Simpson Thacher

Registered Funds Regulatory Update

April 7, 2023

Table of Contents

SEC Rulemaking

SEC Proposes Enhanced Safeguarding Rule for Registered Investment Advisers

In a 4-1 vote on February 15, 2023, the SEC proposed amendments to existing Rule 206(4)-2, the so-called "Custody Rule," under the Advisers Act. The proposal, if adopted, would redesignate the Custody Rule as new Rule 223-1 and rename it the "Safeguarding Rule." The SEC's proposal seeks to modernize certain aspects of the existing Custody Rule and enhance investor protection relating to advisory client assets over which registered investment advisers have custody. The SEC proposed a staggered implementation timeline, with a 12-month compliance period for large advisers and 18 months for smaller advisers.

Summary of the Proposal

Qualified Custodian Agreements and Assurances. The proposal would require advisers to enter into new written agreements with each client's "Qualified Custodian" and obtain several written assurances from that Qualified Custodian. Among these are an assurance that the Qualified Custodian will indemnify the client against losses resulting from the Qualified Custodian's negligence, recklessness or willful misconduct and that the existence of any sub-custodial or similar arrangement will not excuse any of the Qualified Custodian's obligations to the client. The Qualified Custodian also would need to assure the adviser that it will exercise due care, in accordance with reasonable commercial standards, in discharging its duty as custodian and will segregate client assets from the Qualified Custodian's proprietary assets and liabilities. The SEC acknowledged that these requirements are a substantial departure from current practice.

New Conditions to a Key Exception for Private Securities. The proposal would continue to except certain privately offered securities from the requirement they be held with a Qualified Custodian; however, the proposal would add two significant new requirements to rely on the exception:

1. First, the adviser must reasonably determine, and document in writing, that such securities cannot be recorded and maintained by a Qualified Custodian. This would be a significant departure from the current exemption. The SEC release acknowledges that an adviser's reasonableness determination necessarily depends on the facts and circumstances at issue, including an analysis of the security and the available custodial market for the security. However, the release does not clarify how impracticable it must be for the Qualified Custodian to maintain the asset.
2. Second, the proposal would require that an independent public accountant verify promptly any purchase, sale, or other transfer of any privately offered securities relying on the exception.

All Assets Coverage. The proposed rule would apply to all assets in a client's account, while the current Custody Rule only applies to "funds and securities." As statements from several SEC Commissioners made clear, this aspect of the proposed rule was intended to cover investments in crypto assets (although it also would apply to other assets that are not securities, such as real estate).

New Requirement on Qualified Custodians. The proposal would require Qualified Custodians to have possession or control of assets in order to be viewed as "maintaining" the assets for purposes of meeting the Safeguarding Rule requirements. One challenge with this requirement is how and whether the adviser, which is the only party subject to Rule 223-1, can determine whether the Qualified Custodian has such possession and control.

Broadened Advisory Activities. The proposal would broaden the types of advisory activities that could be deemed to confer custody to an adviser. These new circumstances include the authority to engage in discretionary trading without the ability to otherwise direct assets out of an account.

Implications

There is widespread consensus that safeguarding client assets is vitally important, and at the heart of the SEC's responsibility for investor protection. As proposed, the amendments would only apply to investment advisers subject to the Advisers Act but not to registered funds or business development companies. Nonetheless, the release may be indicative of the SEC's broader thoughts on issues that would otherwise impact the protection of advisory clients' assets.

Comments on the proposals are due 60 days after the release is published in the Federal Register.

Safeguarding Advisory Client Assets, SEC Release No. IA-6240 (Feb. 15, 2023), available at: https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

SEC Proposes Amendments to Regulation S-P to Further Safeguard Customer Information

The SEC voted to propose amendments to Regulation S-P that would require broker-dealers, investment companies (including BDCs), RIAs, and transfer agents ("Covered Institutions") to provide notice to individuals whose personal information may have been compromised by a data breach. Currently, Regulation S-P requires Covered Institutions to implement certain policies and procedures involving the protection and disposal of customer information. If adopted, the March 15, 2023 proposal would broaden these policies to cover not only personal information of Covered Institutions' own customers but also personal information received about customers of other institutions. The proposed amendments would also require Covered Institutions to implement written policies and procedures to address a data breach and notify individuals who were or are reasonably likely to have been affected by a data breach. Individuals would have to be notified as soon as practicable but no later than thirty days after a Covered Institution becomes aware of any incident involving unauthorized access to customers' personal information. Among other things, the proposal:

- creates a federal minimum standard regarding Covered Institutions' practices for preventing and responding to data breaches. The minimum notification standard proposed by Reg. S-P would require a Covered Institution to provide notice, within 30 days of learning of a breach, to individuals whose sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization. If the Reg. S-P amendments do not preempt, or override, state laws, Covered Institutions could face challenges when state and Reg. S-P customer notification requirements do not align, resulting in duplicative notifications that, instead of providing a stronger warning to affected customers, could reduce the impact of receiving notification;
- includes requirements related to service providers. The proposed amendments would mandate that Covered Institutions' contracts with service providers include measures designed to protect against unauthorized access to or use of Covered Institutions' customer information; and
- implements an exception to the annual notice delivery requirements in certain circumstances, provided by legislative action in 2015, provided that the Covered Institution only shares non-public information with unaffiliated third parties in certain limited circumstances and has not changed its policies and practices with regard to disclosing non-public personal information in the past year.

