Morgan Lewis

REGS & EGGS

RECENT DEVELOPMENTS IMPACTING REGISTERED FUNDS AND THEIR INVESTMENT ADVISERS

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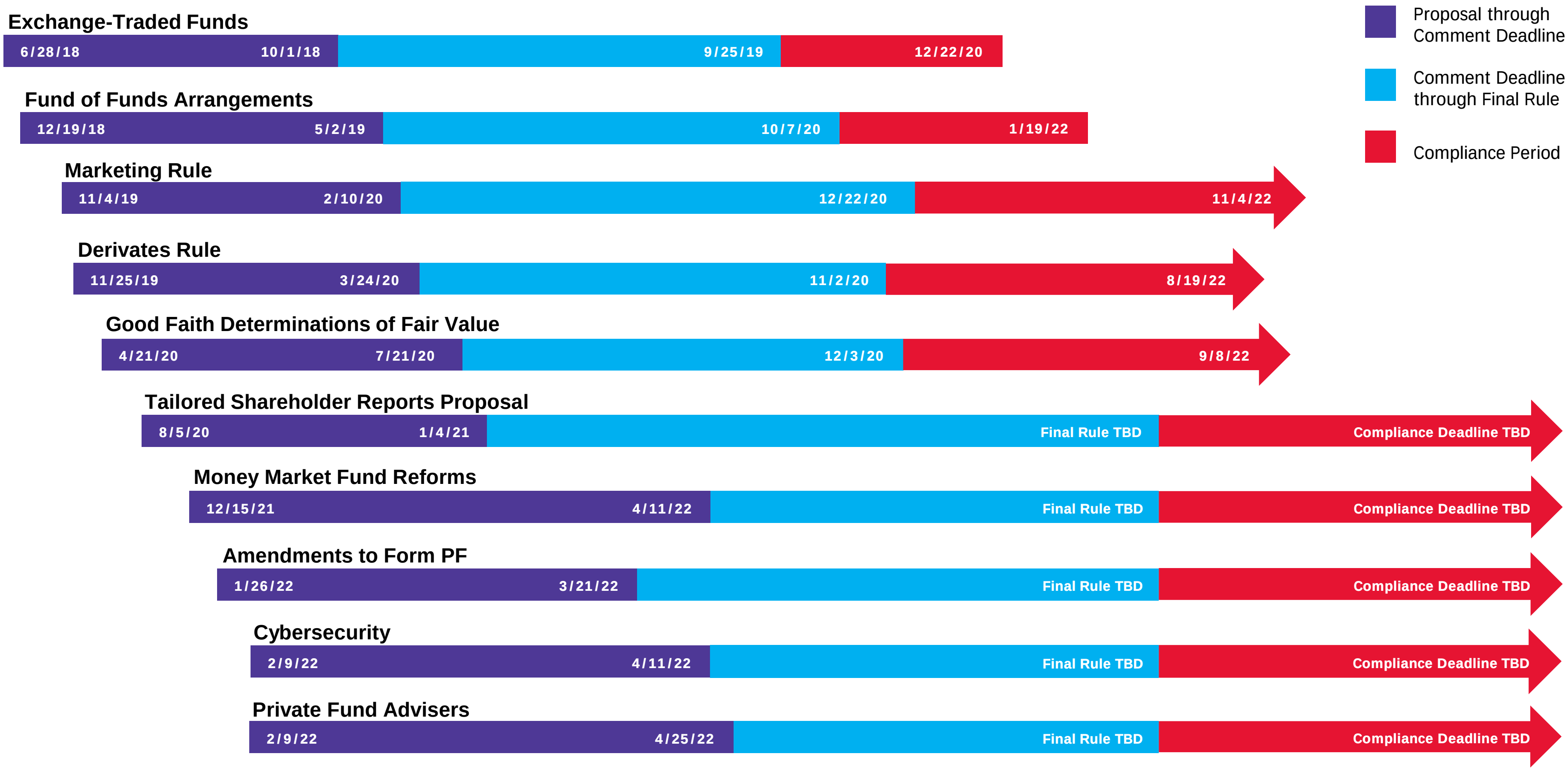
Recent Rulemakings

Transformational SEC Rulemakings: June 2018 to present



SEC IM Rulemakings: On the Horizon

ESG: FUNDS AND ADVISERS

The Division is considering recommending that the Commission propose requirements for investment companies and investment advisers related to environmental, social and governance (ESG) factors, including ESG claims and related disclosures.

