Davis Polk

Investment Management Regulatory Update - May 2022

May 31, 2022 | Client Update | 14-minute read

In this issue, we discuss, among other things, an SEC rule proposal relating to ESG disclosures and a recent enforcement action relating to alleged ESG disclosure failures.

Rules and regulations

SEC reopens comment period for proposed rules regarding private fund advisers
SEC proposes to enhance disclosures by certain investment advisers and investment companies about ESG investment practices
SEC proposes amendments to the Name Rule under the Investment Company Act to prevent misleading or deceptive fund names

Industry update

Commissioner Peirce delivers statement regarding SPACs

Litigation

SEC settles with investment adviser over alleged ESG disclosure failures
Investment adviser and two former employees settle SEC charges, plead guilty to criminal charges arising out of allegedly false statements regarding risks of private fund strategy

Rules and regulations

SEC reopens comment period for proposed rules regarding private fund advisers

On May 9, 2022, the U.S. Securities and Exchange Commission (SEC) announced that it would reopen the public comment period for the recently proposed rule pertaining to the enhanced regulation of private fund advisers. The SEC noted that it reopened the comment period because the proposed rule has "drawn significant interest from a wide breadth of investors, issuers, market participants and other stakeholders."

The public comment period will be reopened for 30 days following publication of the reopening release in the Federal Register. For more information on the proposed rule, please refer to the summary in our March 2022 Investment

Copyright 2022 Davis Polk & Wardwell LLP

Management Regulatory Update.

SEC proposes to enhance disclosures by certain investment advisers and investment companies about ESG investment practices

On May 25, 2022, the SEC announced proposed amendments to rules and disclosure forms concerning certain funds' and advisers' incorporation of environmental, social and governance (ESG) factors in order to establish consistent, comparable and reliable information on ESG matters. The proposed amendments would apply to registered investment companies, business development companies, registered investment advisers and certain advisers exempt from registration.

According to the proposing release, the proposed enhanced disclosure requirements are intended to address the inconsistency with which funds and advisers currently describe and define ESG strategies, which makes it difficult for investors to understand which investments are associated with particular ESG strategies.

The proposal requires funds that consider ESG factors in their investment process to disclose additional information about their ESG strategies, with the amount of disclosure depending on the centrality of ESG strategies to the fund. The proposal categorizes ESG funds into three categories:

- *Integration Funds*: Funds integrating ESG factors with non-ESG factors would be required to detail how ESG factors are used in the investment process.
- *ESG-Focused Funds*: Funds significantly or mainly focusing on ESG factors as part of their investment strategies would be required to provide detailed information regarding such strategies, including a standardized overview table.
- *Impact Funds*: Certain ESG-Focused Funds that seek to achieve a specific ESG goal would be required to disclose additional information on how they measure their progress regarding such goals.

Some primary elements of the proposed amendments include:

- Requiring specific disclosures to investors detailing ESG strategies in fund registration statements, fund annual reports and adviser brochures.
- Requiring ESG-Focused Funds focusing on environmental issues to disclose greenhouse gas emissions associated with their investments, including the carbon footprint and weighted average carbon intensity of their portfolios. Integration Funds that consider greenhouse gas emissions would be required to disclose additional information, such as methodology and data sources used in how the fund considers greenhouse gas emissions.
- Requiring Impact Funds to detail their progress towards achieving such impacts in both qualitative and quantitative terms.
- Funds using proxy voting or other engagement with issuers as a significant means to implement their strategies would be required to disclose in fund annual reports information regarding proxy voting on ESG-related matters and other engagement meetings.
- Funds and advisers would also be required to report on ESG matters on Form N-CEN and Form ADV Part 1A to provide the SEC and market participants with data on industry trends in the market for ESG investment products and services.

The SEC requested comments within 60 days after publication of the proposing release in the Federal Register.

