

Investment Management Update – December 2022

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Covering legal developments and regulatory news for funds, their advisers, and industry participants for the quarter ended June 30, 2022.

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Rulemaking and Guidance

SEC Adopts Rules to Require Electronic Filing for Investment Advisers and Institutional Investment Managers

06.23.22

On June 23, the Securities and Exchange Commission (SEC) adopted rule amendments to provide for electronic submissions of: (1) applications for orders under the Investment Advisers Act of 1940, as amended (Investment Advisers Act) and the Investment Company Act of 1940, as amended (Investment Company Act); (2) applications for Confidential Treatment Requests for filings on Form 13F; and (3) Form ADV-NRs. The SEC also adopted amendments to Form 13F.

Amendment to Regulation S-T and Investment Advisers Act Rule 0-4

Under Section 206A of the Investment Advisers Act, the SEC may grant exemptions from any provision of the Investment Advisers Act to an applicant, provided that the SEC finds the exemption to be appropriate in the public interest and consistent with the protection of investors. To obtain an exemption, applicants currently must apply to the SEC to obtain an order.

Under the amendment, applicants requesting an exemption will be required to file their applications through the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR). The SEC also amended rule 201 of Regulation S-T such that the rule does not permit temporary hardship exemptions from electronic filings for orders under the Investment Advisers Act, but continuing hardship exemptions from electronic filing will be available, as is the case under the Investment Company Act. This is because there are no deadlines for filling orders under either the Investment Advisers Act or the Investment Company Act, so temporary exemptions would be unnecessary.

The SEC notes that this change promotes consistency, because applications for orders under the Investment Company Act are already filed via EDGAR. Additionally, the SEC is confident that it will see similar improvement in searchability and efficiency that occurred when orders under the Investment Company Act were moved to electronic filing via EDGAR.

Other minor amendments to further align the requirements for applications for orders under the Investment Advisers Act and the Investment Company Act include: (1) eliminating the requirement for applicants to notarize statements of fact in conjunction with their application (a requirement which has already been eliminated under the Investment Company Act); (2) eliminating the requirement for applicants to include proposed notices as exhibits to applications (a requirement which also has already been eliminated under the Investment Company Act); and (3) removing references to microfilming in Investment Advisers Act rule 0-4(b) and Investment Company Act rule 0-2(b).

Amendment to Submission of Form ADV-NR

Section 211(a) of the Investment Advisers Act allows the SEC to collect the information included on Form ADV-NR. Nonresident general partners and nonresident managing agents of SEC-registered investment advisers and Exempt Reporting Advisers must file Form ADV-NR to appoint an agent for service of process in the United States.

The amendment adopted by the SEC requires that Form ADV-NRs now be filed through the Investment Adviser Registration Depository (IARD), the same system that advisers currently use to file Form ADV. IARD will present

Form ADV-NR in a fillable format and require electronic signatures. Nonresident general partners and nonresident managing agents should also note that the amended rule will require them to amend Form ADV-NRs by filing a new form within 30 days of information in the form becoming inaccurate.

The SEC notes that this change will allow members of the public to view Form ADV-NR through the same system they view Form ADV which ultimately promotes transparency to the public, in addition to reducing the burden of filing and processing paper forms.

Amendment to Rule 13f-1

Section 13(f) of the Securities Exchange Act (Exchange Act) requires managers that exercise discretion over accounts holding 13(f) securities having an aggregate fair market value of at least \$100 million on the last trading day of any month of any calendar year to file quarterly reports of 13(f) securities holdings with the SEC using Form 13F. Section 13(f) allows the SEC to prevent public disclosure of certain information contained in Form 13F upon a manager's request, and when the SEC determines that confidentiality is appropriate in the public interest.

To request confidentiality, managers currently must make multiple filings. The first is an electronic filing via EDGAR of a public Form 13F that names the securities that must be disclosed under 13(f), but which excludes the securities for which the manager is requesting confidential treatment. The second is a paper 13(f) Confidential Treatment Request that includes a separate, nonpublic Form 13F for the same quarter that lists any 13(f) securities for which the manager is requesting confidential treatment, and a supporting letter that explains the basis for the Confidential Treatment Request.