(April 2022?)

THIRD PARTY SERVICE PROVIDERS

The Division is considering recommending that the Commission seek public comment on the role of certain third-party service providers, such as index providers and model providers, and the implications for asset management industry.

(April 2022?)

FUND NAMES RULE

The Division is considering recommending that the Commission propose amendments to Investment Company Act rule 35d-1, which applies to names used by registered investment companies.

(April 2022?)

LIQUIDITY AND DILUTION MANAGEMENT

The Division is considering recommending that the Commission propose changes to regulatory requirements relating to open-end fund's liquidity and dilution management.

(April 2022?)

TAILORED SHAREHOLDER REPORTS

The Division is considering recommending that the Commission adopt:

- A new streamlined shareholder report under the 1940 Act
- Rule and form amendments to improve and modernize certain aspects of the current disclosure framework under the 1940 Act
- Proposal included repeal of Rule 30e-3

(October 2022?)

Proposed Cybersecurity Rules

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Overview of Proposed Cybersecurity Rules

Applicability	(1) Registered investment advisers (2) Registered investment companies (3) Closed-end funds that have elected to be treated as business development companies
Background	• Growing number of cybersecurity risks for advisers and funds • No existing SEC rules requiring comprehensive cybersecurity risk management programs • Clients and investors may not be receiving sufficient information on cybersecurity incidents
Proposal Elements	(1) Adopt and implement cybersecurity risk management policies and procedures (2) Report significant cybersecurity incidents to the SEC (3) Disclose information about cybersecurity risks and significant incidents (4) Prepare and maintain related records
Comment Period	• Comments should be received on or before April 11, 2022 • As with many recent proposed rulemakings, several industry organizations have filed requests asking the SEC to extend the comment period

Cybersecurity Risk Management Policies and Procedures

Proposed Rule 206(4)-9 and Proposed Rule 38a-2. Cybersecurity policies and procedures would be required to include the following elements:

- Periodic risk assessments;
- User security and access;
- Information protection (including oversight of third parties);
- Cybersecurity threat and vulnerability management; and
- Cybersecurity incident detection, response, and recovery.

Annual Reviews and Written Reports

- At least annually, advisers and funds would be required to (1) review the effectiveness of their policies and procedures and (2) prepare a written report.

Cybersecurity Risk Management Policies and Procedures (cont.)

Board Oversight and Reporting

- Fund boards would be required to initially approve the policies and procedures and review the annual written report.
- Board oversight should not be a passive activity.

Reporting Cybersecurity Incidents to the SEC

Proposed Rule 204-6

- Advisers would be required to submit proposed Form ADV-C to the SEC promptly, but in no event more than 48 hours, after having a reasonable basis to conclude that a significant adviser cybersecurity incident or a significant fund cybersecurity incident had occurred or is occurring.
- Advisers would be required to amend any previously filed Form ADV-C within 48 hours:
  (1) After information previously reported becomes materially inaccurate;
  (2) If additional or new material information about a previously reported incident is discovered; or
  (3) After resolving a previously reported incident or closing an internal investigation relating to a previously reported incident.

Reporting Cybersecurity Incidents to the SEC (cont.)

Proposed Form ADV-C

- Structured as a series of check-the-box and fill-in-the-blank questions.
- Captures, among other things, identifying information about the adviser, details about the nature and scope of the incident, whether law enforcement or other government agencies have been notified, and whether the incident is covered under a cybersecurity insurance policy.

