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Investment Management Update

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In this Update

Covering legal developments and regulatory news for funds, their advisers, and industry participants through December 2020.

Table of Contents

Rulemaking and Guidance

The SEC's New Investment Adviser Marketing Rule: Merging and Modernizing Advertising and Solicitation Regulation

01.05.21

Just before we said goodbye to 2020, the Securities and Exchange Commission (SEC) finalized amendments to its advertising and solicitation rules under the Investment Advisers Act of 1940, as amended (Advisers Act). The SEC proposed the amendments back in November 2019, kicking off more than a year of significant industry comments, debates, and speculation.[1] Such enthusiasm was fully warranted given the challenges industry participants faced applying outdated rules to a vastly changed industry. Indeed, neither the Advisers Act's current advertising rule (Rule 206(4)-1), nor cash solicitation rule (Rule 206(4)-3) had changed materially since their adoption in 1961 and 1979, respectively.

In adopting its amendments, the SEC surprisingly merged the two rules into one — Rule 206(4)-1 Investment Adviser Marketing. The merger makes complete sense and, in fact, rectifies duplicity and potential inconsistency between the current advertising rule's prohibition on certain endorsements as testimonials and the cash solicitation rule's permissible endorsement activities.[2] The final marketing rule's adopting release totals 430 pages of details regarding the 100+ comment letters and guidance for compliance policies and procedures.

Consistent with the proposed amendments to the advertising rule, the final marketing rule establishes a more principles-based approach regulating advertisements, departing from the currently prescriptive regulatory framework. In addition to permitting the use of certain testimonials, endorsements, third-party ratings, and past investment advice in advertisements, the final rule (subject to certain conditions) permits the use of performance results. The final rule requires advisers to include appropriate disclosures concerning various marketing practices to help investors evaluate adviser claims. Required disclosures in some cases must be tailored to the intended audience receiving certain advertisements, but generally advisers are free to determine the specifics of the disclosure needed. Unlike the proposed rule, the final rule does not expressly require separate requirements for performance advertising in retail advertisements and non-retail advertisements.

In addition to certain required disclosures and other conditions, the provisions on compensated testimonials and endorsements, which include traditional referral and solicitation activity, have been expanded to merge concepts from the current cash solicitation rule. Particularly, compensated testimonials and endorsements are subject to disqualification provisions under the final marketing rule.

Perhaps a holiday gift to compliance personnel, the SEC dropped its proposed requirement for advisers to review and approve their advertisements prior to dissemination, which should ease the additional compliance burden to some extent.

Definition of Advertisement

Advertisement means any direct or indirect communication an investment adviser makes to more than ***one person***, or to ***one or more persons***, if the communication includes hypothetical performance, which offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser.

To the relief of many advisers, the SEC did not to expand the proposed definition of advertisement to include communications addressed to one person. The final rule retains the current rule's exclusion of one-on-one communications, except regarding compensated testimonials and endorsements and certain communications that include hypothetical performance information. Another change from the proposal, the definition will not include communications designed to retain existing investors.

The following types of communications are also excluded from the definition of advertisement:

1. extemporaneous, live, oral communications;
2. information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication; or
3. a communication that includes hypothetical performance that is provided: (a) in response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser; or (b) to a prospective or current investor in a private fund advised by the investment adviser in a one-on-one communication.

As a change from the proposed advertising rule amendments, the final marketing rule merges with the cash solicitation rule in part by expanding the definition of an advertisement. The final definition also includes any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly (*e.g.*, directed brokerage, awards, or other prizes, as well as reduced advisory fees), but generally does not include any information contained in a statutory or regulatory notice, filing, or other required communication to satisfy the requirements thereof. While one-on-one communications are generally excluded from the definition, to the extent they include compensated endorsements or testimonials, those communications would fall back within the definition of an advertisement. Compliance personnel will need to have policies and procedures in place to manage this differing treatment of one-on-one communications.

Importantly, the final definition of an advertisement includes communications not only to clients and prospective clients, but also to investors and prospective investors in private funds that those advisers manage as proposed. The SEC clarified that the following will not be deemed an advertisement for purposes of the rule: (1) information included in a private fund's private placement memorandum (PPM) about the material terms, objectives, and risks of a fund offering; and (2) private fund account statements, transaction reports, and other similar materials delivered to existing private fund investors, as well as presentations to existing clients concerning the performance of funds in which they have invested. However, other information included in the PPM could be covered, making it difficult for private fund managers to ensure compliance when applying the rule to a portion, but not the entire, PPM. Furthermore, the SEC warned that pitch books or other materials accompanying PPMs could fall within the definition of an advertisement.