The adopted amendment, however, changes the requirement such that the 13(f) paper Confidential Treatment Request will now also be filed via EDGAR. Additionally, the SEC adopted an amendment to the instructions on Form 13F to require managers seeking confidential treatment to demonstrate that the information is kept private by the manager and that failure to maintain confidentiality with respect to the information would likely cause harm to the manager.

The SEC notes that filing the Confidential Treatment Request electronically via EDGAR will expedite the SEC's review of the requests and impose less of a burden on managers who already must file through EDGAR.

Amendments to Form 13F

The SEC also adopted several technical amendments to Form 13F. Such amendments are as follows:

- Each Form 13F filer must provide its Central Registration Depository number (CRD Number) and SEC file number, if any.
- If a manager is filing a Form 13F notice report on Form 13F-NT, the manager must include the CRD number and SEC file number, if any, of any other manager included in the "List of Other Managers Reporting for this Manager" table on the cover page.
- All dollar values listed on Form 13F must now be rounded to the nearest dollar, rather than to the nearest \$1,000.
- Filers no longer must omit "000" when reporting dollar values on Form 13F.
- The 80-character limit for the information that filers include on the cover page and the summary page has been

removed, as has the 132-character limit on the information table.

Additionally, the SEC adopted an amendment that allows, but does not require, managers to use FIGI, in addition to CUSIP as an additional security identifier when making filings. The SEC notes that giving the managers this option improves the utility of information included on Form 13F for the SEC, other regulators, and members of the public.

The amendments related to Investment Advisers Act Applications, Form ADV-NR, and the electronic filing requirements of 13F Confidential Treatment Requests became effective on August 29, 2022, with a compliance date of six months after that date. With respect to the amendments to Form 13F, the SEC is delaying the effective date until January 3, 2023.

A copy of the SEC's adopting release can be found at: <https://www.sec.gov/rules/final/2022/34-95148.pdf>.

SEC Requests Information and Comment on Investment Advisers Act Regulatory Status of Index Providers, Model Portfolio Providers, and Pricing Services

06.15.22

On June 15, the SEC requested comments on certain information providers, whose activities may cause them to meet the definition of "investment advisers" under the Investment Advisers Act. The request focused on three types of information providers: index providers; model portfolio providers; and pricing services.

Index Providers

The SEC is concerned with index providers because they may be making active decisions in designing or administering the index. Index providers decide the market that the index measures, which constituents should be included, and how much weight to give to each constituent. The SEC is seeking comment about index providers because an index provider's decision to include or exclude a particular security or sector in an index can lead to client-facing advisers who are monitoring that index to buy or sell securities in response.

Model Portfolio Providers

Model portfolio providers create a diversified group of assets that are designed to achieve a particular investment goal, such as capital preservation or income, while balancing corresponding risks. These providers offer several models, all with different risk targets. Investment advisers commonly outsource portfolio management to model portfolio providers. The SEC wants to learn more about model portfolio providers because as of late, there is a higher demand for a specialized target allocation model. For example, a specialized model that focuses on sustainable investments. In addition, the client-facing adviser directly communicates with the model portfolio provider, rather than the client communicating with the provider, which may lead to the client not knowing who is performing the services and who owes the client a fiduciary duty. The lack of clarity in the roles and duties owed may increase if the investment adviser disclaims or limits its fiduciary duty.

Pricing Services

Pricing services are receiving attention from the SEC because of the significant discretion they possess when providing pricing information to investors, which could pose conflicts of interest. Pricing services self-determine their valuation methodology, valuation model template, and input sources, which can lead to different pricing levels for the same security across pricing service companies. The SEC recently adopted Rule 2a-5 under the Investment Company Act, which concerns valuation practices and the board of directors' oversight. Rule 2a-5 requires the board to oversee and evaluate pricing services used to satisfy the standard for fair value as determined in good faith. Comments are being requested because the SEC believes there is a potential conflict of interest for pricing services that value the securities of registrants and unclear fiduciary relationships.