Disclosure of Cybersecurity Risks and Incidents

Amended Form ADV

- Proposed Item 20 of Form ADV Part 2A would require advisers to describe:
  (1) Any cybersecurity risks that could materially affect the advisory services they offer and how they assess, prioritize, and address cybersecurity risks; and
  (2) Any cybersecurity incidents that have occurred in the last two fiscal years that have significantly disrupted or degraded the adviser's ability to maintain critical operations, or have led to the unauthorized access or use of adviser information, resulting in substantial harm to the adviser or its clients.
- Proposed Rule 204-3(b) would require an adviser to promptly deliver interim brochure amendments to existing clients if the adviser adds disclosure of a cybersecurity incident to its brochure or materially revises information already disclosed in its brochure about such an incident.

Disclosure of Cybersecurity Risks and Incidents (cont.)

Amended Fund Registration Statements

- The proposal would also require funds to disclose, in their registration statements, any significant fund cybersecurity incidents that have occurred in the last two fiscal years.
- Disclosure must include (1) the entity or entities affected; (2) when the incident was discovered and whether it is ongoing; (3) whether any data was stolen, altered, or accessed or used for any other unauthorized purpose; (4) the effect on the fund’s operations; and (5) whether the fund/service provider has remediated or is currently remediating the incident.

Final Thoughts

1

Fund Boards Need Additional Clarity Regarding Oversight Role

- Standard for board approval of cybersecurity policies and procedures
- Oversight of fund third-party service providers

2

48-Hour Reporting Requirement Will Be a Significant Challenge

- Goes beyond most state and federal cybersecurity reporting requirements
- Ongoing requirement to amend reporting creates additional burden

3

Oversight of Third Parties Could Be a Significant Challenge

- Likely a significant burden for smaller advisers and funds
- Third parties may not be willing to accept certain contractual risks/terms

4

Maintain Thorough Records and Documentation

- Ensure disclosure is consistent with and supported by records and documentation
- Ensure due diligence and oversight of third parties is sufficiently documented

Implementation Issues with Derivatives and Valuation Rules

Derivatives Rule – Implementation Tips

- Establish Derivatives Risk Management Program
  - Whose program is it anyway?
  - Derivatives Risk Manager (DRM) must be approved by the board
    - “officer or officers of the adviser;” segregated from portfolio manager functions.
  - Role of DRM
    - Derivatives risk identification and assessment -- documentation
    - Derivatives risk guidelines -- responding to exceedances
  - Roles of (and delegation to) subadvisers -- single vs. multi-manager
- Derivatives policies and procedures
  - Limited Derivative User identification and compliance (including exceedance protocol)
  - Qualifications for DRM appointment

Valuation Rule – Implementation Tips

- Who is doing what? Clarify responsibilities
  - Designation of the fund's adviser
  - Specification of the titles and functions of individuals responsible for fair valuation (including pricing challenges)
  - Segregation from portfolio management
  - Describe interactions with other groups, including any escalation process
- Assess valuation risks
  - Describe frequency, documentation and reporting
- Specific requirements
  - Identify testing methods as well as the minimum frequency
  - Description of challenge process, including when a challenge should be initiated
- Impact to cross-trading

Proposed Money Market Fund Reform

Events of March 2020

- Amid escalating concerns about the economic impact of COVID-19 in March 2020, market participants sought to rapidly shift their holdings toward cash and short-term government securities, placing stress on various components of the short-term funding markets, including prime and tax-exempt money market funds.
- Government money market funds experienced record inflows, whereas institutional prime and tax-exempt funds experienced massive outflows.
  - During the period of March 11 to 24, publicly offered institutional prime funds had a 30% redemption rate (about $100 billion in redemptions), which included outflows of approximately 20% of assets during the week of March 20 alone.
  - Government funds had record inflows of $838 billion in March 2020 and an additional $347 billion of inflows in April 2020.

Events of March 2020 (cont.)

