GODFREY & KAHN S.C.

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Investment Management Legal and Regulatory Update

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LATEST DEVELOPMENTS: FUNDS

SEC Extends Relief for Virtual Meetings of Fund Boards

The SEC has extended temporary exemptive relief from in-person voting requirements for fund boards through at least December 31, 2020. The Investment Company Act requires that investment advisory agreements, distribution agreements, Rule 12b-1 plans and the selection of an independent registered public accounting firm be approved by the company's board by an in-person vote. As discussed in our April 2020 Update, the SEC initially granted relief from in-person voting requirements in March 2020 as part of broader exemptive orders that provided temporary exemptive relief from several requirements of the Investment Company Act and Advisers Act. The SEC did not extend temporary exemptive relief to any other requirements of the Investment Company Act or Advisers Act.

Sources: SEC Extends Relief for Virtual Meetings of Fund Boards, SEC Press Release 2020-139 (June 19, 2020), available here; Order, SEC Release IC-33897 (June 19, 2020), available here.

SEC Emphasizes Importance of Delivering Timely and Material Information to Fund Investors

The SEC recently issued a statement emphasizing the ongoing importance of delivering updated information to investors in a manner consistent with the disclosure obligations of investment companies. In light of investors' need for high-quality financial information due to uncertainties and market disruptions related to COVID-19, the SEC reminded funds of their obligations to update information in their prospectuses, including required financial information. The SEC also encouraged funds to consider revising risk disclosures in their prospectuses based on events related to COVID-19.

Source: Importance of Delivering Timely and Material Information to Investment Company Investors, Staff Statement (April 14, 2020), available here.

SEC Proposes Rule to Modernize Framework for Fund Valuation Practices

The SEC has proposed a new rule to codify fair valuation requirements for registered investment companies. Proposed Rule 2a-5 under the Investment Company Act would establish requirements for making good faith determinations of fair value and clarify the board's role relating to such determinations. Fair valuation is required where market quotations for a security are not "readily available;" however, when a market quotation is "readily available" is not defined under the statute or current rules.

If adopted, the proposed rule would:

- establish a regulatory framework for fair value determinations;
- define that a market quotation is "readily available" when it is a quoted price (unadjusted) in active markets for identical investments that the

fund can access on the valuation date, provided that the quotation is reliable;

- permit a fund's board to assign the fair value determination to an adviser of the fund, subject to specific reporting by the adviser, clear specification of responsibilities and reasonable segregation of duties among the adviser's personnel; and
- with respect to making fair value determinations, require a periodic assessment of material risks and conflicts of interest that may affect such determinations and the management of such risks and conflicts.

The proposed rule seeks to modernize and formalize the framework for fair valuation determinations in light of current industry practices. The proposed rule would create a risk-based valuation approach focused on process, testing and oversight. Funds and advisers, if fair value duties are assigned, would be required to periodically assess risks, establish and apply appropriate valuation methodologies, test those methodologies and evaluate pricing services, as applicable. The SEC noted that effective oversight of fair valuation by the board "cannot be a passive activity."

The SEC has proposed a one-year transition period. Accordingly, if adopted, the rule would become effective one year following the publication of the final rule in the federal register.

Comments on the SEC's proposal are due on or before July 21, 2020.

Sources: Good Faith Determinations of Fair Value, SEC Release IC-33845 (April 21, 2020), available here; SEC Proposes to Modernize Framework for Fund Valuation Practices, Press Release 2020-93 (April 21, 2020), available here.

SEC Adopts Expedited Exemptive Application Procedures

The SEC has approved amendments to Rule 0-5 under the Investment Company Act and a new rule (17 CFR 202.13) that were previously proposed in October 2019, as discussed in our January 2020 Update. The amendments establish an expedited review procedure for exemptive applications seeking relief under the Investment Company Act that are substantially identical to recent precedent. The rule also establishes a timeframe for SEC review of applications that would not qualify for the new expedited review procedure. The SEC intends to grant relief as quickly and efficiently as possible while ensuring that applications are reviewed carefully and in a manner consistent with statutory standards.

Expedited Review Procedure for Routine Applications. Expedited review will be available to applications substantially identical to two previous applications for which an order granting relief was issued within three years of the application's initial filing. Notice for an application filed under expedited review will be issued no later than 45 days from the filing date unless the application is found ineligible for expedited review or the SEC needs additional time to review. If the applicant does not respond to comments from the SEC within 30 days, the application for expedited review will be deemed withdrawn.