Main Topics in Request for Comment

The SEC's questions in the request for comment focus on a few topics:

- Whether the activities the information providers conduct would be considered "analyses or reports concerning securities," and whether the factors for that determination are appropriate for information providers.
- The types of risk and conflicts of interest each information provider may present.
- Whether information providers rely on an exclusion from the definition of "investment adviser," and if not, whether the SEC should use its authority to exempt providers from the definition of "investment adviser."
- Whether information providers believe they owe fiduciary duties to the investors who rely on the information they provide.
- The levels of influence investment advisers have on the creation of indexes or portfolios by index providers or model portfolio providers, and investment advisers' ability to limit pricing services' discretion.
- Whether information providers disclose changes or updates to the services provided to investment advisers and the clients they serve.
- The form of compensation the information providers receive.
- The economic benefits and costs associated with declaring information providers as investment advisers.

Comments were due to the SEC by August 16, 2022.

A copy of the SEC's request for comment can be found at: <https://www.sec.gov/rules/other/2022/ia-6050.pdf>.

SEC Proposes Fund Names Rule Amendments and Rules Governing ESG Investment

05.25.22

In two separate May 25 releases, the SEC proposed amendments to: (1) Rule 35d-1 (the Names Rule) under the Investment Company Act; and (2) rules and disclosure forms concerning funds' and advisers' incorporation of environmental, social, and governance (ESG) factors. The final rules, if adopted, would make investment companies and advisers subject to tighter standards, regarding how funds are named and how ESG factors are disclosed.

Amendments to the Fund Names Rule

Adopted in 2001, the Names Rule mandates that a fund's name does not misrepresent the fund's investments and risks, and that investors' assets in funds are invested in accordance with their reasonable expectations based

on a fund's name. The proposed amendments come nearly a year after Chair Gary Gensler, in [prepared remarks](#) before the Asset Management Advisory Committee, compared investment fund names to a fat-free milk nutrition label, expressing his concerns that it's more challenging to determine what a "green" or "sustainable" fund is invested in, than to determine how many grams of fat are on a nutrition label. Building off those concerns, the SEC's proposal would, among other changes, do the following:

- Expand the 80% investment policy requirement to apply to any fund name with terms suggesting that the fund focuses on investments that have particular characteristics (*e.g.*, fund names with terms, such as "growth" or "value" and those indicating that the fund's investment decisions incorporate ESG factors);
- Prohibit a fund that considers ESG factors alongside but not more centrally than other non-ESG factors in its investment decisions (*i.e.*, Integration Funds) from using ESG or similar terminology in its name, which practice would be defined to be materially deceptive and misleading;
- Require fund prospectus disclosure that defined the terms used in a fund's name and amend Form N-PORT to require greater transparency on how fund investment selection methods match the investment name focus that the fund's name suggests; and
- Prohibit a registered closed-end fund or business development company (BDC) with shares not listed on a national securities exchange from changing its 80% investment policy without a shareholder vote.

Amendments to Rules and Disclosure Forms Concerning ESG Investments

The proposed amendments to rules and forms under both the Investment Advisers Act and the Investment Company Act would require registered investment advisers, certain registration-exempt advisers, registered investment companies, and BDCs to provide additional information regarding their ESG investment practices. The proposed amendments, which Chair Gensler stated would enable investors "to drill down to see what's under the hood of [ESG] strategies," include the following changes to promote consistent and reliable information for investors:

