GODFREY & KAHN S.C.

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Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS

SEC Publishes Draft FY22-26 Strategic Plan for Public Comment

On August 24, 2022, the Securities and Exchange Commission (SEC) released its draft strategic plan for public comment. As part of the strategic plan, the SEC outlined its mission, vision, values and goals for the 2022-2026 fiscal years. The SEC's stated mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, which is supported by its vision and values. The goals span over a four-year time period and are summarized below.

Goal 1: Protect working families against fraud, manipulation, and misconduct

The SEC intends to achieve this goal through rulemaking, enforcement and examinations. The staff will continually evaluate products and other financial arrangements to determine whether they comply with securities laws. Through enforcement, the SEC hopes to deter both individuals and the industry as a whole from violations. The SEC will continue to monitor for misconduct and work in conjunction with other agencies in enforcement actions. The SEC Division of Examinations (Division) will continue to focus on key risks and violations that could harm investors, such as cybersecurity and private fund adviser conflicts of interest. The SEC intends to invest in its technology and data analytics abilities to keep pace with the industry. Lastly, the SEC plans to continue to focus on disclosure to investors, notably regarding climate risks and cybersecurity, and will continue to evolve its disclosure framework.

Goal 2: Develop and implement a robust regulatory framework that keeps pace with evolving markets, business models, and technologies

The SEC noted that as the markets continue to evolve technology plays a key role and therefore cybersecurity risks continue to increase. In addition, with the global interconnectedness of the markets, SEC oversight becomes more challenging. The staff intends to require more transparency into the private markets via disclosure requirements and noted greater need for data protection across global regulators. The SEC stated a need for expanded authority from Congress to address digital currencies. The plan also underscored the importance of continuing to educate diverse and underserved communities and also educate investors on new and relevant industry issues, using feedback from investor and community outreach. The staff also recognizes the need to further understand crypto assets, fixed income investments and derivatives.

Goal 3: Support a skilled workforce that is diverse, equitable, and inclusive and is fully equipped to advance agency objectives

The SEC is committed to diversity, equity and inclusion across its workforce. The staff intends to provide opportunities for collaboration and cross-training

of its employees and plans to encourage job rotations. The staff deems its biggest internal risks as data and information security protection, including information from third parties. Lastly, the plan noted the importance of internal modern technology and to continue to invest in up-to-date technological systems, such as migrating to the cloud.

The request for comment closed on September 29, 2022.

Sources: SEC Publishes Draft FY22-26 Strategic Plan for Public Comment, SEC Press Release (Aug. 24, 2022), available here; U.S. Securities and Exchange Commission Strategic Plan, Fiscal Years 2022-2026 (Aug. 24, 2022), available here.

LATEST DEVELOPMENTS: ADVISERS

SEC Risk Alert Regarding Upcoming Examinations for Compliance with New Marketing Rule

On September 19, 2022, the Division published a risk alert announcing its intent to conduct examinations focused on compliance with Rule 206(4)-1 under the Advisers Act (Marketing Rule). Any advertisements disseminated by advisers, including advisers to private funds, on or after November 4, 2022 must comply with the Marketing Rule.

The Division staff noted Marketing Rule exams would focus on the following areas:

Marketing Rule Policies and Procedures

The staff will confirm whether advisers have instituted written policies and procedures to comply with the Marketing Rule. Examiners will look for objective and testable means reasonably designed to prevent violations of the Marketing Rule, such as conducting internal pre-reviews of and approving advertisements, reviewing a sample of advertisements based on risk, or pre-approving templates.

Substantiation Requirement

The staff will review whether advisers have a reasonable basis to believe they will be able to substantiate material statements of fact in advertisements. There are a number of ways to do this, including making a record contemporaneous with the advertisement or adding citations and sources to advertisements. If an adviser is unable to produce information to substantiate statements of fact when the staff demands it, the staff will presume that the adviser did not have a reasonable basis for its belief.

Performance Advertising Requirements

The staff will review compliance with the performance advertising requirements 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;
- 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 performance, unless the personnel primarily responsible for achieving the prior performance manage accounts at the advertising adviser and 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. In addition, the advertising adviser must include all relevant disclosures clearly and prominently in the advertisement.

Books and Records

The staff will also review for compliance with the amended books and records rule (Rule 204-2 under the Advisers Act). Advisers will be required to answer the new questions in Item 5L of Form ADV, Part 1A regarding their marketing practices in their next annual update after November 4, 2022.