- As prime money market funds experienced heavy redemptions, conditions in both the private and municipal short-term debt markets worsened rapidly during the second half of March 2020.
  - Commercial paper and certificates of deposit became “frozen,” making it more difficult to sell those instruments.
  - New issuances of commercial paper declined markedly and shifted to short tenors, causing the share of commercial paper issuances with overnight maturity to climb nearly 90% on March 23.
  - Tax-exempt funds reduced their holdings of variable-rate demand notes by 16 percent ($15 billion) between March 9 and March 23.

SEC’s Response to the March 2020 Events

- The effects of March 2020 on prime and tax-exempt money market funds again revealed structural vulnerabilities in money market funds that had contributed to a significant increase in redemptions over a short period.
- In December 2020, the president’s Working Group on Financial Markets issued a report discussing those events along with several potential money market fund reform options, and the SEC issued a request for comment on the various reform options discussed, which included:
  - Reform of conditions for imposing redemption gates
  - Swing pricing requirement
  - Capital buffer requirements
  - New requirements governing sponsor support
  - Countercyclical weekly liquid-asset requirements

SEC's Response to the March 2020 Events (cont.)

- On December 15, 2021, the SEC, in a 3-2 vote, proposed amendments to Rule 2a-7 in response to the liquidity stresses experienced in March 2020 and the associated stresses in the short-term funding markets.

Key Proposals

Removal of Liquidity Fees and Redemption Gates

- Currently, the board of directors of a nongovernment money market fund is permitted to impose a liquidity fee of up to 2% or temporarily suspend redemptions for up to 10 business days in a 90-day period if the money market fund's "weekly liquid assets" fall below 30%.
  - Separately, a nongovernment money market fund is required to impose a 1% liquidity fee on all redemptions if its weekly liquid assets fall below 10% of its total assets, unless its board of directors determines that imposing such a fee would not be in the best interests of the fund.
- These fees and gates were implemented during the 2014 reforms and were designed to provide a "cooling off" period to calm short-term investor panic, preserve liquidity levels in times of market stress, and better allocate the costs of providing liquidity to redeeming shareholders.

Key Proposals

Removal of Liquidity Fees and Redemption Gates (continued)

- During its review of market activity during and immediately following the period of market stress in March 2020, the SEC found that although no money market funds imposed liquidity fees or gates in March 2020, the possibility of their imposition appears to have exacerbated redemption pressure on money market funds during that period.
- The SEC conceded that the fees and gates did not have the intended effect and, accordingly, the amendments would remove the liquidity fee and redemption gate provisions from Rule 2a-7.

Key Proposals

Swing-Pricing Requirement

- In lieu of redemption fees and gates, the amendments would require institutional prime and institutional tax-exempt money market funds to implement swing pricing for any periods of net redemptions.
  - In accordance with this requirement, an institutional prime or institutional tax-exempt money market fund would be required to adjust its current NAV by a swing factor reflecting spread and transaction costs, and, if the fund has net redemptions exceeding a “market impact threshold,” market impact costs.
  - The adjusted NAV would reflect costs resulting from shareholder redemptions, and would, in the view of the SEC, ensure that these costs are fairly allocated to the redeeming shareholders.

Key Proposals

Swing-Pricing Requirement (continued)

- A swing pricing administrator, designated by the money market fund's board of directors, would be responsible for administering the money market fund's swing pricing policies and procedures and determining the swing factor.
  - The swing pricing administrator would also determine whether the money market fund should adopt a "market impact threshold" lower than the default threshold (i.e., 4% of the fund's net asset value divided by the number of pricing periods the fund has in a business day).
  - The swing-pricing administrator would be responsible for drafting an annual report that would include the swing-pricing administrator's review of the adequacy of the money market fund's swing pricing policies and procedures and the effectiveness of their implementation.

Key Proposals

Swing-Pricing Requirement (continued)

- The SEC believes that this swing-pricing approach would address some of the issues the SEC observed as problematic during the March 2020 market turmoil. Specifically, in the SEC's view, the swing-pricing provisions would mitigate the risk of institutional investors seeking first-mover advantage and discourage excessive redemptions, particularly in times of stress.
- However, the SEC acknowledged that the swing-pricing requirement would create significant new operational issues and costs for money market funds, including obtaining timely flow information to inform swing-pricing decisions, determining whether the fund has net redemptions, and calculating and applying the swing factor to the NAV prior to processing shareholder transactions—potentially multiple times per day.