General Framework: Prohibitions, Restrictions, and Conditions

General Prohibitions. The following practices are expressly prohibited for all advertisements by registered advisers under the new rule, similar to the per se prohibitions under the current advertising rule (General Prohibitions):

1. making an untrue statement of a material fact, or omitting a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
2. making a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;

3. including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser;
4. discussing any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
5. referencing specific investment advice provided by the investment adviser, where such investment advice is not presented in a manner that is fair and balanced;
6. including or excluding performance results, or present performance time periods, in a manner that is not fair and balanced; or
7. being otherwise materially misleading.

Under this framework, advisers need to evaluate the particular facts and circumstances of each advertisement. In particular, the SEC noted the nature of the audience to which the advertisement is directed as a key factor for determining how the general prohibitions should be applied. These general prohibitions are in addition to any further restrictions and conditions set forth below for particular marketing practices and must be separately analyzed. As a chilling reminder to compliance personnel, the SEC stated in both the proposed and adopting releases that, to establish a violation of the rule, the SEC will not need to demonstrate that an investment adviser acted with scienter — mere negligence is sufficient.

Importantly, the adopting release states that certain existing SEC staff no-action letters will be withdrawn as those positions are either incorporated into the final rule or will no longer apply. Despite commenters' concerns with withdrawing these letters for lack of remaining guidance, the SEC stated it does not view the principles of the new rule's general prohibitions to be substantive departures from the positions in existing staff no-action letters and guidance. As of the date of this advisory, the SEC's website for Modified or Withdrawn Staff Statements has not been updated to reflect those withdrawn letters. The SEC does note in the adopting release that, in some cases, advisers may find SEC staff positions from the no-action letters helpful in complying with the final rule, especially when referring to specific investment advice. The SEC staff no-action letters that address the cash solicitation rule will be nullified as the rule itself is being rescinded.[3]

Testimonials and Endorsements. A welcome reprieve from the current advertising rule's prohibitions, advisers will be able to include testimonials and endorsements in its advertisements subject to the following conditions:

1. the adviser discloses, or reasonably believes that the person giving the testimonial or endorsement discloses, the following at the time the testimonial or endorsement is disseminated:
    - clearly and prominently (a) that the testimonial was given by a current client or investor, and the endorsement was given by a person other than a current client or investor, as applicable; (b) that cash or noncash compensation was provided for the testimonial or endorsement, if applicable; and (c) a brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person;
    - the material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement;

- description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement; and

2. the adviser must have (a) a reasonable basis for believing that the testimonial or endorsement complies with the requirements of the rule, and (b) a written agreement with any person giving a testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation for those activities.

If the adviser provides compensation, directly or indirectly, for a testimonial or endorsement, the adviser must comply with conditions 1-2 above. Additionally, advisers cannot compensate anyone, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an ineligible person at the time the testimonial or endorsement is disseminated, unless they are exempt under the rule (*e.g.,* brokers, certain affiliates, those receiving *de minimis* compensation, and "covered persons" under Regulation D, rule 506(d)). However, this does not disqualify any person for any matter(s) that occurred prior to the effective date of the new rule if such matter(s) would not have disqualified such person under the current cash solicitation rule. As proposed, the final rule expands the current cash solicitation rule to apply to noncash compensation, including sales awards or other prizes, gifts, and entertainment.

Third-party Ratings. Advisers will be able to include third-party ratings in their advertisements if they (1) they have as a reasonable basis for believing that any questionnaire or survey used to prepare the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and it is not designed or prepared to produce any predetermined result; and (2) they clearly and prominently disclose, or reasonably believe, that the third-party rating clearly and prominently discloses:

- the date on which the rating was given and the period of time upon which the rating was based;
- the identity of the third party that created and tabulated the rating; and
- if applicable, that compensation was provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating.

