August 7, 2023

Ropes & Gray's Investment Management Update June – July 2023

The following summarizes recent legal developments of note affecting the mutual fund/investment management industry.

JULY ALERTS ON REGULATORY DEVELOPMENTS

Since our prior Investment Management Update, we have covered the SEC's money market fund adopting release and Dimensional Fund Advisors' filing of an application with the SEC to permit its mutual funds to offer an ETF share class. We discussed these developments in separate July Alerts that are summarized below with a hyperlink to the full text of each Alert.

SEC Adopts Money Market Fund Reforms and Changes to Reporting Requirements for Large Liquidity Fund Advisers

On July 12, 2023, the SEC issued a release (the "Release") adopting rule and form amendments concerning money market funds under the 1940 Act. The amendments are intended to address problems experienced by certain money market funds in connection with the economic shock at the onset of the COVID-19 pandemic. The Release also amended Form PF, which is the confidential reporting form for investment advisers to private funds, to require additional information regarding the private liquidity funds they advise. Notably, the Release did not adopt the proposing release's swing pricing requirements for institutional prime and institutional tax-exempt money market funds ("institutional funds"). Instead, if an institutional fund has total daily net redemptions that exceed 5% of the fund's net assets – or a smaller amount of net redemptions as the fund's board determines – the fund must (unless the *de minimis* exception applies) charge a mandatory liquidity fee to all shares that are redeemed at a price computed on that day. For all prime and tax-exempt money market funds, the Release adopts a discretionary liquidity fee so that liquidity fees remain an available tool to manage redemption pressures where a mandatory fee does not apply. Government money market funds may choose to rely on the ability to impose liquidity fees, as well.

Dimensional Fund Advisors Files for Exemptive Relief for an ETF Share Class

Dimensional Fund Advisors became the second asset manager this year to file an application with the SEC to permit its mutual funds to offer an ETF share class. Dimensional's filing, which seeks to build upon ETF share class relief obtained by Vanguard nearly 20 years ago, as well as the February 2023 SEC filing by Perpetual US Services, LLC (discussed in an earlier Ropes & Gray Alert), would permit certain actively managed Dimensional mutual funds to offer a class of shares operating as an ETF.

The following summarizes additional recent legal developments of note affecting the mutual fund/investment management industry.

SEC Proposes Rules Regarding Conflicts of Interest Arising from Firms' Use of Predictive Data Analytics

On July 26, 2023, the SEC published a release (the "Release") containing proposed Rule 211(h)(2)-4 under the Advisers Act and proposed Rule 15l-2 under the Exchange Act (the "proposed conflicts rules" or "PCRs") applicable to, respectively, investment advisers and broker-dealers (collectively, "firms").

The proposed conflicts rules would require firms to identify and eliminate (or neutralize the effect of) the conflicts of interest arising from investors' interactions with a firm through the firm's use of covered technologies, such as predictive

data analytics ("PDA"), that, among other things, predicts, guides, forecasts, or directs investment-related behaviors or outcomes.

- The proposed conflicts rules also would require every firm that uses a covered technology in any investor interaction to adopt and implement written policies and procedures reasonably designed to prevent violations of the applicable rule.

- The Release also contains proposed amendments to the recordkeeping rules under the Advisers Act and the Exchange Act that would require firms to make and maintain new required records related to the PCRs.

I. Background

The Release notes that, in addition to PDA, firms have adopted and used artificial intelligence, including machine learning, deep learning, neural networks, natural language processing ("NLP"), or large language models (including generative pre-trained transformers or "GPT"), as well as other technologies that make use of historical or real-time data, lookup tables or correlation matrices, among others (collectively, "PDA-like technologies"). The Release states that firms' adoption and use of PDA-like technologies have accelerated and that, while "this adoption and use can bring potential benefits for firms and investors . . . they also raise the potential for conflicts of interest associated with the use of these technologies to cause harm to investors more broadly than before."

The SEC believes that the existing regulatory framework should be updated "to help ensure that firms are appropriately addressing conflicts of interests associated with the use of PDA-like technologies." The Release states that the SEC is proposing that firms should be "required to identify and eliminate, or neutralize the effect of, certain conflicts of interest associated with their use of PDA-like technologies because the effects of these conflicts of interest are contrary to the public interest and the protection of investors."