Source: Division of Examinations Risk Alert: Examinations Focused on the New Investment Adviser Marketing Rule (Sept. 19, 2022), available here.

SEC Requests Information and Comment on Whether Index Providers, Model Portfolio Providers and Pricing Services Are Acting as Investment Advisers

Overview

On June 15, 2022, the SEC issued a request for comment regarding information providers (such as index providers, model portfolio providers and pricing services) to determine if the services provided qualify the information provider as an "investment adviser" under the Advisers Act and the Investment Company Act.

The request describes the services provided by index providers, model portfolio providers and pricing services as follows:

Index Providers compile, create the methodology for, sponsor, administer, and/or license market indexes. The request highlights the discretion index providers have in changing the index (*i.e.*, constituents, weightings, etc.), the prevalence of indexes in the market and the fact that information published in indexes leads advisers to buy or sell particular securities. Index providers are compensated through licensing agreements. Of note, the request states that three index providers account for over two-thirds of the market (MSCI, S&P Dow Jones Indices and FTSE Russell).

Model Portfolio Providers design allocation models, may update or rebalance them over time, provide various degrees of customization, and may offer this information on a discretionary or non-discretionary basis. Model portfolio providers charge fees either for the use of the portfolio, from securities bought, sold or held in the model, or based on transactions. The fees associated with model portfolios as well as potential for conflicts of interest can be cause for concern to investors. Investors may be unclear as to who is actually managing the portfolio, who the fees are going to, and where the fiduciary duties lie.

Pricing Services provide prices, valuations and additional data about a particular investment (*e.g.*, a security, a derivative, or another investment) to assist users with determining an appropriate value of the investment or provide pricing information when market quotations are not readily available. Pricing services determine valuations at their discretion based on their choice of methodologies, models, inputs, adjustments and other variables. As was also discussed by the SEC in the adopting release for Rule 2a-5 under the Investment Company Act (the Valuation Rule), pricing services are pivotal in assisting with fair value determinations and therefore oversight of pricing service providers is essential. Pricing service providers may be compensated through subscription fees, fixed fees or as a percentage of assets.

Investment Adviser Status under the Advisers Act

The Advisers Act defines an "investment adviser" as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or any person who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." Three elements must all be met in order for a person to be considered an investment adviser: the person (1) provides advice or issues analyses or reports concerning securities; (2) is in the business of providing such services; and (3) is compensated for the services.

The request describes exclusions that may be relied upon to be excluded from the definition of an investment adviser and of relevance is the "publisher's exclusion." The publisher's exclusion, as discussed in the Supreme Court case, *Lowe v. SEC*, allows for the exclusion as long as the publication: (1) provides only impersonal advice; (2) is "bona fide," meaning that it provides genuine and disinterested commentary; and (3) is of general and regular circulation rather than issued from time to time in response to episodic market activity. The staff believes index providers and pricing services may be relying on the publisher's exclusion.

The request for comment speaks to the staff's overarching question whether certain information providers should be regulated as investment advisers.

Implications of Investment Adviser Status

Registration under, and Applicability of, the Advisers Act. Under the Advisers Act, a person that meets the definition of "investment adviser" must register as an investment adviser with the SEC, unless they fall under Section 203A of the Act (applicable to small- and mid-sized advisers that have assets under management (AUM) below a certain level and are regulated by the state their office is located in) or qualify for an exemption.

Advisers Prohibited from Registering under the Advisers Act. The SEC may allow firms to register that are under the AUM threshold but have a national presence. Examples could include a pricing service that is used across the national market, well known index providers that play a large role in the marketplace, or model portfolio providers whose model portfolios are used to manage large amounts of assets, even though the AUM are not attributable to the model portfolio provider.

Related Investment Company Act Matters

Advisers to funds are subject to the Investment Company Act, including approval of the advisory contract, prohibitions on self-dealing and certain affiliated transactions, compliance requirements and board oversight. The Investment Company Act includes exceptions to the definition of investment adviser to a fund, including for persons distributing their publications to subscribers or providing statistical information without regularly furnishing advice or making recommendations concerning specific securities.

The SEC states that certain information providers may qualify as investment advisers under the Investment Company Act, particularly index providers that maintain a bespoke index created for a single fund. The request for comment asks firms to consider how the Investment Company Act requirements could be applicable to information providers.