Performance Results. As expected, advisers will be expressly permitted to include performance results in advertisements, subject to several restrictions and conditions. In particular:

1. gross performance must be presented with net performance (a) with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and (b) calculated over the same time period, and using the same type of return and methodology, as the gross performance;
2. performance results of any portfolio or any composite aggregation of related portfolios, in each case other than any private fund, must include performance results of the same portfolio or composite aggregation for one-, five-, and 10-year periods, each presented with equal prominence and ending on a date that is no less recent than the most recent calendar year-end; except that if the relevant portfolio did not exist for a particular prescribed period, then the life of the portfolio must be substituted for that period;
3. no statement, express or implied, can be made that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the SEC;
4. performance results must include performance for all related portfolios (with certain exclusions permitted);

5. extracted performance must include the performance results of the total portfolio from which the performance was extracted (or the adviser must offer to provide the same promptly);
6. inclusion of hypothetical performance requires the adviser to (a) adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement, (b) provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance, and (c) provide (or, if the intended audience is an investor in a private fund provide, or offer to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using such hypothetical performance in making investment decisions; and
7. inclusion of predecessor performance requires (a) the person or persons primarily responsible for achieving the prior performance results manage accounts at the advertising adviser; (b) the accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising investment adviser that the performance results would provide relevant information to clients or investors; (c) all accounts managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance, and the exclusion of any account does not alter the presentation of any applicable time periods prescribed by the rule; and (d) the advertisement clearly and prominently includes all relevant disclosures, including that the performance results came from accounts managed at another entity.

The SEC departed from its proposal and adopted the final rule without the proposed separate requirements for performance advertising for retail and non-retail investors.

Books and Records

The SEC also adopted its related proposed amendments to Advisers Act Rule 204-2 books and records rule. The amended rule requires registered advisers to maintain the following new books and records relating to performance advertisements, in addition to those currently required by the books and records rule:

1. predecessor performance and the performance or rate of return of any or all portfolios (in addition to those for managed accounts and securities recommendations required by the books and records rule);
2. for oral advertisements, a copy of any written or recorded materials used by the adviser in connection with the oral advertisement;
3. for compensated oral testimonials and endorsements, a record of the disclosures provided to clients or investors pursuant;
4. a copy of any questionnaire or survey used to prepare a third-party rating included or appearing in any advertisement in the event the adviser obtains a copy of the questionnaire or survey;
5. in lieu of the previously required copies solicitor disclosure statements, if not included in the advertisement, (a) a record of the material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the person for a testimonial or endorsement and (b) a description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement;

6. documentation substantiating the adviser's reasonable basis for believing that a testimonial, endorsement, or the third-party rating complies with the new marketing rule;
7. a record of the names of all persons who are an investment adviser's partners, officers, directors, or employees, or a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director, or employee of such a person excepted from certain requirements under the testimonials and endorsements provisions of the new marketing rule;
8. all accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of any performance or rate of return of any portfolios (in addition to those for managed accounts and securities recommendations required by the books and records rule);
9. copies of all information provided or offered in connection with hypothetical performance advertisements; and
10. a record of who constitutes the "intended audience" in connection with hypothetical performance advertisements and model fee net performance advertisements.

Form ADV Disclosure

The final rule also adds new Item 5.L of Form ADV, Part 1A, whereby registered advisers must disclose whether any of their advertisements contain performance results, a reference to specific investment advice, testimonials, endorsements, or third-party ratings. The final rule does not include the proposed-related question regarding whether the performance results were reviewed or verified. Advisers must also state whether they pay or otherwise provide cash or noncash compensation, directly or indirectly, in connection with the use of testimonials, endorsements, or third-party ratings. Additionally, advisers must disclose whether any of their advertisements include hypothetical performance and predecessor performance. As for all Item 5 disclosures, advisers will be required to update responses to these questions in their annual updating amendment only. As with other recent additions to Form ADV, such as the outsourced chief compliance officer disclosure in Item 1 of Part 1A, engaging in practices requiring disclosure could indicate a higher risk profile for purposes of SEC exams.

Effective Date and Compliance Period

The new marketing rule and the amended recordkeeping rule will be effective 60 days after publication in the *Federal Register*. Until the new rule becomes effective, the current advertising and cash solicitation rules remain in effect. Advisers will be required to complete the amended Form ADV in their next annual updating amendment that is filed after the compliance date. Although the SEC initially proposed a 12-month compliance period, the final rule extends the compliance period to 18 months after the effective date to provide advisers with a sufficient transition period. During this time, the SEC expects to engage in consultation with advisers regarding implementation and encourages advisers to ask the staff questions via email to IM-Rules@sec.gov.

