an ERISA account to an IRA); and
- Adjust compensation for financial professionals who fail to adequately manage conflicts of interest associated with account recommendations.

In the staff's view, firms should exercise particular care when creating incentives that could have the effect of encouraging account recommendations that would place the interests of the firm or financial professional ahead of the interest of the retail investor. The staff strongly encourages firms to eliminate or mitigate any incentive that poses a risk of causing the firm or its financial professionals to place their interests ahead of the retail investor's interest. The SEC has previously brought a settled enforcement action in connection with compensation incentives for financial professionals making account recommendations.

Source: Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Account Recommendations for Retail Investors (Mar. 30, 2022), available here; See In the Matter of TIAA-CREF Individual & Institutional Services, LLC, IA Release No. 5772 (July 13, 2021), available at here.

Wisconsin Adopts a New Rule Requiring Investment Adviser Representative Continuing Education

The Wisconsin Department of Financial Institutions (DFI) Division of Securities adopted Section 11 under the Wisconsin Administrative Code that includes new rules requiring state-registered and federal covered investment adviser representatives (IARs) to satisfy annual continuing education requirements. Starting with the 2023 calendar year, Rule 11.02 requires every IAR to complete 12 continuing education credits annually. IARs will be required to complete at least six credits of products and practices courses and six credits of ethics and professional responsibility courses. IARs will be required to complete courses that meet the criteria established by the North American Securities Administrators Association. IARs that are dually registered as agents of broker-dealers may apply up to six credits earned in FINRA continuing education courses to satisfy the requirements of Rule 11.02.

IARs who fail to meet the continuing education requirements at the end of an annual reporting period will be permitted to renew their license with a status of “CE Inactive” until the required continuing education credits have been completed. An IAR who still has a CE Inactive status at the end of the next reporting period will be ineligible to renew their registration. IARs who have a primary place of business in another state will be in compliance with the DFI rule if the IAR has satisfied the home state continuing education requirements, provided such requirements are as stringent as the requirements under Wisconsin regulations. IARs who earn more than 12 credits in a reporting period may not carry those credits forward to a future year.

Sources: Wisconsin Adopts New Rule Requiring Investment Adviser Representative Continuing Education (Mar. 24, 2022), available here; Final Clearinghouse Rule 21-057: Order of the Department of Financial Institutions - Securities (Mar. 24, 2022), available here.

LATEST DEVELOPMENTS: ENFORCEMENT

SEC Charges Adviser for Misstatements and Omissions Concerning ESG Considerations

The SEC issued an order finding that BNY Mellon Investment Adviser, Inc. (BNY) made misstatements and omissions about ESG considerations in making investment decisions for certain mutual funds that it managed. The SEC’s order finds that, from July 2018 to September 2021, BNY represented to investors via mutual fund prospectuses and to those funds’ boards that its affiliated subadviser had performed an ESG quality review of all investments in the funds’ portfolios, when in fact numerous investments held by certain funds did not have an ESG quality review score as of the time of investment. The SEC found that the statements made in the funds’ prospectuses and to the boards were incomplete because they failed to clarify that the subadviser could and did select portfolio investments that were not necessarily subject to ESG quality reviews. The order notes that in determining to accept the offer of settlement from BNY, the SEC considered remedial acts promptly undertaken by BNY to update relevant processes, policies and procedures, and cooperation afforded to the SEC by BNY during the proceedings.

Without admitting or denying the SEC’s findings, BNY agreed to a cease-and-desist order, a censure, and to pay a $1.5 million penalty. The enforcement action was brought by SEC officials who are a part of the SEC’s Division of Enforcement Climate and ESG Task Force, which was formed in March 2021 to analyze disclosures and compliance issues stemming from ESG investments.

Sources: SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations, SEC Press Release 2022-86 (May 23, 2022), available here; In the Matter of BNY Mellon Investment Adviser, Inc., IA Release No. 6032 (May 23, 2022), available here.