Procedures for Other Applications. The new rule establishes non-binding guidelines for the SEC to take action on applications outside of the expedited review process within 90 days of the initial filing and each of the first three amendments thereto, and within 60 days of any subsequent amendment to the application. Applications outside of the expedited review process will be deemed withdrawn if the applicant does not respond to comments from the SEC within 120 days.

The new procedures will be effective 270 days following their publication in the federal register.

Sources: SEC Adopts Amendments to Exemptive Applications Procedures, Press Release 2020-150 (July 6, 2020), available here; Amendments to Procedures With Respect to Applications Under the Investment Company Act of 1940, SEC Release IC-33921 (July 6, 2020), available here.

LATEST DEVELOPMENTS: ADVISERS

OCIE Issues Risk Alert Regarding Examination Initiative: LIBOR Transition Preparedness

On June 18, 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert stating OCIE's intention to conduct examinations of advisers, broker-dealers, investment companies and others to assess their preparations for the anticipated discontinuation of the London Interbank Offered Rate (LIBOR) and the transition to an alternative reference rate. LIBOR is currently used in the United States and globally as a benchmark or reference rate for various commercial and financial contracts, such as corporate and municipal bonds and loans, floating rate mortgages, asset-backed securities, consumer loans, interest rate swaps and other derivatives.

When conducting examinations, OCIE will review whether and how registrants have evaluated the potential impact of the LIBOR transition on their business activities, operations, services, and clients and/or investors. For example, OCIE intends to review registrants' plans and any steps taken to prepare for the discontinuation of LIBOR, including:

- The registrant's operational readiness, including any enhancements or modifications to systems, controls, processes, and risk or valuation models associated with the transition to an alternative reference rate;
- The registrant's disclosures, representations, and/or reporting to investors regarding its efforts to address the discontinuation of LIBOR and the adoption of an alternative reference rate; and
- Identifying and addressing any potential conflicts of interest associated with the discontinuation of LIBOR and the adoption of an alternative reference rate.

The Risk Alert provides a non-exhaustive sample list of requests for information that OCIE may use in conducting examinations of registrants regarding their preparations for the discontinuation of LIBOR.

Although the Risk Alert states that the discontinuation of LIBOR is expected to occur after 2021, OCIE has yet to provide a timeframe for when a transition should be completed nor has OCIE specified a preferred alternative reference rate to replace LIBOR.

Source: OCIE Risk Alert: Examination Initiative: LIBOR Transition Preparedness (June 18, 2020), available here.

OCIE Issues Risk Alert Regarding Private Fund Advisers

OCIE recently issued a Risk Alert that provides an overview of compliance issues it observed in examinations of advisers that manage private equity funds or hedge funds (private fund advisers), noting three general areas of deficiencies: conflicts of interest; fees and expenses; and policies and procedures relating to material non-public information.

Conflicts of Interest. OCIE observed the following conflicts of interest that appeared to be inadequately disclosed, among others:

- *Conflicts related to allocation of investments.* Private fund advisers preferentially allocated limited investment opportunities to new clients, higher fee-paying clients or proprietary accounts or allocated securities at different prices or in inequitable amounts among clients without providing adequate disclosure or in a manner inconsistent with their disclosure.
- *Conflicts related to multiple clients investing in the same portfolio company.* Private fund advisers failed to provide adequate disclosure about conflicts created by clients who invest at different levels of a capital structure, such as one client owning debt and another owning equity in a single portfolio company.
- *Conflicts related to financial relationships between investors and the private fund adviser.* Private fund advisers did not provide adequate disclosure about economic relationships between themselves and certain investors, such as seed investors or investors with economic interests in the adviser.

- *Conflicts related to preferential liquidity rights.* Private fund advisers entered into undisclosed side letters with certain investors that established special terms, such as preferential liquidity terms.
- *Conflicts related to private fund adviser interest in recommended investments.* Private fund advisers had undisclosed preexisting ownership interests or other financial interests, such as referral fees or stock options, in investments recommended to investors.
- *Conflicts related to service providers.* Private fund advisers with financial incentives for portfolio companies to use certain service providers, such as incentive payments from discount programs, failed to adequately disclose those incentives and conflicts.
- *Conflicts related to cross-transactions.* Private fund advisers established the price at which securities would be transferred between client accounts in a manner that disadvantaged either the selling or purchasing client without providing adequate disclosure.

