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Talking Investment Management: What Is Coming Down the Pike?

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David Grim (00:04):

Welcome to Stradley Podcasts. I'm Dave Grimm, and I'm joined with two of my terrific partners, Mena Larmour and Christopher Zimmerman. And Chris, Mena and I were just talking about what is coming down the pike from the SEC that might be helpful to share with fund boards. And there are a lot of different initiatives that the SEC is working on that we think we should be keeping an eye on. We're gonna spend the next 15 minutes or so focused on three of them: the ESG rule, the names rule, and the cybersecurity rule. And what we're gonna try to lay out for you is some practical tips on what to expect about these rules. In particular, we're gonna give you just a quick summary of what the key provisions are in those rules. A, a flavor of the industry, comments on those rules, and interesting tidbits for boards to think about, assuming these rules get adopted, which we think will happen coming up here. So with that introduction, Mena, let's start with you. Can you walk us through the proposed ESG rule at the SEC a little bit?

Mena Larmour (01:19):

Thanks Dave. Hi, everyone. Yes, the SEC has definitely been busy. So with the ESG role and with ESG in general, it's all about doing what you say you're doing, and the SECC has, you know, expressed concern that investors don't know what they're buying with ESG products or that advisors are characterizing their ESG strategies inappropriately. And so salt, to address this with the ESG proposal, the proposal is really primarily a disclosure role. It attempts to establish a standardized framework for ESD strategies. So it outlines three categories of ESG funds. Along with these categories, there are rather prescriptive disclosure obligations related to each category that vary based on the significance of the ESG factors to a fund strategy. I'm not gonna go into detail on all of these disclosure obligations, but at a high level, the three types of ESG funds that the SEC has identified are integration funds, ESG-focused funds, and impact funds.

Mena Larmour (02:23):

Generally, an ESG integration fund considers one or more ESG factors alongside other non-ESG factors. So the ESG factors aren't, you know, more critical to an investment decision than another factor, such as earnings, and an ESG-focused fund focuses on one or more ESG factors by using them as a significant or main consideration in selecting investments. Then, an ESG impact fund seeks to achieve a specific, measurable ESG impact or outcome. Not in the role, but there also would be a fourth category of funds, which is, you know, no consideration of ESG at all. So, what does all of this mean for a board? The proposal does not necessarily impose new reporting or other obligations like some other SEC rules do, and some that we've discussed on other podcasts. However, the board's role in this new ESG proposal boils primarily to disclosure and compliance oversight.

Mena Larmour (03:21):

You know, the board should understand how an advisor evaluates ESG, how it determines which of the three buckets included in the proposal a fund falls into, and how it monitors whether the fund remains appropriately placed in that bucket. And then, you know, most importantly, the fund disclosure documents speak to what the fund is actually doing. I think boards should really understand the policies and procedures that an advisor has to ensure that a fund's ESG disclosures are supportable and that ESG decisions are documented so that you're comfortable from a registration statement and compliance oversight perspective. Dave, do you wanna discuss some industry comments, which I guess now, as a bonus, given the SEC glitch, there's more time for people to comment, but we can talk about maybe the comments that have been uploaded successfully so far.

David Grim (04:13):

Yeah. I think that when I look at the industry comments, there's a lot of 'em, right? This is a rule that is pretty unpopular with the industry. And, you know, we don't have time today to summarize 'em all. I think, you know, broadly some of the themes in those comments or that the rule proposal elevates ESG over all other kinds of important investment strategies, right? Which isn't the right way to go in a lot of ways, right? Another big theme in the comment letters is that the SEC is separately doing an entire overhaul of corporate ESG disclosure. And because the asset management industry is users of that corporate disclosure, the asset management view of that is please finish that so we can see what kind of information we're gonna be getting from the companies that we invest in, in order to tailor what we tell the world about our fund and our investments.

David Grim (05:23):

So those are some big themes. I think another thing. The last thing I would say about the industry comments is that, interestingly, there's not a whole lot in them focused on the board role, and that can probably be chopped up for a couple of different reasons. One is that the SEC doesn't talk a whole lot about the board's role in these proposals, so there's not much to comment on. And then the other thing is there are so many other issues to comment on the board issues, just, you know, didn't make it high enough on the list to make it into a focus area in people's comments, letters. So that's a little bit on what's going on in the industry, comments. Mena, I'll turn it back to you to take us through the rest of ESG.

Mena Larmour (06:04):

Yeah, sure. So this rule proposal wasn't necessarily a surprise in terms of, you know, what it seeks to do. It's consistent with what we've seen the staff focus on in the ESG suite exams that they've been conducting since, I think, 2021. And you know, I've heard anecdotally they've been over a hundred exams, and they published a risk alert on what they've seen in the exams. And these are, again, the topics. It's, you know, all about doing what you say you're doing. We've seen these same types of comments through the registration statement, comment process, as well as some SEC enforcement actions, like the most recent BNY enforcement action. It's clear that the SEC wants to know and wants disclosure to be very specific about what investments are put through an ESG lens, and how the ESG lens impacts the fund as a whole.