The SEC's final rule is available at https://www.sec.gov/rules/final/2020/ia-5653.pdf.

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[1] For more on the proposed rules, see: "SEC Proposes to Expand Solicitation Rule to Private Funds and Non-Cash Compensation" at https://www.troutman.com/insights/sec-proposes-to-expand-solicitation-rule-to-private-funds-and-non-cash-compensation.html; "SEC Proposes Expanding Permissible Performance Advertising Practices With Favorable Treatment for Private Fund Managers" at https://www.troutman.com/insights/sec-proposes-expanding-permissible-performance-advertising-practices-with-favorable-treatment-for-private-fund-managers.html; "SEC Finally Proposes Modernized Investment Adviser Advertising Rule," *Currents* magazine by the National Society of Compliance Professionals at https://www.troutman.com/insights/sec-finally-proposes-modernized-investment-

adviser-advertising-rule.html; and "SEC Proposes Greater Regulation Of Private Fund Offerings," *Engaging Alternatives* newsletter published by EisnerAmper at https://www.eisneramper.com/sec-regulation-ea-0220/.

[2] The SEC has stated, depending on the facts and circumstances, public commentary made directly by a client about his or her own experience with, or endorsement of, an investment adviser or a statement made by a third party about a client's experience with, or endorsement of, an investment adviser may be a testimonial. See https://www.sec.gov/investment/im-guidance-2014-04.pdf.

[3] As stated in the final rule adopting release, the SEC staff will take a no-action position with respect to the events addressed in solicitor disqualification letters that occurred within the rule's 10-year lookback period to prevent those relying solicitors from being deemed disqualified under the new marketing rule.

ADI 2020-11 Registered Funds' Risk Disclosure for Investments in Emerging Markets

12.14.20

On December 14, 2020, the SEC's Division of Investment Management Disclosure Review and Accounting Office issued an Accounting and Disclosure Information (ADI) providing advice on enhancing fund risk disclosure for fund investments in emerging markets. This advice follows a close review of fund filings.

Following several recent SEC statements on specific risks associated with investing in emerging markets, particularly China, the ADI recommends that funds provide tailored risk disclosures on the emerging markets in which they invest to enable investors to make informed investment decisions about and among funds. In particular, the ADI emphasizes that the availability and accuracy of financial and other information from companies with significant operations in emerging markets may be limited due to the lack of access provided by those countries' regulatory authorities to the Public Company Accounting Oversight Board (PCAOB) and other U.S. regulators that may seek to inspect certain public accounting firms and audit work papers and practices.

Among its recommendations, the ADI encourages funds to consider the following factors when disclosing risks in the emerging markets in which the fund invests, and to create tailored disclosure that contemplates how the factors may affect the fund:

- risks related to liquidity, market manipulation concerns, limited reliable access to capital, political risk, and foreign investment structures, among others;
- whether emerging markets risks arising from differences in regulatory, accounting, auditing, and financial reporting and recordkeeping standards could inhibit an adviser's ability to evaluate local companies or impact a fund's performance;
- any limitations on the rights and remedies available to a fund, individually or in combination with other shareholders, against fund portfolio companies; and
- with respect to index funds, specifically:
    - whether the index provider will have less reliable or current information when assessing if a company should be included in an index or determining a company's weighting within the index;
    - any limitations in the adviser's ability to assess the index provider's process assimilating data prior to its use in index computation, construction, and/or rebalancing; and
- whether any of the above noted limitations could impact the investment objective of a fund.

The ADI encourages funds investing in emerging markets to consider whether existing risk disclosures about companies with significant operations in emerging markets are adequate or require updating in light of the factors noted above.

The ADI represents the views of the Division of Investment Management — it is not a rule, regulation, or statement of the SEC. Further, the SEC has neither approved nor disapproved its content.

The ADI is available at https://www.sec.gov/investment/accounting-and-disclosure-information/principal-risks/registered-funds-risk-disclosure.

