IAA NEWSLETTER

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INSIDE

November 2022 Compliance Date for New Marketing Rule Finalized

Posted to IAA Today on March 10, 2021

The new Investment Adviser Marketing Rule was recently published in the *Federal Register*. As a result, advisers will have an 18-month transition period after the effective date of May 4, 2021 to comply with the new rule, meaning that they will need to be in full compliance by **November 4, 2022**.

The SEC has also published its first FAQ responding to questions about the new rule and its implementation. (*See related stories – SEC Staff Publishes First FAQ Regarding New Marketing Rule on* page 3 *and The New Marketing Rule | Seven Implementation Challenges on* page 17.)

In a significant victory for long-term IAA advocacy, the SEC voted unanimously in December to amend the marketing rules for investment advisers. The amendments create a single rule that replaces the current Advertising and Cash Solicitation Rules, and improve markedly on the regulatory framework the SEC proposed in 2019. The IAA strongly supported the SEC's efforts to modernize these rules and in particular has long advocated for modernizing the Advertising Rule – which had not been amended since its adoption in 1961 – and replacing it with a principles-based approach that better reflects modern communications and investor needs for meaningful information. We have been at the forefront of identifying issues and offering workable solutions, and submitted extensive comments on ways the rule could be improved. In fact, our 79-page comment letter was cited in the SEC's adopting release over 100 times.

The new Marketing Rule includes virtually all of the key recommendations the IAA has made over the years, including taking a principles-based approach to regulation, removing the *per se* prohibitions on testimonials and past spe-

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Special Sections in this Issue

SEC Focus on Climate, ESG

SEC initiatives to elevate Climate and ESG to high priority status accelerated rapidly in March – with a new Enforcement Division Task Force, new examination priorities, an increased focus on related corporate filings, a call for public comment, and an investor education bulletin. Our special section begins on page 6.

Compliance Conference Takeaways

Reports and videos from the 2021 IAA Compliance Conference – including talks with IAA enforcement, examinations, and investment management officials, a keynote with Commissioner Hester Peirce, and sessions on the new Marketing Rule, ERISA, international developments, SEC exam prep, COVID-19 impacts, DE&I, and more. Our coverage beings on page 17.

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SEC Staff Publishes First FAQ Regarding New Marketing Rule

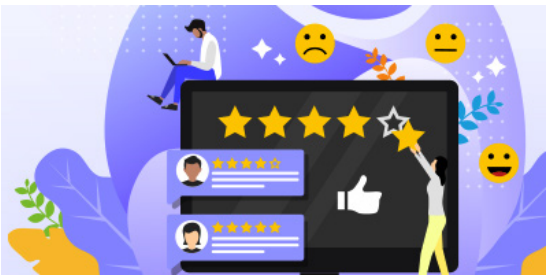
Confirms that Partial Compliance Not Permitted

Posted to IAA Today on March 25, 2021

The SEC staff has published the first response to what will likely be many questions regarding the new Marketing Rule for investment advisers. Advisers will have an 18-month transition period after the effective date of May 4, 2021 to comply with the new rule, meaning that full compliance will be required by November 4, 2022.

The FAQ formally confirms that partial compliance will not be permitted. Beginning May 4, advisers may comply with the entire rule at any time during the transition period, but will not be permitted to "pick and choose" provisions of the new rule for early compliance. Other important reminders from the FAQ:

- You should review your compliance policies and procedures in light of regulatory developments, including the adoption of the new Marketing Rule.
- When transitioning to the new Marketing Rule, you should implement necessary revisions to your policies and procedures in light of the requirements under the new rule.
- You are required to maintain a copy of all compliance policies and procedures in effect at any time within the previous five years, and it should be clear when those policies and procedures were in effect (*e.g.*, when you transitioned to complying with the new rule).



This FAQ confirms what SEC staff had previously told the IAA informally and more recently at the IAA's annual Compliance Conference.

The IAA has launched a number of initiatives to assist members with understanding and implementing the new Marketing Rule, including dedicated resource pages on our website. We also encourage interested members to join our Marketing Implementation Group. The group provides a forum for members to share interpretive and operational concerns and questions through regular conference calls. The group will also help the IAA develop further requests for FAQs from the SEC staff. To join the group and its associated online community on the IAA Exchange, please contact the IAA Legal Team at iaalegalteam@investmentadviser.org.

We are also planning the third webinar in our series ***The New Marketing Age for Advisers*** for Tuesday, April 20 at 2:00 pm ET. More information will be available on our website shortly.

November 2022 Compliance Date for New Marketing Rule Finalized—*continued from cover page*

cific recommendations, including disclosure-based guidelines for testimonials, endorsements, and third-party ratings, incorporating the piecemeal guidance issued over decades into a comprehensive approach, and providing sensible guidance on the use of performance advertising. Importantly, and in response to comments by the IAA and others, the SEC refined the proposed definition of "advertising" in the final rule and dropped the proposed pre-approval of all marketing materials that would have imposed an enormous compliance burden on advisers.

Advisers may begin complying with the new rule anytime after the May 4th effective date, but may not begin to comply until the effective date. Under guidance provided by the SEC staff at the recent IAA Compliance Conference, partial compliance will not be permitted. In other words, advisers will have the option to comply with the entire rule at any time during the transition period, but will not be permitted to "pick and choose" provisions of the new rule. Similarly, the new related recordkeeping requirements begin once an adviser starts complying with the new rule.

Advisers have much to learn and put into practice during the new rule's 18-month implementation period. The IAA has developed a dedicated website section that includes a range of online resources to assist members with implementation including, for example, easy to read summaries and analysis, FAQs, a continuing series of webinars on the rule's significant provisions, and compliance-focused columns appearing in future editions of *IAA Today*.

We have also created a **Marketing Implementation Group** to help members with their review and implementation of the rule and created an online community on the IAA Exchange. IAA members with questions or who want to join the Implementation Group should contact the IAA Legal Team at iaalegalteam@investmentadviser.org.

DOL Will Not Enforce ESG and Proxy Rules, Pending Agency Review

Announcement Highlights Concerns Raised by the IAA

Posted to IAA Today on March 10, 2021

In a welcome development, the Department of Labor has announced that it intends to revisit the recently adopted ESG rule, "Financial Factors in Selecting Plan Investments," and proxy rule, "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights." In the meantime, and until it provides further guidance, it will not enforce either of these rules.

Both rules were adopted during the final days of the Trump Administration and both took effect in mid-January.

Specifically, the DOL "will not enforce either final rule or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with those final rules with respect to an investment, including a Qualified Default Investment Alternative, or investment course of action or with respect to an exercise of shareholder rights." Notably, this enforcement statement will not preclude the DOL from "enforcing any statutory requirement under ERISA, including the statutory duties of prudence and loyalty in section 404 of ERISA."

The DOL's announcement directly addresses concerns raised by the IAA following the proposal and adoption of the ESG and proxy rules. We objected to both rules and requested that the proposals be withdrawn. After their adoption, we discussed with DOL staff the need to issue a non-enforcement position for both rules, expressing concern about the chilling effect of the rules on ESG investing and the use of ESG integration. The DOL discusses these and other concerns in its statement.

Another IAA concern that the DOL addresses is whether the rules "were rushed unnecessarily and failed to adequately consider and address the substantial evidence submitted by public commenters on the use of [ESG] considerations in improving investment value and long-term investment returns for retirement investors."

As previously reported in *IAA Today*, the DOL's ESG rule was included in a list of rules to be reviewed in connection with an executive order from President Biden titled "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis." The executive order requires agencies to review and take action to address regulations and other actions taken during the prior administration that conflict with objectives regarding the environment and climate change outlined in the executive order.

The IAA will continue to engage with the DOL as it reviews these rules.

IAA ADVISER ADVOCACY DAY

THURSDAY, JUNE 10, 2021
VIRTUAL EVENT

Making Advisers' Voices Heard on Capitol Hill

A new Administration and a new Congress mean a new focus on a wide range of issues affecting investment advisers – ESG, a financial transaction tax, carried interest, changes to capital gains, advisory fee deductibility, asset manager diversity, new disclosure mandates, e-delivery, retirement changes, and more.

How debate on these issues progresses – and how legislation on these issues is developed – will have lasting impact on advisory firms and their clients, so it's crucial that we make our voices heard on Capitol Hill. Legislators say the voices they listen to most closely are those of their constituents – which is why it's critically important that you join us for our 2021 Adviser Advocacy Day on **Thursday, June 10**.

Participation is free, but advance registration is required.

REGISTER NOW

How Our Virtual Program Works

Unlike previous years when we visited legislators' offices in person, this year's Adviser Advocacy Day will take place virtually. Attendees will be grouped and matched with legislators based on their work address and can expect to participate in three to five virtual meetings with lawmakers and/or their staffs, which will take 15-20 minutes each.

One week in advance, you will gain access to our Adviser Advocacy Day portal that includes:

- Your schedule
- Zoom links to all meetings
- Talking points and brief position papers on priority issues
- Industry economic and employment data for your state
- Contact information for attendees in your meetings

For Sponsorship Opportunities: Contact Alex Ioannidis at alex.ioannidis@investmentadviser.org.

SEC & CLIMATE & ESG

SEC initiatives to elevate Climate and ESG to high priority status accelerated rapidly in March. After appointing Biden transition team member **Satyam Khanna** to the newly created post of Senior Policy Advisor on Climate Change and ESG in February, Acting SEC Chair **Allison Herren Lee** has created an Enforcement Task Force on Climate and ESG, directed the SEC's Division of Corporation Finance to enhance its focus on climate-related disclosures, and issued a call for public input from investors, registrants, and other market participants on climate change disclosure.

The Division of Examinations has put Climate and ESG issues on its 2021 examination priorities list. And the agency's Office of Investor Education and Advocacy has released an Investor Bulletin offering guidance for investing in ESG funds.

The SEC's website says that as "investor demand for climate and other environmental, social, and governance (ESG) information soars, the SEC is responding with an all-agency approach" – and has created a web section detailing the initiatives of that approach called **SEC Response to Climate and ESG Risks and Opportunities**.

On these pages, we present content focusing on the latest SEC initiatives.

SEC Announces Enforcement Task Force on Climate and ESG

Commissioners Peirce, Roisman Question Timing, Recent Focus on ESG

Posted to IAA Today on March 5, 2021

In yet another move to intensify its focus on matters relating to ESG disclosures and investments, the SEC's Division of Enforcement has created a Climate and ESG Task Force, led by **Kelly L. Gibson**, Acting Deputy Director of the Division. Its 22 employees will analyze disclosure and compliance issues relating to investment advisers' and funds' ESG strategies and identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules. The task force is charged with developing initiatives to "proactively identify ESG-related misconduct" and will review ESG-related tips, referrals, and whistleblower complaints.

In announcing the new task force, Acting Chair **Allison Herren Lee** said she expects it to "play an important role in enhancing and coordinating the efforts of the Division of Enforcement, the Office of the Whistleblower, and other parts of the agency to bolster the efforts of the [SEC] as a whole on these vital matters." Lee has long described climate risk and sustainability as "critical issues for the investing public and our capital markets."

But the move drew criticism from Commissioners **Hester Peirce** and **Elad Roisman**, who issued a statement ques-

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tioning the SEC's recent actions related to ESG. Regarding Lee's recent statement on the Division of Corporation Finance's review of climate-related disclosure in public company filings, Peirce and Roisman "assume that the new initiative is simply a *continuation* of the work the staff has been doing for more than a decade and not a program to assess public filers' disclosure against any new standards or expectations."

Peirce and Roisman challenge Lee's stated intent to update the SEC's 2010 guidance on climate change, emphasizing the need for a new SEC vote if the plan is to collect more specific information or move from a principles-based to a prescriptive approach. They are also critical of the SEC's press release related to the Division of Examinations' 2021 Examination Priorities which discussed an "enhanced focus" on ESG when the priorities themselves only briefly discuss ESG-related risks. According to Peirce and Roisman, "[t]he focus [in the priorities] is a variation of the same theme that has motivated examinations for many years: advisers owe a fiduciary duty to their clients, which includes doing what you tell them you're doing and informing them about conflicts of interest."

With respect to the new task force, Peirce and Roisman ask whether it would be more prudent to wait for the Divisions of Corporation Finance and Examinations to complete their reviews and findings from the next exam cycle "before allocating resources to an ESG-specific Enforcement initiative." They also stress that the SEC "must continue to review any alleged securities violations in light of the regulations and guidance *in existence* at the time of the conduct in question."