Mena Larmour (07:05):

They want funds that have ESG in their name to have an 80% policy, which we'll talk about later. And so given all of this background and what we know, the s e C wants, I think from a disclosure, oversight perspective, it's important for boards to just understand and educate themselves on, you know, how a particular fund implements its ESG strategy, how the factors are considered in making an investment decision, whether it's ES or G or all three. And, you know, whether these Es are determinative as to buyer-seller decisions or, you know, just a factor. I think the board should understand the use of third-party external data, how an advisor's proxy voting policies look at ESG of public companies, and how the advisor engages with their portfolio companies. And then also just, you know, what third party initiatives the advisor has signed on, you know, net zero asset management, un p i just, just, you know, things that could be out there in the world is this advisor saying that, you know, they commit to this and just kind of understand what that is.

Mena Larmour (08:21):

Then, we will discuss how all of the above are factors in the funds disclosure documents. Chris, I know for multi-manager funds, there are some different aspects or angles that boards should be thinking about. In terms of sub-advisor oversight. Do you wanna talk about that?

Christopher Zimmerman (08:40):

Sure, Thanks. So whether this this, this specific rule is adopted as proposed or not I think boards of course should be aware of the subadvisors strategies in the portfolios that they oversee, you know, which is, which is in many ways similar to how it would be for directly advised fund. You know, understanding where your fund sits on the SCC hierarchy, if adopted, is gonna be important to understand, you know, whether or not multi-aged or not. You know, however, for multi-managed funds, boards can rely on the primary advisor to assess and report on the supervisor's strategies. It may also be appropriate to receive presentations in this regard, which can take on various flavors, including addressing all the questions that That raised earlier. Overall, you know, as a reminder, trustees sign the registration statement on one of the funds. So, you know, boards should look to the advisors' process for understanding the sub-advisor strategies to make sure that any of the disclosures that are included for ESG are appropriate. That's a great wrap on ESG. Thanks to both of you for walking through that. Let's turn to the next rule on our hit list today, which is the names rule. I think Chris and Mino, you guys are gonna sort of provide a summary of the rule and a view on some of the industry comments. So take it away.

Mena Larmour (10:07):

All right, so there's lots of industry climb around this one. And perhaps rightly so. Among other things, the proposed amendments to the names role really expand the universe of funds that would be subject to the role. So the role would now include funds with names that suggest a focus on investments that have a particular characteristic. So this is growth or value funds, and surprise, surprise, ESG funds. So, tying this back to the ESG proposal discussion, we just had the new names rule, which would bring ESG-focused and impact funds into the role and require them to have an 80% policy. Another ESG-related aspect of the names rule is that the SEC specifically called out the integration funds. So those that consider ESG alongside other factors would, per se, be materially deceptive or misleading under the proposal if they include ESG in their name.

Mena Larmour (11:07):

So they can't there are other elements associated with the proposed role, including some specifications of circumstances under which a fund made apart from its 80% policy, and then a timeframe requiring the fund to come back into compliance, which is generally 30 days. So what does this mean for boards? Boards currently already approve 80% policies under 35 D one, so that wouldn't change but boards may be asked to approve new or revised policies for funds, given the expanded scope of the rule as they currently do, board should just understand a funds process for ensuring compliance with its 80% policy and monitoring adherence to such policy. And then the other aspect of the proposal that implicates boards is related to the record-keeping requirement for funds that do not adopt an 80% policy; they are required to maintain a written record of the analysis supporting why they don't need an 80% policy. And in the role, the SEC noted that this would give, you know, compliance personnel and fund boards assistance in evaluating the fund analysis. So, I suggested that this would be something that the boards would see. Chris, I'll turn it over to you if you wanna discuss industry comments on the proposal.

Christopher Zimmerman (12:29):

Thanks, Mena. So, as Mena mentioned, there's been a fair amount of, you know, comments to the names rule from industry participants, including from Stradley Ronon's Disclosure Group, which is an internal group here at Stradley Ronon that thinks through and addresses various disclosure issues on behalf of our clients. So a comment response letter to this rule is right within the bailiwick of our disclosure group. So, with respect to the board the SEC did request comments in a few instances in the proposing release that suggested or contemplated a role of the board, such as, you know, what Mena just mentioned, making a finding, with respect to the analysis of a fund, that does not adopt 80% policy, or instead of, having a 30 day limit, that mean a reviewed whether the board should instead be notified or even approve of the funds departure from the 80% policy that exceeds 30 days.