SEC Adopts Modernized Framework for Fund Valuation Practices

12.11.20

On December 3, 2020, the SEC unanimously adopted new Rule 2a-5 (the Rule) under the Investment Company Act of 1940, as amended (the 1940 Act) to update the existing valuation framework for registered investment companies and business development companies[1] [2] Rule 2a-5 continues the SEC's initiative to modernize various responsibilities of fund boards.

Rule 2a-5 and related requirements approved in conjunction with the Rule, such as new Rule 31a-4, contain several noteworthy changes from the Rule as proposed in April. The SEC received more than 60 comment letters to the proposal. The changes to the Rule as proposed, and other important aspects of the rulemaking, are discussed in further detail below.

Under Rule 2a-5, determining fair value in good faith with respect to a fund will require the following functions and elements: (1) the periodic assessment and management of material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest; (2) the establishment and application of fair value methodologies and the periodic review of the selected methodologies; (3) the testing of the appropriateness and accuracy of the fair value methodologies selected; and (4) the oversight and evaluation of pricing services, when used. These functions and elements were adopted largely as initially proposed, though the final Rule does not include the proposed provision that would have separately required a fund to adopt written policies and procedures reasonably designed to achieve compliance with the requirements of the Rule. The adopting release states that Rule 38a-1 requires the adoption and implementation of policies and procedures reasonably designed to prevent violations of Rules 2a-5 and 31a-4, and that a fund board must approve such policies and procedures irrespective of whether the policies and procedures are those of the fund or the fund's adviser.

Under the new Rule, a fund board may choose to determine fair value by applying the functions and elements set forth above, or it may choose to designate a "valuation designee" to perform such responsibilities, subject to board oversight as outlined below. If the board designates the performance of fair value determinations to a valuation designee of the adviser, the designee will be required to specify the titles of the individuals responsible for determining the fair value of the designated investments, including specifying the functions for which each is responsible.

When using a valuation designee, board oversight and reporting requirements will include both quarterly and annual written reporting, and in certain instances, more immediate reporting.

- **Quarterly Reporting** would include any reports or materials requested by the board related to the fair value of designated investments or the valuation designee's process for fair valuing fund investments, as well as a summary or description of material fair value matters that occurred in the prior quarter, including material changes to the valuation risks, methodologies, and process for selecting and overseeing pricing services during the quarter.
- **Annual Reporting** would include an assessment of the adequacy and effectiveness of the valuation designee's process for determining the fair value of the designated portfolio of investments that includes, at a minimum, a summary of the results of the testing of fair value methodologies required and an assessment of the adequacy of resources allocated to the process for determining the fair value of designated investments, including any material changes to the roles or functions of the persons responsible for determining fair value.
- More Immediate Reporting involves prompt board notification, and board reporting would be required within five business days for matters that materially affect the fair value of the

designated portfolio of investments. Material matters may include a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process or of material errors in the calculation of net asset value.

The final Rule provides that the board may "designate" the performance of these fair value determinations to a valuation designee. The use of this term is a change from the rule proposal that would have allowed the board to "assign" the role to an adviser, and it serves to clarify the role of the board's oversight if it elects to use a designee. Additionally, while the final Rule largely declines to expand the range of permitted designees beyond the adviser, it allows for an officer of the fund to serve as a designee if the fund is internally managed. Finally, the final Rule's board reporting requirements were adjusted to be more flexible and less prescriptive than those initially proposed.

It seems likely that most fund boards will choose to use a valuation designee, and one issue registrants need to consider is the need for separate compensation arrangements for fund advisers because designated valuation services are typically excluded from the scope of services in existing advisory agreements.

In connection with the adoption of Rule 2a-5, the SEC also adopted new Rule 31a-4 under the 1940 Act, which will require funds or their advisers to maintain appropriate documentation to support fair value determinations and, where applicable, documentation related to the designation of the valuation designee. The substance of new Rule 31a-4 was originally included in the language of Rule 2a-5 in the proposing release, but it was separated in the adopting release to create greater consistency with other 1940 Act recordkeeping requirements.

