

## Investment Management Regulatory Update

May 27, 2021

### COVID-19 Update

#### Rules and Regulations

- Updated FAQs on Modernized Registered Investment Company Reporting
- SEC Staff Statement Regarding Termination of Exemptive Relief and Withdrawal of Staff Letters Related to COVID-19 Response

#### Industry Update

- The SEC Division of Examinations Issues Risk Alert Regarding ESG Investing
- SEC Statement on Registered Funds Bitcoin Investing

## COVID-19 Update

Please refer to Davis Polk's "[Coronavirus Updates](#)" webpage for content related to the outbreak.

## Rules and Regulations

### Updated FAQs on Modernized Registered Investment Company Reporting

On April 21, 2021, the staff of the SEC's Division of Investment Management (the "**Staff**") issued an update to the Frequently Asked Questions ("**FAQs**") related to the investment company reporting modernization reforms, which were adopted in October 2016 and revised in 2017 and 2019. In this latest update to the FAQs, the Staff added one additional question and response.

The new FAQ asked for examples of methodologies a fund could use to calculate the "monthly average of the value of portfolio securities on loan" and the "monthly average net assets during the reporting period" in response to Items C.6.f and C.19.a, respectively, on Form N-CEN. In response to this, the Staff noted that both responses should reasonably represent the monthly averages and that they had observed a wide range of calculation methodologies, all of which properly reflected these averages. The Staff offered a few examples of these methodologies:

1. First, for each month during the reporting period, take the sum of the value of securities on loan, or net assets, for each day during the month and divide by the number of days in the month. Then, take the sum of each of these monthly values during the reporting period and divide by the number of months in the reporting period;
2. Take the sum of the value of securities on loan, or net assets, at the end of each month and divide that sum by the number of months in the reporting period; or
3. Take the sum of the values of securities on loan, or net assets, as of the first day of the reporting period and the last day of each month in the period and divide that sum by the number of months in the reporting period plus one.

In each case, the Staff noted that the calculation should include and treat equally any days on which no securities were on loan.

The Staff also flagged the importance of the information reported in response to items C.6.f and C.19.a, noting that this information could help “inform investors and other interested parties about the use of and potential risks associated with a management company’s securities lending activities.” The Staff believes that calculation of these items “in a consistent manner will help promote comparability of data and better facilitate the use of the information reported on Form N-CEN.”

- [See a copy of the updated FAQs](#)

## SEC Staff Statement Regarding Termination of Exemptive Relief and Withdrawal of Staff Letters Related to COVID-19 Response

Effective April 30, 2021, certain temporary relief provided in response to the COVID-19 pandemic was terminated or withdrawn by the Staff. Specifically, the Staff announced that the following order and no action letters have been terminated or withdrawn, respectively:

- A **conditional exemptive order** dated March 23, 2020 that allowed greater flexibility for registered open-end management investment companies other than money market funds, and insurance company separate accounts registered as unit investment trusts, to borrow from certain affiliates and enter into certain lending arrangements.
- A **temporary no-action letter** dated March 19, 2020 to the Investment Company Institute that permitted registered money market funds regulated under Rule 2a-7 to sell securities under certain circumstances to their affiliated persons (or affiliated persons of such persons) that are subject to Sections 23A and 23B of the Federal Reserve Act.
- A **temporary no-action letter** dated March 26, 2020 to the Investment Company Institute that permitted registered open-end investment companies that are not ETFs and do not hold themselves out as money market funds to sell debt securities under certain circumstances to their affiliated persons (or affiliated persons of such persons) that are not registered investment companies.
- [See a copy of the Staff statement](#)

## Industry Update

### The SEC Division of Examinations Issues Risk Alert Regarding ESG Investing

#### Introduction

In a Risk Alert dated April 9, 2021, the SEC’s Division of Examinations (the “**Division**”) noted increasing investor demand for products that incorporate environmental, social, and governance (“**ESG**”) values, while firms that offer ESG products and services vary in how they incorporate ESG considerations in their investment decisions. The Division noted that growth in consumer demand for ESG products, the corresponding increase in the number of ESG products offered, and lack of standardization in ESG definitions collectively present certain investing risks. For example, the lack of consistency with which firms use ESG terms can lead to confusion among investors.