Christopher Zimmerman (13:25):

Now, in each of these instances, commentators have generally argued against any sort of board approval, as it's, you know, generally outside of the board's role, of that, of oversight. Although notification of a temporary departure could be appropriate, as most boards receive notification. Now, in any event, beyond the role of the board in general, again, there's been a fair amount of criticism of the proposed rule. In particular, there's been criticism on the expansion of the name subject to the rule. You know, there's likely gonna be interpretive issues associated with the expansion of funds, names to strategies, you know, which is gonna have added compliance costs you know, for strategies that require in essence flexibility and, and new nuance. The other element is that the temporary departure from investment policies made for sale of securities at in opportune times the terms value and growth, for example, are inherently subjective names and based upon expectations at that moment in time could result in forced sales due to the application of the funds name, with no further consideration of things like tax implications or active portfolio management of the portfolio.

Christopher Zimmerman (14:39):

Now, I think overall, the, the overall arching overarching concern here is that funds simply will choose not to convey important information in a fund's name and, you know, potentially rely on some generic funds name so us not to trip up the requirements under the proposed rule and not having a fund name that conveys any sort of meaningful information is ultimately at the end of the day not going to be very helpful to shareholders of the fund. And with that, I turn it back over to Dave. Excellent summary of the issues, both of you. Thank you for doing that. Anything else on the names rule? Is it time to turn to our last rule of the day, which is cybersecurity? So when it comes to cyber, look, I think everyone in the industry is spending a ton of time on cyber issues already, and the SEC has proposed a rule that would impose some specific legal requirements to be implemented into the existing processes that folks in our industry already have.

David Grim (15:41):

At a high level, the rule proposal has four main elements. One is the adoption of a cybersecurity risk management policy and procedure. The second is reporting of certain cyber incidents to the SEC. The third is disclosure to the public about cybersecurity-related risks and incidents. The fourth is sub-record keeping obligations that relate to the first three in terms of what it means for boards. If this rule gets adopted as it's proposed, I think that the actions that the board is gonna have to take, right? They're gonna have to approve policies and procedures, the cybersecurity risk management policies and procedures that have to be developed, and then there will be some annual reporting on how it's going under the program and whether there are any material changes to the program. The last thing I would say, sort of about the board role is, you know, as with all of these issues we've been talking about, but particularly in the area of cyber security, it's really important to try to find that, to stay on the right side of the line between oversight and not getting into the, the weeds of, of cyber security, right?

David Grim (17:10):

There are experts at, you know, every manager that you work with, right, on these cybersecurity issues, and that's what their job is to do every day. So, rely on them and their expertise in terms of what the industry comment has been on regarding this rule proposal. I think there's a lot of concern about a lot of different elements of it, but I wanna just focus particularly on the board piece of it. I think broadly speaking, there is support for the idea that the board will be asked to approve the policies and procedures and be reported to in an annual way, right? That's an approach that works in a lot of areas. I think it is a sensible way to deal with cybersecurity issues as well. Another point that was made in the comment letters is that the board is concerned with the importance of having the option to rely on certifications from primary service providers.

David Grim (18:19):

Right? When you think about where the cyber risks lie in the fund world, it's at the service providers, right? That's, that's, that's where the information is. Allowing the board to rely on certifications is an important part of implementing this rule. The one piece of the release on cyber that I think the board should keep an eye on relates to this service provider concept. There's some talk about the board's role vis-à-vis the reviewing of contracts and risk assessments by service providers. And I think it's going to be important for that guidance to be calibrated correctly. So that, of course, you know, the board having an oversight role with respect to those issues makes sense. But drawing them into the specifics of a particular contract revision, right? That's something that the boards should be able to rely on others to make sure is okay. So that's a little bit about what the rule says and what the industry comments have been around the board piece. Chris, Nina, anything you'd like to chime in on when it comes to cybersecurity?

Mena Larmour (19:33):

Yeah, I'll just touch on Dave. What you discussed is that the board isn't required to be experts in cyber. I thought it was interesting that the corporate cyber role does have a disclosure requirement for boards to disclose their level of expertise on the subject of cyber, and this fund board rule does not. So to me, that was sort of indicative of the SEC not expecting that fund boards would have expertise on cyber, and, you know, can rely on experts that do have that expertise.

Christopher Zimmerman (20:10):

Dave, you touched upon this already, but you know that the board obviously needs to approve the policies and repeaters and receive an annual written report. I would say it's, you know, it is sounding familiar to what we've seen with things like liquidity risk management and derivative risk management. You know, now we are essentially seeing that with cybersecurity risk management as well. Great. Well said. Thank you. So we hope this gives you a flavor of these three rules, which are coming at us. As a reminder, these rules are not yet final, right? They've been proposed by the SEC, and there's been a public comment period. And so now it's up to the SEC to decide whether to adopt. We do expect that all three of them will be adopted at some point in 2023, hopefully revised to address many of the thoughtful comments that folks share with the SEC.

David Grim (21:05):

So with that, I'd just like to say thank you so much to my fantastic colleagues for hanging out with me today and sharing their insights with you on these rules. Thanks to all of our listeners for joining us. If you like what you heard, please tune in for the other part of our series of podcast. That one's about some SEC rules that most boards have already heard about. But there's more to come valuation and, and derivatives. So, check that podcast out. That's a wrap for thanks again so much for listening. Have a good day.

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