Key Proposals

Amendments Related to Potential Negative Interest Rates

- Rule 2a-7, in its current form, does not explicitly address how money market funds must operate when interest rates are negative. However, the SEC provided guidance in the proposing release related to the operation of government and retail money market funds that seek to maintain a stable NAV in negative interest rate environments.
- According to the proposing release, if negative interest rates turn a stable NAV money market fund’s gross yield negative and the fund’s board of directors reasonably believes that the stable share price does not fairly reflect the fund’s market-based share price, the fund would be required to convert to a floating share price.

Key Proposals

Amendments Related to Potential Negative Interest Rates (continued)

- The amendments would require a government or retail money market fund to determine that its financial intermediaries are able to process transactions in the fund's shares at prices that do not correspond to a stable price per share (in the event that the fund converts to a floating NAV).
  - If such determination cannot be made, the amendments would require the money market fund to prohibit the relevant financial intermediary from purchasing the fund's shares in nominee name, potentially resulting in operational issues and additional costs for government and retail money market funds.

Other Proposed Amendments

Reverse Distribution Mechanism

- Due to concerns regarding the potential misleading or confusing nature of a reverse distribution mechanism, the SEC is proposing to amend Rule 2a-7 to prohibit money market funds from operating a reverse distribution mechanism, routine reverse stock split, or other device that would periodically reduce the number of the fund's outstanding shares to maintain a stable share price.

Calculation of WAM and WAL Under Rule 2a-7

- The amendments would specify that money market funds must use the market value in the fund’s portfolio when calculating dollar-weighted average portfolio maturity (WAM) and dollar-weighted average life maturity (WAL) under Rule 2a-7 (some money market funds currently use amortized cost instead of market value when making these calculations).

Other Proposed Amendments (cont.)

Stress Testing

- The SEC is proposing to amend money market fund stress-testing and related board of directors reporting requirements.

Reporting Requirements

- Amend Forms N-MFP and N-CR to include additional information about money market funds, as well as make certain conforming changes to Form N-1A to reflect certain of the other amendments.

Final Thoughts

- The comment period on these proposed amendments is ongoing and will end on April 11, 2022.
- The SEC voted to propose the amendments along party lines with a 3-2 vote, and, because these amendments represent significant changes, especially with respect to the imposition of swing pricing for institutional prime and tax-exempt funds, they may be meaningfully revised prior to their adoption.
- If the amendments are ultimately adopted as proposed, money market funds, their sponsors, and their boards of directors will be required to undertake the implementation of new policies and procedures as well as reevaluate the way in which they operate their money market funds in order to come into compliance with the new regulatory regime.

ESG

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Themes in ESG Investing

- Investor demand has led to rapid growth and innovation in the ESG investing space in the last several years
- Growth and innovation have been outpacing regulatory action in the United States
- US regulators are very focused on all aspects of, and risks associated with, ESG investing – through disclosure review, exams, etc.
- ESG investing presents challenges across the industry due to a lack of common definitions and standardized terms
- Bottom line, consistency is key: “Say what you do; do what you say”

What is ESG?

E is for "Environment"	S is for "Social"	G is for "Governance"
• Climate change • Greenhouse gas emissions (GHG) • Energy use • Water use • Pollution • Hazardous waste • Recycling • Sustainability	• Diversity and inclusion • Corporate giving and philanthropy • Working conditions • Workplace health and safety • Compensation and benefits • Internal pay equity • Employee opportunity • Labor and human rights • Child and forced labor • Supplier practices	• Board structure and composition (including tenure and diversity) • Executive compensation • Shareholder rights • Enterprise risk management • Audit oversight • Disclosure and reporting • Ethics and compliance • Privacy and cybersecurity

What is an ESG Strategy?