The PCRs are described below. Proposed Rule 211(h)(2)-4 (for investment advisers) and proposed Rule 15l-2 (for broker-dealers) are substantially similar, except as specifically noted.

II. Key Definitions

The PCRs would apply when a firm uses a "covered technology" in an "investor interaction."

- For an investment adviser, "investor" would mean "any prospective or current client of an investment adviser or any prospective or current investor in a pooled investment vehicle (as defined in Rule 206(4)-8 under the Adviser Act)[1] advised by the investment adviser." For a broker-dealer, "investor" would mean "a natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes."

- "Covered technology" would be defined as "an analytical, technological, or computational function, algorithm, model, correlation matrix, or similar method or process that optimizes for, predicts, guides, forecasts, or directs investment-related behaviors or outcomes."[2]

[1] Rule 206(4)-8 defines "pooled investment vehicle" as "any investment company as defined in section 3(a) of the [1940 Act] or any company that would be an investment company under section 3(a) of that Act but for the exclusion provided from that definition by either section 3(c)(1) or section 3(c)(7) of that Act."
[2] The Release states that the proposed definition of "covered technology" is designed to capture PDA-like technologies.

- "Investor interaction" would mean "engaging or communicating with an investor, including by exercising discretion with respect to an investor's account; providing information to an investor; or soliciting an investor; except that the term does not apply to interactions solely for purposes of meeting legal or regulatory obligations or providing clerical, ministerial, or general administrative support."

III. Identification, Determination, and Elimination or Neutralization of a Conflict of Interest

Overview. The PCRs would require firms to (i) evaluate any use or reasonably foreseeable potential use of a covered technology in any investor interaction to identify any conflict of interest associated with such use or potential use, including through testing the technology prior to use and periodically thereafter, (ii) determine if any such conflict of interest places the interest of the firm (or an associated person) ahead of investors' interests and (iii) eliminate or neutralize the effect of any such conflict of interest. These elements are discussed below.

Evaluation and Identification. The PCRs would require a firm to evaluate any use or reasonably foreseeable potential use of a covered technology by the firm (or a natural person who is an associated person of the firm) in any investor interaction to identify any conflict of interest associated with that use or potential use.

- The PCRs would not specify the particular methodologies to be employed by a firm to evaluate its use or potential use of a covered technology or to identify a conflict of interest associated with that use or potential use.

- Instead, a firm may adopt any approach that is appropriate for its particular use of the covered technology, provided that its evaluation approach is sufficient for the firm to identify the conflicts of interest that are associated with how the technology has operated in the past (*e.g.*, based on the firm's experience in testing or based on research the firm conducts into other firms' experience with the technology) and how it could operate once employed by the firm.

Testing. As part of the evaluation and identification requirement described above, the PCRs would also require a firm to test each covered technology that it uses in investor interactions to determine whether that use is associated with a conflict of interest. Testing would be required (i) prior to the covered technology's implementation and (ii) before deploying any "material modification" of the technology (*e.g.*, a modification to add new functionality like expanding the asset classes covered by the technology).

- Retesting also would be required "periodically." A firm would have to determine the frequency and manner of retesting. The Release states that, consistent with the proposed identification requirement, "a firm's testing methodologies and frequencies may vary depending on the nature and complexity of the covered technologies it deploys."

Conflicts of Interest. The PCRs provide that a "conflict of interest exists when [a firm] uses a covered technology that takes into consideration an interest of the [firm], or a natural person who is [a firm's associated person]." The Release states that the PCRs definition of conflict of interest is intended to be construed broadly to clarify that, "if a covered technology considers any firm-favorable information in an investor interaction or information favorable to a firm's associated persons," the firm should evaluate the conflict so that it is in a position to make the determination described below.

Determination. The PCRs would then require a firm to determine whether an identified conflict of interest places or results in placing the firm's or an associated person's interest ahead of investors' interests, subject to certain exceptions.

- The Release notes that making the required determination "is a facts and circumstances analysis, and would depend on a consideration of a variety of factors, such as the covered technology, its anticipated use, the conflicts of interest involved, the methodologies used and outcomes generated, and the interests of the investor."