- Require funds that consider ESG factors in their investment process to disclose additional information regarding their strategy, with the amount of disclosure dependent on how central ESG factors are to a fund's strategy. The proposal specifically identifies three types of ESG funds — Integration Funds, ESG-Focused Funds, and Impact Funds.
 - Integration Funds would be required to describe how ESG factors are incorporated into their investment process.
 - ESG-Focused Funds (*i.e.*, funds for which ESG factors are a significant or main consideration) would be required to provide detailed disclosure, including a standardized ESG strategy overview table.
 - Impact funds (*i.e.*, a subset of ESG-Focused Funds that seek to achieve a particular ESG impact) would be required to disclose how they measure progress on their objectives.
- Require funds that use proxy voting or engagement with issuers as "significant means" of implementing their ESG strategy to provide additional information about their proxy voting or ESG engagements.
- Require ESG-Focused Funds that consider environmental factors in their investment strategies to disclose additional information regarding the greenhouse gas (GHG) emissions associated with their investments (*e.g.*, carbon footprint and weighted average carbon intensity of their portfolio). Integration Funds that consider GHG emissions would be required to disclose information about how they consider GHG emissions, including the methodologies and data sources the fund relies on.

These proposed rules and enhanced reporting requirements will show up in several forms, outlined below:

- **Prospectus ESG Disclosure Enhancements.** A registered fund would be required to provide investors with

specific information about the fund's implementation of ESG factors in the fund's principal investment strategies. The level of detail required in the fund's prospectus would depend on the level the fund considers ESG factors in its investment process, with a layered disclosure approach: (1) Open-End Funds would only need to provide an overview of their ESG strategy in the summary section of the prospectus, with more detail in the statutory prospectus; (2) Integration Funds would provide a more limited disclosure, "summarizing in a few sentences" the ESG factors it considers and incorporates into its investment strategy; (3) ESG-Focused Funds (with Impact Funds as a subset of ESG-Focused Funds) would be required to provide specific and detailed disclosures concerning how the fund focuses on ESG factors in its investment strategy; and (4) Impact Funds would be required to provide the disclosures that an ESG-Focused Fund would provide, while additionally providing an overview of the impact(s) the fund is seeking to achieve and the manner in which it is seeking to achieve said impact(s).

- **Form N-CEN.** Proposing to add Item C.3(j) that is specific to ESG funds' strategies and processes. Specifically, it would require ESG funds to report, among other things: (1) the type of strategy employed (Integration, ESG-Focus, or Impact); (2) the ESG factor(s) it considers; and (3) the method(s) it uses to implement its ESG strategy. Additionally, registered funds would be required to disclose whether they consider ESG-related information, or scores provided by ESG providers, and if so, to provide the legal name and legal entity identifier of each provider. The proposed amendment to Form N-CEN would also require a fund to report whether the fund follows any third-party ESG frameworks in its investment strategies, and if so, to provide the full name of such frameworks.
- **Form ADV Part 1A.** The amendment would require information about advisers' uses of ESG factors for their separately managed account clients and reported private funds. Registered advisers would be required to disclose their use of ESG factors and any third-party ESG frameworks used in connection with their advisory services. Both registered and exempt advisers would be required to provide information on whether they conduct other business activities as ESG service providers or consultants, or have any related persons that are third-party ESG service providers or consultants.
- **Form ADV Part 2A.** The amendment would require registered investment advisers that consider ESG-related factors in their investment strategy to include information about their ESG practices. Specifically: (1) a description of the ESG factor(s) considered and the method of implementation into the adviser's investment strategy; (2) an explanation of whether, and how, the adviser employs ESG integration, ESG-focused strategies, or ESG impact strategies; (3) a description of any ESG strategy, criteria, or methodology employed in investment evaluation or selection, if applicable; (4) a description of any relationship or arrangement that is material to the adviser's business or clients that the adviser or its management persons have with any related person that is an ESG consultant or ESG service provider; (5) for advisers with specific voting policies or procedures that include one or more ESG considerations, a description of the ESG factors considered, and how they consider them; and (6) for advisers that sponsor wrap fee programs, a description of the ESG factors they consider and how they incorporate such factors under each program, an explanation of whether they review, or whether a third party reviews, portfolio managers' application of relevant ESG factors and the nature of such review, or an affirmative statement that no such review occurs and an explanation of any limitations on calculation, assessment, or presentation of ESG factors as a result.