The IAA is creating an ESG Committee to help guide our engagement on ESG policymaking efforts and to provide a forum for member consideration of ESG-related policy and regulatory issues more generally. Please contact IAA Associate General Counsel Sarah Buescher at sarah.buescher@investmentadviser.org if you are interested in joining the ESG Committee.

See SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021); and Enhancing Focus on the SEC's Enhanced Climate Change Efforts (Mar. 4, 2021).

SEC Staff to Increase Focus on Climate-Related Disclosures

New ESG Committee to Guide IAA Policy Responses

Posted to IAA Today on March 1, 2021

In another action focusing on climate and ESG issues, Acting Chair **Allison Herren Lee** has directed staff in the SEC's Division of Corporation Finance to "enhance its focus on climate-related disclosure in public company filings." In a statement issued on February 24, Lee highlighted "immediate steps the agency can take on the path to developing a more comprehensive framework that produces consistent, comparable, and reliable climate-related disclosures."

Lee instructed the staff to review the extent to which public companies have addressed the topics discussed in SEC guidance from 2010 regarding how SEC disclosure requirements apply to climate change matters. She intends for the staff to use information from its review to update the 2010 guidance.

Last month, Lee created a new senior policy advisor position on climate change and ESG. She appointed **Satyam Khanna** – an attorney who served on the Biden transition team reviewing banking and securities regulators – to the post. On climate matters, Lee has issued warnings publicly about the "market consequences of waiting until a crisis is upon us to respond." She also spoke at length about her concerns regarding climate change, and the attendant risks for investors arising from a lack of appropriate disclosure, in her keynote address at the 2020 IAA Investment Adviser Compliance Conference. A video of her remarks is available here.

Satyam Khanna, Senior Policy Advisor, SEC

The SEC's Office of Investor Education and Advocacy has added to the agency's focus on sustainable investing with an Investor Bulletin addressing ESG funds and their investment strategies.

The IAA expects that climate and ESG issues will be a high priority for the SEC with the new Administration, and we plan to be actively engaged in related policymaking efforts, with the help of our members. To encourage and facilitate member involvement, we are creating an ESG Committee to help guide our efforts and also to provide a forum for member consideration of ESG-related policy and regulatory issues more generally. While the ESG Committee will focus primarily on U.S. regulatory efforts, it will also provide opportunities for members to discuss implementation of the European Commission's disclosure regulation, or SFDR, which begins to go into effect on March 10 and is the first highly substantive ESG regulation to become effective.

Please contact IAA Associate General Counsel Sarah Buescher at sarah.buescher@investmentadviser.org if you are interested in joining the ESG Committee.

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SEC Acting Chair Lee Calls for Public Input on Climate Change Disclosures, Directs Staff to Review 2019 Adviser Proxy Guidance

Posted to IAA Today on March 17, 2021

Adding momentum to the SEC's intensifying focus on climate change and ESG risks, SEC Acting Chair **Allison Herren Lee** is inviting public input from investors, registrants, and other market participants on climate change disclosure. That input is intended to supplement a recently launched staff review ordered by Lee aimed at enhancing climate-related disclosure in public company filings.

"Since 2010, investor demand for, and company disclosure of information about, climate change risks, impacts, and opportunities has grown dramatically," Lee said in a statement on March 15. "Consequently, questions arise about whether climate change disclosures adequately inform investors about known material risks, uncertainties, impacts, and opportunities, and whether greater consistency could be achieved."

Lee said staff is evaluating disclosure rules "with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change." She is asking commenters to weigh in on a wide range of questions, including:

- How can the SEC best regulate, monitor, review and guide climate change disclosures?
- What information related to climate risks can be quantified and measured?
- What are the advantages and disadvantages of establishing different climate change reporting standards for different industries?
- How should any disclosure requirements be updated, improved, augmented, or otherwise changed over time?
- Should registrants disclose their internal governance and oversight of climate-related issues?
- What are the advantages and disadvantages of developing a single set of global standards applicable to companies around the world?
- Should climate-related requirements be one component of a broader ESG disclosure framework?
- What climate-related information is available with respect to private companies, and how should the SEC's rule address private companies' climate disclosures, such as through exempt offerings, or its oversight of certain investment advisers and funds?

The full set of questions is contained in Lee's statement. Comments are due within 90 days of the statement issue date. The SEC has created an online webform for submitting comments. Interested parties may also submit comments through the dedicated email address rule-comments@sec.gov.

Lee also gave two recent speeches that focus on ESG and proxy voting. In the first speech, she emphasized that "no single issue has been more pressing" for her "than ensuring that the SEC is fully engaged in confronting the risks and opportunities that climate and ESG pose for investors, our financial system, and our economy."

She discussed actions that she and the SEC staff have taken in recent weeks, including the establishment of a dedicated Enforcement Task Force; a Division of Corporation Finance staff review of climate-related disclosures; identifying climate and ESG risks as top examination priorities; the appointment of a Senior Policy Advisor on Climate Change and ESG; and the issuance of an Investor Bulletin that focuses on ESG principles and provides information on ESG funds and their investment strategies.

Adviser and Fund Proxy Voting

In her second speech, Lee highlighted two key trends – the growth in households invested in funds, and "the soaring demand for opportunities to invest in vehicles with ESG strategies."

According to Lee, SEC rules and guidance "should clearly emphasize the importance of voting as part of funds' and advisers' fiduciary obligations to their clients." Lee is concerned that funds with ESG strategies "may not always reflect those preferences in their voting" and highlights that this year's examination priorities include "examining ESG fund proxy voting policies and practices to ensure alignment with investors' best interests and expectations."

Lee has asked staff to revisit the 2019 guidance to investment advisers on proxy voting out of concern that it "discourages fiduciaries from voting in certain circumstances." Lee wants to "ensure that advisers understand how to weigh competing concerns of all types in deciding whether and how to cast votes on behalf of their clients." She also raises concerns about securities lending by index funds when shares are not recalled in time to vote proxies, citing "potential conflicts of interest for advisers in light of fee splits and revenue sharing that an adviser may receive."

She has also asked the staff to consider updates to Form N-PX, the form used by funds to report their proxy votes, and to review a Dodd-Frank Act rulemaking proposal that would require

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certain institutional managers to report votes on executive compensation on Form N-PX. Laying out potential changes to Form N-PX, Lee discussed enhancing "investors' ability to understand how funds or fund families vote on shareholder proposals." She is also asking staff to review the shareholder proposal process, which may involve reopening last year's rulemaking in this area, describing as a "mistaken decision" that rulemaking's bar on proponents working together and "restricting their ability to act through experienced agents." Lee also addresses proxy infrastructure issues, which has long been an area of concern for the IAA.

Separate from proxy voting, Lee raises the possibility of a requirement for an "ESG-specific policies and procedures requirement" for ESG funds. She also emphasizes the importance of international engagement and supports IOSCO's statement regarding the creation of a Sustainability Standards Board. Domestically, Lee proposes for consideration a "dedicated standard setter for ESG (similar to FASB) under SEC oversight to devise an ESG reporting framework that would complement our financial reporting framework."

The IAA plans to be actively engaged in related policymaking efforts, with the help of our members. To encourage and facilitate member involvement, we are creating an ESG Committee to help guide our efforts and also to provide a forum for member consideration of ESG-related policy and regulatory issues more generally. While the ESG Committee will focus primarily on U.S. regulatory efforts, it will also provide opportunities for members to discuss implementation of the European Commission's disclosure regulation, or SFDR, which went into effect on March 10 and is the first highly substantive ESG regulation to become effective.

Please contact IAA Associate General Counsel Sarah Buescher at sarah.buescher@investmentadviser.org if you are interested in joining the ESG Committee.

See Public Input Welcomed on Climate Change Disclosures (March 15, 2021), A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC (March 15, 2021), Every Vote Counts: The Importance of Fund Voting and Disclosure (March 17, 2021).

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WEBINAR

What Does the SEC's Focus on Climate and ESG Mean for Investment Advisers?

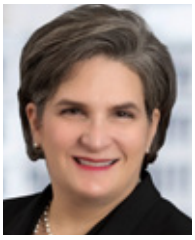
REGISTER NOW

At our webinar on Tuesday, May 4 from 2:00 – 3:00 pm ET, **Kelly L. Gibson**, Acting Deputy Director of the SEC's Division of Enforcement and leader of a division task force that is focused on ESG and climate issues, will join an expert panel that includes **Amy J. Greer** and **Jennifer L. Klass**, Co-Chairs of Baker McKenzie's North American Financial Regulation and Enforcement Practice, and IAA Associate General Counsel **Sarah Buescher**. The panel will discuss the SEC's initiatives and issues that advisers should consider. Topics to be addressed include potential areas for examination and enforcement, disclosures, advertising, compliance programs, and proxy voting.

This webinar is free to IAA members and Associate Members.
A recording of the webinar will be available the day after the live event.

Kelly L. Gibson, SEC

Amy J. Greer, Baker McKenzie



Jennifer L. Klass, Baker McKenzie

Sarah Buescher, IAA

SEC Offers Guidance for Investing in ESG Funds

Posted to IAA Today on March 1, 2021

In another sign of the SEC's increased focus on sustainable investing, the agency's Office of Investor Education and Advocacy has released an Investor Bulletin that focuses on environmental, social, and governance (ESG) principles. The Investor Bulletin provides information for investors on ESG funds and their investment strategies.

The bulletin explains ESG components, emphasizing that a fund manager may choose securities that meet one or multiple criteria. It also discusses different investment strategies in the ESG area, including "select[ing] companies based on their stated commitment to one or more ESG factors" and "screening out companies in certain sectors or that, in the view of the fund manager, have shown poor performance with regard to management of ESG risks and opportunities."

The bulletin highlights the fact that ESG factors may be defined in different ways by different funds or sponsors and informs investors that the SEC does not issue ESG ratings or scores.

The bulletin urges investors to understand what they are investing in to ensure that an investment matches the investor's "investment goals, objectives, risk tolerance, and preferences." To assist with this understanding, the bulletin recommends that investors review disclosure documents and websites to gain a better understanding of a fund's investment strategy, fees, and expenses.

To encourage and facilitate member involvement, the IAA is creating an ESG Committee to help guide our engagement on ESG policymaking efforts and to provide a forum for member consideration of ESG-related policy and regulatory issues more generally. Please contact IAA Associate General Counsel Sarah Buescher at sarah.buescher@investmentadviser.org if you are interested in joining the ESG Committee.

See Environmental, Social and Governance (ESG) Funds – Investor Bulletin (Feb. 26, 2021).

SEC Announces 2021 Examination Priorities, Greater Focus on Climate and ESG

Posted to IAA Today on March 5, 2021

The SEC staff has announced its examination priorities for fiscal year 2021 – and many of the themes are perennial risk areas the agency routinely covers in its examinations, with an enhanced focus this year on ***climate risks*** and ***ESG***-related issues. (See related story and video from the 2021 IAA Compliance Conference – *Form CRS, ESG Disclosure are Priorities for SEC Exams, Enforcement, on page 21.*)

The following is an overview of the SEC's examination priorities for investment advisers:

Retail Investors, Including Seniors and Those Saving for Retirement through Fiduciary Duty Compliance

The SEC will continue its emphasis on investments and services marketed to retail investors, including seniors and individuals saving for retirement, such as mutual funds and exchange-traded products, municipal securities and other fixed income instruments, and microcap securities, such as those traded over-the-counter. Specifically, examiners will continue to focus on:

Fiduciary Duty: Whether advisers have fulfilled their fiduciary duty including, among other things, whether advice provided (including as to account types) "continue[s] to be, in the *best interests* of their clients, based on their clients' objectives," and whether advisers "eliminate or make full and fair disclosure of all conflicts of interest which might incline RIAs — consciously or unconsciously — to render advice which is not disinterested such that their clients can provide informed consent to the conflict."

Fees and Expenses: Risks associated with fees and expenses, complex products, best execution, and undisclosed or inadequately disclosed compensation arrangements.

Compliance with Form CRS: Exams will continue to focus on whether firms have filed their Form CRS on a timely basis and have made the required disclosures.

Fraud, Sales Practices, and Conflicts: The *appropriateness of recommendations* and advice provided to retail investors, with a particular emphasis on: (i) seniors, including recommendations and advice made by entities and individuals targeting retirement communities; (ii) teachers; (iii) military personnel; and (iv) individuals saving for retirement.