- Based on this analysis, "a firm must reasonably believe that the covered technology either does not place the interests of the firm or its associated persons ahead of investors' interests, or the firm would need to take additional steps to eliminate, or neutralize the effect of, the conflict."

- If a firm cannot determine that its use of a covered technology in investor interactions does not result in a conflict of interest that places its (or an associated person's) interest ahead of those of investors, the Release states that the "firm generally should consider any conflict of interest associated with such use as one that must be eliminated or its effect neutralized, and take steps necessary to do so."

Elimination or Neutralization of Effect. The PCRs would require a firm to eliminate, or to neutralize the effect of, any conflict of interest it determines results in an investor interaction that places the firm's (or an associated person's) interest ahead of the interests of its investors. The requirement would apply only where the firm makes (or reasonably should make) such a determination.

- The PCRs require an elimination or neutralization to occur "promptly after" the time when the firm determined (or reasonably should have determined) that the conflict of interest places the firm's (or an associated person's) interest ahead of the interests of its investors. The Release states that what constitutes "promptly" "would depend on the facts and circumstances."

- According to the Release, the "reasonably should have determined" standard reflects that a firm is required to use reasonable care. The standard is intended to require firms to understand the covered technology they use well enough "to consider all the material features of the technology both when evaluating the technology and identifying conflicts, and later when determining whether those conflicts place their own (or their associated persons') interests ahead of investors' interests."

Exceptions. The PCRs would not require conflicts of interest that exist solely due to a firm seeking to open a new investor account to be eliminated or neutralized. While opening an account would likely be in the interest of the firm, "the proposed conflicts rules are not designed to limit firms' abilities to attract clients and customers." However, the Release states, "incentivizing specific types of activity (such as . . . investing in a particular type of investment, as opposed to just opening an account to invest) that is particularly profitable to a firm . . . is intentionally addressed by the proposed conflicts rules."

IV. Policies and Procedures

The PCRs would require every firm that uses a covered technology in any investor interaction to adopt and implement written policies and procedures reasonably designed to prevent violations of (or, for broker-dealers, to achieve compliance with) the PCRs.

For all firms, these policies and procedures would need to include the following:

- A written description of the process for evaluating any use or reasonably foreseeable potential use of a covered technology in any investor interaction covered by the PCRs and a written description of any material features of, including any conflicts of interest associated with the use of, any covered technology used in any investor interaction prior to such covered technology's implementation or material modification, which must be updated periodically;

- A written description of the process for determining whether any identified conflict of interest results in an investor interaction that places the interest of the firm or an associated person ahead of the interests of the investor;

- A written description of the process for determining how to eliminate, or to neutralize the effect of, any conflicts of interest determined to result in the interest of the firm or an associated person being placed ahead of the interests of the investor; and

- A review and written documentation of that review, no less frequently than annually, of the adequacy of the policies and procedures and written descriptions established pursuant to the policies and procedures requirement, as well as the effectiveness of their implementation.[3]

V. Proposed Recordkeeping Amendments

The Release would amend Rule 204-2 under the Advisers Act and Rules 17a-3 and 17a-4 under the Exchange Act to set forth, as applicable, new requirements for investment advisers and broker-dealers to maintain and preserve, for the specific retention periods, books and records related to the requirements of the PCRs. The proposed recordkeeping amendments would require firms to make and maintain the specific records discussed below.

1. Written documentation of the evaluation of any conflict of interest associated with the use or potential use by the firm or associated person of a covered technology in any investor interaction. This written documentation would include a list or other record of all covered technologies used by the firm in investor interactions, including (i) the date on which each covered technology is first implemented and each date on which any covered technology is materially modified and (ii) the firm's evaluation of the intended use as compared to the actual use and outcome of the covered technology.

2. Documentation describing any testing of a covered technology, including (i) the date on which testing was completed, (ii) the methods used to conduct the testing, (iii) any actual or reasonably foreseeable potential conflicts of interest identified as a result of the testing, (iv) a description of any changes or modifications made to the covered technology that resulted from the testing and the reason for those changes and (v) any restrictions placed on the use of the covered technology as a result of the testing.

3. Written documentation of the determination whether any identified conflict of interest places the interest of the firm, or associated persons of the firm, ahead of the interests of investors. This would include the rationale for such determination.