SEC proposes amendments to the Name Rule under the Investment Company Act to prevent misleading or deceptive fund names

In a May 25, 2022 release, the SEC proposed amendments to Rule 35d-1 under the Investment Company Act (Name Rule) and related disclosure and reporting rules. The proposed amendments apply to registered investment companies and business development companies (BDCs) and are designed to ensure that a fund's name accurately reflects the fund's investments and risks. The primary elements of the proposed amendments include:

- **Modernization of the 80% investment policy requirement**
  The Name Rule currently requires registered investment companies and BDCs (funds) with names that suggest investment in certain investments, industries, countries or geographic regions to adopt a policy to invest at least 80

Copyright 2022 Davis Polk & Wardwell LLP

percent of the value of their assets in such investments. Under the proposed amendments, the Name Rule would be expanded to apply to a fund with a name suggesting that the fund focuses on investments or issuers with "particular characteristics." For example, under the proposed amendments, the Name Rule would also apply to a fund with a name suggesting that the fund incorporates one or more ESG factors or that includes terms such as "growth" or "value" in its name. The proposed amendments also specify the types of derivatives can be included in the 80 percent basket for purposes of the Name Rule.

- **Temporary departures from the 80 percent investment policy requirement**
  The proposed amendments specify the circumstances under which a fund can depart from the 80 percent investment policy, including sudden changes in market value of underlying investments. The proposed amendments also specify the timeframes in which a fund must return to compliance with its 80 percent investment policy.

- **Unlisted closed-end funds and BDCs**
  Given the limited exit options for shareholders of registered closed-end funds or BDCs whose shares are not listed on a national exchange, the proposal would prohibit such registered closed-end funds or BDCs from changing their 80 percent investment policies without a shareholder vote.

- **Enhanced prospectus disclosure, reporting and recordkeeping**
  The proposal includes several amendments regarding disclosure, reporting and recordkeeping, including:
  - requiring a fund's prospectus disclosure to define the terms used in a fund's name;
  - requiring amendments to Form N-PORT to require greater transparency regarding how the fund's investments match the fund's investment focus; and
  - requiring funds to keep certain records regarding how they comply with the Name Rule or why they are not subject to the Name Rule.

- **Materially deceptive and misleading use of ESG terminology**
  Under the proposal, a fund would not be permitted to use ESG or similar terminology in its name if that fund considers ESG factors alongside but not more centrally than other, non-ESG factors in its investment decisions. Under the SEC's proposal, such practice would be deemed materially deceptive and misleading.

- **Modernization of notice requirement**
  The proposal would retain the current requirement under the Name Rule regarding notice to investors of changes in the fund's 80 percent investment policy. The proposal would also update the Name Rule's notice requirement with specific provisions on how such notice should be provided, including with respect to funds that use electronic delivery methods to provide information to their shareholders.

The SEC requested comments within 60 days after publication of the proposing release in the Federal Register.

Industry update

Commissioner Peirce delivers statement regarding SPACs

On April 15, 2022, Commissioner Hester M. Peirce delivered a statement regarding the SEC's enhanced scrutiny of SPACs and their proposed treatment under the Investment Company Act of 1940 (Investment Company Act). Citing the recent termination by a business combination target of its merger agreement with a SPAC, Commissioner Peirce questioned why SEC staff had not taken the routine step of granting the SPAC's acceleration request and declaring effective its registration statement around the time of filing. She noted that the SEC's inaction challenged its "general policy" under Rule 461(b) of the Securities Act of 1933 of "permit[ting] acceleration of the effective date of the registration statement as soon as possible after the filing…"

Commissioner Peirce situates this example within the broader context of the SEC's "newfound hostility to SPAC capital formation." This includes the SEC's vote in March 2022 to propose expansive new rules pertaining to SPACs, including a proposed nonexclusive safe harbor (Rule 3a-10) under the Investment Company Act. As Division of Investment Management Director William Birdthistle stated, "This proposal is the first time that the [SEC] had specifically addressed the question of whether SPACs are investment companies." The proposed safe harbor focuses on conditions that limit a SPAC's duration, asset composition, business purpose and activities. As the proposing release states, the SEC is concerned that the longer the SPAC operates with its assets invested in securities and its income derived from securities, the more likely investors will come to view the SPAC as a fund-like investment. According to the proposing release, longer periods between a SPAC's IPO and the completion of its business combination may raise questions about its status as an investment company under Section 3(a)(1)(A) of the Investment Company Act.

Copyright 2022 Davis Polk & Wardwell LLP

However, Commissioner Peirce maintains that, without affording registrants adequate notice, the SEC should not start treating SPACs which do not meet an "arbitrarily determined" timeframe for their consummation of a de-SPAC as investment companies. To promote good faith and credible engagement with SPAC registrants, Commissioner Peirce concludes that the SEC should inform them of major issues earlier in the process.