This proposal comes on the heels of a [\\$1.5 million penalty](#) assessed against BNY Mellon Investment Adviser, Inc. for alleged misstatements and omissions about its ESG considerations in making investment decisions for certain mutual funds that it managed.

Each proposal passed on a 3-1 vote. As with the March 21 climate-related disclosures proposal for registrants, Commissioner Peirce opposed both proposals, which she characterized as overly prescriptive and burdensome on funds and fund managers.

Comments on each of the proposed rules were due to the SEC by August 16, 2022.

The SEC's proposed Names Rule Amendments can be found

at: <https://www.sec.gov/rules/proposed/2022/33-11067.pdf>.

The SEC's proposed ESG Disclosure rules can be found at: <https://www.sec.gov/rules/proposed/2022/33-11068.pdf>.

Risk Alert: Investment Adviser MNPI Compliance Issues

04.26.22

On April 26, the SEC Division of Examinations (EXAMS) issued a Risk Alert highlighting deficiencies identified by staff members during their review of investment advisers relating to Section 204A of the Investment Advisers Act (Section 204A-) and Rule 204A-1 (the Code of Ethics Rule). Section 204A requires all investment advisers, registered and unregistered, to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of material nonpublic information (MNPI) by the adviser or any person associated with the adviser. The Code of Ethics Rule requires investment advisers that are registered or required to be registered under the Investment Advisers Act to adopt a code of ethics that sets forth, among other things, the standards of business conduct expected from the adviser's "supervised persons." The Code of Ethics Rule requires certain supervised persons to report their personal securities transactions and holdings to the adviser's chief compliance officer or other designated persons.

Compliance Issues Related to MNPI

Policies and Procedures – Alternative Data

EXAMS staff noted that advisers who used data from nontraditional sources (alternative data) did not adopt or implement reasonably designed written policies and procedures to address the potential risk of receipt and use of MNPI through alternative data sources. One situation involved advisers who had policies and procedures in place, but inconsistently implemented the policies and procedures for alternative data service providers by not regularly applying or adequately memorializing the advisers' diligence processes for alternative data sources. The other situation highlighted by the EXAMS staff concerned advisers, who failed to implement policies and procedures for assessing the terms, conditions, or legal obligations related to the collection or provision of alternative data, including when advisers knew of red flags associated with the sources of the alternative data.

Policies and Procedures – Value-Add Investors

EXAMS staff highlighted that advisers did not implement adequate policies and procedures regarding investors who are more likely to have MNPI. Some advisers did not have any policies and procedures for value-add investors that posed MNPI risks, while others had policies and procedures for value-add investors in place, but did not correctly identify the value-add investors or track their relationships with potential sources of MNPI.

Policies and Procedures – Expert Networks

EXAMS staff observed inadequate and poorly implemented policies and procedures for expert network

consultants who have access to MNPI or are related to publicly traded companies. In particular, the advisers did not have effective policies and procedures regarding expert network consultants for: (1) tracking and logging calls; (2) reviewing detailed notes; and (3) reviewing relevant trading activity of supervised persons in public company securities that are in similar industries as those discussed during calls.

Compliance Issues Related to the Code of Ethics Rule

The EXAMS staff observed that advisers did not identify certain employees as access persons, or found adviser codes of ethics that did not define access person or accurately reflect which employees are access persons. Additionally, the EXAMS staff found that access persons did not obtain required pre-approval for certain investments. For example, there were no provisions in the adviser codes requiring access persons to obtain pre-approval before directly or indirectly acquiring any interests in an initial public offering or limiting offering. The staff observed deficiencies in the required reports for personal securities transaction and holdings. These deficiencies related to: (1) the review of holdings and transaction reports; (2) submission of holdings and transaction reports; and (3) content of holdings and transaction reports. The EXAMS staff also noted examples where supervised persons were not provided a copy of the adviser's code or did not provide written acknowledgement of their receipt of the code or any amendments. The SEC also provided recommendations for advisers to consider when crafting their codes. The SEC recommended including a restricted list of issuers about which the advisory firm has inside information, and prohibit any trading in the securities of those issuers while they remain on the restricted list. The SEC also recommended that procedures should be implemented so that investment opportunities are first offered to clients before the adviser or its employees may act on them.