Through this proposal, the SEC intends to update Regulation S-P to address the risks associated with technology advancements since its original adoption in 2000. The proposed amendments will heighten Covered Institutions' requirements to protect and notify customers of any unauthorized use of their personal information, and Covered Institutions may need to prepare for any increased costs associated with incident response and notification.

The proposed amendments are subject to comment for 60 days after publication in the Federal Registrar. The proposed compliance date is 12 months from adoption.

Regulation S-P: Privacy of Consumer Financial Information and Safeguarding Customer Information, SEC Release Nos. 34-97141; IA-6262; IC-34854 (March 15, 2023), available at https://www.sec.gov/rules/proposed/2023/34-97141.pdf.

SEC Shortens Standard Settlement Cycle to T+1

On February 15, 2023, the SEC adopted changes to Rule 15c6-1 under the Exchange Act in an effort to decrease risk, latency and inefficiency in the market. These changes were proposed following the highly turbulent market conditions of early 2021, which were largely driven by a social media-based trading frenzy. During this period of intense volatility, retail flows tied to the T+2 settlement cycle overwhelmed broker-dealers, leading to shut-offs in trading.

The adopted amendments to Rule 15c6-1 shorten the standard settlement cycle. Securities currently must settle within two business days after the trade date – the changes to Rule 15c6-1 will shorten the standard settlement cycle to one business day, while clarifying that parties can still opt out of T+1 settlement if both the buyer and the seller agree. Similarly, firm commitment offerings that price after 4:30 p.m. ET will now have a settlement cycle of two days instead of four days. These amendments are expected to increase the responsiveness and resilience for market participants generally. Furthermore, the adoption of new Rule 15c-2 requires broker-dealers to maintain robust recordkeeping practices and encourages the completion of allocations, confirmations, and affirmations by no later than the end of each trade date, with the aim of improving institutional trade processing.

In adopting Rule 15c6-2, the SEC seeks to incentivize the timely completion of institutional trades as soon as technologically feasible, and by end of the applicable trade date at the very latest. Furthermore, in connection with transaction processes that include allocations, confirmations, and affirmations, Rule 15c6-2 requires broker-dealers to (i) enter into written agreements that are in compliance with the market participant's policies and procedures and clearly discuss potential issues regarding timing, or (ii) establish, maintain, and enforce robustly developed policies and procedures that address potential obstacles to same-day affirmation.

The historic market failures of early 2021 have also given rise to other SEC rule proposals regarding clearinghouse reform and decreasing payment for order flow, among others. The compliance date of the amended rule is May 28, 2024.

Shortening the Securities Transaction Settlement Cycle, SEC Release Nos. 34-96930, IA-6239; File No. S7-05-22, available at: https://www.sec.gov/rules/final/2023/34-96930.pdf.

SEC Enforcement

Bloomberg Finance Fined $5M for Misleading Valuation Disclosures

Bloomberg Finance L.P. recently agreed to settle charges from the SEC that it omitted material information as to how BVAL, Bloomberg's paid subscription pricing service, calculated valuations for certain fixed income securities. The SEC order found that, from at least 2016 through October 2022, Bloomberg failed to disclose that valuations for certain thinly-traded and hard-to-price fixed income securities could be based on a single data input, such as a broker quote, rather than calculated using previously disclosed proprietary algorithmic methodologies. According to the SEC, Bloomberg knew that BVAL clients, including mutual funds, private funds and other financial services entities, utilized BVAL's prices to value bonds and securitized products, including for determining NAV calculations and for purposes of computing prices for which shares were offered, sold or redeemed from investors. Although there was no evidence that BVAL's prices were erroneous or not reflective of market value, the SEC asserted that the fact that Bloomberg delivered valuations contrary to its disclosed methodologies made the statements materially misleading in violation of the Securities Act.

Without admitting or denying the findings, Bloomberg agreed to pay a civil monetary penalty of $5 million and cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) of the Securities Act. The SEC noted that Bloomberg took steps to resolve the issue in a timely manner, hired an outside expert and provided additional disclosure to BVAL customers about its pricing calculations, including details regarding its use of single broker quotes.

In the Matter of Bloomberg Finance L.P., SEC Admin. Proc. File No. 3-21284 (Jan. 23, 2023), available at: https://www.sec.gov/litigation/admin/2023/33-11150.pdf.