Fees and Expenses. OCIE observed the following fees and expenses issues, among others:

- *Allocation of fees and expenses.* Private fund advisers allocated shared expenses among the adviser and its clients, including private fund clients, employee funds and coinvestment vehicles, in a manner inconsistent with disclosures or policies and procedures. Private fund advisers also charged private fund clients for expenses not permitted under the fund's operating agreement and failed to comply with contractual limits on expenses, thereby causing investors to overpay. Additionally, private fund advisers failed to follow their own travel and entertainment expense policies.
- *Operating partners.* Private fund advisers failed to provide adequate disclosure regarding the compensation and role of individuals that provide services to the private fund or portfolio companies, but who are not employees of the private fund adviser.
- *Valuation.* Private fund advisers did not value client assets in accordance with their valuation processes or client disclosures.
- *Fees and fee offsets.* Private fund advisers incorrectly allocated portfolio company fees across fund clients, including private fund clients not required to pay management fees. Private fund advisers failed to offset portfolio company fees paid to an affiliate of the adviser that were required to be offset against management fees.

Policies and Procedures Relating to Material Non-Public Information (MNPI). OCIE observed the following issues, among others:

- *MNPI*. Private fund advisers failed to address risks posed by their employees interacting with insiders of publicly-traded companies, outside consultants or value added investors (e.g., corporate executives or financial professional investors with information about investments) for purposes of assessing whether MNPI could have been exchanged. Private fund advisers failed to address risks posed by employees who could obtain MNPI by virtue of their access to the adviser's or its affiliates' office spaces or systems.
- *Code of Ethics*. Private fund advisers failed to enforce trading restrictions on securities placed on the adviser's "restricted list." Private fund advisers maintained codes of ethics that provided for the use of restricted lists but failed to define policies and procedures for adding or removing securities from such lists. Private fund advisers also failed to enforce requirements in their codes of ethics regarding the receipt of gifts and entertainment from third parties to employees. Lastly, private fund advisers failed to correctly identify access persons, require access persons to submit timely transactions and holdings reports or require personal securities transactions to be submitted for preclearance.

Source: OCIE Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), available here.

SEC Proposes Amendments to Reporting Threshold on Form 13F

The SEC has proposed to increase the reporting threshold for institutional investment managers filing on Form 13F from $100 million to $3.5 billion to reflect the growth in the U.S. equities market since the form was adopted in 1975. The proposal would also amend certain information provided in Form 13F.

Institutional investment managers are currently required to file quarterly reports with the SEC if the accounts over which they exercise investment discretion hold an aggregate of more than $100 million in equity securities known as "13(f) securities." The information reported on Form 13F becomes publicly available upon filing unless the SEC has granted confidential treatment to the filing.

The proposing release notes that today, 5,089 managers that exceed the $100 million threshold file Form 13F holding reports, which is approximately 17 times the number of filers covered in 1975. The release states that the SEC believes that "increasing the reporting threshold would provide meaningful regulatory relief for smaller managers that manage less than $3.5 billion in 13(f) assets and would no longer have to file the form in terms of a reduction in direct compliance costs and indirect costs." The SEC cited the potential for front-running and copycatting of investment strategies as indirect costs of Form 13F filings.

The release also notes that raising the reporting threshold to $3.5 billion "would retain disclosure of 90.8 percent of the dollar value of the Form 13F holdings data currently reported while relieving the reporting burdens from approximately 4,500 Form 13F filers, or approximately 89.2 percent of all current filers."

Comments are due 60 days after publication in the federal register.

Source: Reporting Threshold for Institutional Investment Managers, SEC Release No. No. 34-89290 (July 10, 2020), available here.

DOL Reinstates Five-Part Test, Proposes New Exemption for Investment Advice Fiduciaries and Addresses Rollovers

Two years after the Department of Labor's (DOL) fiduciary rule was vacated, the DOL officially reinstated its five-part test to determine whether a person is an investment advice fiduciary and has proposed a prohibited class exemption to allow investment advice fiduciaries to receive compensation for providing fiduciary investment advice, including advice regarding rollovers, and to engage in certain principal transactions. If adopted, the proposal will expand the scope of what constitutes fiduciary investment advice to generally include rollovers and other non-discretionary advice to IRA owners and provide exemptive relief from prohibited transactions that is essentially a less onerous version of 2016's best interest contract exemption.

Five-Part Test and Rollovers

A person with non-discretionary authority is an investment advice fiduciary under ERISA or the Internal Revenue Code (Code) if they receive a fee or other compensation and give advice: (1) as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property; (2) on a regular basis; (3) pursuant to a mutual agreement, arrangement or understanding with the plan, plan fiduciary or IRA owner; (4) that will serve as a primary basis for investment decisions with respect to plan or IRA assets; and (5) that will be individualized based on the particular needs of the plan or IRA. All prongs of the five-part test must be satisfied.