The comment period closed on August 16, 2022 but has been reopened. Comments on the proposal are now due within 14 days after publication of the reopening release in the Federal Register. As of the date of this Update, the reopening release has not been published in the Federal Register.

Sources: SEC Requests Information and Comment on Advisers Act Regulatory Status of Index Providers, Model Portfolio Providers, and Pricing Services, SEC Press Release 2022-109 (June 15, 2022), available here; Request for Comment on Certain Information Providers Acting as Investment Advisers, IA Release No. 6050 (June 15, 2022), available here; Index Providers Take Record $5bn in Revenue in 2021, Financial Times (May 23, 2022), available here; SEC Reopens Comment Periods for Several Rulemaking Releases Due to Technological Error in Receiving Certain Comments, SEC Press Release 2022-186 (October 7, 2022), available here; Resubmission of Comments and Reopening of Comment Periods for Several Rulemaking Releases Due to a Technological Error in Receiving Certain Comments, SEC Reopening Release (October 7, 2022), available here.

SEC Staff Bulletin Addresses Standards of Conduct for Broker-Dealer and Investment Adviser Conflicts of Interest

On August 3, 2022, the SEC issued a staff bulletin in a question-and-answer (Q&A) format to reiterate the standards of conduct in identifying and addressing conflicts of interest for broker-dealers under Regulation Best Interest (Reg BI) and for advisers under the Advisers Act's fiduciary standard (IA fiduciary standard). Broker-dealers and advisers have a duty to act in a retail investor's best interest and not place their own interests ahead of the investor's interest. Under both Reg BI and the IA fiduciary standard, a conflict of interest is "an interest that might incline a broker-dealer or investment adviser—consciously or unconsciously—to make a recommendation or render advice that is not disinterested." The bulletin indicates that recognizing and addressing conflicts of interest under Reg BI and the IA fiduciary standard should be a "robust, ongoing process that is tailored to each conflict."

Identifying Conflicts of Interest

The bulletin states unequivocally that all broker-dealers, advisers and financial professionals have at least some conflicts of interest with their retail investors.

The bulletin cites as common sources of conflict any compensation, revenue or other benefits (financial or otherwise) to:

- The firm or its affiliates, including fees for services provided to retail investors (*e.g.*, AUM fees) and payments from third parties;
- The firm or its affiliates resulting from sales of proprietary products;
- Financial professionals from their firm or its affiliates (*e.g.*, differential or variable compensation based on AUM or services provided); and
- Financial professionals resulting from business relationships (*e.g.*, gifts, entertainment, meals, travel and related benefits).

As to policies and procedures, the bulletin advises firms to, among other things: (1) define conflicts in a way that is relevant to the firm's business and that enables personnel to understand and identify conflicts; (2) establish a process to identify the types of conflicts that the firm and its financial professionals may face; (3) provide for an ongoing and regular process to identify conflicts associated with changes in the firm's business; and (4) establish training programs.

The bulletin advises firms to establish a "culture of compliance"—an environment where conflicts are taken seriously and financial professionals feel empowered and encouraged to take an active role in identifying conflicts.

Eliminating Conflicts of Interest

In certain circumstances, an adviser has a duty to eliminate a conflict of interest. This may occur when a client cannot provide informed consent after a conflict has been disclosed and mitigation is not an option or when the nature of the conflict is such that the adviser is unable to provide advice in the best interest of the retail investor.

Mitigating Conflicts of Interest

In order to mitigate conflicts of interest, firms need to evaluate sources of the firm's compensation, revenue or other benefits and compensation and incentive arrangements for financial professionals.

Product Menus

Firms should evaluate their list of products to ensure that product recommendations are in the best interest of the retail investor and assess if the products offered create a conflict of interest (*e.g.*, only proprietary products, specific asset classes or products with revenue sharing). To assist with assessing product menus, the staff encourages firms to implement a review process to identify and mitigate conflicts.

Disclosing Conflicts of Interest

Disclosures stating that a firm "may" have a conflict when the conflict actually exists are not sufficiently specific to disclose the conflict adequately to retail investors. Disclosures should be tailored to each conflict, explained in plain English and if the conflict cannot be disclosed fully and fairly, the conflict should be mitigated or eliminated.

