Investment Management Regulatory Update

April 30, 2021

COVID-19 Update

Please refer to Davis Polk's "**Coronavirus Updates**" webpage for content related to the outbreak.

Rules and Regulations

SEC Staff Statement on Withdrawal and Modification of Staff Letters Related to Rulemaking on Use of Derivatives and Certain Other Transactions by Registered Funds and Business Development Companies

In March 2021, the staff of the Securities and Exchange Commission ("**SEC**") Division of Investment Management (the "**Staff**") issued an information update (the "**March Update**") regarding its withdrawal of numerous no-action letters previously issued and relating to derivatives and certain other transactions by registered funds and business development companies. According to the March Update, the Staff's withdrawal of the no-action letters stems from the SEC's adoption of Rule 18f-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**")—a rule which will permit registered investment companies and business development companies to enter into derivatives and certain other transactions notwithstanding the restrictions under Section 18 and Section 61 of the Investment Company Act, provided they meet certain conditions. The date of withdrawal of the no-action letters is August 19, 2022.

For further information on Rule 18f-4, please refer to Davis Polk's client memorandum dated December 18, 2020.

- **See a copy of the Client Memorandum**
- **See a copy of the March Update**

Industry Update

Acting SEC Chair Allison Herren Lee's Speech on the Importance of Fund Voting and Disclosure

In a speech at the ICI Mutual Funds and Investment Management Conference on March 17, 2021, the acting chair of the SEC, Allison Herren Lee, called for clearer disclosure and increased transparency regarding proxy voting to ensure the system of shareholder democracy meets the demands of the twenty-first century marketplace. Noting that the current proxy voting rules and, specifically, the Form N-PX, have not kept pace with the changing investment landscape, Lee said "[i]t is high time to revisit this critical [Form N-PX] and make it useful in creating needed transparency around the fundamental exercise of shareholder voting." Lee referred to the disclosures on current Form N-PX as "unwieldy, difficult to understand, and difficult to compare across fund complexes."

Lee cited two intertwined factors in urging changes to the proxy voting process; namely, (1) the exponential increase in demand for opportunities to invest in vehicles with ESG strategies, (2) the growth in the percentage of U.S. households invested in funds and the concomitant rise of passive index funds. Regarding the first development, she pointed to the fact that millennials, in particular, are increasingly focused on socially responsible investing and, with the largest wealth transfer in history from baby boomers to millennials soon to be upon us, this trend looks to only increase. Second, she noted that nearly 47% of U.S. households owned funds in 2019, up from only 6% in 1980. However, passive index funds, which despite being broadly beneficial to retail investors, "may operate to the detriment of corporate accountability," particularly with respect to ESG matters, because the SEC's rules have not kept pace with marketplace developments.

Given this, Lee noted that she had instructed SEC staff to begin considering options for updating the Form N-PX, which has not lived up to its potential in her view. Specifically, she indicated a renewed focus on updating the Form N-PX to make it more useful for retail investors by, for instance, standardizing voting disclosures, structuring and tagging the data included in it, providing more clarity in the description of issues voted on as well as the number of shares voted versus shares available to vote, and modifying it to facilitate more timely disclosure so investors can "act quickly to reward fund managers that best match their needs and expectations."

"Ultimately, corporate accountability is only possible when the funds that manage American investors' savings diligently exercise their authority to vote, clearly disclose their votes to investors, and operate in a system that efficiently provides accurate information about vote execution," Lee said. Accordingly, the SEC will look to alleviate the inequities of the current system of proxy voting by seeking to improve transparency around shareholder proposals and improving the utility of Form N-PX disclosures to the average retail investor.

- **See a copy of the speech**

Litigation

SEC Settles with Investment Adviser Principals Responsible for Alleged Misstatements and Omissions Regarding Due Diligence, Valuation, and Conflicts of Interest

On March 24, 2021, the SEC issued three orders (the "**Foundry Orders**") instituting and settling cease-and-desist proceedings against Troy E. Marchand, Scott T. Wolfrum, and Tyler C. Sadek, principals and an owner of the Foundry Capital Group ("**FCG**"), an investment adviser to the Foundry Mezzanine Opportunity Fund ("**FMOF**"), a private fund. Sadek and Marchand were allegedly responsible for misstatements made to investors of FMOF regarding the fund's investments and due diligence; Wolfrum,

allegedly directed his advisory clients to FMOF without adequately disclosing his interests in FMOF or that FMOF invested in companies in which he had a financial interest.

According to the Foundry Orders, Marchand and Sadek founded FCG in 2015; Marchand acted as the portfolio manager for FMOF. Wolfrum, a representative of a broker and a registered investment adviser, acquired 100% of FCG by July 2018.

FCG launched FMOF in 2015; FMOF's strategy was described as investing in "high yield private loan investments with complementary short-term liquidity plays." FMOF's communications with investors stated that the fund's portfolio would be independently valued by a valuation firm, and that FCG undertook a "rigorous due diligence approach" when selecting investments.

The SEC alleges that FCG failed to obtain independent valuations of the fund's holdings or to perform due diligence in accordance with its statements to investors. According to the Foundry Orders, Marchand allegedly chose not to obtain an independent valuation of the fund after a valuation firm verbally told Marchand that the fund would have to write down the value of certain holdings. Marchand also allegedly failed to conduct "any independent due diligence" in one FMOF investment, failed to investigate whether another FMOF investment would be able to make principal and interest payments on a loan that FMOF made, and failed to determine whether the felony conviction and $1.5 million in outstanding liabilities of a personal guarantor on a third investment would have an impact on FMOF's investment.

The SEC further alleges that Marchand and Sadek were responsible for misleading investor newsletters. While certain companies in which FMOF was invested were performing poorly and, in one instance, contemplating bankruptcy, FMOF's investor newsletters allegedly failed to disclose negative information and, instead, predicted positive investment returns and future growth.

FCG and Wolfrum expected Wolfrum to serve as the primary source of FMOF investors. In 2016, Wolfrum and FCG entered into arrangements whereby Wolfrum obtained 50% of FCG's management fees and 80% of FCG's performance fees attributable to investments from investors directed to FMOF. In addition, Wolfrum allegedly received finder's fees from two companies in connection with loans from FMOF to those companies. According to the Foundry Orders, the "specified details" of Wolfrum's compensation were not disclosed to investors, though investors were told that Wolfrum "would benefit financially from the activities of the fund." Wolfrum's interests in the companies in which the fund invested, and his receipt of finders' fees in connection with those investments were not disclosed to fund investors.

Each of Marchand, Sadek, and Wolfrum agreed to be censured. Marchand agreed to an industry bar, subject to the right to reapply after five years. Sadek agreed to pay a civil monetary penalty of $30,000; Wolfrum agreed to pay disgorgement of $140,125 and prejudgment interest of $21,354, plus a civil monetary penalty of $75,000. No civil monetary penalty was imposed on Marchand on account of his financial condition.

- **See a copy of the Marchand Order**
- **See a copy of the Sadek Order**
- **See a copy of the Wolfrum Order**
- **See a copy of the SEC Press Release regarding the Foundry Orders**

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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