4. Written documentation evidencing how the effect of any conflict of interest has been eliminated or neutralized. This written documentation generally would include a record of the specific steps taken by the firm in deciding how to eliminate, or to neutralize the effects of, any conflicts of interest, as required under the PCRs.

5. The written policies and procedures, including any written descriptions, adopted, implemented (and, with regard to broker-dealers, maintained) pursuant to the PCRs. This documentation would include the date on which the policies and procedures were last reviewed, written documentation evidencing a review (occurring at least annually) of the adequacy of the policies and procedures, and the effectiveness of their implementation, as well as a review of the written descriptions.

[3] The Release notes that any policies and procedures that an investment adviser adopts under the PCRs could be reviewed in conjunction with an annual review pursuant to Rule 206(4)-7 under the Advisers Act.

6. A record of any disclosures provided to investors regarding the firm's use of covered technologies, including, if applicable, the date such disclosure was first provided or the date such disclosure was updated.

7. Records of each instance in which a covered technology was altered, overridden, or disabled, the reason for such action and the date thereof.

VI. Comment Deadline

The Release states that comments on the proposed conflicts rules should be received no later than 60 days after publication of the Release in the *Federal Register*. As of this date, the Release has not been published therein.

SEC Proposes Narrowing the Registration Exemption for Internet Investment Advisers

On July 26, 2023, the SEC published a release (the "Proposing Release") containing proposed amendments to Rule 203A-2(e) under the Advisers Act (the "Internet Adviser Exemption") and related amendments to Form ADV. The Internet Adviser Exemption exempts certain investment advisers that provide advisory services through the internet ("internet investment advisers") from the prohibition on registration with the SEC. The Proposing Release would:

- Require an adviser relying on the Internet Adviser Exemption to have an "*operational* interactive website" (defined below) (instead of an "interactive website" under the current rule). The operational interactive website (which may be a mobile application) would have to be available on an ongoing basis.

- Prohibit advisers relying on the Internet Adviser Exemption from providing investment advice to clients by other means.

Background

The Release states that the Internet Adviser Exemption was intended to create a narrow exemption from the prohibition on SEC registration for certain advisers that do not manage the assets of their clients (or advise a registered investment company) and, therefore, do not meet the statutory thresholds for SEC registration. The Internet Adviser Exemption "relieves certain advisers that provide advisory services primarily through the internet from the burdens of multiple state regulation and allows them to register with" the SEC.

Under the current Internet Adviser Exemption, an adviser is exempt from the prohibition on SEC registration if, among other things, the adviser:

- Provides investment advice to all its clients entirely through an interactive website, except that the adviser may provide investment advice to fewer than 15 clients by other means during the preceding 12 months; and

- Maintains a record demonstrating that it provides investment advice to its clients in accordance with the conditions described in the bullet point immediately above.

The Release states that, while some advisers have used the exemption as intended, "others have used this exemption by registering with the [SEC] while failing to satisfy the conditions of the exemption." One example cited by the SEC is an adviser that has registered in reliance on the Internet Adviser Exemption but has not provided investment advice to any clients through an interactive website for years. The SEC believes that "the 'narrow exemption' . . . should be amended to reflect its intended, narrow use in light of technological advances and changes in the investment adviser industry." This would result in a "better allocati[on of] the Commission's limited oversight and examination resources to those advisers that should be subject to national rules."

Proposed Amendments to Rule 203A-2(e)

Operational Interactive Website. The current Internet Adviser Exemption requires, among other things, that an internet investment adviser provide investment advice to all of its clients exclusively through an "interactive website," subject to the exception discussed above. The Proposing Release would make the following amendments to the Internet Adviser Exemption:

- The existing definition of "interactive website" would be replaced by "operational interactive website."
- An "operational interactive website" would be defined as a website or mobile application through which the investment adviser provides digital investment advisory services on an ongoing basis to more than one client (except during temporary technological outages of a *de minimis* duration).
    - This proposed definition specifies that advisers' use of technology may include their use of mobile applications in connection with their eligibility to rely on the Internet Adviser Exemption, thereby expressly permitting internet investment advisers to use mobile applications to provide investment advice to clients.
- "Digital investment advisory service" would be defined as investment advice to clients that is generated by the operational interactive website's software-based models, algorithms, or applications based on personal information each client supplies through the operational interactive website.
- An internet investment adviser must provide advice through an operational interactive website at all times during which the adviser relies on the Internet Adviser Exemption.