#### Examinations of Investment Advisers and Funds

According to the Risk Alert, the Division has examined, and will continue to examine, how accurately firms disclose their ESG investing approaches. Such examinations include the following considerations:

- *Portfolio management.* Examinations will include a review of the firm’s policies related to ESG, the firm’s use of due diligence in selecting investments given its ESG policies, and whether a firm’s proxy voting decision-making processes are consistent with its ESG disclosures.

- *Performance advertising and marketing.* Examinations will include a review of a firm's published information (including its regulatory filings, websites, and other sources), including its marketing materials.
- *Compliance programs.* Examinations will include a review of the firm's ESG policies and procedures and their implementation.

## Staff Observations

During such examinations, the Division has observed instances of potentially misleading statements regarding ESG investing processes. Such observations included the following:

- *Portfolio management practices were inconsistent with disclosures about ESG approaches.* For example, some firms claimed in their marketing materials to adhere to ESG frameworks but the Division found that such firms did not indeed adhere to such frameworks. The Division also observed firms holding issuers with low ESG scores, despite stated investing approaches to the contrary.
- *Controls were inadequate to maintain, monitor, and update clients' ESG-related investing guidelines, mandates, and restrictions.* For example, some firms apply negative screens to investments: they exclude issuers that have certain negative ESG characteristics. However, the Staff observed that some of those firms did not have adequate controls to implement clients' negative screens (e.g., prohibitions on investing in alcohol, tobacco, or firearms industries), or to stay up to date on clients' changing screens. Notably, the Staff observed instances where firms had not yet implemented clients' positive screens (i.e., making certain investments with issuers that have desirable ESG characteristics), despite firms' marketing claims to the contrary.
- *Proxy voting may have been inconsistent with advisers' stated approaches.* For example, firms made claims that ESG-related proxy proposals would be internally evaluated on a case-by-case basis, but had no policies that provided for such analysis. Additionally, firms made claims that clients could vote separately on ESG-related proxy proposals, but offered no such opportunities.
- *Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches.* The Staff observed inflated returns for ESG-oriented funds and exaggeration of firms' contributions to the development of certain ESG products.
- *Inadequate controls to ensure that ESG-related disclosures and marketing are consistent with the firm's practices.* For example, the Staff observed false claims of adherence to certain ESG investing practices, a lack of documentation on ESG investing decisions, and failures to update marketing materials in a timely fashion.
- *Compliance programs did not adequately address relevant ESG issues.* For example, the Staff noticed compliance programs that did not address a firm's adherence to ESG frameworks, despite firms' claims to the contrary. The Staff also noted firms' inability to substantiate ESG-related marketing claims and to oversee sub-advisers' activities.
- The Staff noted that compliance programs were less effective when compliance personnel had limited knowledge or oversight of ESG-related disclosures and decisions.

## Staff Observations of Effective Practices

Some best practices that the Staff observed include the following.

- *Disclosures that were clear, precise and tailored to firms' specific approaches to ESG investing, and which aligned with the firms' actual practices.* The Staff observed some disclosures that were simple and clear, such as when firms prominently stated that their ESG investing approach involved relying on unaffiliated advisers to do the vetting, when firms offered choices among

standardized ESG-friendly portfolios, and when firms disclosed clearly that some of their investments that appeared inconsistent with ESG directives could still satisfy global ESG frameworks. The Staff also observed some instances of clear explanations regarding how firms evaluated investments with regard to ESG objectives, including by publishing quantitative information regarding the impacts of their investments.