SEC Charges Allianz Global Investors and Three Former Senior Portfolio Managers with Multibillion Dollar Securities Fraud

As part of a coordinated settlement with the SEC and Department of Justice (DOJ), Allianz Global Investors U.S. LLC (AGI US) pleaded guilty to defrauding institutional investors that had invested in multiple structured alpha funds managed by AGI US, resolved civil fraud charges and agreed to pay $6 billion in penalties and restitution to investors. The SEC alleged that AGI US marketed and sold the structured alpha funds while misleading investors about the significant downside risks of its complex options trading strategy. The SEC found that when Covid-related volatility occurred in markets during March 2020, the funds suffered catastrophic losses, up to 90% in certain funds, resulting in the loss of billions by investors. The order also found that the portfolio management team then made multiple, ultimately unsuccessful, efforts to conceal their misconduct from the SEC. According to the order, AGI US earned over $550 million in fees from managing the structured alpha funds but lost over $5 billion in investor funds when the market volatility of March 2020 exposed the true risk of their products. Additionally, the SEC alleged that AGI US failed to maintain sufficient risk controls.

AGI US admitted that its conduct violated the federal securities laws and agreed to a cease-and-desist order, a censure and payment of $315 million in disgorgement, $34 million in prejudgment interest, and a $675 million civil penalty. As a result of its guilty plea, AGI US is disqualified from providing advisory services to registered investment funds for the next ten years.

The SEC and DOJ also brought criminal and civil charges against three former senior portfolio managers at the center of the scandal. The SEC alleged that the portfolio managers manipulated financial reports and other information provided to investors to conceal the magnitude of the structured alpha funds' true risk and the funds' true performance. Two portfolio managers pleaded guilty and agreed to be barred from association with any broker-dealer or adviser. The third is awaiting trial.

Sources: SEC Charges Allianz Global Investors and Three Former Senior Portfolio Managers with Multibillion Dollar Securities Fraud, SEC Press Release 2022-84 (May 17, 2022), available here; In the Matter of Allianz Global Investors U.S. LLC, IA Release No. 6027 (May 17, 2022), available here; In the Matter of Trevor L. Taylor, IA Release No. 6025 (May 17, 2022), available here; In the Matter of Stephen G. Bond-Nelson, IA Release No. 20854 (May 17, 2022), available here; Three Portfolio Managers and Allianz Global Investors U.S. Charged in Connection with Multibillion-Dollar Fraud Scheme, DOJ Justice News (May 17, 2022), available here; Greg Saitz, Boards Race Against Clock to Replace Allianz, BoardIQ (May 31, 2022), available by subscription.

SEC Charges Adviser with Breach of Fiduciary Duty and Orders It to Repay Over $800,000 to Harmed Clients

The SEC announced settled charges against Madison Avenue Securities, LLC (MAS), a California-based dually-registered investment adviser and broker-dealer, for breach of fiduciary duty in connection with its share class selection practices and related receipt of third-party compensation.

The SEC's order finds that since at least February of 2016, MAS invested advisory clients in cash sweep money market funds for which MAS received revenue sharing, mutual funds that resulted in MAS receiving 12b-1 fees when lower-cost share classes were available, and no-transaction-fee mutual funds for which MAS also received revenue sharing payments. The order finds that while MAS was receiving such payments, it did not disclose or did not adequately disclose the conflicts of interest associated with the receipt of such compensation The order also notes that MAS did not self-report to the SEC pursuant to the SEC's Share Class Selection Disclosure Initiative.

In addition to the foregoing, the order finds that MAS breached its duty to seek best execution by causing clients to invest in more expensive share classes of mutual funds when lower-cost share classes were available and that MAS breached its duty of care by failing to undertake an analysis to determine whether the particular mutual fund share classes and money market funds it recommended were in the best interest of its advisory clients. Without admitting or denying the findings, MAS agreed to pay disgorgement of approximately $579,000, prejudgment interest of approximately $74,000 and a civil money penalty of $150,000.

Sources: SEC Charges Investment Adviser with Breach of Fiduciary Duty and Orders it to Repay Over $800,000 to Harmed Clients, Administrative Proceeding File No. 3-20872 (May 31, 2022), available here; In the Matter of Madison Avenue Securities, LLC, IA Release No. 6036 (May 31, 2022), available here.