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The exam staff will also concentrate on *recommendations regarding account type,* conversions, and rollovers, as well as the sales practices used by firms for *various product types,* such as structured products, exchange-traded products, real estate investment trusts, private placements, annuities, digital assets, municipal and other fixed income securities, and microcap securities. The SEC will also assess how firms are complying with the recent changes to the definition of *accredited investor* when recommending and selling interests in certain private offerings.

Examinations will include review of *disclosures regarding conflicts of interest, including those related to fees and expenses* (*e.g.,* revenue sharing arrangements and direct or indirect compensation to personnel for executing client transactions). Examiners will also scrutinize fee and expense disclosures provided by advisers operating and utilizing turnkey asset management platforms.

In addition, in reviewing fees and expenses, the staff will review for: (i) advisory *fee calculation errors,* including, but not limited to, failure to exclude certain holdings from management fee calculations; (ii) inaccurate calculations of *tiered fees*, including failure to provide breakpoints and aggregate household accounts; and (iii) failures to refund *prepaid fees* for *terminated accounts*.

Retail-Targeted Investments: Issues regarding retail-targeted investments will continue to be a priority, including incentives provided to firms and professionals that may influence the selection of particular higher cost *mutual fund share classes* when lower cost classes are available.

Compliance Programs

SEC examiners will continue to assess the compliance programs of *advisers (and registered funds) that have not been examined* for a number of years or have never been examined, including newly registered advisers.

The examination staff will also focus on *climate and sustainability related products and services* (*i.e., ESG*) that are widely available (*e.g.,* mutual funds and ETFs) as well as those offered to accredited investors (*e.g.,* qualified opportunity funds). Specifically, examiners will assess the consistency and adequacy of disclosures provided regarding these strategies, determine whether the firms' processes and practices match their disclosures, review fund advertising for false or misleading statements, and review *proxy voting policies and procedures and votes* to assess whether they align with the strategies.

With respect to *dually registered firms or advisers with broker-dealer affiliates,* areas of focus will include whether the advisers maintain effective compliance programs to address the risks associated with these business models, including conflicts of interest that arise from certain compensation arrangements and outside business activities, best execution, and prohibited transactions.

Private Funds

Examinations of private fund advisers will include, among other things: *preferential treatment* of certain investors where private funds have experienced liquidity issues, including imposing gates or suspensions on withdrawals; *portfolio valuations* and the impact on management fees; *adequacy of disclosure* and regulatory compliance relating to cross trades, principal investments, or distressed sales; and *conflicts around liquidity*, such as adviser led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund.

With respect to private funds that have a *higher concentration of structured products*, such as collateralized loan obligations and mortgage-backed securities, examiners will assess whether the funds are at a higher risk for holding non-performing loans and having loans with higher default risk

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than that disclosed to investors. SEC examiners will also focus on private funds that invested in *portfolio companies materially impacted by recent economic conditions* (*e.g.,* real estate related investments).

Registered Funds, including Mutual Funds and ETFs

With respect to registered funds, examinations will focus on compliance programs, governance practices, disclosures, valuation (particularly for investments in market sectors impacted by the pandemic, such as energy, real estate, or products such as bank loans and high yield corporate and municipal bonds), SEC filings, personal trading activities, contracts and agreements, and securities lending arrangements. Other focus areas include compliance with *exemptive relief, liquidity risk management* programs, and *money market funds'* compliance with stress-testing requirements, website disclosure, and board oversight.

Information Security and Operational Resiliency

Citing the increase in *remote operations in response to the pandemic*, the SEC will review whether firms have taken appropriate measures to: (i) *safeguard client accounts* and prevent account intrusions, including verifying an investor's identity to prevent unauthorized account access; (ii) oversee *vendors and service providers;* (iii) address *malicious email* activities, such as phishing or account intrusions; (iv) *respond to incidents*, including those related to ransomware attacks; and (v) manage *operational risk* as a result of dispersed employees in a work-from-home environment. The exam staff will also focus on controls surrounding:

- Online and mobile application access to investor account information
- Electronic storage of books and records and personally identifiable information maintained with third-party cloud service providers
- Protection of investor records and information

The SEC will review *business continuity and disaster recovery plans* and whether firms (particularly those that are deemed systemically important) continue to assess and make necessary improvements.

FINTECH and Innovation, including Digital Assets

Examinations of firms providing advice through *automated* investment tools and platforms or firms offering automated asset allocation, fractional share purchases, customized portfolios, and mobile applications will focus on evaluating whether firms are operating consistently with their representations and handling client orders in accordance with client instructions, and will review compliance around trade recommendations made in mobile applications.

LIBOR

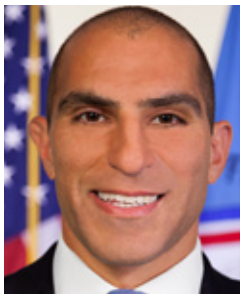
The examination staff will continue to engage with firms to assess their understanding of LIBOR exposure and preparations for the expected discontinuation of LIBOR and the transition to an alternative reference rate, in connection with a firm's own financial matters and those of its clients.

According to the published priorities, specific areas of focus covered during examinations vary depending on the type of firm and business activities, including: products and services offered, including certain products identified as having higher risk characteristics; compensation and funding arrangements; disclosures and representations made to clients; prior examination observations and regulatory history; whether the firm has never been examined, is newly registered, or has not been examined in many years; material changes in firm leadership or other key personnel; and whether a firm has access to investor assets, *i.e.,* custody.

Please contact the IAA legal staff if you have any questions.

CFTC Establishes New Climate Risk Unit to Focus on Role of Derivatives

Posted to IAA Today on March 23, 2021



Rostin Behnam, CFTC

Noting that, "[c]limate change poses a major threat to U.S. financial stability," CFTC Acting Chairman **Rostin Behnam** announced that he has established a CFTC Climate Risk Unit (CRU) to focus on the role of derivatives in understanding, pricing, and addressing climate-related risk and transitioning to a low-carbon economy. The CRU includes CFTC staff from multiple operating divisions and offices. It is intended to facilitate the CFTC's response to tackling climate change and to support industry-led and market-driven processes in the climate and larger ESG area that are critical to ensuring that new products and markets fairly facilitate hedging, price discovery, market transparency, and capital allocation.

The CRU will undertake research and outreach to facilitate:

- **proactive engagement** with the exchanges, clearinghouses, industry groups, and market participants on discussing new and emerging risks related to climate change and the impact of extreme and increasingly frequent and severe weather events, and how these market risks are being or ought to be addressed in a fair and equitable way;

- understanding of the derivatives and related products being developed to address climate-related market risks and the **transition to a net-zero economy**, and how such products fit within the CFTC's regulatory and supervisory framework, including the identification of areas where refinements or modifications could be made either to products or to the CFTC's approach;

- building domestic and international consensus for **consistent standards**, taxonomies, disclosures, and practices across derivatives products and markets, as well as clarity on regulatory, capital, and accounting standards;

- efforts to support the development of relevant and reliable climate-related market risk **data resources**; and

- evaluation of whether tools like **climate finance labs** or **regulatory sandboxes** would enhance development of climate-related market risk tools, products, and services.

The CFTC must address emerging risks and build a "climate-resilient financial system," Behnam says. Behnam earlier led the CFTC's effort to establish the agency's Market Risk Advisory Committee's Climate-Related Market Risk Subcommittee and called for the CFTC's September 2020 report on Managing Climate Risk in the U.S. Financial System.

Committees, Working Groups, and Forums

We encourage all members to participate in our Committees, Working Groups, and Forums.

To join an IAA Committee, Working Group or Forum – or to join an online community on the IAA Exchange – contact iaaservices@investmentadviser.org or call (202) 293-4222.

SEC's Division of Examinations Releases Roadmap for Advisers that Invest Clients in Digital Assets

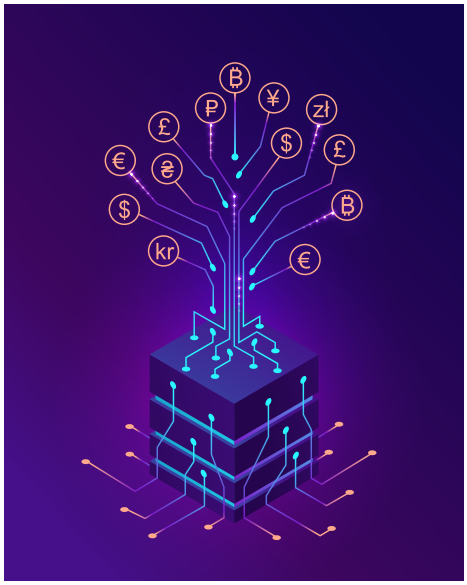
Posted to IAA Today on March 1, 2021

Saying activities involved in the offer, sale, and trading of digital assets present unique risks to investors, the SEC's Division of Examinations has issued a new Risk Alert to assist firms in developing and enhancing their compliance practices related to digital securities and other distributed ledger assets. The Alert also outlines areas of focus for future exams.

The Division of Examinations prepared the Alert following recent exams of investment advisers, broker-dealers, and transfer agents. Risks identified during exams of investment advisers managing digital securities, other digital assets, and derivatives products for clients – either directly or through pooled vehicles such as private funds – have prompted the Division to focus future exams on regulatory compliance in these areas:

Portfolio Management. The Division plans to review advisers' policies, procedures, and practices with a particular focus on: how digital assets managed for clients are classified, *e.g.,* are they securities?; whether appropriate due diligence is done on these assets, including with respect to an adviser's understanding of all relevant aspects of the assets and their trading; how risks relating to trading venues, execution, and settlement are evaluated and mitigated; how risks and complexities relating to "forked" and "airdropped" assets are managed; and whether advisers are satisfying their fiduciary duty with respect to their advice and across all client types.

Books and Records. Exams will scrutinize whether advisers are making and keeping accurate books and records. Because digital asset trading



platforms vary in reliability and consistency, the Division will expect to see that an adviser has considered trading-related recordation and notification risks.

Custody. Regardless of how digital assets are stored, exams will review several custody-related risks and practices, including unauthorized transactions, safekeeping controls, business continuity plans where key personnel have exclusive access to private keys and how the adviser evaluates harm from the loss of private keys, reliability of relevant software, storage of digital assets, and security procedures related to wallets.

Disclosures. Exams will focus on whether advisers are disclosing across a variety of media the unique risks associated with digital assets. In this regard, the Division will look at disclosures relating to several specific risks, including the complexities of the products and underlying technology, technical, legal, market, and operational risks, and risks relating to valuation, price volatility and illiquidity, related party transactions, and conflicts of interest.

Pricing Client Portfolios. The Division believes that advisers may face valuation challenges due to market fragmentation, illiquidity, volatility, and the potential for manipulation. Exams will thus include a review of valuation methodologies, disclosure related to these methodologies, and advisory fee calculations and the impact valuation practices have on these fees. The Division will review valuation methods used to determine principal markets, fair value, valuation after significant events, and recognition of forked and airdropped digital assets.

Registration Issues. Exams will review "compliance matters related to appropriate registration," including how the adviser calculates its RAUM and how it characterizes the status of clients and the digital assets in the pooled vehicles it manages. Exams will also look at how private funds determine the applicable exemption from registration as investment companies.

As more advisers wade into the digital assets space on behalf of clients, they will need to assess their compliance programs frequently to ensure they are keeping up with fast-paced developments in this area. The Division encourages advisers that have questions to reach out to the SEC's Strategic Hub for Innovation Technology (FinHub).

The risk alert is available at https://www.sec.gov/files/digital-assets-risk-alert.pdf.

The IAA's invitation-only Technology Innovation Committee provides a forum for members directly engaged in financial technology efforts to explore issues related to emerging technologies. Please contact IAA General Counsel Gail Bernstein at gail.bernstein@investmentadviser.org if you would like to discuss joining the Committee.

Leading Asset Management CEOs Address New Data on Gender Diversity and Commitment to Accelerate Change

Posted to IAA Today on March 23, 2021

Despite some encouraging signs in specific regions, women's participation in the investment management industry has remained stagnant for more than 20 years, according to data presented during DE&I in the Investment Management Industry, a virtual Executive Roundtable hosted by the Women Business Collaborative, the Investment Adviser Association, and Morningstar.

"Our profession has a long way to go in matters of diversity, equity, and inclusion," said IAA President & CEO **Karen Barr**, one of the roundtable's moderators. "We must step up to confront these issues. Now is the time to bring our community together to share perspectives on how we can do better and drive effective change."

The data picture of women's underrepresentation in investment management was presented by **Laura Lutton**, Head of Asset Management Solutions at Morningstar and **Sarah Maynard**, Global Head of External Inclusion and Diversity Strategies and Programs at the CFA Institute.

