

## Investment Management Legal and Regulatory Update

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### LATEST DEVELOPMENTS

#### SEC Announces New Chairman and Regulatory Agenda *Chairman Gary Gensler*

On April 17, 2021, Gary Gensler was sworn in as the new Chairman of the SEC. Mr. Gensler was previously the chair of the U.S. Commodity Futures Trading Commission.

Chairman Gensler has publicly identified a number of regulatory priorities in comments to Congress and speeches. In May 2021, Chairman Gensler testified to the U.S. House Appropriations Committee regarding the breadth and scope of the capital markets, including the growth in the number of registered advisers and the need for additional resources at the SEC. The Division of Investment Management (IM Division) has since asked to increase its budget to hire 15 additional full-time employees in fiscal 2022 to monitor markets, assess industry risks and support examinations. The IM Division currently has 221 employees.

Chairman Gensler has stated plans to increase investor protections, particularly with regard to cryptocurrency. He has expressed the need for authority from regulators to oversee crypto investments in the market, stating that he believes that many cryptocurrencies qualify as securities and should fall under the purview of the SEC. Chairman Gensler also announced plans to address the “meme stock” trading surge and payment for order flow (whereby broker-dealers route retail orders in return for payments), as well as environmental, social and governance (ESG) investing by funds and public company disclosures around climate risk.

Chairman Gensler has also indicated the need for updating rules relating to transparency, such as the beneficial ownership reporting rules under Section 13(d) of the Securities Exchange Act and the related reporting deadline. He has also expressed the need for more robust disclosures around security-based swaps, citing the recent defaults by the Archegos Capital Management family office. Separately, the IM Division recently included an item on its regulatory flexibility agenda that the Division is considering recommending that the SEC propose amendments to the family office rule (Rule 203(m)-1) under the Investment Advisers Act, signaling that additional regulation may be forthcoming.

#### **SEC Regulatory Agenda**

On June 11, 2021, the SEC announced an update to its 2021 regulatory agenda, which includes the following rulemaking topics:

- Amendments to the custody rule for advisers
- Amendments to the cross trading rule for funds (Rule 17a-7 under the Investment Company Act)

- Money market fund reform
- ESG-related rules for advisers and funds
- Open-end fund liquidity and dilution management
- Proxy voting advice
- Public company disclosures relating to climate risk, workforce diversity, corporate board diversity and cybersecurity risk
- Market structure modernization within equity markets, treasury markets, and other fixed income markets
- Transparency around stock buybacks, short sale disclosure, securities-based swaps ownership, and the stock loan market
- Unfinished work directed by the Dodd-Frank Act, including rules around securities-based swaps and incentive-based compensation arrangements
- Special purpose acquisition companies (SPACs)

There are 49 items on the new regulatory agenda at various stages (pre-rule, proposed rule and final rule). Given the recent focus on ESG investing by regulators, as discussed below, we expect to see rulemaking in this area for registered funds and advisers in the near term.

*Sources: Gary Gensler Sworn in as Member of the SEC, SEC Press Release 2021-65 (Apr. 17, 2021), available [here](#); SEC Announces Annual Regulatory Agenda (Jun. 11, 2021), available [here](#); CFTC Former Commissioners Chairman Gary Gensler, available [here](#); Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee (May 26, 2021), available [here](#); U.S. SEC chair signals sweeping review of exchange, broker rules (Jun. 9, 2021), available [here](#); Dave Michaels and Alexander Osipovich, SEC to Review Market Structure as Meme Stocks Stir Frenzy, The Wall Street Journal (Jun. 9, 2021), available by subscription; Jesse Pound, SEC Chairman Gary Gensler says more investor protections are needed for bitcoin and crypto markets, CNBC (May 7, 2021), available [here](#); Prepared Remarks at London City Week, Speech (June 23, 2021), available [here](#); Regulatory Flexibility Agenda (Mar. 31, 2021), available [here](#).*

## LATEST DEVELOPMENTS: FUNDS

### SEC Risk Alert on ESG Investing

On April 9, 2021, the SEC's Division of Examinations issued a Risk Alert regarding ESG investing based on recent examinations of advisers and funds offering ESG products. The Division of Examinations staff (Examinations staff) stated that the objective of the Risk Alert is to highlight risk areas, assist firms in advancing and improving ESG-related compliance and provide transparency to the industry regarding the staff's ESG focus during examinations.

The Examinations staff reported on increased investor interest in ESG in recent years and noted firms now offer ESG investment products in various forms, including registered funds, unregistered pooled investment vehicles and separately managed accounts. The Examinations staff noted that advisers approach ESG in various ways, from considering ESG factors alongside many other factors to impact investing (investing with a goal of generating measurable ESG-related benefits). The Examinations staff reported that some advisers analyze ESG factors by applying positive or negative screens while others engage directly with companies to improve specific ESG practices. The Examinations staff noted a lack of standard and precise ESG definitions which create risk and lead to investor confusion.

