

The SEC Under New Management—Outlook for 2021 and Beyond

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The SEC is now under new management. The SEC is operating at the time of this writing under the leadership of Acting Chair and Democratic Commissioner Allison Herren Lee. Gary Gensler, former Chair of the CFTC, has been nominated—but has not yet been confirmed—to become the next permanent Chair of the SEC.

Though we are in early days, there are many indications of the future direction of the SEC, and some clear distinctions with the SEC under Chair Jay Clayton's term.

Looking back: To look forward, sometimes it first helps to look back to where we have been. Under Chair Clayton, the SEC will be remembered by those in the asset management industry for numerous, highly significant rulemakings aimed at that industry. Many of those rulemakings were intended to be business-friendly, although as we point out elsewhere in this Alert, some had negative aspects for the industry. Among the more consequential rulemakings for regulated funds and their sponsors that were adopted during Chair Clayton's tenure were:

1. A long-awaited rule regarding fair value determinations that allows a fund board to delegate such determinations to the fund's investment adviser (summarized [here](#) and [here](#));
2. A reformulated derivatives rule that addressed many of the most severe criticisms of the original rule proposed in 2015 (summarized [here](#));
3. A rule permitting fund-of-funds arrangements intended to replace the need for basic fund-of-funds structures to obtain individualized exemptive relief from the SEC (summarized [here](#));
4. A rule package addressing broker-dealer and investment adviser conduct standards, including when recommending regulated fund investments (*i.e.*, Reg BI);
5. A rule providing ETFs the most commonly needed exemptions that previously required new ETF sponsors to apply for exemptive relief; and
6. Offering reforms for closed-end funds and BDCs designed to implement legislation adopted by Congress in 2018 that was designed to allow funds to utilize some of the favorable offering rules available to operating companies (summarized [here](#) and [here](#)).

In addition, Chair Clayton's Division of Enforcement led a very significant "voluntary" self-reporting initiative for investment advisers with undisclosed conflicts relating to regulated fund share class selection. That initiative, among others, led to a sharp increase in enforcement actions against investment advisers under his watch, at least in number if not scope.

Looking forward: Now, turning the corner, it is very clear that the new SEC will start with almost a complete break from the leadership team under Chair Clayton. Acting Chair Lee has [appointed a series of acting leaders for various positions](#) across the SEC, many of which we anticipate becoming permanent upon Mr. Gensler's confirmation. In particular, we expect personnel brought from outside the SEC into acting positions at the SEC are highly likely to be permanently appointed upon Mr. Gensler's confirmation.

What priorities does Mr. Gensler intend to pursue with this new leadership team? Below are a few thoughts, supplemented with some suggestions of our own.

The SEC Will Focus on ESG

It is clear that ESG priorities will rise to the top of the SEC's regulatory agenda under the Biden administration, which has identified climate change in particular as a top policy priority.^[1] Indeed, the SEC already has [created and staffed a new senior policy advisor position](#) to advise the agency on ESG matters and advance related new initiatives across its offices and divisions.

One potential implication of the SEC becoming more active on ESG is a shift to focus non-financial public company disclosure more on what investors are "interested in knowing," as opposed to the current focus on materiality.^[2] This could lead to more public company disclosure not only on environmental matters, but also disclosure about social justice and human rights matters, such as workplace diversity, gender pay ratios and conflict minerals. Increased ESG disclosures by public companies, particularly if standardized and comparable across companies, could facilitate significant innovation in product development for regulated funds. If this shift occurs in corporate issuer filings, however, we should anticipate a similar trend for regulated fund disclosure and regulatory disclosures by asset management firms.

Specific ESG-related regulatory initiatives that the SEC may pursue during the Biden administration could include:

- Amending Rule 35d-1 under the 1940 Act, known as the "Names Rule," to explicitly address the naming of funds that pursue an ESG strategy;
- Establishing mandatory standards for public company disclosures regarding ESG risks, practices and impacts (while several public companies voluntarily align their ESG disclosures with standards published by private organizations, such as the Sustainability Accounting Standards Board (SASB), there remains a lack of uniform ESG disclosure standards for all public companies to follow);
- Publishing best practice guidance for enhancing ESG investment product disclosures to foster comparability; and
- Publishing guidance clarifying the application of fiduciary duty obligations under the Advisers Act to investment advisers that make investment decisions or recommendations for their clients based, in whole or in part, on non-economic considerations, such as ESG factors.