SEC Staff Guidance

SEC Staff Issues Reminder Regarding Differential Advisory Fees

In a February 2, 2023 Staff Bulletin, the Staff of the Division of Investment Management reminded investment companies and their boards to consider the operation of fee waivers and expense reimbursement arrangements that result in different advisory fees being charged to different share classes of the same fund. The Staff noted that such differential advisory fee waivers could result in cross-subsidization between share classes in violation of Section 18 of the Investment Company Act and Rule 18f-3 thereunder. As a general matter, Rule 18f-3 provides a limited exemption from Section 18 to permit an open-end fund to issue multiple classes of voting stock as long as the fund's board approves a written plan setting forth the separate arrangement and expense allocation of each class based on a finding that the plan is in the best interests of each class individually and of the fund as a whole. Many open-end funds and closed-end funds operate as multi-class funds in reliance on Rule 18f-3 or pursuant to exemptive relief requiring the fund to comply with Rule 18f-3, respectively.

In the Bulletin, the Staff reminded boards of their independent fiduciary obligations to each share class and stated that advisory fees should generally be the same percentage amount across share classes because shareholders receive the same advisory services regardless of the class they invested. Rule 18f-3 expressly allows expenses to be waived or reimbursed, though in Rule 18f-3's Adopting Release, the SEC noted that waivers and reimbursements should not become "de facto modifications of the fees provided for in advisory or other contracts so as to provide a means for cross-subsidization between classes." The Bulletin indicates these fee modifications are permitted on the limited premise that fund sponsors could have achieved the same result indirectly by waiving or reimbursing class expenses (as opposed to advisory fees). According to the Staff, differential advisory fee waivers that are long-term or permanent, without a clearly substantiated purpose, could present a means for cross-subsidization.

While acknowledging that a board's determination regarding a differential advisory fee waiver will depend on the facts and circumstances, the Staff suggested that the fund's investment adviser and counsel should help the board to document and consider all relevant factors before making its determination. Specifically, a board may wish to consider whether existing differential fee waivers risk cross-subsidization between classes, such waivers continue to be effective, and alternative fee arrangements would be appropriate. Further, the Staff recommended funds consider the extent to which these considerations and the board's determination should be disclosed in the shareholder report as part of the discussion of the board's approval of the fund's investment advisory contract.

*Differential Advisory Fee Waiver*s, Division of Investment Management Staff Bulletin: (Feb. 2, 2023), available at: https://www.sec.gov/investment/differential-advisory-fee-waivers.

SEC Issues Regulation Best Interest Risk Alert

The SEC issued a Risk Alert highlighting a series of deficiencies it has observed in its initial examinations conducted since Reg BI's June 2020 compliance date. The Risk Alert is intended to assist broker-dealers in enhancing their compliance programs, as the SEC intends to include compliance with Reg BI into its retail-focused examinations of broker-dealers going forward.

When making recommendations of securities transactions or investment strategies to a retail customer, Reg BI provides that a broker-dealer must act in the customer's best interest at the time the recommendation is made and not place its own interests ahead of its customer. In particular, Reg BI requires that a broker-dealer comply with four core obligations:

Disclosure Obligation: requires certain disclosure about the recommendation and the relationship between the customer and the broker-dealer before or at the time the recommendation is made.

Care Obligation: requires the exercise of reasonable diligence, care, and skill to understand potential risks, rewards, and costs associated with a recommendation as well as having a reasonable basis for believing that a recommendation is in the customer's best interest.

Conflict of Interest Obligation: requires that written policies and procedures designed to identify and address conflicts of interest are established, maintained, and enforced.

Compliance Obligation: requires that written policies and procedures reasonably designed to achieve compliance with Reg BI and its various obligations are established, maintained, and enforced.

Compliance Obligation Deficiencies

With respect to policies and procedures intended to comply with the Disclosure Obligation, the Staff noted that examples of deficiencies included: not specifying when disclosures must be made or updated or how such disclosures will be delivered to customers; not identifying the parties responsible for disclosures; and not having processes in place to track the delivery of disclosures to customers.

The Staff also found certain policies and procedures to be inadequate to ensure compliance with the Care Obligation. Observed deficiencies included: directing financial professionals to consider costs and reasonably available alternatives without providing guidance as to how to do so; allowing but not mandating financial professionals to evaluate costs or reasonably available alternatives; and directing financial professionals to document the basis for their recommendations without instructing them as to when documentation is required or the type of information to be documented.

Compliance programs may include training programs and periodic reviews and testing. Examples of weaknesses in such compliance programs included: relying on monitoring systems put in place prior to the adoption of Reg BI without considering whether updates were required and/or relying on systems that captured only executed transactions; maintaining documentation locally rather than at central locations to facilitate firm-wide reviews; and conducting trainings on Reg BI without discussing the firm's specific processes for compliance.

In addition to the above, the Staff observed several instances of generic policies and procedures that were not tailored to the broker-dealer's firm or were merely restatements of Reg BI's requirements.

Conflict of Interest Obligation

The Staff found that broker-dealers did not always have written policies and procedures reasonably designed to address how conflicts of interest are to be identified or mitigated. Observed deficiencies included: not identifying the parties responsible for identifying and addressing conflicts; not reflecting all types of conflicts that may be associated with recommendations made by the broker-dealer firm; and improperly relying on disclosure as a mitigating act, instead of establishing policies and procedures that would "modify practices to reasonably reduce" conflicts of interest.