Strategies for creating a path forward to accelerate change were offered by three leading asset management CEOs with more than 85 years of combined experience and overseeing more than $4.5 trillion in assets: **Yie-Hsin Hung**, CEO of New York Life Investment Management; **Jenny Johnson**, President & CEO of Franklin Templeton; and **Michelle Seitz**, Chairman & CEO of Russell Investments. The roundtable was moderated by Barr and former Oak Hill Advisors Partner **Alex Jung**.

Globally, the rate of women mutual fund managers is unchanged since 2000 at about 14 percent, according to new data presented by Morningstar's Lutton. There are bright spots – the representation of women in parts of Asia is north of 20 percent and is approaching 30 percent in China. But in the U.S. and U.K. the rate is below the global average.

WATCH THE VIDEOS

*A recording of the executive roundtable **DE&I in the Investment Management Industry** is available online. Additional IAA video resources include **Diversity, Equity & Inclusion: An Investment Industry Imperative** from the IAA's **2020 Leadership Week** and **Diversity, Equity & Inclusion in the Investment Management Industry** from our **2021 Compliance Conference**.*

One point of encouragement is that more women are in the talent pipeline, seeking the professional credentials seen as relevant to participating in the investment management industry. The CFA Institute's Maynard noted that between 2015 and 2020, the participation by women in the CFA Program grew from 32 percent to 41 percent. In real numbers, the number of women candidates for the CFA designation doubled over that period, from 70,000 to 140,000.

Continuing to build reliable data sets is crucial to building strategies for change. Each of the CEO panelists provided insights for accelerating positive change.

Franklin Templeton President & CEO Jenny Johnson said investment management executives need to view the hiring and promotion of women as "an unbelievable opportunity. If you have an underutilized group of very talented individuals, you have to look at it as an incredible investment opportunity. Firms must look critically at their practices to see what they are doing to build a pipeline and ensure advancement opportunities for women. We must advocate for groups that have been historically underrepresented to start joining investment management firms and to envision themselves in our industry in the future. Firms need to help plant the seed early at the foundation of their careers."

"You have to resource this effort like any major strategic initiative with commitment from the top and embed diversity and inclusion into every step of our processes around talent, in interviews and promotions, to increase the likelihood of achieving the outcome we all desire," said New York Life Investment Management CEO Yie-Hsin Hung. "As women leaders, there's also an opportunity for us to bring more women into our industry by sharing our stories with the next generation and better connecting what we do to making a difference in peoples' lives."

"We have the women taking the exams, graduating from esteemed universities, and applying for jobs. We need to make sure that once they're in our pipeline, we provide opportunities to get them on track for promotions and leadership roles," said Russell Investments CEO Michelle Seitz. "We need to attract and retain people once they're in the field."

SEC Commissioner Crenshaw Encourages Change in Approach on Enforcement Penalties

Posted to IAA Today on March 16, 2021

SEC Commissioner **Caroline Crenshaw** says the agency's enforcement policies allow companies to "profit from fraud" because they unnecessarily limit the Commission's ability to craft appropriately tailored penalties that are more effective at deterring misconduct." In determining penalties, Crenshaw says, the SEC places too much emphasis on factors unrelated to the conduct – specifically, whether the corporation's shareholders benefited from the misconduct and whether they will be harmed by the assessment of a penalty.

"This approach is fundamentally flawed," Crenshaw said in a recent speech. "If we are going to confront the novel issues today's markets present and deter ever more complicated and hard to detect frauds, we must revisit our approach."

Crenshaw was focusing on a 2006 Commission position regarding penalties that she regards as "myopic" – one that discourages the Commission from imposing penalties that "unduly burden shareholders."

The Commissioner faults this approach because, in her view, penalties "should be tied to the *egregiousness of the actual misconduct* – not just the benefit or impact on the shareholders." She also argues that the SEC should not treat as a threshold issue "the presence or absence of a shareholder or corporate benefit," because adequately measuring the extent of these benefits is extremely challenging.

Caroline Crenshaw, SEC Commissioner

For example, she asks, how should the SEC identify and measure intangible benefits or impacts such as those that come from a good reputation, or from fraud on the market, *e.g.,* from "dripping" bad information through disclosures over time. Crenshaw also questions whether SEC penalties actually harm investors and would be interested in seeing studies on this issue.

"If the penalties are sufficiently high to motivate the company to remediate problems, strengthen internal controls, clarify lines of responsibility, and prioritize individual accountability, those are all changes that likely lead to better future outcomes, and higher profits for shareholders," Crenshaw said. "Penalties are intended to incentivize compliance, and higher penalties can be effective in deterring violations that are particularly hard to detect. There becomes less of an incentive for shareholders to invest in companies that choose to follow the law if there are no repercussions for investing in those that do not."

Instead of focusing on the impact on shareholders, Crenshaw proposes that the SEC gather additional data to inform how it assesses corporate penalties, that it consider the extent of harm to victims as well as the corporate culture in the organization, and that it look at other factors identified in the 2006 statement, including the degree of cooperation with investigations and self-reporting.

She observes, however, that "[m]eaningful cooperation requires a commitment to proactively identifying and remediating wrongdoing" and holding those responsible accountable for misconduct.

See Moving Forward Together – Enforcement for Everyone (Mar. 9, 2021).

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE **2021**

EFFECTIVE STRATEGIES & BEST PRACTICES

TAKEAWAYS

"A Huge Undertaking"
The New Marketing Rule / Seven Implementation Challenges

Posted to IAA Today on March 23, 2021

WATCH THE VIDEO

"This is going to be a huge undertaking," said **Pamela Pendrell** of GlobeFlex Capital about her firm's implementation of the SEC's new marketing rule. "I'm expecting that this is going to take a year."

Pamela Pendrell, GlobeFlex Capital

Pendrell was speaking at the 2021 IAA Investment Adviser Compliance Conference panel discussion *The New Marketing Rule for Advisers*. The session, which was moderated by the IAA's **Sanjay Lamba**, also included speakers **Melissa Harke** of the SEC's Division of Investment Management and **Michael McGrath** of K&L Gates.

Melissa Harke, SEC

At the opening of the session, Lamba discussed the advantages of the new rule. "The SEC struck just the right balance between understanding the need for firms to market their services and investor protection concerns," he noted. At the same time, the principles-based approach of the rule means that there are no longer any *per se* prohibitions on using past specific recommendations, testimonials or third-party ratings in marketing material.

Michael McGrath, K&L Gates

Sanjay Lamba, IAA

In addition, he explained how the new rule eliminated one of the "pain points" of the previous regulatory regime, namely the "patchwork" of the regulation. The new marketing rule combines the existing advertising rule, the current cash solicitation rule and the guidance included in a myriad of no-action letters. (Harke noted that she expects that the SEC will withdraw most of these letters soon.)

However, for most advisers, the new rule will require significant changes to marketing materials and the policies and procedures that govern their production. Advisers will also need to invest in training team members on those revised policies and procedures.

The panelists highlighted seven areas that are changing under the new rule that compliance officers will want to look at:

1. **Templates.** Under the new rule, templates are advertisements, subject to all the disclosure and other requirements that apply to advertisements. Therefore, materials that include templates – even if they're otherwise outside the definition of "advertisement" – might need to be treated as advertisements.

   For example, one-on-one presentations to an institutional client would generally not be an advertisement. However, if those presentation materials used elements from a master presentation that could be considered a template, the presen-

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tation might be an advertisement. Similarly, an outreach email sent by a sales rep to a single prospect might be an advertisement if it includes standardized language about the firm.

2. **Fair and balanced.** The new rule requires that advisers provide "fair and balanced" disclosure of material risks and limitations whenever there's a discussion of potential benefits. "But what falls into the camp of a 'discussion of potential benefits'?" asked Pendrell, "And is the pitch book as a whole considered the 'discussion of benefit,' or does an adviser need to go through each section and determine if there are individual 'discussions of benefit'?"

3. **Performance.** Under the new rule, all advertisements with performance information must include returns for 1, 5 and 10 years (though advisers have the option of including performance results for other time periods). If gross performance is presented, gross and net returns must be given equal prominence.

   Firms that are using representative accounts rather than composites will need to make an analysis of materiality to demonstrate that they are not cherry-picking account performance.

Which Conditions Apply to the Use of Testimonials and Endorsements?

		CONDITIONS				
			Oversight and Compliance			
		Required Disclosures	Written Agreement	Reasonable Basis for Believing the T/E Complies with the Rule	Disqualification	General Prohibitions
PARTIAL EXEMPTIONS	Compensated	✓	✓	✓	✓	✓
	De minimis Compensation	✓		✓		✓
	Uncompensated	✓		✓		✓
	Affiliated Personnel			✓	✓	✓
	Registered Broker-Dealers	Exempt from some if rec is subject to Reg BI or non-retail	✓	✓	'34 Act disqualification	✓
	Covered Persons in 506(d) Offerings	✓	✓	✓	Reg D Rule 506 disqualification	✓

4. **Hypotheticals.** The new rule includes an expansive definition of "hypothetical performance statements" and requires among other things that they be accompanied by related disclosures. A statement like "we would expect to outperform by 300 basis points over a full market cycle" is now a hypothetical, noted Pendrell.

5. **Testimonials and endorsements.** While testimonials and endorsements will no longer be entirely prohibited, as they were under the current rule, the specific conditions governing their use vary based on particular facts and circumstances. For example, additional requirements would apply to *compensated* testimonials similar in scope to traditional solicitations under the current cash solicitation rule. The panelists provided a summary chart clearly comparing the conditions that apply to the particular uses of testimonials and endorsements under the new rule.

6. **Employee social media.** In adopting the new rule, the SEC suggested that advisers consider adopting a policy designed to prevent firm employees from using personal social media accounts to market the firm's advisory services. The SEC also suggested that advisers consider adopting policies and procedures involving oversight, training, and periodic review of employee accounts that are publicly available. However, explained McGrath, an adviser that implements effective policies and procedures and trains employees around the appropriate use of personal social media accounts will not likely be held accountable if an employee does not comply with the "no promotion" standard.

7. **Intended audience.** Much of the new rule is "contextual and based on the nature of the audience," noted Harke. Therefore, advisers should be sure that they can demonstrate that a specific communication is appropriate for the intended audience.

   "You need to have an answer for the Division of Examinations examiner," said McGrath. "If you have a manager with both institutional and individual clients, that manager might want to take extra steps to document the difference."

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In terms of the implementation timeline, the compliance date for the new rule is November 4, 2022. Firms can comply early any time after the May 4 effective date, though Harke cautioned that they can't "pick and choose" which sections of the rule to comply with. "Once you flip the switch, you're flipping the switch entirely," she added.

Even though advisers have 18 months to get ready for compliance, Pendrell explained that she is getting started now. Her first step will be to read and digest the rule's adopting release which, she notes, contains many insightful examples. She then plans to inventory her firm's existing materials. Once she has this background, she plans to make a presentation to senior management with next steps.

Compliance teams need to be prepared, stressed McGrath. "Under this rule, compliance officers and in-house counsel will be called upon to make more judgement calls," he explained. Harke echoed this thinking, noting that, because the rule is principles-based, it provides "more flexibility, but less certainty."

Europe Not a Model for ESG Regulation in U.S., Says SEC's Peirce

Commissioner Questions Agency's Recent ESG, Climate Initiatives

Posted to IAA Today on March 9, 2021

WATCH THE VIDEO

The European "merit regulation" on ESG is not a model for the United States, suggested SEC Commissioner **Hester Peirce**, in her keynote conversation with IAA President & CEO **Karen Barr** at the 2021 IAA Investment Adviser Compliance Conference.

The European Union is "trying to drive capital toward certain areas and away from others and to coopt asset managers into that effort," Peirce explained. "I would hope that we don't follow that same route . . . our capital markets are working very well in allocating capital."

In terms of the SEC's effort on ESG, Peirce commented, "As far as I can tell, this is a continuation of the work that the SEC has been doing for a long time." However, she recognizes that the SEC is in a period of transition and that direction could change. But she cautioned, "If there's going to be a sea change, then the Commission needs to be involved in whatever that sea change is."

On the issuer side, Peirce expressed skepticism about the need for more specific guidance on climate change and other ESG-related issues, arguing that the current principles-based regime is sufficient.

Peirce understands why ESG has become an area of focus, given that "asset managers have been using this ESG label." She advised managers to be honest with their clients – and not "Pollyannaish" – about whether there's a return trade-off involved in using an ESG approach.