Elimination of the 15 Non-Internet Client Exception. The current Internet Adviser Exemption permits an internet investment adviser to provide investment advice to fewer than 15 non-internet clients during the preceding 12 months. The Proposing Release would amend the Internet Adviser Exemption to eliminate this exception. Consequently, an internet investment adviser would be required to provide investment advice to all of its clients exclusively through an operational interactive website.

Form ADV

The Proposing Release would amend Form ADV to require that an adviser relying on the Internet Adviser Exemption to represent on Schedule D of its Form ADV that, among other things, it (i) provides investment advice to all of its clients exclusively through an operational website at all times when it relies on the exemption and (ii) maintains a record demonstrating compliance with that requirement. This change is intended to reinforce the conditions of the Internet Adviser Exemption to the internet investment adviser.

Comment Deadline

Comments on the Proposing Release should be received by the SEC no later than October 2, 2023.

REGULATORY PRIORITIES CORNER

The following brief update exemplifies certain trends and areas of current focus of relevant regulatory authorities.

Navigating State Regulation of ESG Investments. Ropes & Gray is pleased to share an interactive website offering resources for monitoring the rapidly evolving legal and regulatory landscape concerning what role, if any, ESG factors should play in managing public retirement plan assets and other related developments. We continue to monitor

developments, including the following, to assist clients respond to the many challenges and inquiries raised about ESG investing.

Fifteen State Attorneys General's Inquiry Letter to BlackRock Funds' Trustees

On July 6, 2023, the Republican attorneys general of 15 states (the "AG") sent an open letter (the "Letter") to the trustees of various BlackRock mutual funds and open-end funds (the "Funds"), claiming to have initiated an inquiry into the board's independence and its oversight of BlackRock's ESG-related activities.[4] The trustees are ten individuals, eight of whom are not "interested persons" of the Funds. The Letter does not allege any violations of law.

Among the Letter's assertions that serve as topics for the inquiry are the following:

- Six of the trustees "have a relationship with BlackRock as either a BlackRock employee or a board member of a company where BlackRock owns more than a 5% stake and . . . financial entanglement between the [trustees] and BlackRock undermines the principles of independence undergirding the Investment Company Act of 1940."

- The trustees oversee at least 44 BlackRock funds, and "that level of board commitment ironically exceeds by a factor of ten the ESG standards for over-boarding that BlackRock imposes on other companies." Additionally, the trustees receive $400,000 to $500,000 or more as compensation for their services. Therefore, the AG "are also inquiring into whether financial relationships and over-boarding reinforce each other to threaten the board's independence and ability to give proper attention to each fund."

- BlackRock and its CEO "have made commitments to use [BlackRock-advised funds'] assets for non-financial purposes by joining groups that engage with companies to 'accelerate' the global achievement of net zero greenhouse gas emissions." In addition, "many retail investors have no interest in ESG investing and simply want the best financial return on their investments. This appears to present a conflict-of-interest."

- Taken together, "these issues raise questions about whether [the trustees] are sufficiently independent and active to conduct the appropriate inquiry into the propriety of BlackRock serving as the [Funds'] investment adviser and whether [the trustees] have in fact received the requisite disclosures and conducted inquires based on such disclosures."

ADDITIONAL ROPES & GRAY ALERTS AND PODCASTS SINCE OUR APRIL – MAY 2023 UPDATE

Changing Tides or a Ripple in Still Water? Examining the *SEC v. Ripple* Ruling
July 25, 2023
On July 13, 2023, Judge Analisa Torres of the U.S. District Court for the Southern District of New York issued her highly anticipated ruling on the parties' cross-motions for summary judgment in the SEC action against Ripple Labs, Inc. and two of its executives, alleging the unregistered offer and sale of XRP, a digital token, as a security. In the decision, Judge Torres rejected the theory that the XRP digital token itself embodied a security and instead examined the different facts and circumstances by which the tokens are sold. In doing so, Judge Torres handed a rare (partial) victory to a cryptocurrency issuer in an action brought by the SEC. This Alert examines the Court's ruling and discusses the potential impacts it could have on future cases and the broader regulation of digital assets.

