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Publications

Retirement Asset Management: Regulatory Update

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As the markets continue to create challenges for plan fiduciaries and asset managers, financial regulators are actively working on a number of projects that impact the investment of benefit plan assets. The Securities and Exchange Commission (the "SEC") has several initiatives underway related to environmental, social, and governance ("ESG") investing, and they are pursuing fundamental changes to the relationship between investors and private fund advisors. The Department of Labor ("DOL") also caught the asset management industry by surprise when it became public that the agency is preparing to amend Prohibited Transaction Exemption 84-14 ("QPAM Exemption"), which provides prohibited transaction relief for asset managers that qualify as qualified professional asset managers ("QPAMs").

I. The SEC's "Greenwashing" Enforcement

Over the past few years, some asset managers have increasingly focused on ESG investment practices, and the Biden Administration has largely been supportive of these efforts, particularly with respect to environmental considerations. However, regulators have also raised concerns about funds and managers making misleading statements related to ESG investment practices. This practice – often referred to as "greenwashing" – has now come under scrutiny by the SEC's enforcement arm. In fact, the SEC created a Climate and ESG Task Force in its Division of Enforcement to specifically focus on issuers' disclosures of climate risks in their filings and advisers' disclosure and compliance issues relating to their funds' ESG strategies.

On May 23, 2022, the SEC charged BNY Mellon Investment Adviser, Inc. ("BNY Mellon"), a registered investment adviser, for misstatements and omissions about its ESG considerations in its investment decision-making process for certain mutual funds that it manages. For some of the funds in question, BNY Mellon had stated that it incorporated ESG considerations into investment decisions, and for the other funds, BNY Mellon had stated that ESG considerations were part of the funds' principle investment strategy. BNY Mellon represented to its investors by way of the fund prospectus and certain responses to potential investors' "request for proposals" that proprietary ESG quality reviews were part of its investment research process, without any qualifying language indicating that such reviews were not required. The SEC alleged that BNY Mellon did not always perform the ESG quality review, and was in violation of several provisions of the Investment Advisers Act and Investment Company Act of 1940. Without admitting or denying the SEC's findings, BNY Mellon agreed to a cease-and-desist order, a censure, and to pay a $1.5 million penalty.

There are now public reports of other large asset managers facing similar SEC investigations. We fully expect the SEC's enforcement to continue and there to be more developments, particularly as the SEC makes the rule changes discussed below.

II. Proposed ESG Disclosures

On May 25, 2022, the SEC issued the proposed rule, *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social and Governance Investment Practices*, aimed at amending rules and reporting forms with the goal of promoting consistent, comparable, and reliable information for ESG advisory services and funds to inform and protect investors. In the SEC's view, the lack of such consistent, comparable, and reliable information has created the risk that a fund or an adviser's recommendation does not match an investor's expectations, and the lack of specific disclosure requirements tailored to ESG investing has created the risk that such funds and advisers marketing ESG strategies may overstate ESG's impact on the adviser's investment practices or the extent to which their funds take into account ESG factors. To that end, the SEC's proposal attempts to address greenwashing by making the following changes:

- Classifying ESG funds as "Integration Funds" (*i.e.*, funds that utilize ESG Factors alongside other pecuniary and non-pecuniary factors in investment decisions), "ESG-Focused Funds" (*i.e.,* funds that utilize ESG factors as a significant or the main consideration in their investment decisions), and "Impact Funds" (*i.e.,* ESG-Focused Funds that seek to achieve a particular ESG impact);
- Requiring specific disclosures for each type of ESG fund tailored to how those funds utilize ESG factors;
- Providing a model disclosure template to be included in the prospectus of any fund that markets itself as an ESG-Focused Fund or an Impact Fund;
- Requiring that certain ESG-related funds and advisers, for which proxy voting or other engagement with issuers is a significant means of implementing its strategy, provide disclosures in their annual reports and filings, including (a) information about how the adviser voted certain proxies and information regarding the adviser's ESG engagement at shareholders' meetings; and (b) for funds that consider environmental factors, requiring disclosure regarding certain greenhouse gas emissions metrics;
- Requiring funds to tag their ESG disclosures using machine-readable data that investors and other market participants could use to more efficiently access and evaluate ESG funds;
- Requiring registered investment advisers to provide disclosure regarding ESG practices as part of Form ADV Part 2A; and
- Amending disclosure forms to collect census-type information about funds' and advisers' use of ESG factors, including their use of ESG providers in order to understand trends in ESG, for instance changes in total assets under management for funds or advisers that incorporate ESG.

There is still time to comment on the proposal as the comment period closes on August 16, 2022.