Turning to the standards of conduct rulemaking, Peirce was in favor of waiting before making any changes. "This rule is very new; there was a lot of work done on implementation. It makes sense to me to see how this all plays out," she said.

Even so, she was open to the idea of doing more investor testing around Form CRS. The feedback that she has received is that Form CRS is "so dense" that investors are not finding it inviting to read. Peirce is concerned that preparing Form CRS has become a "compliance exercise" rather than a help to investors, and she suggested that a digital format might be more effective.

Commenting on the issues raised by the recent volatility in stocks like GameStop, Peirce noted the "positive side," which is that a new generation of investors has been drawn into the markets. In addition, she believed market infrastructure generally worked well, though the volatility highlighted the need for automation of remaining manual processes.

On the other hand, "we care about companies wanting to be in our public markets," she explained. "If stock prices are extremely volatile, that can be a real disincentive for our companies to take advantage of our public markets."

At the same time, payment for order flow is "something to think about" though "having retail access to the markets at amazingly low prices has been beneficial for the markets."

Washington Outlook: Seven Initiatives to Watch

Posted to IAA Today on March 9, 2021

WATCH THE VIDEO

The change in Administration is bringing major changes to the regulatory and legislative environment for the investment advisory industry.

Rana Wright, Harris Associates

In the opening session of the 2021 IAA Investment Adviser Compliance Conference – ***Hot Topics from Inside the Beltway*** – **Rana Wright**, Partner, Chief Administrative Officer and General Counsel at Harris Associates, **Langston Emerson**, Partner at Mindset DC, and **Neil Si-**

Langston Emerson, Mindset DC

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Neil Simon, IAA

Karen Barr, IAA

mon, Vice President, Government Relations at the IAA, talked about the initiatives that they expect will lead the revamped agenda. The session was moderated by **Karen Barr**, President & CEO of the IAA.

Diversity, equity and inclusion. The first initiative to move into the spotlight could well be diversity, equity and inclusion.

In March, the House Financial Services Committee's Subcommittee on Diversity, chaired by **Joyce Beatty** (D-Ohio), will be making requests for information about racial justice and diversity and inclusion within corporate entities. Asset managers could well be included in this initiative, cautioned Emerson, who added that request would likely address D&I efforts within a company, diversity in third-party vendors, and board diversity.

At roughly the same time, the SEC's Asset Management Advisory Committee is likely to release its recommendations on the subject, added Simon.

But, while diversity issues are "clearly a focus," remarked Wright, it's less clear what specific actions might be taken.

Standards of conduct. The appropriate standard of conduct for both investment advisers and broker-dealers will continue to be a subject of debate, predicted the panelists.

"It's a complex landscape that remains complex," noted Wright, explaining that this isn't just an SEC issue. "You've got the DOL landscape, and the states doing their own thing."

At the SEC, the two Democratic commissioners have expressed reservations about the recent rulemaking package, as has Gary Gensler, who has been nominated to become the next head of the agency. And, in his confirmation hearings, Marty Walsh, who is the nominee to head the Department of Labor, stated that a re-examination of the DOL rule will be a priority.

"Neither agency will go back to the drawing board," predicted Barr, while Emerson added that legislation on the subject is unlikely.

However, FAQs, other interpretive guidance, and enforcement actions from the regulators, combined with Congressional hearings, are likely to keep the issue front and center.

Climate change and ESG. The Biden Administration's focus on climate change will have an impact on the asset management industry, the panelists agreed. As evidence, the SEC has joined the other regulatory agencies in designating a senior policy advisor for climate change, noted Barr.

The DOL has been specifically instructed to review the November 2020 "financial factors" rule which prohibits ERISA fiduciaries from considering non-pecuniary factors when making investments for retirement plans. The Biden Administration is concerned that this rule may conflict with the national priority to address climate change. In addition, the DOL might revisit its recent proxy voting rule, suggested Barr.

New regulations from the SEC are likely, predicted Wright. In the meantime, ESG disclosure will be a priority for the Division of Examinations. The exam staff has already conduct "mini sweeps" on the issue, she added.

Financial stability. In a "blast from the past," the panelists concurred that financial system stability concerns will return to the headlines, after four years of receiving relatively little attention.

Emerson warned that measures related to financial stability could be included in the infrastructure package, which will be the next big piece of legislation that Congress takes up after the COVID relief package. "Financial stability is part of recovery," he noted.

Of particular concern to asset managers, the Financial Stability Oversight Council (FSOC) might again start designating non-banks as "systemically important financial institutions" (SIFIs). The trickle-down effects of those designations would be significant, cautioned Simon, even to smaller firms.

Money market funds. In the financial stability arena, the SEC is taking "another bite at the money market fund apple," Wright explained. The agency has published a request for comment on suggestions to improve the resiliency of money market funds.

The SEC request follows up on a report from the President's Working Group highlighting structural vulnerabilities in prime and tax-exempt money market funds. The report specifically notes that these funds were severely impacted by the market volatility of March 2020, despite the post-financial crisis reforms.

"There's more to watch in this space," added Wright.

Retirement savings. "I believe that there will be retirement legislation in this Congress," Simon forecasted, noting that there could be bipartisan support for legislation building on the 2019 SECURE Act.

Specific provisions of any legislation could include increasing the incentives for employees to participate in employer-sponsored retirement plans, further raising the age for required minimum distributions (RMDs), expanding investment flexibility for 403(b) plans, and shifting toward e-delivery of information

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to plan participants.

How legislators would offset the costs of these benefits isn't clear, cautioned Simon.

Tax changes. Speaking of offsets, Emerson suggested that any infrastructure bill would likely include tax increases that would fund at least a portion of its costs.

Some of the tax items that have been floated include imposing a financial transaction tax, changing the taxation of carried interest, raising corporate tax rates, raising capital gains tax rates, and imposing a tax on the "uberwealthy." In addition, Democrats were frustrated by the failure to raise the minimum wage and, as an alternative, have proposed a tax on employers who fail to adequately pay workers.

There has been considerable push back on many of the provisions. For example, the financial transaction tax is strongly opposed by the IAA and many others in the financial industry.

However, a major tax overhaul is unlikely, Emerson predicted.

Form CRS, ESG Disclosure are Priorities for SEC Exams, Enforcement

Posted to IAA Today on March 9, 2021

WATCH THE VIDEO

Form CRS filing and ESG disclosure are among the top examination priorities, noted **Peter Driscoll**, Director of the SEC's Division of Examinations, in a conversation with IAA General Counsel **Gail Bernstein** at the 2021 IAA Investment Adviser Compliance Conference.

Form CRS exams are focused on firms that haven't filed and that failed to respond to an inquiry about why they hadn't filed, explained Driscoll. "They were nonresponsive with two different outreaches." Driscoll added that Form CRS is "the number one document that our examiners will read as they're preparing for an exam."

Pete Driscoll, SEC

Gail Bernstein, IAA

With regard to **ESG disclosure**, a risk alert summarizing issues from exams over the past year is "in the pipeline," said Driscoll. He noted that whether ESG is part of the examination will "depend on the firm." If "ESG is a large part of what they do" or highlighted in advertising, ESG is more likely to be included.

In addition, **private funds** continue to be an area of focus, especially given market volatility and the challenges it has created. Driscoll referred the audience to the "robust" risk alert issued last year for more detail.

The Division is also continuing to see issues around **share class selection** and related disclosure. In many cases, Driscoll noted, the problems are related to legacy investments that haven't been reviewed recently, perhaps after the migration of an account from a broker-dealer to a registered investment adviser.

He also highlighted the risks related to the **LIBOR transition**. "The big issue here is that the use of LIBOR is widespread," in everything from risk models, to accounting systems, to contracts. The Division will be doing exams in this area to raise awareness.

In terms of the Division's operations, Driscoll explained that **exam coverage of investment advisers** remained at 15 percent in 2020, despite the year's many challenges, including COVID, market volatility and cybersecurity concerns.

Going forward, Driscoll expects that more exams will be done entirely remotely, though he noted that, for some things, "you've got to be there."

Driscoll also highlighted their new status as the Division of Examinations (replacing the Office of Compliance Inspections and Examinations). "This is a statement from the Commission," he explained, about "how important compliance is."

In a follow-on conversation, **Adam Aderton** and **Dabney O'Riordan**, Co-Chiefs of the Asset Management Unit of the SEC's Division of Enforcement, explained that their unit was focusing on similar priorities.

With regard to **ESG disclosure**, Aderton highlighted the need for consistency, noting that in their early cases, a firm advertised an ESG methodology that was inconsistent with its actual processes. He emphasized that they are applying the same approach that they use for any investment style.

Seven Tips for Preparing for an SEC Exam

Posted to IAA Today on March 29, 2021

While the pandemic has slowed down much of life, it has had little impact on one of the bigger challenges that an investment advisory compliance effort will face: an SEC examination.

Mark Perlow, Dechert

"I have experienced vicariously a handful of examinations that clients have gone through, and I can confirm that after an initial period

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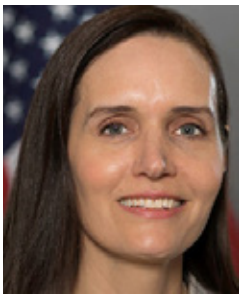
of figuring out the mechanics of doing remote examinations, the whole thing settled into a groove pretty quickly," said **Mark Perlow** of Dechert. "It seemed like a full-bore examination."

Anil Abraham, Focus Financial Partners

Michelle Jacko, Jacko Law Group



Kristin Snyder, SEC

Perlow was speaking at the 2021 IAA Compliance Conference in a panel session titled *Tips and Trends to Help Advisers Prepare for SEC Examinations*. He moderated the session, which featured panelists **Anil Abraham** of Focus Financial Partners, **Michelle Jacko** of Jacko Law Group, and **Kristin Snyder** of the SEC's Division of Examinations.

The speakers had these tips for compliance officers getting ready for their next exam:

1. **Focus on Form CRS.** One of the first things that compliance officers might want to focus on is the new Form CRS.

   Overall, "The challenge for the industry was trying to meet the spirit of the form – giving the essential information that the SEC wanted in the format that the SEC wanted in a user-friendly way – but not at the same time sell yourself short or leave out key points," summarized Perlow. The SEC is looking at "the basics on content, to determine if there are any omissions of required information from the Form [and] to ensure that there is a consistent presentation of the information," added the SEC's Snyder.

   More specifically, many advisers have stumbled over the section on disciplinary information. Some have "inappropriately marked 'no'" in this section, noted Snyder. "People are used to thinking of disciplinary history in a particular way," namely the way it's treated in Form ADV, explained Abraham. "But the CRS is a different beast… It's a very low threshold [for reporting disciplinary history]."

   Jacko stressed the need for thinking of Form CRS as a year-round exercise. She recommends evaluating "on a continuous basis" whether there has been a material change that would trigger an update.

   She also advised firms to think about the operational complexities. Firms need to identify "who is responsible for delivering the Form CRS and when," she noted.

   To get up to speed, advisers should take a look at the Division of Examinations April 2020 Risk Alert on Form CRS, advised Snyder. A small entity guide is available on the SEC website as well, she added. Advisers can also ask the SEC staff questions that are not addressed in the release or related FAQs at iabd-questions@sec.gov.

2. **Be intentional about fiduciary duty.** Also on the recommended reading list: the SEC's 2019 "Interpretation Regarding Standard of Conduct for Investment Advisers," which sets out the Commission's thinking on an adviser's fiduciary duty.

   "The staff is unquestionably drilling down on the particulars of fiduciary interpretation," cautioned Perlow. He notes that the release spells out specifics that can guide firms, especially around suitability and the disclosure and mitigation of conflicts of interest.

   Advisers should be careful to document that they are paying attention to their fiduciary responsibilities. "We all know that we have to do what's in the best interest of clients," explained Jacko. "The challenge is the documentation. . . I've seen a lot of analysis being done, but that analysis isn't necessarily documented." Advisers should be writing down why a client has been placed in a particular program type, strategy or mutual fund share class.

   She also suggested that compliance professionals should be able to say, "Not only have we thought about it, we've documented it, [and] we've developed an internal control system to better assess whether what we're doing is truly in the best interest of the clients."

3. **Standardize across offices.** The move to a remote working office has highlighted the risks that result from multiple offices.

   "Folks don't necessarily do things the same way as the home office," noted Jacko. "That's the challenge." For example, different offices may compute advisory fees differently. "One office may aggregate a household for the purposes of fee breakpoints in one way, while another office is doing it with a completely different definition of household" she explained.