Disclosure Obligation

Deficiencies observed that relate to the Disclosure Obligation included: providing only references to Reg BI disclosures, and not the disclosures themselves, on websites or in documents delivered to customers and not adequately disclosing the capacity in which financial professionals may act in multiple roles or disclosing additional conflicts of interests that may arise as a result of the multiple relationships.

Observations from Broker-Dealer Examinations Related to Regulation Best Interest, SEC Risk Alert (Jan. 30, 2023), available at: https://www.sec.gov/file/exams-reg-bi-alert-13023.pdf.

Industry Developments

Trade Associations Submit Joint Letter to SEC Regarding Electronic Communications

On January 31, 2023, SIFMA, SIFMA's Asset Management Group, the Managed Fund Association, the U.S. Chamber of Commerce, the American Securities Association, the National Venture Capital Association, the American Investment Council, the Investment Company Institute, the Small Business Investor Alliance, and the Association for Corporate Growth submitted a joint comment letter to the SEC addressing the scope of the recordkeeping provisions of the Advisers Act and their application to text messaging and other electronic communications. The commenters submitted the letter in response to a recent sweep by the Division of Enforcement seeking to examine the personal phones of several investment adviser employees for off-channel business communications.

The comment letter identifies the different statutory treatment of business communications of broker dealers and of registered investment advisers, noting that the books and records rule under the Advisers Act governing written communications only requires investment advisers to maintain four narrowly enumerated categories of written communications, whereas the Exchange Act requires broker-dealers to retain all communications "relating to its business as such." Accordingly, the commenters asserted that the SEC's demand to review all business communications of certain investment adviser employees exceeds the regulatory framework governing investment advisers. In addition, the commenters noted that the examination of personal phones is extremely invasive and unnecessary and inappropriate in the context of the enumerated categories of records that investment advisers are required to retain.

The commenters also note that many investment advisers adopt compliance policies and procedures covering employee communications that are broader than the strict regulatory requirements for a number of reasons not related to the securities laws. The commenters point out that the treatment of an employee violation of these broad policies as a violation of the Advisers Act compliance rule could have unintended policy consequences. For instance, advisers could determine to narrow the scope of their compliance policies and procedures to avoid a potential foot fault being treated as a rule violation or imposing subjective determinations on employees that are not equipped to determine whether a particular communication should be retained.

The commenters generally asserted that the SEC's demand to review personal devices of certain investment advisor employees amounts to regulation by enforcement, and to the extent the SEC wishes to change its application of the Advisers Act recordkeeping requirements, it should provide applicable written guidance after input from industry participants.

Investment Adviser Recordkeeping Requirements, SEC Comment Letter (Jan. 31, 2023), available at: https://www.sifma.org/wp-content/uploads/2023/02/Investment-Adviser-Recordkeeping-Requirements.pdf.

SEC Division of Examinations Announces 2023 Examination Priorities

The SEC's Division of Examinations announced the following six enumerated priorities for 2023: (i) compliance with new investment adviser and investment company rules; (ii) RIAs to private funds; (iii) ESG; (iv) standards of conduct for broker-dealers and RIAs; (v) information security and operational resiliency; and (vi) crypto-assets and emerging financial technology. The following sets forth an overview of the Division's 2023 examination priorities:

Compliance with New Investment Adviser and Investment Company Rules.

Advisers Act Rule 206(4)-1 (Marketing Rule). The Division will assess whether RIAs have adopted and implemented written policies and procedures that are reasonably designed to prevent violations by advisers and their supervised persons of the Marketing Rule. The Division will also review whether RIAs have complied with the substantive requirements of the Marketing Rule, including the requirement that RIAs have a reasonable basis for believing they will be able to substantiate material statements of fact and requirements for performance advertising, testimonials, endorsements, and third-party ratings.

Investment Company Act Rule 18f-4 (Derivatives Rule). For funds relying on the Derivatives Rule, the Division will, among other things: (i) assess whether funds have adopted and implemented policies and procedures reasonably designed to manage the funds' derivatives risks and to prevent violations of the Derivatives Rule, and (ii) review for compliance with Rule 18f-4, including the adoption and implementation of a derivatives risk management program, board oversight, and whether disclosures concerning the fund's use of derivatives are incomplete, inaccurate, or potentially misleading.

Investment Company Act Rule 2a-5 (Fair Valuation). The Division will: (i) assess funds' and fund boards' compliance with the new requirements for determining fair value, implementing board oversight duties, setting recordkeeping and reporting requirements, and permitting fund boards to designate valuation designees to perform fair value determinations subject to oversight by the board, and (ii) review whether adjustments have been made to valuation methodologies, compliance policies and procedures, governance practices, service provider oversight, and/or reporting and recordkeeping.

RIAs to Private Funds. The Division will continue to focus on fiduciary duties and will assess risks, including a focus on compliance programs, fees and expenses, custody, the new Marketing Rule, conflicts of interest, and the use of alternative data (i.e., data derived from beyond traditional financial statements, company filings, and press releases). The Division will also review private fund advisers' portfolio strategies, risk management, and investment recommendations and allocations as well as disclosure relating to each of those areas. Additionally, the Division will focus on RIAs to private funds with specific risk characteristics, including: (i) highly leveraged private funds; (ii) private funds managed side-by-side with BDCs; (iii) private equity funds that use affiliated companies and advisory personnel to provide services to their fund clients and underlying portfolio companies; (iv) private funds that hold certain hard-to-value investments, such as crypto assets and real estate-related investments, with an emphasis on commercial real estate; (v) private funds that invest in SPACs; and (vi) private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds.