Different ways to implement ESG:

ESG Integration / ESG Aware	ESG Screening (inclusionary / exclusionary)	ESG Objective / Impact Investing
• ESG information considered when making investment decisions • Portfolio managers "think" about ESG all the time	• Strategy excludes certain industries, sectors or issuers (e.g., tobacco, firearms, fossil fuels, etc.) • Only certain securities are eligible for investment after "making the cut" based on pre-determined criteria	• Investment mandate is ESG-focused • Product is intended to effectuate an ESG impact or result as part of its objective
Example Strategies		
• Emerging Market Small-Cap • ESG High-Yield	• ESG International Stock	• US Large-Cap Low-Carbon • Global Impact

US ESG Regulatory Landscape

SEC – Issuers	• What is “material” and does it even have to be? What data is available and possible? • Immediate focus on climate risk and carbon sensitivities • **SEC Proposal (3/21/22): Proposes to require enhanced and standardized disclosures regarding GHG emissions and climate change risks, management and impacts**
SEC – Funds/Advisers	• Disclosures regarding investments and investment strategies; funds and advisers • What is available and possible? Data limitations based on issuer reporting • **Prediction: Enhanced “names rule” for US registered funds; ESG disclosure requirements in registration statements; investment adviser disclosures (Form ADV)**
DOL	• ERISA creates challenges for ESG investing – “solely in the interests of the [plan] ... and for the exclusive purpose of ... providing benefits ... and defraying reasonable expenses” • New proposed rule intended to smooth these challenges • **Prediction: Proposed Rule passes with ESG examples, but risks another reversal; limited practical impact**
Examinations/ Enforcement	• Issuers and managers asked to “show their work”; scrutiny of ESG-branded funds and strategies • Even generic statements can be a trigger for inquiries – many access points to start an examination or investigation that can become an enforcement • **Prediction: More inquiries; more examinations; more enforcement**

Non-Regulatory Global Landscape

- Growth of non-regulatory ESG standard setters:
  - UN PRI (Principles for Responsible Investment)
  - US SIF (Forum for Sustainable and Responsible Investment)
  - CFA Institute proposed ESG standards
  - GRI (Global Reporting Initiative) Standards
  - SASB (Sustainability Accounting Standards Board)
  - TCFD (Task Force on Climate-related Financial Disclosures)
  - Net zero initiatives (asset managers, asset owners, foundations, etc.)
- Individual client commitments
  - Reduced carbon footprint (as a company or in investment portfolios)
  - Service provider diversity

SEC ESG Focus Areas for Funds

- **Greenwashing**: Consistency in messaging across all documentation and messaging (including website disclosures and public statements and client communications)
- **Cross-Firm Coordination**: Compliance, legal, investment management, investment risk, marketing, RFI teams, service provider oversight (e.g., index providers, data providers, and ESG ratings providers)
- **Risk Management**: ESG risk is increasingly important to consider when making investment decisions (e.g., data integrity, operational risk, transition risk, litigation risk, opportunity cost)

SEC ESG Focus Areas for Funds

- **Consistent and Clear Disclosure**: Say what you do; do what you say.
  - Even benign ESG representations could be "material," so they must be accurate and unexaggerated
  - Avoid overstating ESG characteristics and factors
  - Precision in definitions – generalizations and ambiguity can cause miscommunication
  - Focus on fund names
- **Materiality**: Consider any mention of ESG (or similar terms) material
- **Documentation**: Be prepared to back up any ESG claims made in offering documents, on websites, in RFIs, etc.
  - Consider whether compliance policies and procedures are appropriate – either dedicated ESG policies or enhancements to existing policies

SEC ESG Focus Areas for Funds

- **Other Areas**: Proxy voting, client communications (RFIs, DDQs, and RPFs), model portfolios, trading records, proprietary scoring, reliance on third-party service providers, representations surrounding global standard setters

Digital Assets

Digital Assets: An Evolving Definition

- **SEC Digital Asset Definition:** The term “digital asset” refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology (distributed ledger technology), including, but not limited to, so-called “virtual currencies,” “coins,” and “tokens.”
  - A digital asset may or may not meet the definition of a “security” under federal securities laws.
  - A “digital asset security” is a digital asset that meets the definition of a “security” under federal securities laws.