The Examinations staff reported that for firms engaging in ESG investing, the following areas were and will continue to be examined and noted their observations:

- **Portfolio Management:** The Examinations staff examined policies, procedures and practices related to ESG and ESG terminology, and also due diligence and other processes firms use to analyze their ESG approach and investments. The Examinations staff also reviewed proxy voting decision-making to evaluate if a firm's voting was consistent with their ESG disclosures and marketing materials. The Examinations staff observed:

- Differences in portfolio management practices versus client disclosures in Form ADV Part 2A brochures and other client/investor documents. For example, the staff noted inconsistencies between firms claiming adherence to an ESG framework in their offering materials and their actual investments.
- Weak internal controls with regard to portfolio monitoring of ESG-related directives for a client or fund. As an example, the staff noted that some advisers did not have negative screens in place to exclude investments, and that if screens were in place they were not updated consistently to reflect client directives.
- Inconsistencies in proxy voting between public disclosure of ESG-related proxy voting and internal guidelines. For example, the staff noted that firms were not evaluating ESG-related proxies on a case-by-case basis as disclosed, nor allowing clients to vote on ESG proposals as disclosed.
- **Performance Advertising and Marketing:** The Examinations staff examined regulatory filings, websites, reports to sponsors of global ESG frameworks, marketing materials and other communications to clients. The Examinations staff observed unsupported and potentially misleading claims related to ESG and insufficient internal controls for ensuring ESG marketing was consistent with the firm's practice. For example, the Examinations staff observed a lack of compliance with internal ESG frameworks and documentation of ESG investments despite marketing disclosure stating otherwise and delays in updating marketing materials on a timely basis.
- **Compliance Programs:** The Examinations staff examined written policies and procedures, implementation, oversight and ESG investing practices and disclosures. The Examinations staff observed that firms engaged in significant ESG investing did not have policies or procedures in place to address their internal ESG investment analysis, decision-making, compliance review or oversight. The Examinations staff also observed that compliance programs were less effective when the compliance personnel was not knowledgeable regarding ESG investing.

In the Risk Alert, the staff also included a list of practices for firms to consider with regard to ESG investing:

- Clear and tailored disclosures regarding the firm's ESG approach, including simple and precise disclosures in client materials.
- A statement (if applicable) that ESG factors may be considered as part of an investment process together with many other factors.
- Explanations of how ESG investments are assessed under goals established by global ESG frameworks (as applicable for funds and firms seeking to comply with United Nations or other global ESG-related requirements).
- Implementing detailed, comprehensive ESG policies and procedures that specify the investment process for ESG decision-making for each step in the process.
- Compliance personnel that are knowledgeable regarding ESG and a firm's approach and practices.

To the extent advisers or funds follow an ESG strategy, the SEC guidance set forth above can help guide prospectus disclosure and the implementation of compliance policies and procedures. This area will only continue to evolve, and as noted above, ESG-related rulemaking has been added to the SEC's spring 2021 regulatory agenda.

Sources: Division of Examinations Risk Alert: *The Division of Examinations' Review of ESG Investing (Apr. 9, 2021)*, available [here](#).

## **SEC Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market**

The IM Division staff issued a public statement on May 11, 2021 related to registered open-end mutual funds (mutual funds) investing in the Bitcoin futures market and the associated investment risks. Cash-settled Bitcoin futures traded on an exchange regulated by the CFTC are referred to as "Bitcoin futures." The IM Division staff stated that potential investors interested in investing in mutual funds with exposure to the Bitcoin futures market should consider the fund's

risk disclosure, their own tolerance for risk and the possibility of loss. The IM Division staff stated that investments by mutual funds in the Bitcoin futures market are highly speculative, volatile, lack regulation and have potential exposure to fraud or manipulation in the underlying Bitcoin market. However, the IM Division staff also noted developments in the Bitcoin futures market, such as increased trading volumes, expanded open-interest positions and fewer custody issues than other cryptocurrency-based investments that are not cash-settled.

The IM Division staff reported that, in connection with the Examinations staff, for mutual funds and advisers that invest in Bitcoin futures, they will closely oversee and review compliance with the Investment Company Act and other federal securities laws. The IM Division staff also reported that, in connection with both the Division of Economic and Risk Analysis and Division of Examinations, they will monitor the impact of fund investments in Bitcoin futures on “investor protection, capital formation and the fairness and efficiency of markets.” The statement provides that the IM Division staff expects to:

- Evaluate the liquidity and depth of the Bitcoin futures market and whether or not the investments are appropriate in a mutual fund structure and can meet liquidity requirements;
- Analyze a mutual fund's ability to sell Bitcoin futures positions in order to meet daily redemption demands and assess derivatives risk management including leverage;
- Review valuations for Bitcoin futures and consider the overall market impact on valuations due to mutual funds investing in the Bitcoin futures market, including the potential for market disruptions;
- As part of compliance with Rule 22e-4 (the liquidity rule) assess how mutual funds classify Bitcoin futures, including the basis for the classification and the funds' overall liquidity risk management programs;
- Evaluate possibilities for fraud or manipulation in the underlying Bitcoin markets and its corresponding potential impact on the Bitcoin futures market; and
- Assess whether the Bitcoin futures market could accommodate investments by ETFs.