Operational Due Diligence: Considerations for Investors
July 19, 2023

[4] The 44 funds identified in the letter are all closed-end funds. However, the identical persons comprise the board of a cluster of BlackRock mutual funds. The body of the Letter refers to the Funds having nine trustees, but the Letter itself is addressed to ten trustees, which is the correct number.

With a choppy fundraising climate and uncertainty about broader global macro trends, as well as in some cases heightened capital constraints, many LPs are keenly focused on ways to improve their investment processes. On this episode of Ropes & Gray's *Alternative Asset Insights* podcast series, partners Emily Brown, Isabel Dische, Vince Ip and Sean Seelinger focused on some best practices for operational due diligence to assess potential risks stemming from a sponsor's operations.

The Clash Over ESG in Retirement Plans: Congressional Republicans Continue Attack on 2022 ESG Rule
July 6, 2023
It has been almost five months since the U.S. Department of Labor (the "DOL") rule, clarifying that ESG factors may be considered just like any other relevant factor as part of the risk-return analysis in choosing investments for retirement plans like 401(k) plans, took effect (the so-called 2022 ESG Rule). The 2022 ESG Rule reversed the ESG investing rule adopted under the Trump administration that received a large volume of negative feedback during the rulemaking process from a diverse array of commentators. The 2022 ESG Rule has received widespread support from the same community for its return to the DOL's historic neutral posture on specific investment considerations and the elimination of confusing and costly extra requirements under the Trump administration's rule. Despite this support from affected institutions, the 2022 ESG Rule continues to be in the crosshairs of Congressional Republicans who have repeatedly sought to invalidate it through resolutions pursuant to the Congressional Review Act, the latest of which was the subject of the first veto of President Biden's administration in March.

California Privacy Laws for Asset Managers
June 30, 2023
We are pleased to introduce a new Ropes & Gray podcast series, *California Law for Asset Managers*, which explores California state laws of importance to asset managers. In this opening episode, asset management counsel Catherine Skulan was joined by data, privacy & cybersecurity counsel Kevin Angle to discuss recent developments in California privacy law.

This series will examine California state privacy, lobbying, fee disclosure and other laws that are relevant to asset managers that are, or are thinking about becoming, active in the state. California's privacy laws can implicate a wide range of managers—from those based in the state to those that simply have California investors. And given the importance to many sponsors of partnerships with state and local pension plans, two episodes will focus on lobbying and fee disclosure issues that asset managers must grapple with when dealing with these plans. We will look to provide updates on these matters and insights into other relevant California law matters for asset managers in later podcasts.

Implications of Florida Restriction on Ownership by Foreign Principals of Interests in Real Property
June 29, 2023
On May 8, 2023, Florida Governor Ron DeSantis signed into law Senate Bill 264 ("SB 264"), which restricts the ability of a wide range of governmental bodies and persons or entities referred to as "foreign principals" from or domiciled in any "foreign country of concern" to directly or indirectly own, have a controlling interest in, or acquire any interest in "real property" in the state of Florida (subject to certain limited exceptions discussed in the Alert).

While SB 264 has certain sweeping restrictions on foreign principals owning direct or indirect interests in real property consisting of "Agricultural Land" and/or real property within 10 miles from "Critical Infrastructure" (as each term is defined in SB 264), the Alert is focused on the restriction on direct or indirect ownership of any interest in real property by "PRC Investors."

Digital Assets Discussion: Consequences of the Proposed Safeguarding Rule for Crypto Asset Custody
June 28, 2023
On this Ropes & Gray podcast, asset management attorneys Melissa Bender and Charlie Humphreville discussed the SEC's proposed amendments to Rule 206(4)-2 under the Advisers Act, the so-called "custody rule," and how they will

impact registered investment advisers that hold and invest in crypto assets. Ropes & Gray has a number of resources regarding the proposed changes to the custody rule and how they will impact registered advisers. If you would like to learn more about these matters, please contact your usual Ropes & Gray attorney contacts.

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If you would like to learn more about the developments discussed in this Update, please contact the Ropes & Gray attorney with whom you regularly work or click here.