As proposed, the final Rule defines a "readily available market quotation" for purposes of Section 2(a)(41) of the 1940 Act, as one that is "is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable." With respect to interplay between the new definition and the requirements of Rule 17a-7, the SEC stated that, under the Rule 2a-5 definition of readily available market quotations, some securities may no longer be eligible for cross trades under Rule 17a-7. The final adopting release acknowledges that some funds enter into cross trades in reliance on certain SEC staff no-action letters. It states that the SEC is currently in the process of reviewing these no-action letters to determine whether these letters, or portions thereof, should be withdrawn. In addition, the SEC states that potential revisions to Rule 17a-7 may be forthcoming.

In connection with the adoption of Rule 2a-5, the SEC is rescinding the following releases, no-action letters, and guidance:

- Accounting Series Releases 113 and 118, which provide guidance on, among other things, how to determine fair value for restricted securities, as well as on accounting and auditing matters;
- SEC staff letters related to the board's role in the fair value process and other matters covered by the proposed Rule;
- Valuation-related guidance in the SEC's 2014 Money Market Funds rule release;
- Any staff guidance that is inconsistent or conflicts with the requirements of the Rules, even if not specifically identified in the list contained in the adopting release.

A complete list of the letters being rescinded is contained on page 100 of the adopting release.

With respect to Unit Investment Trusts, which do not have a board or adviser, the final Rule provides that the trustee or depositor must perform the fair value functions and elements noted above.

Rules 2a-5 and 31a-4 will become effective on March 8, 2021, and they will have a compliance date 18 months following the effective date to provide sufficient time for funds and valuation designees to come into compliance with the Rules.

The SEC's final Rule is available at https://www.sec.gov/rules/final/2020/ic-34128.pdf.

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[1] Rule 2a-5 was proposed on April 21, 2020, as described in our *Investment Management Update* article titled, "SEC Proposes to Modernize Framework for Fund Valuation Practices" (https://www.troutman.com/insights/investment-management-update-september-2020.html).

[2] While not controlling on unregistered funds, such as hedge funds, the staff's perspectives on valuation matters may provide a useful framework for those fund sponsors that grapple with valuation issues in unregistered funds that are not subject to regulation under the 1940 Act *per se*.

SEC Issues Temporary Changes to Document Retention Requirements Under Rule 302(b) of Regulation S-T

12.24.20

The SEC's staff of the Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets responded to inquiries from persons and entities subject to Regulation S-T regarding the authentication document retention requirements under Rule 302(b) due to health, transportation, and other logistical issues raised by the spread of COVID-19.

Rule 302(b) requires that signatories of documents electronically filed with the SEC maintain a hard copy of an executed signature page or other document certifying the signature from the electronic filing. The hard copies must be retained for five years after filing and provided to the SEC upon request.

On November 20, 2020, the staff issued a statement temporarily amending certain documentation requirements under Rule 302(b) to permit a signatory to an electronic filing, who follows certain procedures discussed below, to sign an authentication document through an electronic signature that meets certain requirements specified in the EDGAR Filer Manual.

The SEC's statement permits filers to forgo following Rule 302(b) without risking SEC enforcement action so long as:

1. hard copies of a signature page or other document are created and retained as soon as practicable;
2. the document shows a record of what day and time it was signed; and
3. policies and procedures are created by the filer to address the process.

This relief is temporary. It shall remain in effect until the staff provides public notice that it no longer will be in effect. Any such notice will be published at least two weeks before the announced termination date.

A copy of the SEC's statement is at

https://www.sec.gov/corpfin/announcement/staff-statement-rule-302b-regulation-st-covid-19.

OCIE Observations: Investment Adviser Compliance Programs

11.19.20

On November 19, 2020, the SEC's Office of Compliance Inspections and Examinations released a Risk Alert which provides an overview of notable compliance issues identified by OCIE related to Rule 206(4)-7 under the Investment Advisers Act (*i.e.*, the Compliance Rule).

Under the Compliance Rule, registered investment advisers must adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act and the rules thereunder by the adviser and its supervised persons. Such policies and procedures must be reviewed no less frequently than annually, and advisers are encouraged to review their policies and procedures on an interim basis in response to significant compliance events, changes in business arrangements, and regulatory developments. Finally, the Compliance Rule requires each adviser to designate a chief compliance officer to administer its compliance policies and procedures.