The DOL previously issued an advisory opinion in 2005 that generally provided that a person with no prior relationship to an ERISA plan would not become a fiduciary by reason of providing a rollover recommendation to a participant. The DOL had opined that a rollover recommendation would not meet the first prong of the five-part test. In the preamble to the proposed exemption, the DOL stated that it does not intend to apply the analysis in the advisory opinion and believes that a recommendation to roll assets out of a plan is advice with respect to moneys or other property, thus satisfying the first prong. A rollover recommendation would still need to satisfy the other prongs to be considered fiduciary investment advice, including the regular basis prong. However, the DOL makes clear that the regular basis prong may be satisfied by rollover advice as part of an ongoing relationship or an anticipated ongoing relationship (i.e., the rollover recommendation may be the first step or beginning of an advice relationship).

Proposed Exemption

The proposed exemption would provide relief from the restrictions of ERISA and the Code for the receipt of prohibited compensation (such as commissions, sales loads, 12b-1 fees, revenue sharing and other payments from third parties) in connection with providing non-discretionary investment advice. It would be available to financial institutions (including advisers and broker-dealers) to exempt prohibited transactions that arise by reason of the payment of otherwise prohibited compensation in connection with the recommendation of any investment product, including proprietary products, and fiduciary rollover recommendations.

If an adviser is an investment advice fiduciary that charges only an assets under management fee, the adviser may not violate the prohibited transaction rules. However, if the adviser provides investment advice that causes it to receive the fee, such as through advice to roll over plan assets to an IRA, the fee (including an ongoing management fee paid with respect to the IRA) is prohibited under ERISA and the Code, absent an exemption. The proposed exemption would provide relief for this prohibited transaction if the adviser provides investment advice that satisfies the "Impartial Conduct Standards" (described below) and complies with the other applicable conditions discussed below.

Conditions of the Exemption. The proposed exemption would condition relief on:

- *Impartial Conduct Standards*. A financial institution and its investment professionals would be required to provide advice in accordance with the following Impartial Conduct Standards:
  - Provide advice that is in a retirement investor's best interest (the DOL indicates that the standard is to be interpreted and applied consistent with Regulation Best Interest for broker-dealers and the SEC's fiduciary duty interpretation for advisers);
  - Charge only reasonable compensation;
  - Make no materially misleading statements; and
  - Seek best execution.
- *Written Disclosure.* A financial institution would be required to provide a written disclosure:
  - acknowledging that it and its investment professionals are fiduciaries under ERISA and the Code, as applicable; and
  - describing the services to be provided and material conflicts of interest.
- *Policies and Procedures.* A financial institution would be required to adopt policies and procedures designed to ensure compliance with the Impartial Conduct Standards and mitigate conflicts of interest.
- *Retrospective Review.* A financial institution would be required to conduct an annual compliance review that would be provided to regulators upon request.
- *Documentation of Rollovers.* A financial institution would be required to document the specific reasons that any of the following recommendations are in the best interest of the retirement investors, specifically recommendations to roll over assets from: a plan to another plan or IRA; an IRA to a plan; an IRA to another IRA; or one type of account to another (e.g., from a commission-based account to a fee-based account).
  - *Plan to IRA.* A recommendation to roll over from a plan to an IRA would necessarily include consideration and documentation of the following:

- the retirement investor's alternatives to a rollover, including leaving the money in his or her current employer's plan, if permitted, and selecting different investment options;
- the fees and expenses associated with both the plan and the IRA;
- whether the employer pays for some or all of the plan's administrative expenses; and
- the different levels of services and investments available under the plan and the IRA.

- *IRA to IRA; Change in Account Type.* For rollovers from another IRA or changes from a commission-based account to a fee-based account, a recommendation would include consideration and documentation of the services that would be provided under the new arrangement.

There is only a 30-day comment period on the proposal and comments are due August 6, 2020. Lawmakers and consumer and investor advocates have written to the DOL requesting an extension of the comment period from 30 days to 90 days.

Sources: Improving Investment Advice for Workers & Retirees (July 7, 2020), available here; Beagan Wilcox Volz, We Need 60 More Days to Parse Fiduciary Rule Redux: Groups, IGNITES (July 10, 2020), available by subscription; Melanie Waddell, Short DOL Fiduciary Rule Comment Period Faces Criticism, ThinkAdvisor (July 8, 2020), available here.