   In fact, a November 2020 Division of Examinations Risk Alert reported that, in its examinations of 40 investment advisers with multiple offices, the "vast majority" of the advisers were cited for at least one compliance deficiency and "more than one-half" were cited for deficiencies

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related to portfolio management practices.

Jacko cautioned advisers that, "You need to think about policies and procedures at an enterprise level."

4. **Harmonize ESG disclosures.** "ESG is probably one of the biggest secular trends that we as a firm have been seeing," noted Perlow. "The SEC has not been ignoring this trend." Notably, ESG is priority for the Division of Examinations again this year.

   "Like any other strategy, we are looking to see whether the disclosure and the marketing around the strategy matches up with what's happening in practice," noted Snyder. "As an example, if a firm is stating that they exclude certain stocks . . . do they have mechanisms in place to ensure that those securities are being excluded from the portfolio?"

   Advisers should consider, "What does it mean across the enterprise?" suggested Jacko. Firms should think about how an approach will affect trading and proxy voting in addition to portfolio management and marketing.

5. **Don't forget about private funds.** "Private funds are an important part of the portfolio we cover," said the SEC's Snyder. "Almost 36 percent of the adviser population manages one or more private funds."

   In terms of new priorities for 2021, the Division of Examinations will be looking at the impact of the market volatility, focusing on firms that may have been harder hit by the pandemic because they own commercial real estate or certain structured products.

   In addition, the SEC will continue to review the "bread and butter" areas outlined in the Division's June 2020 Risk Alert. "Conflicts is certainly an important area," Snyder emphasized. "What's surprising is that we continue to see issues around undisclosed fees and expenses" given enforcement activity in the past. "It's something to be looking at on a dynamic basis with compliance involved," she suggested.

   Other areas of SEC focus include allocation of investment opportunities and controls over material nonpublic information. With regard to the latter, Snyder stressed that firms need "good controls around the intake and the due diligence" on alternative data and other nontraditional sources of information that drive portfolio decision making.

6. **Develop a "meet the firm" presentation.** "We advised for some time that firms should voluntarily prepare a 'meet the firm' deck, and share that with the staff right up front," said Abraham. "If you can help them understand who you are, it gets the exam off on the right foot."

   Jacko concurred, noting that attention to the "opening ceremonies" can lead to a "difference in the examination experience." She recommends that firms include a discussion of how they dealt with the COVID crisis. "It sets a great tone for compliance in the organization and how you responded to the pandemic," she added.

7. **Accentuate the positive.** Abraham ended the session on a positive note: "People tend to think of them as a burden," he argued, "But another side of exams is that they're an opportunity, because here's a chance to hear from your primary regulator." If you prepare properly, it can help make your compliance effort "state of the art," he concluded.

Rule Implementation is Priority for Division of Investment Management

Posted to IAA Today on March 9, 2021

WATCH THE VIDEO

Speaking on the opening day of the 2021 IAA Investment Adviser Compliance Conference, **Sarah ten Siethoff**, Acting Director of the SEC's Division of Investment Management, explained that even while in a transition, "we are focused on carrying on the work of the Division."

Sarah ten Siethoff, SEC

In a conversation with **Gail Bernstein**, General Counsel of the IAA, ten Siethoff noted that the implementation of rules adopted late last year was a top priority. The staff has been answering questions from the industry about specific aspects of the rules.

Ten Siethoff acknowledged that follow-up remains to be done. With regard to the new **Marketing Rule**, which she noted was "a challenging rule because we took a look at an entire landscape," the Division is reviewing all related no-action letters. She expects that a "long list" of these letters will be withdrawn, either entirely or in part.

Rule 17a-7 cross trading, which was affected by the new Valuation Rule, is another area that needs to be addressed. The current cross-trading rule focuses on exchange-traded securities, she noted, while most cross trading today involves fixed income securities. The Division understands the benefit case for cross trading, ten Siethoff explained, but needs to develop a framework that addresses the risks and conflicts.

At the same time, the Division con-

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tinues to address the need for **regulatory relief stemming from the COVID-19 crisis**. For example, ten Siethoff expects that in-person fund board meeting relief will "be in place as long as the pandemic lasts."

Some of the pandemic relief could become more permanent, she noted. She cited the example of the **electronic signature rulemaking** of November 2020, which started out as pandemic relief.

Similarly, "the pandemic has put **e-delivery** in a different light," ten Siethoff noted. The Division is gathering information and encourages industry participants to submit information on client preferences, especially as they have changed as a result of the pandemic.

In terms of new initiatives, the Commission is taking another look at money market funds, given that "there was basically another run on prime **money market** funds" in March. They are looking for input on the options presented in the President's Working Group report on money market reform and for any other suggestions that would make these funds more resilient.

Clarifying the custody rule is also on the Division's agenda, ten Siethoff noted that the large number of FAQs is a testament to the confusion that the rule has created. Digital access is an emerging area that needs to be addressed, she added.

Looking toward the future, ten Siethoff expected that the Division would continue to work on these areas as well as on "the priorities that new and coming leadership will bring."

Long-Term Commitment, Transparency Needed to Increase Industry Diversity

Posted to IAA Today on March 17, 2021

WATCH THE VIDEO

The investment management industry has made progress on diversity, but still has a lot of work to do, agreed **Carlotta King** of Diamond Hill Capital Management and **Robert Burks, Jr.** of Brown Capital Management. King and Burks were speaking at the 2021 IAA Investment Adviser Compliance Conference at a session titled *Diversity, Equity, and Inclusion in the Investment Management Industry*, which was moderated by **Hope Newsome** of Virtus.

Robert Burks, Jr., Brown Capital Management

Hope Newsome, Virtus

"The fact that we're having this conversation is evidence of progress," said Burks. "Conversations like this one are an important first step," agreed King, and they have gotten people thinking "proactively."

"Where our industry is lagging is in coming up with clear, long-term, firm commitments that they can be held accountable for," King added. Many firms have made broad statements about their commitment to diversity or made financial donations to support diversity programs, she added, but they need to establish goals for diversity at their firms, in their communities, and in the industry.

Greater transparency is also essential if the industry is to make progress, stressed Burks. He expects legislators and regulators to support increased disclosure of diversity efforts, specifically noting the efforts of the House Financial Services Committee and the Disclosure and Inclusion subcommittee of the SEC's Asset Management Advisory Committee.

For both King and Burks, the value of diversity is clear. "Having diverse perspectives is fundamental to good decision-making" and is essential to investment success, explained King. At the same time, diversity promotes employee engagement and reduces turnover, which leads to business success.

Investors are demanding diversity at the firms that they hire, added Burks. And since the buying power of diverse consumers is growing, these demands will only increase.

For Burks, hiring more people of color into the industry is critical. It's not just that the industry needs to "light a path" for young people to a career in finance, through educational programs and mentorships. Putting them in "positions that allow them to experience the wealth generation of the career path" will help to close the economic wealth gap.

For those who may feel discouraged by the lack of progress, King advises, "Don't lose heart. Don't give up on your individual commitment." She suggests focusing on the long term and thinking about ways to "pay it forward."

And change is coming, asserts Burks. "It can't be a fad... We have to check our moral compass and decide that it won't be a fad," he stressed.

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Navigating Regulatory Change in Europe | Four Hot Topics

Posted to IAA Today on March 16, 2021

Tracy Soehle, Affiliated Managers Group

Daniel Worthington, T. Rowe Price

Michelle Kirschner, Gibson Dunn & Crutcher

With Brexit roiling the waters, the regulatory environment in Europe is particularly dynamic at the moment. In the *International Developments* session at the 2021 IAA Investment Adviser Compliance Conference, speakers highlighted current hot topics in European regulations. The session featured panelists **Daniel Worthington** of T. Rowe Price and **Tracy Soehle** of Affiliated Managers Group and was moderated by **Michelle Kirschner** of Gibson Dunn & Crutcher.

U.S. investment advisers with European clients or prospects should pay particular attention to these four issues, the speakers suggested:

Brexit. "Brexit has posed issues for funds distribution," summarized Kirschner. While advisers can continue to rely on the passporting regimes for fund sales within the European Union, they will need to establish separate access to the U.K. market.

T. Rowe Price prepared for the worst-case scenario of a hard Brexit by restructuring its European operations, explained Worthington. It consolidated some operations in Luxembourg, moving most distribution to the European Union, while at the same time strengthening the independence of its U.K. fund range.

For advisers without a European presence, decisions about equivalency will be critical. When a determination of equivalency is made, a firm can operate in another country by complying with the regulations in its home country. Kirschner noted that, to keep markets functioning in the immediate wake of Brexit, the European Union and the United Kingdom have granted each other narrow, time limited equivalency.

But Kirschner stressed that equivalency is unlikely to provide a quick fix to distribution challenges. There is a "patchwork of equivalency regimes," she noted, which means that a single favorable equivalency decision will not open all sales doors. In addition, given the post-Brexit environment, the European Union seems likely to grant equivalency only when needed to keep markets operating.

Reverse solicitation. While proactive distribution has become more challenging, advisers are now at greater regulatory risk even if they wait for clients to come to them in a "reverse solicitation." That's because, in January 2021, the European Securities and Markets Authority (ESMA) issued a statement on reverse solicitation, stating that "some questionable practices… have emerged."

The statement "was a bit of a surprise," noted Soehle, adding that "this type of scrutiny will put more pressure on firms and their compliance." She stressed the need to maintain good records and to be careful not to "overengineer" reverse solicitations.

Delegation. Also a surprise: the European Commission's re-examination of the rules surrounding delegation under the Alternative Investment Fund Managers Directive (AIFMD). "The Commission has created a problem out of nothing," said Worthington. "There haven't really been any issues with the delegation rules."

The Commission is studying whether the rules on delegation should be more restrictive, making it more difficult to delegate management responsibilities to third parties outside the European Union. Possible changes include imposing quantitative restrictions or prohibiting the delegation of core or critical services. Alternatively, portfolio managers outside the European Union could be required to comply in full with all AIFMD requirements.

These potential changes could have a significant adverse impact on U.S. advisers. "Delegation is important for all of our firms," explained Soehle. "Advocacy here is very important… Nobody wants to see cross-border management mechanisms unnecessarily restricted."

ESG Disclosure. The EU Sustainable Finance Disclosure Regulation (SFDR) is creating significant challenges for advisers. A large part of the problem is that the Level 2 measures, which would help with implementation, haven't been finalized, even though the regulation goes into effect this month. As a result, "there are a multitude of uncertainties" around implementation, said Kirschner.

For example, the regulation requires that advisers categorize funds as having a sustainable investment objective (Article 9 or "dark green"), promoting environmental and/or social characteristics (Article 8 or "light green"), or other (Article 6). But the criteria for making that categorization haven't been established.

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Differentiating between Article 6 and Article 8 funds has been most challenging, noted Worthington. "What is the 'step up' required to 'promote' certain environmental and social characteristics?" he asked, adding that the European Commission seems to want managers to integrate sustainability risks into their processes. Yet, overpromoting a fund's environmental and social credentials could lead to accusations of greenwashing and the potential for litigation, cautioned Kirschner.

The lack of data to support categorization decisions only adds to the difficulty, stressed Worthington, citing issues with both the availability of data and its quality. "It's getting better, but there's a way to go," he added.

A global standard for ESG disclosures is "imperative," said Soehle, noting that neither the United States nor the United Kingdom has requirements like the EU's SFDR. "It's challenging for firms marketing and providing services on a global basis to provide disclosures that are helpful and meaningful," she explained.

One Year into COVID | CCOs Reflect on Lessons Learned

Posted to IAA Today on March 26, 2021

It has been almost exactly one year since the COVID pandemic pushed investment advisers into a virtual work environment – virtually overnight.

Lee Faria, Columbia Management

In a panel discussion at the 2021 IAA Compliance Conference, investment adviser CCOs and their counsel reflected on what the transition to "work from home" has meant for their work and their firms. The panel featured speakers **Lee Faria** of Columbia Management Investment Advisers, **Christopher Hayes** of 1919 Investment Counsel, and **Jennifer Klass** of Baker McKenzie and was moderated by the IAA's **Laura Grossman**.

Christopher Hayes, 1919 Investment Counsel

Jennifer Klass, Baker McKenzie

Changing practices. For all the speakers, the past year has been one of change in their operational practices. "We found things that just didn't work as well remotely," summarized Hayes.

For example, approaches to supervision and monitoring needed to be re-evaluated as work moved from in-person to virtual. "Most firms have been focused on coming up with a plan for how they can interact with employees in remote locations… to have a sense of what they're doing and have a control environment around that," explained Klass.