Digital Assets: 1940 Act Funds

- What types of digital asset investments are permitted for each type of fund listed below?
  - Mutual Funds
  - Active ETFs
  - Index ETFs
- What types of digital asset investments are not permitted?
- What practical/operational limitations still exist?
- What effect does the inclusion of digital asset investments have on a fund's compliance program?

Digital Assets: What's on the horizon?

- **Future Regulation**
  - Executive Order on Ensuring Responsible Development of Digital Assets
  - Legislative efforts
  - Regulatory enforcement actions
  - Regulatory guidance
- **Product Development**
  - Ether
  - Tokens
  - Smart contracts
  - Private funds

Q&A

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With more than a decade of experience as senior in-house counsel with global investment managers, Lance Dial has a deep understanding of mutual fund law and operation and is fluent in the myriad regulations applicable to investment managers. He is well versed in the creation of investment products and environmental, social and governance (ESG) and sustainability matters. Lance works extensively on regulatory policy matters engaging with various financial services regulators, including the US Securities and Exchange Commission, US Department of Labor, Internal Revenue Service, and US Department of Treasury.

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Laura E. Flores’ practice focuses on the regulation of investment companies and investment advisers. Laura regularly represents exchange-traded funds (ETFs), mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. She counsels both well-established clients and clients that are new to the industry on a variety of regulatory, transactional, compliance and operational issues, including the development of new financial products and services, federal and state registration issues, the preparation and implementation of compliance programs, business combinations involving investment companies and investment advisers, interpretive and “no-action” letter requests, requests for Securities and Exchange Commission exemptive relief, and regulatory examinations. Laura also counsels investment advisory clients on matters, including advertising and communications with the public, investment adviser registration, and separately managed account (or wrap fee) programs. Laura also has significant experience representing “liquid alt” funds, funds that invest through offshore subsidiaries, and funds that utilize QFII/RQFII quotas to invest directly in securities issued and traded in China.

Prior to joining Morgan Lewis, Laura was a partner in the financial services practice of another international law firm, where she also served on the firm’s diversity committee. Before that, Laura was assistant general counsel in the asset management division of a global bank and an associate in the Washington D.C. office of Morgan Lewis.

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Sean Graber advises companies in the securities industry on investment management matters. Investment advisers, mutual funds, closed-end funds, private investment companies, registered funds of hedge funds, and exchange-traded funds seek his advice on organizational issues, registration, and ongoing regulatory compliance matters. He also serves as counsel to the boards of directors of mutual funds, and he advises insurance companies on regulatory matters relating to variable insurance products.

Sean counsels clients on regulatory and transactional investment management matters. These include the development of new products and services, US federal and state registration and compliance issues, and US Securities and Exchange Commission (SEC) enforcement actions. He advises clients on mergers and acquisitions involving investment companies and investment advisers, and addresses interpretive and "no-action" letter requests, SEC exemptive orders, and related matters.

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Amy McDonald advises registered funds, including mutual funds and exchange-traded funds (ETFs), and their investment advisers in a number of areas, such as US Securities and Exchange Commission (SEC) filings, regulatory and compliance issues, corporate matters, and Board governance. Amy also helps clients with advocacy efforts surrounding SEC rulemakings and advising on subsequent implementation and compliance questions. Amy is an active member of the firm's environmental, social, and governance (ESG) and sustainability working group, and frequently advises clients on ESG investing, disclosure, and compliance questions.

In addition to supporting clients in drafting fund documents, including registration statements, proxy materials, and exemptive applications, Amy has experience in a broad range of legal, regulatory, and transactional matters. Before joining Morgan Lewis, Amy spent almost 10 years practicing in house, serving most recently as legal counsel to the ETF business of a New York–based asset manager. Prior to this, Amy served in legal, regulatory and compliance roles for a Boston-based investment adviser/fund complex. Amy began her legal career as an associate in the financial services group of an international law firm, resident in Boston.