The Risk Alert is available at: <https://www.sec.gov/files/code-ethics-risk-alert.pdf>.

LITIGATION AND ENFORCEMENT

SEC Charges That Schwab Subsidiaries Misled Robo-Adviser Clients About Absence of Hidden Fees

06.13.22

On June 13, the SEC charged three Charles Schwab investment adviser subsidiaries for misleading investors about fees associated with Schwab's robo-adviser product, Schwab Intelligent Portfolios (SIP). The subsidiaries agreed to settle the charges and pay, jointly and severally, disgorgement, prejudgment interest, and a civil penalty, totaling approximately \$187 million.

The SEC alleged that from March 2015 until at least November 2018, the Schwab subsidiaries failed to disclose to clients that the way client funds were allocated would be less profitable under most market conditions. The Schwab subsidiaries decided that each SIP portfolio would contain anywhere from 6% to 29.4% of their assets in cash. The cash was then deposited with Schwab Bank, where it was loaned out at a higher interest rate than the interest rate Schwab Bank paid to the SIP clients. Schwab's own internal models showed that the pre-set cash allocations would reduce the SIP's portfolios' returns under market conditions where other assets, such as equities, outperform cash. Schwab did not charge investors an advisory fee for the SIP service, in large part because Schwab was receiving revenue from the pre-set cash allocations. Schwab's failure to make disclosures in their Form ADV filings resulted in violations because, under market conditions where other assets such as equities outperform cash, the cash allocations in the investors' portfolios would lower clients' returns by

approximately the same amount as an advisory fee would have. The failure to disclose violated Sections 206(2) and 206(4) of the Investment Advisers Act. The violations of the Investment Advisers Act were also a result of Schwab failing to disclose their conflict of interest in setting the cash allocations.

The SEC also noted that Schwab falsely claimed that the cash allocations in the SIP portfolios were determined through a “disciplined portfolio construction methodology,” when in reality, the allocations were pre-determined to compensate Schwab for not charging an advisory fee. In addition, Schwab had an ongoing marketing campaign that advertised SIP as a no-advisory-fee product, which Schwab listed as a strong competitive advantage over other robo-advisers. This advertisement falsely implied that investors could keep more of their money by investing in SIP as opposed to other robo-advisers that charged advisory fees. The SEC found that investors were unable to make a fully informed decision regarding whether the lack of an advisory fee benefited them due to the disclosure failures in Schwab’s Form ADV and misleading advertisements.

A copy of the SEC’s Administrative Order can be found at: <https://www.sec.gov/litigation/admin/2022/34-95087.pdf>.

SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations

05.23.22

On May 23, the SEC entered a cease-and-desist order and imposed remedial sanctions alongside a \$1.5 million fine against BNY Mellon Investment Adviser, Inc. (BNYMIA).

According to the SEC, BNYMIA made material misstatements and omissions related to its consideration of ESG principles in making investment decisions for certain mutual funds advised by BNYMIA (the Overlay Funds) between July 2018 and September 2021.

In prospectuses and board meetings for its mutual funds, and responses to requests for proposals (RFP responses) for other investment firms, an affiliated sub-adviser of BNYMIA, (the Sub-Adviser) misrepresented to investors the role that ESG principles play in its investment decisions.

The Sub-Adviser’s policy was to maintain a Responsible Investment Team that researched ESG issues and prepared written reviews for securities and bonds. The written reviews would include a ranking of the issuer of the security from 1-10, with 10 being “world-leading” with respect to the issuer’s commitment to ESG principles and their implementation into the issuer’s business strategy. This review process, however, was only conducted with respect to certain mutual funds that the Sub-Adviser sub-advised (the Sustainable Funds).