III. The SEC's Fund Naming Rule

On May 25, 2022, the SEC proposed amendments to the fund naming rule under Rule 35d-1 of the Investment Company Act of 1940 (the "Fund Names Rule"). The current Fund Names Rule requires a registered investment fund with a name suggesting a focus on a particular type of investment to adopt a policy to invest at least 80% of the value of the fund's assets under management in that type of investment. The proposed amendments would expand the circumstances when such a policy would have to be adopted by applying it to any fund whose name includes terms suggesting that the fund focuses in investments whose issuers have particular characteristics. The proposed amendments would also narrow the instances and timeframe during which a fund could deviate from its 80% policy. In the SEC's view, a fund's name is an important marketing tool that can have a significant impact on an investor's decision, and thus amendments are needed to close the gaps in the current Fund Names Rule in relation to today's markets.

Although the proposal includes multiple updates and amendments, the ESG components are particularly notable. As discussed, the SEC is concerned with greenwashing by funds and their advisers, so the SEC's proposed rule would subject funds with names including certain ESG terminology to the 80% investment policy requirement and would deem any Integration Fund as materially misleading and deceptive if ESG terminology is included in the fund's name.

There is still time to comment on the Fund Names Rule as the comment period closes on August 16, 2022.

IV. Private Fund Advisers Rule

On February 9, 2022, the SEC issued the *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews* proposed rule (the "Private Fund Advisers Rule") to enhance the regulation of private fund advisers and to protect private fund investors by increasing transparency, competition, and efficiency in the $18 trillion private funds market space. The SEC was given the authority to promulgate these regulations by the Dodd-Frank Act which passed in the wake of the 2008 financial crisis.

The Private Fund Advisers Rule would make a number of changes, including the following:

- Requiring registered private fund advisers to provide investors with quarterly statements detailing comprehensively, in a tabular format, adviser compensation (direct and certain indirect fees from portfolio companies), other fees and expenses, and performance information for the prior quarter;
- Requiring registered private fund advisers to obtain an annual audit for each private fund and cause the private fund's auditor to notify the SEC upon certain events;
- Requiring registered private fund advisers, in connection with an adviser-led secondary transaction (*e.g.*, offer existing fund investors the option to sell or exchange their interests in a private fund for interests in another vehicle advised by the adviser), to distribute to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider;
- Prohibiting all private fund advisers, including those that are not registered, from engaging in certain activities and practices that are contrary to the public interest and the protection of investors, importantly private fund advisers would be precluded from seeking indemnification, exculpation or a limitation on liability for a breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund, thus establishing a universal minimum standard of care for private fund advisers and stopping the market trend towards a "gross negligence" standard; and
- Prohibiting all private fund advisers from providing certain types of preferential treatment that have a material negative effect on other investors, while also prohibiting all other types of preferential treatment unless disclosed to current and prospective investors. This final change is likely to cause a significant shake-up in investors' and funds' side letter negotiations and MFN processes.

In its justification for the proposal, the SEC noted that the private fund industry is playing a larger role in the economy and people's retirement plans. Accordingly, the SEC intends for the Private Fund Advisors Rule to assist retirement plan fiduciaries in ensuring that their investment decisions are prudent and in the interests of the plan participants and beneficiaries.

The extended comment period officially closed on June 13, 2022. All of the comment letters submitted during the comment period are publicly available.

V. DOL's QPAM Changes

DOL recently sent a proposed amendment to the QPAM Exemption to the White House's Office of Management and Budget for review. The QPAM Exemption is critically important to asset managers as it provides broad relief from the prohibited transaction restrictions under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

The primary regulatory issue with the QPAM Exemption over the past decade has been the disqualification of a financial institution from serving as a QPAM if it, or an affiliate, is convicted of certain crimes, particularly foreign crimes (or domestic crimes based on foreign conduct). Numerous large asset managers have had to seek individual exemptive relief when they have lost QPAM status, and DOL has been under increasing political pressure to stop granting relief. At least in part due to this pressure, DOL has fundamentally changed the terms it imposes when granting exemptions. Under the Trump Administration, DOL issued guidance taking the position that foreign convictions do not necessarily disqualify an asset manager from qualifying for relief under the QPAM Exemption. However, DOL recently disavowed that position.

At this point, DOL has not publicly discussed the proposed changes to the QPAM Exemption, so it is unclear what will be addressed. It is possible DOL could modify the rules related to QPAM disqualification or make changes intended to harmonize the exemption with the duties and obligations under more recent exemptions. Regardless, almost any change to the QPAM Exemption will require careful analysis by asset managers and plan sponsors.

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