The bulletin provides a list of facts that the SEC staff believes should be disclosed with respect to a conflict associated with compensation or other benefits, such as the source and scale of compensation for the firm or financial professional, incentives created by the conflict and the nature and extent of any costs or fees incurred by the retail investor as a result of the conflict. In addition, the bulletin provides a list of facts that should be disclosed regarding proprietary products, third-party compensation and wrap fee accounts.

Monitoring Conflicts of Interest

The SEC staff expresses the view that firms have an ongoing monitoring obligation with respect to conflicts of interest, stating that identifying and addressing conflicts is not a "set it and forget it" exercise.

Source: Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest (Aug. 3, 2022), available here.

LATEST DEVELOPMENTS: FUNDS

Industry Comments on SEC's Proposed ESG Disclosure Rule and Names Rule Amendments

On May 25, 2022, the SEC published two rule proposals. The first rule proposal would require additional disclosures by funds and advisers that take Environmental, Social, and Governance (ESG) factors into consideration when making investing decisions. The proposal requires additional specific disclosures regarding ESG strategies in fund registration statements, the management discussion of fund performance in fund annual shareholder reports (MD&P), and adviser disclosure brochures. The second rule proposal aims to modernize Rule 35d-1 under the Investment Company Act, the SEC's "names rule." The SEC's proposed amendments to the names 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. See our July 2022 Investment Management Legal and Regulatory Update for more information.

The comment period for each proposed rule closed on August 16, 2022 but has been reopened. Comments on the proposals are now due within 14 days after publication of the reopening releases in the Federal Register. As of the date of this Update, the reopening releases have not been published in the Federal Register.

Below is a summary of some of the relevant comments included in the letters submitted by prominent industry organizations:

ESG Rule Comments

- The proposed disclosure requirements for ESG Integration Funds would be applicable to most, if not all, funds (since most funds "consider" ESG factors in their investment process) including funds that do not consider themselves ESG.
- For ESG Focused Funds, the definition is overly broad as it encompasses funds that engage with companies and most funds engage generally with companies in which they invest.
- The proposed disclosure requirements for ESG Focused Funds in the statutory prospectus and shareholder reports are too granular and the proxy voting disclosure requirement may not be particularly informative to investors.
- The categories of ESG Integration Funds and ESG Focused Funds may be confusing to investors and also have the potential to limit innovative ESG strategies by placing funds into these categories.
- With regard to ESG Integration Funds and ESG Focused Funds, the distinction should be based on the significance of ESG factors in a fund's name, advertisements and sales literature rather than on consideration of ESG factors in its investment decisions. Enhanced ESG disclosure requirements should apply only to those funds that hold themselves out as having an ESG focus or claim that ESG factors are a significant or main consideration in investment decisions.
- The requirement for ESG Impact Funds to disclose the Fund's progress on achieving its impact(s) does not take into account that most funds track the progress of individual investments and not the portfolio in the aggregate.

Names Rule Amendments Comments

- Expanding the 80% test to funds that focus on "particular characteristics" (a phrase which is not clearly defined in the proposed rule) would be a drastic extension of the current rule and since the term is not clearly defined would lead to subjective, inconsistent decisions by funds and will likely create more investor confusion.
- In some cases, applicability of the 80% test is easy to apply to, for example, funds with a country or geographic region in the name. This is significantly less true when applied to a strategy rather than a category or classification of securities. For example, while investors generally understand what constitutes a "growth stock" or "growth stock strategy" (or, conversely, a "value stock" or "value stock strategy"), there is no generally accepted way to classify any stock or strategy as one or the other.
- Expanding the 80% requirement to apply to all terms in a fund's name that suggest an investment focus may constrain active managers and may not have the effect of reducing investor confusion and/or style drift.

Sources: Comment Letters Regarding Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices: Investment Company Institute (Aug. 16, 2022), available here; Mutual Fund Directors Forum (Aug. 16, 2022), available here; CFA Institute (Aug. 16, 2022), available here; Comment Letters Regarding Investment Company Names: Investment Company Institute (Aug. 16, 2022), available here; Mutual Fund Directors Forum (Aug. 16, 2022), available here; CFA Institute (Aug. 22, 2022), available here; SEC Reopens Comment Periods for Several Rulemaking Releases Due to Technological Error in Receiving Certain Comments, SEC Press Release 2022-186 (October 7, 2022), available here; Resubmission of Comments and Reopening of Comment Periods for Several Rulemaking Releases Due to a Technological Error in Receiving Certain Comments, SEC Reopening Release (October 7, 2022), available here.