Litigation

SEC settles with investment adviser over alleged ESG disclosure failures

In one of its first announced "ESG Task Force" enforcement actions, the SEC settled with an adviser over allegedly misleading disclosures about the role of ESG review in its investment process.

On March 4, 2021, the SEC announced the creation of a "Climate and ESG Task Force" in the Enforcement Division to address "material gaps or misstatements in issuers' disclosure of climate risks under existing rules," and "disclosure and compliance issues relating to investment advisers' and funds' ESG strategies."

On May 23, 2022, the SEC issued the first adviser-related enforcement order attributed to the Commission's ESG Task Force. That order (Order) instituted and settled administrative and cease-and-desist proceedings against a large investment adviser (Adviser) arising out of alleged material omissions and misstatements regarding the role of ESG quality reviews in the investment process for funds that were, notably, **not** marketed as having an express ESG focus.

As is relevant to the Order, the Adviser, through an affiliated sub-adviser, managed two relevant categories of mutual funds: the "Sustainable Funds" and the "Overlay Funds." According to the Order, the prospectuses of the Sustainable Funds stated that the funds followed certain ESG-related criteria and requirements for investment. The affiliated sub-adviser maintained a "Responsible Investment Team," tasked with researching ESG issues, and preparing a written ESG quality review and assigning an ESG quality score to issuers of equity securities and corporate bonds. According to the Order, the sub-adviser required that the Responsible Investment Team perform an ESG quality review either prior to any investment by the Sustainable Funds, or, in the case of corporate bonds, within 30 days after the investment was made.

By contrast, the SEC alleges that until July 2020, the sub-adviser permitted investments by the Overlay Funds that did not have an ESG quality review prior to (or within 30 days after) selection. According to the SEC, nearly 25% of a certain Overlay Fund's net assets as of March 31, 2021 were in investments that did not have an ESG quality score assigned as of the time of investment (or, for corporate bonds, within 30 days after investment).

Unlike the Sustainable Funds, the prospectuses of the Overlay Funds are not alleged to state that the funds imposed ESG-related requirements on all investments. However, the SEC alleges that the prospectuses for the Overlay Funds contained the following statement:

Integrated into the investment process, [the Sub-Adviser] has a well-established approach to responsible investment. This process includes identifying and considering the Environmental, Social and Governance (ESG) risks, opportunities and issues throughout the research process via [the Sub-Adviser's] proprietary quality reviews, in an effort to ensure that any material ESG issues are considered.

The Order further alleges that the Adviser represented to the Overlay Funds' boards that an ESG quality review rating was assigned to "each company" "prior to making any investment," and that this review as "designed to ensure that any material ESG issues of the company are taken into consideration." In addition, in response to requests for proposals from other investment firms, the Adviser allegedly stated that "ESG considerations are taken into account at every stage of the investment process" and that ESG quality reviews were performed "ahead of investing."

The SEC contends that the disclosure of the Overlay Funds' prospectuses was misleading because a reasonable investor reading that disclosure "could mistakenly conclude that all portfolio holdings" selected for an Overlay Fund "were subject to an ESG quality review," because it did not disclose that the sub-adviser did not require or prepare ESG quality reviews for all investments in the Overlay Funds. The statements made to the Overlay Funds' boards, or in response to requests for proposals, were allegedly misleading because the sub-adviser could select investments that had not received an ESG quality review before investment.

The Order also states that the Adviser's written policies and procedures were not reasonably designed to prevent the alleged misstatements or omissions; according to the Order, compliance personnel did not know, before March 2020, that ESG quality reviews were not performed for all Overlay Fund investments.

Copyright 2022 Davis Polk & Wardwell LLP

The Order notes the Adviser's prompt remedial actions, which included revising the company's disclosure language and modifying related policies and procedures, and also highlights the Adviser's cooperation—including a specific statement that cooperation "advanced the quality and efficiency of the staff's investigation and conserved Commission resources."

The SEC alleges that, as a result of the conduct described above, the Adviser violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder, as well as Section 34(b) of the Investment Company Act. The Adviser agreed to cease and desist from future violations, to be censured, and to pay $1,500,000 in civil monetary penalties.