Importantly, not every investment opportunity for the Overlay Funds was required to be reviewed by the Responsible Investment Team. Instead, individuals within the Sub-Adviser who selected investments were permitted to, and did, select investments that were not reviewed by the Responsible Investment Team for ESG principles.

The SEC said BNYMIA materially misled investors when it stated at board meetings of the Overlay Funds that

“prior to making any investment, the [Sub-Adviser] assigns to each company a proprietary ESG quality review rating designed to ensure that any material ESG issues of the company are taken into consideration,” and included similar language in its Overlay Fund prospectuses and RFP responses. According to the SEC:

[BNYMIA] failed to disclose that the Sub-Adviser neither required nor prepared quality reviews for all investments in the Overlay Funds. A reasonable investor reading an Overlay Fund prospectus could mistakenly conclude that all portfolio holdings selected by the Sub-Adviser were subject to an ESG quality review. Instead, the Sub-Adviser’s personnel who chose investments for the Overlay Funds could, and did, select Overlay Fund investments that did not have an ESG quality review score at the time of investment.

As a result of its conduct, the SEC found that BNYMIA willfully violated Sections 206(2) and 206(4) of the Investment Advisers Act and Rules 206(4)-8 and 206(4)-7 thereunder, and violated Section 34(b) of the Investment Company Act.

The SEC found that BNYMIA lacked policies and procedures reasonably designed to prevent the misleading statements. Further, the compliance personnel were unaware before mid-March 2020 that the quality reviews were prepared only for the Sustainable Funds and thus lacked the knowledge to properly assess the board meeting statements, RFP Responses, and prospectus statements.

Due in part to BNYMIA’s prompt correction of their policies and processes, and cooperation with the investigation, the SEC and BNYMIA reached a settlement in which: (1) BNYMIA must cease and desist from committing or causing any violations of Sections 206(2) and 206(4) of the Investment Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder, and Section 34(b) of the Investment Company Act; (2) BNYMIA is censured; and (3) BNYMIA will pay a fine of \$1.5 million to the SEC.

A copy of the SEC’s Administrative Order can be found at: <https://www.sec.gov/litigation/admin/2022/ia-6032.pdf>.

SEC Charges Allianz Global Investors and Three Former Senior Portfolio Managers with Multibillion-Dollar Securities Fraud

05.17.22

On May 17, the SEC charged Allianz Global Investors U.S. LLC (AGI) and three former senior portfolio managers with a fraudulent scheme that concealed the downside risks of a complex options trading strategy called “Structured Alpha.” In a parallel criminal proceeding, the U.S. Attorney’s Office for the Southern District of New York announced criminal charges for similar conduct against AGI and the three former senior portfolio managers.

The fraudulent scheme was marketed and sold from on or before January 2016 through March 2020, and sold to approximately 114 institutional investors in 17 unregistered funds. This represented approximately \$11 billion in assets under management as of December 2019. The Structured Alpha scheme misled investors by providing false and material misleading statements to investors, including misrepresentations and omissions in connection with the purchase or sale of securities, intentionally understating the risks being taken by Structured Alpha funds. Following the COVID-19 market downturn in 2020, AGI suffered billions in losses, including losses in excess of 90% in certain funds.

Structured Alpha funds marketed and represented to investors certain hedging strategies, which were intended to protect Structured Alpha funds from short-term equity market crashes. The marketed strike price for Structured Alpha's hedging was between -10% and -25%. AGI, however, placed hedges with strike prices between -30% and -50%. AGI had no policies or procedures in place designed to monitor this type of deviation from the stated Structured Alpha investment strategy, which inevitably contributed to the losses suffered by AGI.

Additionally, the portfolio managers failed to implement a risk mitigation program agreed to with Structured Alpha's largest investor, an ERISA plan administrator. After the client had expressed concerns over the significant downside risks associated with Structured Alpha, AGI agreed to a risk mitigation program whereby Structured Alpha's targets would be adjusted according to an agreed upon metric, which represented volatility and stress in the market. The portfolio management team's failure to abide by this risk mitigation program resulted in the client's investments carrying much more risk exposure than agreed upon.