LATEST DEVELOPMENTS: ENFORCEMENT

SEC Charges Two Advisory Firms for Custody Rule Violations, One for Form ADV Violations, and Six for Both

As a result of targeted sweep exams, on September 9, 2022, the SEC announced charges against nine advisers of private funds regarding two issues: (1) failure to comply with the custody rule relating to the safekeeping of assets; and/or (2) failure to file Form ADV updates to reflect the status of audits of financial statements for the private funds they advised. The advisers all agreed to settle the SEC's charges and pay combined penalties of over $1 million.

Custody Rule Violations

Section 206(4) of the Advisers Act and Rule 206(4)-2(a)(1)-(4) thereunder, commonly referred to as the "custody rule," requires advisers who have custody of client funds and securities to: (1) ensure that a qualified custodian maintains the client assets; (2) provide written notice to clients of accounts opened at a qualified custodian on their behalf; (3) have a reasonable basis for believing that the qualified custodian sends account statements at least quarterly to clients, except if the client is a limited partnership or limited liability company for which the adviser or a related person is a general partner or managing member, the account statements must be sent to each limited partner or member; and (4) ensure that client funds and securities are verified by actual examination each year by an independent public accountant.

However, the custody rule provides an alternative known as the "Audited Financials Alternative" to complying with the requirements of Rule 206(4)-2(a)(2), (3) and (4) for advisers to limited partnerships or other types of pooled investment vehicles as long as specific conditions are met. To rely on the Audited Financials Alternative, advisers must (in relevant part) at least annually distribute to all limited partners the fund's audited financial statements prepared by an independent public accountant in accordance with GAAP within 120 days of a fund's fiscal year end.

The SEC charges were related to advisers that were relying on the Audited Financials Alternative for failing to either have the required audits performed or failing to timely deliver the audited financials to investors.

Form ADV Violations

Section 204(a) of the Advisers Act and Rule 204-1(a) thereunder requires advisers to amend their Form ADVs at least annually, and more frequently as required by the instructions to Form ADV.

Particularly, Form ADV, Part 1A, Schedule D requires an adviser to disclose for private funds: (1) whether the financial statements are subject to an annual audit; (2) if the audits are prepared in accordance with GAAP; (3) the auditing firm and whether the firm is an independent public accountant registered with and subject to the PCAOB; and (4) if the audited financial statements for the most recently completed fiscal year have been distributed to investors.

Further, Schedule D requires an adviser to state whether all of the private fund audit reports contained unqualified audit opinions. The adviser must state "Yes," "No," or "Report Not Yet Received." If the adviser selects "Report Not Yet Received" the adviser must file an amendment to Form ADV to update that response once the report becomes available.

The SEC charges were related to advisers failing to promptly file amended Form ADVs to reflect they had received audited financial statements after having initially reported that they had not yet received the audit reports. In addition, one adviser did not properly describe the status of its financial statement audits when filing its Form ADV, nor did it update its response in its Form ADV annual updating amendment for multiple years, as required.

Sources: SEC Charges Two Advisory Firms for Custody Rule Violations, One for Form ADV Violations, and Six for Both, SEC Press Release 2022-156 (Sept. 9, 2022), available here; In the Matter of Steward Capital Management, Inc., IA Release No. 6111 (Sept. 9, 2022), available here; In the Matter of Titan Fund Management, LLC, IA Release No. 6112 (Sept. 9, 2022), available here; In the Matter of Garrison Investment Group LP, IA Release No. 6113 (Sept. 9, 2022), available here; In the Matter of Janus Henderson Investors US LLC, IA Release No. 6114 (Sept. 9, 2022), available here; In the Matter of Polaris Equity Management, Inc., IA Release No. 6115 (Sept. 9, 2022), available here; In the Matter of QVR, LLC, IA Release No. 6116 (Sept. 9, 2022), available here; In the Matter of Ridgeview Asset Management Partners, LLC, IA Release No. 6117 (Sept. 9, 2022), available here; In the Matter of Lend Academy Investments, LLC, IA Release No. 6118 (Sept. 9, 2022), available here; In the Matter of Biscayne Americas Advisers L.L.C., IA Release No. 6119 (Sept. 9, 2022), available here.

COMPLIANCE DATES FOR FINAL RULES

Final Rule	Compliance Dates
Investment Adviser Marketing	**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.