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Jonathan J. Nowakowski advises investment companies, investment advisers, and private funds on a variety of regulatory compliance, corporate, and transactional matters. Jon counsels clients in all aspects of their organization, registration, operation, and liquidation. In addition, Jon advises broker-dealers on various matters, particularly with respect to regulatory compliance issues, market making activities, and transactions in exchange-traded funds. Jon is also a member of the firm's environmental, social, and governance (ESG) and sustainability working group, and regularly counsels clients on ESG investing strategies, disclosure, and related regulatory issues.

Before joining Morgan Lewis, Jon served in various compliance, risk management, and legal roles at an international bank and broker-dealer, a large national law firm, and a global investment bank. He also previously held a FINRA Series 7 license.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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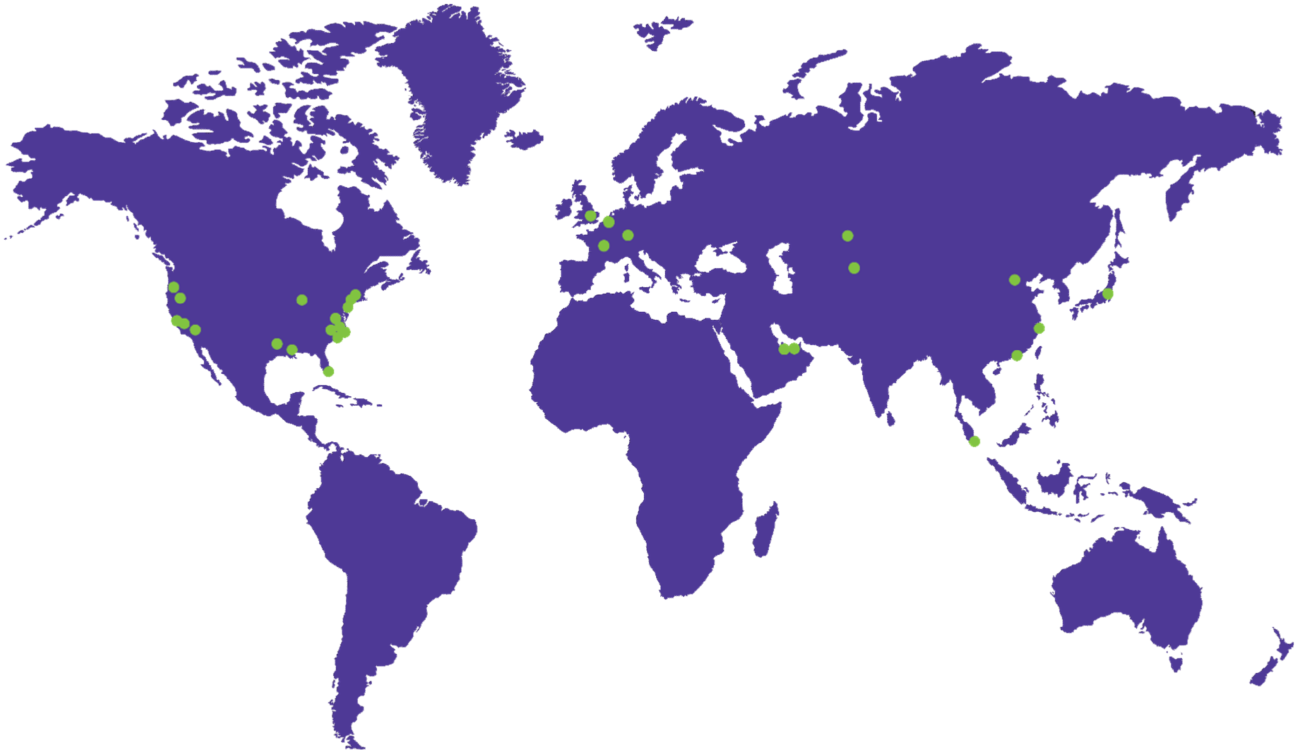

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THANK YOU