Standards of Conduct: Regulation Best Interest, Fiduciary Duty and Form CRS. The Division will continue to focus on standards of conduct for broker-dealers and advisers, specifically related to compliance with Regulation Best Interest and the fiduciary standards of the Advisers Act to "ensure that retail investors and working families are receiving recommendations and advice in their best interests." The Division's examinations will assess practices regarding review of investment alternatives, management of conflicts of interest, and consideration of investment goals and account characteristics. The Division notes the following areas of assessment for its examinations:

- investment advice and recommendations with regard to products, investment strategies, and account types;
- disclosure made to investors and whether such disclosures include all material facts relating to the conflicts of interest associated with the advice and recommendations;
- processes for making best interest evaluations, including those for reviewing reasonably available alternatives, evaluating costs and risks, and identifying and addressing conflicts of interest; and
- factors considered in light of the investor's investment profile, including investment goals and account characteristics.

In the case of RIAs, the Division will review whether conflicts of interest disclosure is sufficient such that a client can provide informed consent to the conflict, whether express or implied. For both broker-dealers and RIAs, the Division will seek to identify and understand the economic incentives (e.g., revenue sharing arrangements, commissions, or use of affiliate service providers) that a firm and its financial professionals have to recommend products, services, or account types. Examinations will review how firms are managing conflicts of interest, including mitigating or eliminating the conflicts of interest, when appropriate, and whether client agreements contain hedge clauses or other language that purport to limit the firm's standard of conduct. Furthermore, the Division will review whether a firm has established written policies and procedures to identify such conflicts of interest and periodically reviewed and updated their policies and procedures, as appropriate.

Additionally, the Division will use its examinations of RIAs and broker-dealers to ensure compliance with Form CRS, which requires that firms (i) deliver their relationship summaries to new and prospective retail investors, as well as to existing retail investors; (ii) file their relationship summary with the SEC; and (iii) post the current relationship summary on the firm's public website, if the firm has one.

ESG Investing. The Division will continue its focus on ESG-related advisory services and fund offerings, including whether the funds are operating in the manner set forth in their disclosure. In addition, the Division will assess whether ESG products are appropriately labeled and whether recommendations of such products for retail investors are made in investors' best interests. The Division recognizes that RIAs and registered funds are competing for the rising investor demand for ESG-related investment strategies and are increasingly offering and evaluating investments that employ such strategies.

Information Security and Operational Resiliency. The Division will review broker-dealer and RIA practices to prevent interruptions to mission critical services and to protect investor information, records, and assets. In particular, the Division's exams will focus on safeguarding customer records and information (including those stored via third-party service providers), governance practices, responses to cyber-related incidents, and broker-dealer and RIA compliance with Regulations S-P and S-ID, where applicable. The Division notes that "[t]he current risk environment related to cybersecurity is considered elevated given the larger market events, geopolitical concerns, and the proliferation of cybersecurity attacks, particularly ransomware attacks." In addition, the Division will continue to assess the operational resiliency planning of systemically significant registrants, such as their efforts to address climate-related risks.

Crypto-Assets and Emerging Financial Technology. Given the disruptions caused by recent financial distress among crypto asset market participants, examinations of registrants will also focus on the offer, sale, recommendation of, or advice regarding trading in crypto or crypto-related assets and include whether the firm (i) met and followed their respective standards of care when making recommendations, referrals, or providing investment advice, and (ii) routinely reviewed, updated, and enhanced their compliance, disclosure, and risk management practices. The Division also will conduct examinations of broker-dealers and RIAs that are using emerging financial technologies (e.g., broker-dealer mobile apps, automated "robo adviser" investment tools, and trading platforms) to meet compliance and marketing demands and to service investor accounts. Examinations of broker-dealers and RIAs will also focus on firms that employ digital engagement practices and the related tools and methods to assess whether: (i) recommendations were made or advice was provided (e.g., through the use of social media marketing and social trading platforms); (ii) representations were fair and accurate; (iii) operations and controls in place were consistent with disclosure made to investors; (iv) any advice or recommendations were in the best interests of the investor taking into account the investor's financial situation and investment objectives; and (v) risks associated with such practices were considered, including the impact these practices may have on certain investors, such as seniors.

Investment Advisers and Investment Company Examination Programs.