Below are examples of notable deficiencies or weaknesses identified by OCIE staff in connection with the Compliance Rule:

A. **Inadequate Compliance Resources.** OCIE staff observed advisers that did not devote adequate resources, such as information technology, staff, and training, to their compliance programs. For example:

   a. CCOs who had numerous other professional responsibilities, either elsewhere with the adviser or with outside firms, and who did not appear to devote sufficient time to fulfilling their responsibilities as CCO.

   b. Compliance staff who did not have sufficient resources to implement an effective compliance program.

   c. Advisers that had significantly grown in size or complexity, but had not hired additional compliance staff or added adequate information technology, leading to failures in implementing or tailoring their compliance policies and procedures.

B. **Insufficient Authority of CCOs.** OCIE staff observed CCOs who lacked sufficient authority within the adviser to develop and enforce appropriate policies and procedures for the adviser. For example:

   a. CCOs with restricted access to critical compliance information, such as trading exception reports and investment advisory agreements with key clients.

   b. CCOs with limited access to senior leadership.

   c. CCOs not consulted by senior leadership on matters with potential compliance implications.

C. **Annual Review Deficiencies.** OCIE staff observed advisers that were unable to demonstrate that they performed an annual review or whose annual reviews failed to identify significant existing compliance or regulatory problems. For example:

   a. Advisers that failed to produce evidence of annual compliance reviews.

   b. Advisers that failed to identify significant business and key risk areas applicable to the adviser.

D. **Implementing Actions Required by Written Policies and Procedures**. OCIE staff observed advisers that did not implement or perform actions required by their written policies and procedures.

E. **Maintaining Accurate and Complete Information in Policies and Procedures.** The staff observed advisers' policies and procedures that contained outdated or inaccurate information about the adviser, including off-the-shelf policies that contained unrelated or incomplete information.

F. **Maintaining or Establishing Reasonably Designed Written Policies and Procedures.** OCIE staff observed advisers that did not maintain written policies and procedures or that failed to establish, implement, or appropriately tailor written policies and procedures that were reasonably designed to prevent violations of the Investment Advisers Act. For example, staff observed advisers that claimed to rely on cursory or informal processes instead of maintaining written policies and procedures. In addition, staff observed advisers that utilized policies of an affiliated entity, such as a broker-dealer, that were not tailored to the business of the advisers.

   Where advisers did maintain written policies and procedures, OCIE staff observed deficiencies or weaknesses in implementing or appropriately tailoring their policies and procedures in the following areas:

   a. Portfolio management,
   b. Marketing,
   c. Trading practices,
   d. Disclosures,
   e. Advisory fees and valuation,
   f. Safeguards for client privacy,
   g. Books and records,
   h. Safeguarding of client assets, and
   i. Business continuity plans.

The Risk Alert is available at https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf.

Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance, and Multiple Branch Offices

11.09.20

OCIE conducted a series of examinations that focused on SEC-registered investment advisers operating from numerous branch offices and with operations geographically dispersed from the adviser's principal or main office (Initiative). The Initiative focused on, among other things, the assessment of the compliance and supervisory practices relating to advisory personnel working within the advisers' branch offices. The Initiative included nearly 40 examinations of advisers' main offices combined with one or more examinations of each adviser's branch offices, specifically regarding (1) compliance programs and supervision, including whether the adviser had adopted and implemented reasonably designed written policies and procedures under Rule 206(4)-7, the Compliance Rule; and (2) the processes by which firms' supervised persons located in branch offices provided investment advice to advisory clients, including the formulation of investment recommendations and the management of client portfolios.

Concerning the Compliance Rule, the OCIE staff observed that more than one-half of these advisers had compliance policies and procedures that were: (1) inaccurate because they included outdated information, such as references to entities no longer in existence and personnel that had changed roles and responsibilities; (2) not applied consistently in all branch offices; (3) inadequately implemented because, among other things, the compliance department did not receive records called for in the policies and procedures; or (4) not enforced.

Concerning the provision of investment advice, more than one-half of the examined advisers were cited for deficiencies related to portfolio management practices. These often were related to: (1) oversight of investment decisions, including the oversight of investment decisions occurring within branch offices; (2) disclosure of conflicts of interest; and (3) trading allocation decisions.