SEC Charges Adviser and Orders It to Pay Over $1.8 Million and Return Funds to Clients Harmed by Undisclosed Conflicts

The SEC announced settled charges against First Republic Investment Management, Inc. (FRIM) for breaches of fiduciary duty in connection with its affiliated broker's receipt of third-party compensation from advisory client investments without having provided clients full and fair disclosure of its conflicts of interest. The SEC's order finds that since at least February 2014, FRIM invested clients in certain mutual funds and cash sweep products that resulted in its affiliated broker receiving revenue sharing payments. The order finds that FRIM provided inadequate disclosure of the conflicts of interest arising from this compensation arrangement and that FRIM also breached its duty to seek best execution by causing certain advisory clients to invest in mutual fund share classes that paid revenue sharing when lower cost share classes of the same funds were available to the clients.

Specifically, the SEC's order states that a clearing broker that FRIM's affiliated broker worked with would share a portion of the revenue sharing payments it received with FRIM's affiliated broker based on customer assets invested in funds in the clearing broker's no-transaction-fee (NTF) program, including FRIM's advisory client assets. The SEC's order finds that FRIM did not disclose that its affiliated broker received such payments or otherwise put clients on notice regarding the conflicts of interest inherent in this arrangement. The SEC's order also finds that while FRIM did ultimately update its Form ADV Part 2A brochure to disclose the arrangement and the inherent conflict of interest, such disclosure was inadequate because it did not disclose that (1) a lower-cost share class of the same mutual fund was available to clients that paid less or no revenue sharing, and (2) mutual funds or share classes in the NTF program are more expensive than other funds or share classes outside the NTF program.

Without admitting or denying the findings, FRIM agreed to pay disgorgement of approximately $1,333,000, prejudgment interest of approximately $243,000 and a civil money penalty of $250,000.

Sources: SEC Charges Investment Adviser and Orders It to Pay Over $1.8 Million and Return Funds to Clients Harmed by Undisclosed Conflicts, Administrative Proceeding File No. 3-20865 (May 19, 2022), available here; In the Matter of First Republic Investment Management, Inc., IA Release No. 6030 (May 19, 2022), available here.

SEC NEWS

Senate Confirms New SEC Commissioners

On June 16, 2022, the Senate unanimously confirmed Jaime E. Lizárraga to succeed Commissioner Allison Herren Lee for a term expiring June 5, 2027 and Mark Toshiro Uyeda for the remainder of Elad L. Roisman's term expiring June 5, 2023.

Mr. Lizárraga has been an advisor to House Speaker Nancy Pelosi for fourteen years. Prior to that, he was on the Democratic staff of the House Financial Services Committee and held appointments at the Treasury Department and SEC. At the SEC, Mr. Lizárraga had been deputy director of legislative affairs. Mr. Uyeda has been a lawyer with the SEC for fifteen years and is currently on detail serving as Republican counsel on the Senate Banking Committee. His SEC roles include senior advisor to former Chair Jay Clayton and former Acting Chair Michael Piwowar, counsel to former Commissioner Paul Atkins and assistant director and senior special counsel in the Investment Management Division.

Sources: The White House, Nominations and Withdrawals Sent to the Senate (Apr. 7, 2022), available here; Joe Morris, Two Commissioners Nominated to SEC, IGNITES (Apr. 7, 2022), available by subscription; Soyoung Ho, Senate Confirms Two New SEC Commissioners, Thomson Reuters (June 16, 2022), available here.

COMPLIANCE DATES FOR FINAL RULES

Final Rule	Compliance Dates
Derivatives Risk Management Rule (Rule 18f-4) and Related Amendments; Rescission of Prior SEC Guidance (Release 10666)	**August 19, 2022** 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. 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)	**September 8, 2022** Rules 2a-5 and 31a-4 became effective on March 8, 2021, and funds have until September 8, 2022 to come into compliance.
Advertising and Cash Solicitation Rule Amendments (Rules 206(4)-1 and 204-2)	**November 4, 2022** The rule became effective on May 4, 2021 and advisers 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.