Registered Investment Advisers. The Division will continue to review the compliance programs of advisers, including whether the various aspects of RIA operations and compliance practices have appropriately adopted and considered current market factors, such as those that might impact the valuation and accuracy of RIA regulatory filings. Typically, examinations of RIAs involve review of compliance programs and related disclosures in one or more core areas, such as custody and safekeeping of client assets, valuation, portfolio management, and brokerage and execution. The Division's reviews of RIAs also often include a review for conflicts, compliance issues, and the oversight and approval process related to RIA fees and expenses, including: (i) the calculation of fees; (ii) alternative ways that RIAs may try to maximize revenue, including revenue earned on clients' bank deposit sweep programs; and (iii) excessive fees. Additionally, examinations will review RIA policies and procedures for retaining and monitoring electronic communications and selecting and using third-party service providers. As in previous years, the Division prioritizes advisers and registered funds that have never been examined, including recently registered firms, and those that have not been examined for a number of years.

Registered Investment Companies. The Division will focus on the fiduciary obligations of RIAs to registered investment companies, particularly with respect to their receipt of compensation for services or other material payments made by such registered investment companies and other sources. As part of its review of registered fund compliance programs and governance practices, the Division will continue to evaluate board processes for assessing and approving advisory and other fund fees, particularly for funds with weaker performance relative to their peers. In addition, the Division will assess the effectiveness of fund derivatives risk management programs and liquidity risk management programs, as applicable.

"As part of its review of fund compliance programs and governance practices, the Division will continue to evaluate board processes for assessing and approving advisory and other fund fees, particularly for funds with weaker performance relative to their peers."

The Division will also focus on funds with specific characteristics, such as: (i) turnkey funds, to review their operations and assess effectiveness of their compliance programs; (ii) mutual funds that converted to ETFs to assess governance and disclosure associated with the conversion (partly to ensure that 12b-1 fees charged to investors of mutual funds do not benefit shareholders of ETF clones); (iii) non-transparent ETFs to assess compliance with the conditions and other material terms of their exemptive relief; (iv) loan-focused funds, such as leveraged loan funds and funds focused on collateralized loan obligations for liquidity concerns and to review whether the funds have been significantly impacted by, and have adapted to, elevated interest rates; and (v) medium- and small-fund complexes that have experienced excessive staff attrition to focus on whether such attrition has affected fund controls and operations. The Division will also monitor the proliferation of volatility-linked and single-stock ETFs and may review such fund disclosures, marketing, conflicts, and compliance with portfolio management disclosure, among other things. As with RIA examinations, the Division will prioritize registered investment companies that have never been examined, including recently registered investment companies, and those that have not been examined in a number of years.

2023 Examination Priorities, Division of Examinations, SEC (Feb. 7, 2023), available at: https://www.sec.gov/files/2023-exam-priorities.pdf.

Adviser Files Exemptive Application to Permit an ETF Multi-Share Class

On February 7, 2023, Perpetual US Services, LLC, doing business as PGIA, a registered investment adviser, filed an exemptive application primarily seeking relief to permit the creation and operation of an actively managed ETF share class of an open-end fund that is not exchange traded. Rule 6c-11 under the Investment Company Act, adopted in 2019 to establish a consistent regulatory framework for ETFs, does not permit a fund with such a structure to rely on the Rule.

Proposed Exemptive Relief

Historical Precedent. This application leverages off of a substantially similar SEC order granted to Vanguard Index Funds in October 2000 for an index-tracking fund, except here relief is also being sought to create an ETF share class of an actively managed fund. Notably, Vanguard holds a patent on this ETF-as-a-share class structure, which is due to expire later this year. If adopted, the fund's board would be permitted to authorize the issuance of an ETF share class following a determination that the expense allocation among any open-end fund class and ETF class is in the best interests of each class individually and of the fund as a whole.

Conversion Privilege. Similar to Vanguard's multiclass structure, PGIA would offer certain holders of fund shares the opportunity to convert such shares into ETF shares of equivalent value ("conversion privilege") with the goal of moving investors who currently hold open-end fund share classes into ETF share classes in an expeditious and tax efficient manner. Solely at the option of the shareholder, this conversion privilege would only permit holders of open-end fund share classes to convert those shares into an ETF share class at NAV, and not vice versa.

Policy Considerations

PGIA submits that this exemptive relief is both necessary and in the public interest because ETFs provide investors with a number of important features, including intra-day liquidity, tax efficiency, and relatively low transfer agency and distribution-related costs. Without this exemptive relief, PGIA argues the existing alternative of reorganizing a mutual fund into an ETF leaves mutual fund investors with only one option, choosing between mutual fund shares or ETF shares. By offering investors a choice in both mutual fund and ETF share classes, their assets would pool into a singular vehicle, thereby enhancing the long-term viability of each share class. The SEC has previously expressed general concerns to expanding this type of exemptive relief to other sponsors and funds, believing the following various policy considerations could be prohibitive to approval:

Share Class Subjugation. Section 18(f)(1) of the Investment Company Act provides that it is unlawful for any registered open-end investment company to issue any class of senior security or to sell any senior security of which it is the issuer. PGIA argues that neither share class would be senior to the other since both would have equal voting rights, and the proposed exemption is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act.

Cost Subsidization. When it declined to include an ETF share class of a mutual fund in Rule 6c-11, the SEC flagged the issue of potential cost subsidization between ETF and traditional mutual fund share classes, such as unequal brokerage and other costs associated with buying and selling portfolio securities in response to inflows and outflows. Under PGIA's proposal, all brokerage expenses are expected to be automatically allocated on a daily basis and fed into the strike of the daily NAV for each share class, obviating brokerage cost or expense subsidization concerns.