- *Policies and procedures that addressed ESG investing and covered key aspects of the firms' relevant practices.* When firms had ESG policies and procedures that dictated that specific documentation be completed at various stages in the investment process (e.g., research, due diligence, selection, and monitoring), the Staff noticed that it led to the creation of documentation and added rigor in the portfolio management process.
- *Compliance personnel that are knowledgeable about the firms' specific ESG-related practices.* When compliance personnel were more integrated into the firm's ESG-related investment practices, firms were more likely to avoid materially misleading ESG-related claims in their marketing.

### Conclusion

The Division encourages market participants to evaluate whether their public statements related to ESG investing are accurate. Firms engaged in ESG investing should ensure that their policies and procedures include such directives, are implemented consistently throughout the firm, and are subject to appropriate oversight. Finally, the Division encourages firms to strive to document important stages of the ESG investing process.

- [See a copy of the Risk Alert](#)

### SEC Statement on Registered Funds Bitcoin Investing

On May 11, 2021, the Staff of the SEC's Division of Investment Management issued a statement firmly suggesting that investors interested in investing in mutual funds with exposure to Bitcoin futures carefully consider the risks involved in the Bitcoin futures market. More specifically, the Staff encouraged investors to consider the volatile and highly speculative nature of the Bitcoin futures market, as well as the lack of regulation and potential for fraud in the underlying Bitcoin market, and balance these aspects with their individual risk tolerance.

The Staff noted that its top priority is investor protection. To that end, the Staff stated that it will continue to monitor and assess mutual funds' and investment advisers' compliance with the Investment Company Act of 1940 and related rules and laws as they engage in Bitcoin futures investments. In coordination with the Division of Economic and Risk Analysis and Division of Examinations, the Staff has committed to closely monitoring the impact of mutual funds' investments in Bitcoin futures on investor protection, capital formation, and the fairness and efficiency of markets, including, among other things: mutual funds' ability to liquidate Bitcoin futures positions to meet daily redemption demands, mutual funds' liquidity classification of Bitcoin futures positions, the overall structure of mutual funds' liquidity risk management programs, the ongoing potential for fraud or manipulation in the underlying Bitcoin market, and whether the Bitcoin futures market could accommodate ETFs.

The Staff closed out the statement by noting that it believes that investment in the Bitcoin futures market should be limited to mutual funds with strategies that are equipped to handle this type of investment and with full disclosure of the associated risks. The Staff plans to be transparent about its approach to registered funds' investment in the Bitcoin futures market, and other types of digital asset investments, in order to prevent market uncertainty and promote a level playing field among funds. The Staff also encouraged "any closed-end fund that seeks to invest in the Bitcoin futures market to consult with the Staff, prior to filing a registration statement, about the fund's proposed investment, anticipated compliance

with the Investment Company Act and its rules, and how the fund would provide for appropriate investor protection.”

- [See a copy of the Staff statement](#)

---

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.

<b>James H.R. Windels</b>	212 450 4978	<a href="mailto:james.windels@davispolk.com">james.windels@davispolk.com</a>
<b>John G. Crowley</b>	212 450 4550	<a href="mailto:john.crowley@davispolk.com">john.crowley@davispolk.com</a>
<b>Leor Landa</b>	212 450 6160	<a href="mailto:leor.landa@davispolk.com">leor.landa@davispolk.com</a>
<b>Gregory S. Rowland</b>	212 450 4930	<a href="mailto:gregory.rowland@davispolk.com">gregory.rowland@davispolk.com</a>
<b>Michael S. Hong</b>	212 450 4048	<a href="mailto:michael.hong@davispolk.com">michael.hong@davispolk.com</a>
<b>Lee Hochbaum</b>	212 450 4736	<a href="mailto:lee.hochbaum@davispolk.com">lee.hochbaum@davispolk.com</a>
<b>Sarah E. Kim</b>	212 450 4408	<a href="mailto:sarah.e.kim@davispolk.com">sarah.e.kim@davispolk.com</a>
<b>Marc J. Tobak</b>	212 450 3073	<a href="mailto:marc.tobak@davispolk.com">marc.tobak@davispolk.com</a>

---

© 2021 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm’s [privacy notice](#) for further details.