Furthermore, the portfolio management team manipulated reports and other information that was provided to investors to intentionally conceal the magnitude of the Structured Alpha downside risk. The false and misleading information misrepresented the investment positions and strategy of AGI and its affiliates, according to the SEC.

In addition, AGI marketed and represented to investors that Structured Alpha had a capacity limit of \$9 billion for certain funds. In reality, however, the capacity limit exceeded what was represented to investors by \$3 billion. AGI represented that certain Structured Alpha funds were closed due to capacity constraint, yet AGI never closed these funds or adhered to the capacity limit, acquiring more than \$12 billion in capacity utilization as of December 2019.

AGI admitted that its misconduct violated the federal securities laws and agreed to pay \$315 million to the SEC in disgorgement, \$34 million in prejudgment interest, and \$675 million in civil penalties, a portion of which will be distributed to investors.

As part of the parallel criminal proceeding, AGI and the three former senior portfolio managers agreed to guilty pleas.

As a consequence of its guilty plea, AGI is automatically and immediately disqualified from providing advisory services to U.S.-registered investment funds for the next 10 years, and will exit the business of conducting these fund services. To avoid disruptions to these funds and for the protection of the fund investors, the SEC will allow a brief transition period solely to transition these services to another investment adviser. The transition period will be 10 weeks for the U.S. mutual funds that AGI sub-advises and four months for the U.S. closed-end funds that AGI advises.

The senior portfolio managers have been barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. Further, the senior portfolio managers have been barred from participating in any penny stock offerings.

A copy of the SEC's complaint can be found at: <https://www.sec.gov/litigation/complaints/2022/comp-pr2022-84.pdf>.

SEC Expands Crypto Assets and Cyber Unit

05.20.22

On May 3, the SEC announced that it will greatly expand its cryptocurrency and cybersecurity unit by adding 20 positions. The additional positions will bring the unit's total members to 50, nearly doubling its size. The new hires will include supervisors, staff attorneys, trial counsel, and fraud analysts.

SEC Chair Gary Gensler said that “[b]y nearly doubling the size of this key unit, the SEC will be better equipped to police wrongdoing in the crypto markets while continuing to identify disclosure and controls issues with respect to cybersecurity.”

The announcement also reveals a name change for the unit, from “Cyber Unit” to “Crypto Assets and Cyber Unit.”

According to the announcement, the unit will focus on crypto asset offerings, crypto asset exchanges, crypto asset lending and staking products, decentralized finance (DeFi) platforms, non-fungible tokens (NFTs), and stablecoins.

Formed in 2017, the unit “has brought more than 80 enforcement actions related to fraudulent and unregistered crypto asset offerings and platforms, resulting in monetary relief totaling more than \$2 billion.”

It is too early to tell what types of cases the expanded unit will undertake. However, the last three years have seen an explosion in NFTs and DeFi that the unit could target. During the 2021 Aspen Security Forum, Gensler stated that DeFi “platforms not only can implicate the securities laws-some platforms but also can implicate the commodities laws and the banking laws.” Additionally, in March 2022, Bloomberg reported that the SEC has issued subpoenas, probing whether NFTs (specifically fractional NFTs) are being used to raise money like traditional securities.

The unit's significant expansion should put all cryptocurrency companies on alert. The SEC's decision to bulk up its enforcement resources means that companies cannot wait for new rules to analyze how they utilize cryptocurrency. Public companies, as well as brokers, dealers, investment companies, and investment advisors, also need to enhance their cybersecurity and disclosures relating to such efforts. Companies must take proactive steps to ensure they are up to date with the SEC's guidance regarding crypto and cybersecurity.

Troutman Pepper attorneys can assist in advising about cryptocurrency and cybersecurity disclosure requirements, as well as assisting with any regulatory investigations relating to such areas.

A copy of the SEC's press release can be found at: <https://www.sec.gov/news/press-release/2022-78>.

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