Tax Implications. Potential distributable capital gains and "tax contagion" issues may arise if the outflows in mutual fund share classes produce more realized capital gains that can be offset and, consequently, the ETF share class owners may need to absorb their *pro rata* share of taxable capital gains. However, PGIA argues that since the redeeming shareholder receives a step-up basis on the ETF class assets received in kind, any federal income tax consequences could be mitigated by having the ETF class shares distribute those securities with the highest built up capital gains, while the mutual fund would convert to cash those securities with the least capital gains. Additionally, PGIA can also employ methods, such as equalization accounting to adjust for any negative tax consequences on an annual basis.

Cash Drag. In 2019, the SEC also voiced concerns associated with cash drag on performance originating from holding the necessary cash amount to satisfy mutual fund share class redemptions. Since mutual funds often hold cash positions in the range of 1-3%, PGIA does not expect cash drag to materialize from the need to meet potential redemptions stemming from the ETF share class.

Operating Expenses. PGIA expects that contractually committed caps on total operating expense ratios would minimize or nullify any potential dislocation in ongoing operating expenses caused by uneven asset bases amongst the mutual fund and ETF share classes.

Conclusion

Despite the similarity of the requested relief to Vanguard's existing fund structure, the SEC is expected to negotiate actively on the final terms of any new relief. Notably, the SEC declined to extend Vanguard's requested relief to actively managed ETFs in 2015. In the current political and regulatory environment, the timeline of such negotiations or their ultimate outcome is uncertain.

In the Matter of Perpetual US Services, LLC d/b/a PGIA, Application for an order under Section 6(c) of the Investment Company Act, for an exemption from Sections 2(a)(32), 5(a)(1), 18(f)(1), 18(i), 22(d) and 22(e) of the Investment Company Act and Rule 22c-1 under the Investment Company Act and under Sections 6(c) and 17(b) of the Investment Company Act for an exemption from Sections 17(a)(1) and 17(a)(2) under the Investment Company Act (Feb. 7, 2023), available at: http://edgar.secdatabase.com/2314/121390023009034/filing-main.htm.

Biden Uses First Veto to Defend DOL's ESG Rule

President Biden used his first veto to a Congressional resolution that would have nullified the Department of Labor's final rule concerning the consideration of ESG factors in U.S. corporate retirement plans ("ESG Rule"). The ESG Rule requires an ERISA fiduciary's investment decision to be based on factors that the fiduciary reasonably determines are relevant to the risk/return analysis of an investment, which may include the economic effects of climate change and other ESG factors on the proposed investment. The ESG Rule does not alter the longstanding requirement for fiduciaries to consider all relevant factors in an investment's risk/return analysis. Additionally, the ESG Rule does not require the incorporation of ESG factors into that analysis where not relevant to the risk/return analysis. The ESG Rule was adopted to overturn a regulation issued in 2020 under the Trump administration, which barred employers from selecting ESG funds for their company 401(k) plans. The ESG Rule also reiterates the DOL's position that fiduciaries can and should consider any and all factors that are relevant to the risk/return analysis of a potential investment.

Multiple lawsuits seeking to enjoin enforcement of the ESG Rule have been filed. Earlier this year, 25 states sued the DOL in the Northern District of Texas, a jurisdiction that may be favorable to plaintiffs, alleging, among other things, violations of the Administrative Procedures Act and the "major questions" doctrine. These lawsuits underscore the politicized nature of ESG, and the landscape is expected to remain uncertain. ERISA fiduciaries, fund sponsors, and investment managers should consider the ESG Rule's applicability by revisiting agreements, policies, and procedures, while also considering efforts by various state legislatures related to ESG to ensure continuing compliance with the plan's laws, rules, and policies.

Joseph R. Biden Jr., Presidential Actions, *Message to the House of Representatives — President's Veto of H.J. Res 30* (March 20, 2023), available at: https://www.whitehouse.gov/briefing-room/presidential-actions/2023/03/20/message-to-the-house-of-representatives-presidents-veto-of-h-j-res-30.

Litigation

Fifth Circuit Court of Appeals Affirms Lower Court's Decision to Dismiss Shareholder Derivatives Suit

The U.S. Court of Appeals for the Fifth Circuit affirmed a District Court's decision to dismiss a shareholder derivative suit against the trustees of the Highland Capital Global Allocation Fund and the Fund's investment adviser, Highland Capital Management Fund Advisors, L.P. ("Highland Capital"). The Court of Appeals held that the District Court (i) applied the correct Massachusetts legal standard to evaluate whether the trustees were "independent;" (ii) properly analyzed and concluded that the majority of the trustees were independent; and (iii) correctly found that the trustees' decision to reject plaintiff's demand was made in good faith and based on a reasonable investigation.