"Very early on, we reassessed the risks to our firm based on the virtual environment and the market volatility," reported Faria about Columbia's transition. "We made sure that our compliance program and our monitoring and oversight really focused on those areas of higher risk."

In this same vein, 1919 Investment Counsel added more formal structure to oversight of its offices, while increasing the frequency of reviews, reported Hayes.

Faria noted that while many of the changes were expected to be temporary, they have now been in place for a long time – and many will become permanent. She recommended reviewing policies and procedures to make sure that they reflect current practices, adding, "It's a really good time to review all your other disclosures, like Form ADV."

Increased efficiency. But the changes to policies and procedures had a silver lining, agreed the panelists.

"We identified a lot of opportunities to be more efficient," said Faria, explaining that some inefficiencies became "awkward" in a virtual environment. "We streamlined certain processes, maybe cutting out a middle man."

Hayes concurred. "It forced us to take a look at what we do to be more efficient, more nimble." More specifically, they began to automate manual processes, realizing that "we have to find a technology solve."

Communicate, communicate, communicate. At the same, the pandemic has highlighted "the critical importance of communication," said Faria. "People feel pretty isolated" when they can't just turn their chair and ask a question, she explained.

She has been trying to "overcommunicate," adding that "I want people on my team as well as the businesspeople to know that we have a virtual open door policy."

"At least for us," noted Hayes, "frequency has been as important as depth… We have a lot of 15-minute catch up meetings… It keeps their attention."

Looking ahead, the panelists are bracing for a complicated return to the office. "The transition back will be equally as hard as the transition out," suggested Hayes.

"I encourage firms to embrace the fact that we are at an inflection point," concluded Klass. "For better or worse, COVID has created a way to look at business before and after and to use that as an opportunity." IAA

Cross Trading

By Richard D. Marshall, Partner, Katten Muchin Rosenman LLP*

Posted to IAA Today on March 23, 2021

The regulation of cross trading is a surprisingly complex area of law. This is because the term itself is defined differently in different statutes and is also regulated differently under different statutes. Although the focus of this article is on the Investment Advisers Act of 1940, as amended ("Advisers Act"), this article also discusses regulation of cross trading under ERISA and the Investment Company Act, both because those statutes are often applicable to cross trading by advisers and because concepts developed under those statutes have been applied in the advisory context.

In general, cross trading involves a situation in which an adviser sells a security from one client account and repurchases that same security for another client account. If the adviser also has a sufficient ownership interest in one or both of the client accounts, the trade may also be a principal trade. Even in the absence of a principal trade, cross trading raises a number of concerns for a fiduciary such as an adviser. First, the adviser owes a fiduciary duty to both the selling account and the buying account, yet determines in a cross trade that it is in the best interest of the selling account to rid itself of a security but in the best interest of the buying account to acquire the same security. This seems on the surface to be inconsistent. Second, unless the cross trade is executed at the "right" price, one side of the trade benefits and the other side of the trade suffers. Thus, if the cross trade is executed at too low a price, the selling account is damaged and the buying account benefits. The opposite occurs if the cross trade is executed at too high a price. Third, if brokerage charges are incurred for the cross trade, there is a potential for churning – incurring brokerage charges that are not in the best interests of both accounts. When principal trades are involved, cross trades raise heightened conflict of interest concerns.

Richard D. Marshall, Partner, Katten Muchin Rosenman LLP

"The regulation of cross trading is a surprisingly complex area of law. This is because the term itself is defined differently in different statutes and is also regulated differently under different statutes."

Because cross trades are defined and regulated differently under different statutes, it is important to begin the analysis of a cross trade by identifying the regulatory standards that apply. This process requires that both the selling account and the buying account be analyzed to determine which law applies to the account. This process may itself be complex, but is beyond the scope of this article.

Cross Trading under ERISA

The Employee Retirement Income Security Act of 1974 ("ERISA") might apply to a cross trade by an adviser if one or both parties to the trade are regulated under ERISA. In this regard, it is important to remember that the prohibited transaction prohibitions under ERISA apply both to traditional ERISA pension plans and to certain tax advantaged retirement accounts.

Under ERISA, a cross trade is defined as a trade between two or more accounts that are managed by the same adviser. Thus, a sale of a security from one client account managed by an adviser to another client account managed by the same adviser would be a cross trade. If one of the client accounts is associated with the adviser, the trade may also be considered a principal trade.

Generally, both cross trades and principal trades are prohibited under ERISA, even if the practice is disclosed and the client consents to the trade.

Under ERISA, the Department of Labor has issued important guidance on how to identify "indirect"

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cross trades, which are also prohibited. Indirect cross trades occur when the sell order is executed through a broker, with the security repurchased for another client account from the same broker. Such trades are treated as "indirect" cross trades and are therefore prohibited under ERISA if the sale and repurchase are either "prearranged" with the broker or are "simultaneous or nearly simultaneous." A prearranged trade involves an agreement with the broker involved at the time of the sale that the adviser will shortly repurchase the security for another client account. A simultaneous or nearly simultaneous trade occurs when the security is sold in the market then repurchased for another client account so quickly that the position is not exposed to meaningful market risk. These concepts have also been applied in the advisory context to apply cross trading rules to trades that are treated as "indirect" cross trades.

Cross Trading under the Investment Company Act

Under the Investment Company Act of 1940 ("Investment Company Act"), a cross trade is defined in the same manner as under ERISA. Because funds managed by the same adviser are treated as affiliates of each other, such trades are prohibited by the ban on principal trading in the Investment Company Act. The SEC has adopted an exemptive rule, Rule 17a-7, that permits cross trades between funds managed by the same adviser, subject to numerous conditions. Three key conditions of this Rule are: (1) the trade must be executed at the midpoint between the bid and ask prices of the security in the market; (2) the trade must be executed without any brokerage fee imposed on either fund; and (3) the trade must be ratified by the funds' independent directors after the fact. The SEC has recently clarified that the first condition can only be satisfied for Level 1 securities, that is where the identical security trades in a regulated market. However, the SEC staff recently announced that is reconsidering the conditions for cross trades under Rule 17a-7. These conditions have been applied by the SEC to evaluate whether cross trades that are not subject to the Investment Company Act are consistent with the fiduciary duties of an adviser under the Advisers Act.

"Even in the absence of a principal trade, cross trading raises a number of concerns for a fiduciary such as an adviser. First, the adviser owes a fiduciary duty to both the selling account and the buying account, yet determines in a cross trade that it is in the best interest of the selling account to rid itself of a security but in the best interest of the buying account to acquire the same security."

Cross Trading under the Advisers Act

Section 206(3) of the Advisers Act regulates cross trading, but that provision defines cross trading in a manner that is materially different from the definition of cross trading set forth above. In Section 206(3), cross trading is defined as a situation in which the adviser (or an affiliate of the adviser) acts as the broker on a trade between a client account and another account. The purpose for regulating such trades is simple – to avoid churning or excessive trading that is not in the best interests of the clients but benefits the adviser or its affiliates. The SEC has clarified that Section 206(3) does not apply, even if an affiliated broker is involved in the trade, if no brokerage charge is imposed on the trade. This is because, in the absence of a brokerage charge, there is no incentive for churning.

Under Section 206(3), the clients must consent to each individual cross trade. However, the SEC has adopted Rule 206(3)-2 which permits blanket consent, rather than trade-by-trade consent, to cross trades, subject to certain conditions. These conditions include reporting to the clients about the trades and prominent written disclosure that the clients can revoke the consent at any time. It is important to note that Rule 206(3)-2 is not available if the adviser (or its affiliate) exercises discretion over both sides of the trade. Since this is typically the case when a discretionary manager executes trades for client accounts, the Rule is seldom available. If Rule 206(3)-2 is not available, disclosure and client consent must be obtained, pursuant to Section 206(3), on a trade-by-trade basis.

Although Section 206(3) does not address the situations described above where a security is moved between client accounts, such trades have been addressed by the SEC under the general anti-fraud provisions of the Advisers Act, Sections 206(1) and (2). The focus is on whether the trade is in the best interests of both the selling and buying accounts, whether the trade is executed at a "correct" price (one that is fair to both the selling and the buying accounts), and whether any brokerage charges imposed for the trade are consistent with the clients' best interests. The SEC has looked to Rule 17a-7 under the Investment Company Act for guidance on these issues. Generally, the trade should not be used to reallocate securities to "favored" client accounts, should be priced at the midpoint between the bid and ask prices in regulated markets for the same security, and should be executed without the imposition of a brokerage charge.

If one of the parties to a cross trade is affiliated with the adviser, the principal trading prohibition in Section 206(3) must be complied with. Like any other principal trade, both clients must consent to each trade, after appropriate

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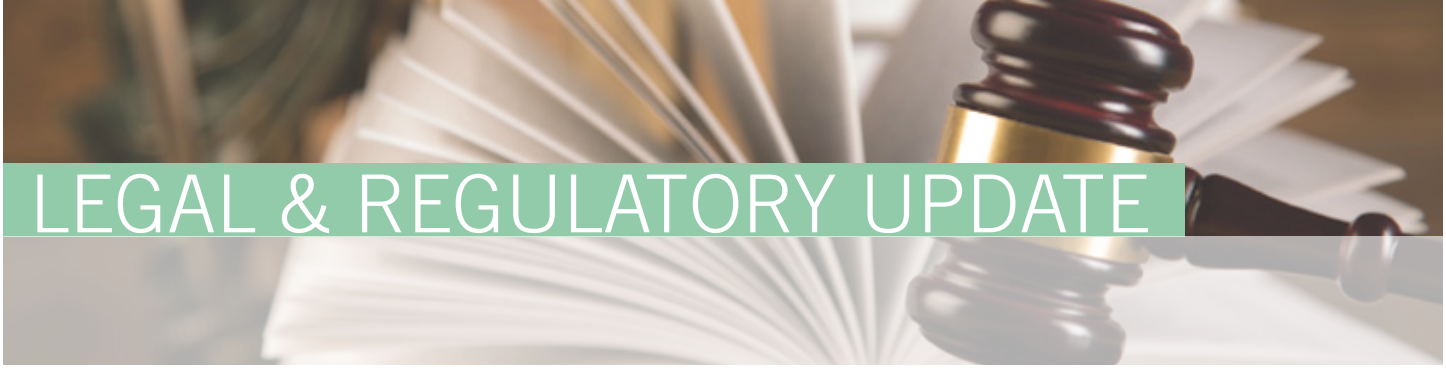

SEC Investment Management Seeks Input on Cross Trading Rule Amendments

New FAQs Confirm September 8, 2022 Compliance Date for "Readily Available Market Quotation" Definition

Updated on IAA Today on March 24, 2021

See related Compliance Corner column on Cross Trade compliance complexity on page 27.

The SEC's Division of Investment Management staff is considering amending Investment Company Act Cross Trading Rule 17a-7 and is requesting recommendations for ways to address valuation challenges that have evolved over the years and other considerations related to conflicts of interest that cross trades may present. A staff statement requests comments by April 11, 2021. Commissioner **Elad Roisman** issued his own statement in support of the SEC staff's outreach.

The rule is also directly affected by the new Valuation Rule adopted in December 2020, which includes a definition of "**readily available market quotations**" that the staff says "may" affect current investment company cross-trading practices under Rule 17a-7. The staff statement notes that the SEC has said that the phrase "for which market quotations are readily available" has the same meaning under Rule 17a-7 as under the valuation provisions under the Investment Company Act. The compliance date for the Valuation Rule, and therefore the new definition of "readily available market quotations," is September 8, 2022. The SEC staff issued an FAQ on March 19 stating this as well.

The statement points out that commenters on the Valuation Rule proposal raised concerns that funds and their affiliates that regularly engage in cross trades of certain fixed-income securities would no longer qualify as having "readily available market quotations" following adoption of the final Valuation Rule. The statement also notes that the staff is considering whether certain SEC staff letters, or parts of the letters, that address the application of the term "readily available market quotations" in the context of certain transactions under Rule 17a-7 should be withdrawn.

The staff seeks comments on aspects of the cross-trading rule, including feedback on the following topics:

- **Cross Trading Practices:** What are current cross trading practices?
- **Pricing and Liquidity:** Whether securities eligible to cross trade should have "readily available market quotations" and what sources of independent current market prices are used to cross trade currently? What could protect against conflicts of interest or other risks?
- **Controls:** What kinds of controls do advisers have in place to assess whether a cross trade is consistent with the adviser's fiduciary obligation to clients and is in their best interests?
- **Market Transparency:** How does cross trading affect market efficiency?
- **Cross Trading Systems:** What is the role of trading venues or platforms in price discovery and liquidity?
- **Potential Costs and Benefits:** When does it benefit both funds and their investors?