Source: Staff Statement on Funds Registered Under the Investment Company Act Investing in the Bitcoin Futures Market (May 11, 2021), available [here](#).

## LATEST DEVELOPMENTS: ADVISERS

### DOL to Amend Definition of Fiduciary (Again)

The Department of Labor (DOL) recently updated the DOL's regulatory agenda to indicate that it will be proposing a rule to amend the definition of “fiduciary” to “more appropriately define when persons who render investment advice for a fee to employee benefit plans and IRAs are fiduciaries” under ERISA and the Internal Revenue Code. The definition of fiduciary dates back to 1975 when the DOL adopted its five-part test. See our [March 2021 Investment Management and Employee Benefits Update](#) for a discussion of the test and the DOL's recent re-interpretation of the test in the preamble to Prohibited Transaction Exemption 2020-02 (PTE 2020-02 or PTE).

The DOL will consider changes in the investment marketplace, particularly with regard to adviser compensation that can create conflicts of interest. In conjunction with this rulemaking, the DOL plans to evaluate available prohibited transaction class exemptions and consider proposing amendments or new exemptions.

The DOL's action was expected because in recent FAQs the agency said it was undertaking a review of the PTE and more generally the regulation of fiduciary investment advice. It is anticipated a formal notice of proposed rulemaking will be released in December 2021, to be followed by a formal comment period. Presuming that past is prologue, we anticipate that there will be substantial industry input regarding any further expansion of the definition of what constitutes investment advice under ERISA and the Internal Revenue Code.

In the interim, however, advisers should continue to work on developing policies and procedures regarding rollover recommendations and client communications to be ready to comply with the conditions of PTE 2020-02 by December 20, 2021 as described in our [April 2021 Investment Management Legal and Regulatory Update](#). The DOL believes

that the core components of the PTE, including the impartial conduct standards and the requirement for strong policies and procedures, are fundamental investor protections that should not be delayed while the agency considers additional protections or clarifications.

Advisers should keep in mind that the DOL's non-enforcement position articulated in Field Assistance Bulletin (FAB) 2018-02, which provides advisers with a transition period from February 2021 to December 2021 to comply with the PTE, only binds the DOL and the IRS. Private plaintiffs can potentially seek to bring an action under ERISA against an adviser for alleged non-compliance with the PTE.

*Sources: Definition of the Term "Fiduciary" (Spring 2021), available [here](#); New Fiduciary Advice Exemption: PTE 2020-02 Improving Investment Advice for Workers & Retirees Frequently Asked Questions (April 2021), available [here](#); Mark Schoeff Jr., DOL seeks to define 'fiduciary', SEC works on ESG disclosures, InvestmentNews (Jun. 14, 2021), available [here](#); Ted Godbout, DOL Confirms Fiduciary Rule Rewrite, Other Agency Priorities, ASPPA (Jun. 14, 2021), available [here](#); Joe Morris, DOL: New Fiduciary Rule Coming This Year, IGNITES (Jun. 14, 2021), available by subscription.*

## Communist Chinese Military Companies – Update

On June 3, 2021, President Biden signed an Executive Order (E.O.) to expand prohibitions on investments in Communist China military companies (CCMCs) to also prohibit investments in Chinese defense and surveillance technology firms. The E.O. found that, in addition to addressing the threat imposed by the Chinese defense sector, "the development or use of Chinese surveillance technology to facilitate repression or serious human rights abuse constitute unusual and extraordinary threats...to the national security, foreign policy, and economy of the United States."

The E.O. bans U.S. persons from purchasing or selling certain publicly traded securities, or any publicly traded securities that are derivative of such securities or are designed to provide investment exposure to such securities, of any listed Chinese military industrial complex companies (CMICs).

The E.O. supersedes the orders from former President Trump that initially prohibited investments in companies designated as CCMCs. The E.O. updated the list of prohibited companies to include 59 entities effective on August 2, 2021. U.S. persons have until June 3, 2022 to divest any prohibited holdings.

The Treasury Department's Office of Foreign Asset Control (OFAC) is tasked with the enforcement of the E.O. and has issued guidance, including FAQs, updated as of June 3, 2021 ([available here](#)), to clarify the terms of the E.O. OFAC has continued to supplement the list of CMICs, updated as of June 16, 2021 ([available here](#)), for which trading by U.S. persons is prohibited.

*Sources: FACT SHEET: Executive Order Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China (Jun. 3, 2021), available [here](#); Addressing the Threat From Securities Investments That Finance Certain Companies of the People's Republic of China (Jun. 3, 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 rescission 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)	<p>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.</p> <p>The SEC will rescind Release 10666 and related staff no-action letters and guidance effective August 19, 2022.</p>
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)	<p>The rule became effective on May 4, 2021 and advisers will have until November 4, 2022 to come into compliance.</p> <p>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 current advertising and cash solicitation rules.</p>