Plaintiff brought a shareholder derivative action under Massachusetts law on behalf of the Fund against Highland Capital and five of the Fund's six trustees alleging breach of contract and breach of fiduciary duty. Plaintiff alleged that the adviser invested a portion of the Fund's portfolio in an affiliated master limited partnership fund, at a time when the MLP's value was falling. Defendants brought a motion to dismiss the derivative suit arguing that a quorum of its independent trustee—the five trustees above—voted to reject Plaintiff's demand after conducting a reasonable and good faith investigation. The District Court agreed with Defendants, dismissing the case. Plaintiff appealed the decision. On appeal, Plaintiff argued that the District Court (i) utilized the wrong legal standard to evaluate whether the trustees were independent; (ii) erred by finding that a majority of the trustees were independent; and (iii) erred by finding that the decision to reject Plaintiff's demand was in good faith and based on a reasonable investigation.

In reviewing Plaintiff's claims regarding trustee independence, the Court of Appeals noted that Massachusetts law states that the Investment Company Act definition of director independence applies to trustees of a trust organized as a registered investment company under the Investment Company Act. The Court of Appeals found that the trustees were independent under the Investment Company Act and, therefore, Plaintiff's claims were invalid.

The Court of Appeals then concluded that the Board made a good faith recommendation to reject Plaintiff's demand based on a reasonable investigation. The Court of Appeals noted that Massachusetts law presumes that a decision to reject a shareholder demand is a valid exercise of a board's business judgment. The Court of Appeals further described how, following Plaintiff's demand, the Board formed a Demand Review Committee consisting of two independent trustees that held 16 meetings, hired independent counsel, reviewed thousands of pages of documents and interviewed 10 witnesses, and prepared a 96 page report recommending to reject Plaintiff's demand.

The Court of Appeals' decision highlights the importance of a reasonable and good faith investigation by a fund's independent trustees, as well as the support of courts to defer to a board's business judgment, in determining whether a shareholder derivative action should be maintained.

Lanotte v. Highland Capital Management Fund Advisors, L.P., et al., No. 20-10649, available at: https://www.ca5.uscourts.gov/opinions/unpub/20/20-10649-CV0.pdf.

Investor Sues Infinity Q Directors and Service Providers for Breach of Fiduciary Duties

Plaintiff, a shareholder of Infinity Q Diversified Alpha Fund, a series of Trust for Advised Portfolios, sued the Fund's Board of Trustees, certain Fund officers, and the Fund's service provider, U.S. Bancorp Fund Services, LLC, in Delaware Chancery Court in February alleging breaches of fiduciary duty. The suit follows settlements in September and November of 2022 reached with the SEC and other investors in connection with a fraudulent valuation scheme involving the Fund and its parallel hedge fund, the Infinity Q Volatility Alpha Fund, L.P., both of which were managed by Infinity Q Capital Management LLC ("Infinity Q"). According to those settlements, from February 2017 through February 2021, James Velissaris, Founder and former Chief Investment Officer of Infinity Q, manipulated securities valuation models from third-party pricing services and altered inputs to hide the Fund's poor performance. In November, Velissaris pled guilty to securities fraud charges brought by the Southern District of New York.

The new suit alleges that the Board and U.S. Bancorp, both of which the Complaint describes as not having the "expertise or willingness" to monitor the complex derivative instruments used by the Fund, abdicated their oversight responsibilities over the valuation process and instead "rubber-stamped" Fund valuations unilaterally determined by Infinity Q and ignored various discrepancies, including "mismatching prices with counterparties, mathematically impossible prices, and inexplicable write-downs of previously valuable securities."

According to the Complaint, U.S. Bancorp was contractually responsible for a variety of the Fund's operations, including valuation, and "expressly agreed in its contracts with the Fund to be liable for its own negligence in performing these duties." U.S. Bancorp offered "turnkey" mutual fund services covering a variety of governance, administrative, transfer, custody, and other services. U.S. Bancorp also served as the fund accountant.

The suit also claims that, instead of acting to recover the Fund's losses for shareholders following the actions filed by the SEC and others in 2022, the Board set aside $500 million of Fund assets to pay for its own defense and the defense of the Fund's service providers that did not have a legitimate claim to indemnification by the Fund. Plaintiff further alleges that the special litigation committee formed by the Board on behalf of the Fund, and led by then-newly nominated trustee Andrew Calamari, has not pursued potential claims and has instead sought to shield the Fund's trustees from liability. According to the Complaint, Calamari, who was also appointed special master to oversee the distribution of Fund assets to shareholders, has refused to bring any actions on behalf of the Fund and allow the claims asserted by Plaintiff to proceed in the Chancery Court or be summarily resolved in the November SEC action.

The Complaint also takes issue with Calamari's position that the Trustees are entitled to indemnification from the Fund "despite their egregious conduct that caused the Fund's collapse" and the relevant governing documents provide no basis for indemnifying the Trustees, which do not provide for indemnification for misconduct, including gross negligence.

The suit seeks damages for the Fund in amounts to be proven at trial, disgorgement from U.S. Bancorp of any fees collected for its services, and declaratory judgment that Defendants are not entitled to indemnification.

Complaint, *Rowan v. Infinity Q Capital Management, et al.*, No. 2022-0176-MTZ (Del. Ch. Feb. 26, 2023).

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