Please contact Associate General Counsel Monique Botkin at monique.botkin@investmentadviser.org if you would like to share any feedback.

Sen. Warren Questions Treasury's Yellen about SIFI Designations for Asset Managers

Posted to IAA Today on March 26, 2021

During a recent Senate Banking Committee hearing, Sen. **Elizabeth Warren** (D-Mass.) pressed Treasury Secretary **Janet Yellen** on whether large asset managers should be designated as "systemically important financial institutions," or SIFIs, often also referred to as "too big to fail." In the wake of the 2008 financial crisis and following adoption of the Dodd-Frank Act, very large banks are considered systemically important and are subject to increased supervision and oversight.

Warren questioned Yellen about whether large asset managers should be designated as nonbank SIFIs. Yellen explained that, while it is important to focus on the asset management industry, in her view the focus should be on the activities that companies undertake rather than on the designation of particular companies. This activities-based approach is currently used by the Financial Stability Oversight Council (FSOC) and Yellen discussed FSOC's work in this area. Yellen did not rule out designating individual companies as SIFIs, however. She noted that she is beginning her work with FSOC and that the risks associated with the asset management industry will be reviewed.

See Senator Elizabeth Warren questions Fed Chair Powell and Secretary Yellen about BlackRock (Mar. 25, 2021).

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SEC Suspends Trading in Multiple Issuers Based on Social Media and Trading Activity

Posted to IAA Today on March 10, 2021

The SEC recently suspended trading in the securities of 15 companies because of what the SEC called "questionable trading" and apparent "social media attempts" to artificially inflate their stock price in an effort to respond to potential attempts to exploit investors during the recent market volatility.

None of the issuers has filed any information with the SEC or OTC Markets, where the companies' securities are quoted, for over a year. The order noted that certain social media accounts may be engaged in a coordinated attempt to artificially influence the share prices of the securities.

The trading suspension remained in effect through March 11. It generally prohibits a broker-dealer from soliciting investors to buy or sell the stock again until certain reporting requirements are met.

The February 26 SEC Press Release is available at https://www.sec.gov/news/press-release/2021-35?utm_medium=email&utm_source=govdelivery, and the SEC trading suspension order is available at https://www.sec.gov/litigation/suspensions/2021/34-91213-o.pdf.

SEC Order Permits Alternative Mutual Fund to Suspend Redemptions for Inability to Value Assets and Strike a Net Asset Value

Posted to IAA Today on March 1, 2021

The SEC has approved an order from an alternative registered investment company (fund) to suspend redemptions due to the fund's inability to value swaps in the fund's portfolio, and therefore, the fund's inability to strike a net asset value (NAV) for the fund.

The fund's investment adviser's Chief Investment Officer had apparently been adjusting certain parameters within the third-party pricing model that affected the valuation of the fund's swaps. The adviser was thus unable to conclude that the CIO's valuation adjustments were reasonable, and was unable to verify that the values the adviser had previously determined for the swaps were reflective of fair value. According to the order, the fund's reported NAV was derived using a valuation for the swaps that resulted in the value of the swaps constituting approximately 18 percent of the fund's reported NAV.

The adviser informed the fund that it would not be able to calculate a fair value for any of the swaps in sufficient time to calculate an accurate NAV for some time, in violation of the Investment Company Act requirement to redeem shareholder interests within seven days after request. The fund has agreed to complete an orderly liquidation of its portfolio and distribute all its assets to current and former shareholders under a plan that will be presented to the SEC for approval. The order also requires the fund to engage an independent third party to assist in determining the fair value of the swaps and any other fund holding for which current and reliable market quotations are not readily available, including re-evaluating the historical valuations of the fund. The adviser's CIO has been terminated.

The fund is also a commodity pool and the adviser is a commodity pool operator, both of which are subject to oversight by the Commodity Futures Trading Commission.

The February 22 order is available at https://www.sec.gov/rules/ic/2021/ic-34198.pdf. The adviser's notice is available at http://www.infinityqfunds.com.

SEC's CorpFin: SEC Should Play Leading Role in Global ESG Reporting Framework

Posted to IAA Today on March 16, 2021

John Coates, Acting Director of the SEC's Division of Corporation Finance, has issued a statement regarding ESG disclosure standards and issues for policymakers to consider in developing these standards. Coates believes that the SEC "should help lead the creation of an effective ESG disclosure system so companies can provide investors with information they need in a cost effective manner." He identifies several questions that must be addressed in connection with the creation of these standards, including, among others:

- What disclosures are most useful?
- What is the right balance between principles and metrics?
- What is the best way to verify or provide assurance about disclosures?
- Where and how should disclosures be globally comparable?

Regarding costs of ESG disclosures, Coates notes that there are also costs associated with *not* having ESG disclosure requirements. Investors are challenged with "a lack of consistent, comparable, and reliable ESG information...upon which to make informed investment and voting decisions." Also, issuers receive numerous requests for ESG information. In terms of whether ESG disclosures should be mandatory or voluntary, Coates explains that the existing disclosure regime "is already more nuanced than that," containing some mandatory ESG disclosure requirements, "and there is no reason an ESG disclosure system would need to be less nuanced."

Coates concludes by discussing the benefits and challenges associated with a single global ESG reporting framework, saying that the SEC "can and should play a leading role in the development of a baseline global framework that each jurisdiction can build upon to address its individual needs."

See ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets (Mar. 11, 2021).

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IOSCO Presses for Globally Consistent Sustainability Disclosure Standards

Posted to IAA Today on March 1, 2021

The International Organization of Securities Commissions (IOSCO) has issued a press release announcing progress made by its Sustainable Finance Task Force and upcoming work with the International Financial Reporting Standards Foundation (IFRS) on sustainability disclosure standards. IOSCO has observed that "investor demand for sustainability-related information is currently not being properly met" and has identified three areas for improvement in company and asset manager sustainability-related disclosure.

These include encouraging globally consistent standards, promoting comparable metrics and narratives, and coordinating across approaches. IOSCO plans to work with the IFRS and others to advance these priorities. The IFRS is establishing a Sustainability Standards Board (SSB) "with a view to delivering an effective system architecture for setting sustainability disclosure standards" that would "sit alongside the International Accounting Standards Board." IOSCO encourages the SSB to leverage existing sustainability-reporting frameworks and is considering establishing a "multi-stakeholder expert consultative committee" to facilitate international coordination.

See IOSCO Media Release (Feb. 24, 2021).

NFA Proposes New Requirement for CPOs to File a Notice upon Certain Market Events or Pool Redemption Suspensions

Rule Expected to be Effective in 2021

Posted to IAA Today on March 17, 2021

The NFA recently announced that it proposed new compliance rule 2-50 that will require a commodity pool operator (CPO) to file a prompt notification, in a specified form and manner, with the NFA by 5:00 pm CT of the next business day after the occurrence of one of the following four market or other events affecting a commodity pool:

- **Pool Unable to Meet Margin Call.** A CPO operates a commodity pool that is unable to meet a margin call within the time prescribed by its FCM or broker, including in situations where the CPO disputes the amount or appropriateness of the margin call;

- **Pool Unable to Meet Redemptions.** A CPO operates a commodity pool that it determines is unable to satisfy redemption requests in accordance with the pool's subscription agreements;

- **Pool Halts Redemptions.** A CPO operates a commodity pool that has unexpectedly halted redemptions, *i.e.,* the halt is not associated with pre-existing gates or lockups or a preplanned cessation of operations; or

- **Pool in Default.** A CPO receives notice from a swap counterparty that a pool that the CPO operates is in default and the CPO does not reasonably believe that the pool can cure the default within the previously agreed to cure period.

It is expected that the new CPO notice filing requirement will be effective later in 2021 and that members will be notified in advance. The NFA may also conduct workshops in the summer to provide additional information.

The proposed rule and accompanying interpretive notice were sent to the CFTC for review on March 5 and are available at https://www.nfa.futures.org/news/PDF/CFTC/Proposed-CR-2-50-and-Interp-Notc-CPO-Notice-Filing-Requirements.pdf.

Virginia Second Major State to Adopt Significant Data Privacy Law

Exempts Entities, Including Investment Advisers, Subject to Gramm-Leach-Bliley

Posted to IAA Today on March 10, 2021

Virginia has earned the distinction of being the second major state (after California) to adopt a significant data privacy law. The Virginia Consumer Data Protection Act (VCDPA) became law on March 2, 2021 and will take effect on January 1, 2023.

Entities that are subject to the Gramm-Leach-Bliley Act (GLBA), such as investment advisers, are exempt from the VCDPA.

The VCDPA gives Virginia residents new rights to access, correct, delete and obtain a copy of the personal data that certain companies hold about them, and to opt out of some personal data processing. In addition, opt-in consent is required for collecting or processing "sensitive" data.

The VCDPA applies to "persons that conduct business [which is not defined] in the Commonwealth or produce products or services that are targeted to residents of the Commonwealth" and that either:

- Control or process personal data of at least 100,000 Virginia residents, or
- Control or process the data of at least 25,000 Virginia residents *and* derive at least 50 percent of their gross revenue from the sale of personal data

The VCDPA has both similarities and differences compared to California's privacy law. For example, the VCDPA permanently exempts individuals who act in commercial (*i.e.,* business-to-business, or B2B) or employment contexts, whereas under California's law this relief is time-limited.

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The VCDPA's use of the concepts "controllers" and "processors" is reminiscent of the EU General Data Protection Regulation (GDPR). Controllers are subject to limits on what personal data can be collected or processed. They must provide a privacy notice to consumers containing disclosures about information processing practices and consumers' rights, have reasonable data security practices to protect personal data, respond to consumer rights requests, and conduct data protection assessments in certain circumstances.

The VCDPA does not create any private right of action. Rather, the Virginia Attorney General may impose fines of up to $7,500 per violation, subject to notice and an opportunity for the controller or processor to "cure" the violation.

Several other states have data privacy laws under consideration at various stages. The IAA strongly supports a uniform, national approach to data privacy law in order to create consistency and reduce complexity and confusion.

The text of the VCDPA is available at https://lis.virginia.gov/cgi-bin/legp604.exe?ses=212&typ=bil&val=HB2307.

Please direct any questions or comments about these or other matters in the Legal & Regulatory Update to the IAA Legal Team at IAALegalTeam@investmentadviser.org.

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disclosure. For private funds, if 25 percent or more of the assets of the fund belong to the adviser or its affiliates, the entire pool is treated as if it was the adviser's own money, thereby triggering the application of Section 206(3).

Summary of the Rules

1. Identify the law applicable to both the selling account and the buying account – ERISA, the Investment Company Act, or the Advisers Act. (Note that the Advisers Act applies even if the accounts are regulated under ERISA or the Investment Company Act.)

2. Identify whether a principal trade is involved. This would occur if the adviser or its affiliates is on one side of the trade. For private funds, if 25 percent or more of fund assets come from the adviser or its affiliates, the entire private fund will be treated as if it was the adviser's own money and a trade with such a private fund would be treated as a principal trade.

3. If principal trades are involved, the trade is banned for accounts regulated under ERISA or the Investment Company Act. For other accounts, Section 206(3) must be complied with – disclosure and client consent on a trade-by-trade basis.

4. If the adviser or its affiliate charges a brokerage commission for the trade, Section 206(3) applies – disclosure and client consent on a trade-by-trade basis. The blanket consent rule, Rule 206(3)-2, may be available, but not if the adviser exercises discretion over both sides of the trade. If Rule 206(3)-2 is available, that Rule requires reporting to clients about the trades and blanket written client consent.

5. Whenever a security is moved from one client account to another, general fiduciary standards must be met. Remember that an "indirect" cross trade is regulated in the same way as a "direct" cross trade. "Indirect" cross trades occur if the sale and repurchase are prearranged with the broker or if the sale and repurchase are simultaneous or nearly simultaneous.

6. General fiduciary standards applicable to cross trades require:

   a. No favoring of one client account over another in the allocation of valuable investment opportunities, although an adviser and client may agree that certain investment opportunities or categories of investment opportunities will not be available to that client;

   b. Executing the cross trade at a price that is fair to both sides, generally at the midpoint between the bid and ask prices for trading of the same security in regulated markets; and

   c. The imposition of brokerage charges for the trade that are not excessive, which generally requires that no brokerage charges be imposed for the trade.

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