The OCIE staff also observed a range of practices regarding branch office activities that firms may find helpful in their compliance oversight efforts. For example, some advisers adopted and implemented written compliance policies and procedures that: (1) were applicable to all office locations and all supervised persons — regardless of whether these individuals were independent contractors or employees of the adviser; (2) include unique aspects associated with individual branch offices; and (3) specifically address compliance practices necessary for effective branch office oversight. Additionally, some firms performed compliance testing or periodic reviews of key activities at all branch offices at least annually and/or required compliance training for branch office employees.

OCIE encouraged advisers, when designing and implementing their compliance and supervision frameworks, to consider the unique risks and challenges presented when employing a business model that includes numerous branch offices and business operations that are geographically dispersed, and to adopt policies and procedures to address those risks and challenges.

The Risk Alert is available at https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf.

SEC and SRO News

Changes at the SEC

12.31.20

Chairman Jay Clayton to Leave SEC by Year-End

SEC Chairman Jay Clayton announced plans to step down from his position at the end of 2020, in time to create a vacancy in the top leadership position to be filled by the incoming Democratic administration under President-elect Joe Biden. Mr. Clayton's 3 ½ year tenure as chairman was marked by an active enforcement agenda and an increase of proposed and adopted rules that modified the regulatory framework in a variety of industries. SEC chairs traditionally step down when the presidency changes parties, and Mr. Clayton's decision to do so keeps with past practices despite leaving with one month remaining in President Trump's term. Prior to becoming SEC chair, Mr. Clayton was an attorney in private practice.

Elad Roisman Named SEC Acting Chairman

On December 28, 2020, President Trump designated Elad L. Roisman as acting chairman of the SEC, following the departure of Chairman Jay Clayton at the end of 2020. President-elect Joe Biden will most likely appoint a new SEC chair after his inauguration in late January. Mr. Roisman was sworn in as an SEC commissioner on September 11, 2018. Prior to joining the SEC, he served as chief counsel on the U.S. Senate Committee on Banking, Housing, and Urban Affairs. He previously held other SEC positions, and prior to that, was an attorney in private practice.

Dalia Blass to Conclude Tenure as Director of the Division of Investment Management

On December 22, 2020, the SEC announced that SEC Director of the Division of Investment Management (Division) Dalia Blass will leave her position in January after leading the Division since September 2017.

As director, Ms. Blass led a number of regulatory initiatives impacting investment companies and investment advisers, including significant rulemaking for exchange-traded funds (ETFs), fund of fund arrangements, business development companies (BDCs), derivatives used by funds, fund valuation practices, investment adviser marketing, and other assorted disclosure-related initiatives. Ms. Blass also participated in the far-ranging rulemaking updating retail investors' relationships with investment advisers and broker-dealers, which introduced Regulation Best Interest, the Form CRS relationship summary, and the interpretation regarding the standard of conduct for investment advisers. Ms. Blass also ran the Division's regulatory response to challenges presented by the COVID-19 pandemic, in addition to the Division's "board outreach" initiative.

Upon Ms. Blass's departure, Sarah ten Siethoff will become the Division's acting director.

Paul G. Cellupica, Division of Investment Management Deputy Director and Chief Counsel, to Conclude Tenure at SEC

On January 7, the SEC announced that Deputy Director and Chief Counsel of the Division of Investment Management Paul G. Cellupica will step down from the SEC at the end of January. During Mr. Cellupica's tenure, the Division promulgated a wide range of new rules and other initiatives, including responses to mitigate the effects of COVID-19 on in-person board meetings for investment companies, as well as exemptive relief allowing novel forms of actively managed ETFs to operate without being subject to daily portfolio transparency. Previously, Mr. Cellupica held a variety of roles at the SEC and in private practice.

Upon Mr. Cellupica's departure, Brent Fields will serve as acting deputy director and acting chief counsel of the Division of Investment Management.

Sagar Teotia to Conclude Tenure as SEC Chief Accountant

On January 13, the SEC announced that SEC Chief Accountant Sagar Teotia will leave the agency by the end of February. Mr. Teotia has served as chief accountant since July 2019. Prior to that, Mr. Teotia served as the SEC's deputy chief accountant since 2017. As chief accountant, Mr. Teotia acted as the SEC's principal advisor on accounting and auditing matters, led the Office of the Chief Accountant, and assisted the SEC in its oversight of the Financial Accounting Standards Board and Public Company Accounting Oversight Board.

Paul Munter will serve as the acting chief accountant upon Mr. Teotia's departure in February.

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