Investment adviser and two former employees settle SEC charges, plead guilty to criminal charges arising out of allegedly false statements regarding risks of private fund strategy

On May 17, 2022, the SEC and the U.S. Attorney's Office for the Southern District of New York announced that the SEC and Department of Justice had reached civil settlements and criminal plea agreements with an investment adviser (Adviser) and two former portfolio managers arising out of alleged false statements regarding the risks of a private fund strategy that allegedly caused billions of dollars of investor losses. Concurrently, the SEC and U.S. Attorney's Office for the Southern District of New York, respectively, filed a civil complaint and unsealed a criminal indictment against a third former portfolio manager.

According to the SEC's Order (Order) instituting and settling cease-and-desist proceedings against the Adviser, the Adviser managed 17 private funds that pursued a strategy of using a portfolio of securities as collateral to purchase and sell options, principally on the S&P 500 Index.

The SEC alleges that the Adviser mislead investors about the "significant downside risk" of the funds in several ways. First, the Adviser allegedly misrepresented its hedging strategy. The Adviser's marketing materials for the relevant funds described hedges as being "laddered" and having "strike distances from - 10% to -25%" with the stated objective of protecting the strategy "from a short-term equity market crash." Contrary to this representation, the SEC alleges, the actual hedges were, on average, far more out of the money than disclosed—from -30% to -40%—and the Adviser made "no effort" to ladder hedges within the stated range of -10% to -25%.

Second, the Adviser and its former employees allegedly failed to implement a "bespoke risk mitigation program" agreed to with its largest investor. The investor agreed to continue to invest in the Advisers' funds after the Adviser agreed to a program whereby the alpha targets of the funds would be adjusted according to the level of the VIX. The Adviser allegedly did not implement that program, resulting in alpha targets significantly higher than agreed.

Third, the Adviser and the former portfolio managers are alleged to have provided falsified reports to clients to conceal the risks of the strategy. The former portfolio managers allegedly altered a number of different reports to conceal the magnitude of the downside risk and volatility of the strategy, through various forms of manipulation including smoothing daily results and reducing certain risk metrics by multiplying the true number by an arbitrary fraction or simply omitting digits in the true number—for example, reducing losses under a certain market crash scenario from -42.1505489755747% to -4.1505489755747% by dropping the digit "2" before the decimal point.

Fourth, the Adviser allegedly misrepresented that the strategy had a capacity limit of $9 billion, when in fact the strategy grew to over $12 billion by December 2019 while the Adviser and its former employees never closed the funds or otherwise adhered to the capacity limit.

COVID-related volatility in March 2020 allegedly caused "catastrophic losses" in the funds, including losses in excess of 90% in certain funds, leading to billions of investor losses.

Following the losses and an SEC investigation, the three former portfolio managers allegedly engaged in "numerous, ultimately unsuccessful attempts" to conceal their alleged conduct from the SEC. For example, the three allegedly agreed that one member would give false testimony to the SEC justifying the manipulated reports. The SEC alleges that after giving such false testimony, that former manager "refused to return from a restroom break" and left the testimony open.

On account of the conduct described above, the SEC contends that the Adviser violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1), 206(2), and 206(4) of the Adviser Act and Rules 206(4)-7 and 206(4)-8 thereunder. The Adviser agreed to cease and desist from further violations, to be censured, and to pay disgorgement totaling $349.2 million—deemed satisfied by the restitution and forfeiture ordered pursuant to the plea agreement described below—and a civil money penalty of $675 million.

Copyright 2022 Davis Polk & Wardwell LLP

In a separate plea agreement, the Adviser pleaded guilty to one count of securities fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. In connection with resolution of the criminal charges, the Adviser agreed to forfeit more than $463 million, to pay more than $40 million, and the Adviser's parent agreed to forfeit more than $134 million. The Adviser also agreed to pay more than $3.2 billion in restitution, and a fine of more than $2.3 billion, approximately $1.8 billion of which was offset by payments to victims and the SEC penalty described above. As a consequence of the guilty plea, the Adviser will be disqualified from advising U.S.-registered funds for ten years, and will no longer provide these services; reports indicate that the Adviser is in the process of selling its asset-management business to another investment adviser.

The criminal and civil actions against the third former portfolio manager, who did not settle or plea, are pending in the U.S. District Court for the Southern District of New York.

Copyright 2022 Davis Polk & Wardwell LLP