We also expect to see a more active effort by SEC enforcement and examination staff to clamp down on "greenwashing," i.e., asset managers conveying a false impression to investors that a given product or service they offer is environmentally friendly. This could take the form of a "green" sweep by the SEC's examination division focusing on fund managers' ESG disclosures and practices.^[3] It would not surprise us if the SEC brings a wave of enforcement actions in the coming years against financial services companies centering on their ESG disclosures.

The Democratization of Alternative Strategies Might Proliferate (With Guardrails)

Mr. Gensler was a co-author of the book “The Great Mutual Fund Trap,” a book notable for its argument that actively managed funds perform worse than passive (index) funds that charge lower management fees (a more well-known theory today than when the book was published in 2002). It will be interesting to see how much weight Mr. Gensler gives this perspective today given the significant fee compression that has developed in recent years in the mutual fund industry due to increased competition, and whether this perspective influences his view of management fees charged for private markets investment strategies given that passive management is not an option for private markets investments.

Under Chair Clayton, the SEC laid the groundwork for increasing retail access to private markets, including by including a number of targeted requests for comment on offering such strategies through regulated funds in a concept release in 2019. While some commentators have suggested a Democratic administration might not continue this initiative or may roll back recent progress, we believe there is bipartisan support for increasing fairness in access to investments and addressing the growing wealth divide and retirement savings crisis. A Gensler-led SEC may well view retail access through the lens of economic equality, one of the top priorities of the Biden administration, and is expected to prioritize investor protections in any reform that would expand retail access.

The SEC’s recent efforts in the retail space under Chair Clayton focused primarily on direct access to private markets, including expanding the Accredited Investor definition to add new categories for natural persons and simplifying the private offering rules to ease capital raising burdens for small businesses. In contrast, under a Gensler-led SEC, expansion of retail access could rely much more heavily on gatekeepers, such as a registered investment adviser and the protections under the Investment Company Act of 1940, to protect those investors. We expect regulated funds to play a key role in providing a more level playing field for retail investors because regulated funds invest in a diversified portfolio, are managed by registered investment advisers and are overseen by an independent board, offering fundamental investor protections that counterbalance many of the risks for retail investors compared to direct access to private markets investments. One does not need a partisan lens to see that Main Street investors do not have access to the same opportunity set as institutional and high net worth investors.

Digital currency investments are another investment strategy that could gain steam in a registered fund wrapper under Mr. Gensler’s SEC. As a professor at MIT Sloan School of Management, Mr. Gensler taught courses on blockchain and digital currencies. Together with his experience leading the CFTC, Mr. Gensler’s familiarity with these issues may offer hope to those advocating for the ability to offer regulated funds that invest in digital assets, which the SEC currently is hesitant to bless due to significant questions regarding the ability to safely custody digital assets.

Mr. Gensler, Please Fix Co-investment Exemptive Orders

It is no overstatement to say that the SEC’s co-investment exemptive order framework under the 1940 Act is broken. Exemptive orders are excessively granular and do not contemplate—much less accommodate—the realities of the marketplace, in particular for credit strategies. This is a topic that we have written about several times in prior Alerts (*e.g.*, [here](#) and [here](#)). As discussed in our [May 2019 Alert](#), the co-investment application filed by FS Global Credit Opportunities Fund presented an opportunity for the SEC to reform some of the most significant issues with the current SEC framework. In particular, the FS Application envisioned a broad, principles-based approach to co-investment relief rather than a detailed and customized application unique to the applicant’s business, which we believe would have been a tremendous step forward. Regrettably, the FS Application has languished.

Whether the SEC grants the FS Application or determines to take another route, significant reform is necessary. Under the current framework, for example, every participant must invest in the same securities, and in a transaction that involves multiple securities can force a regulated or private fund to purchase a security that it otherwise might not want to hold because the fund otherwise would be excluded from the co-investment entirely. It would seem that an investment adviser with a fiduciary duty to its clients should be able to make a determination, possibly with approval by a regulated fund’s board, that the potential conflicts in having funds invest in different parts of an

issuer's capital structure can be managed and that funds should not be put in a situation of choosing between investing in securities that are not part of their core investment strategy or being excluded from an investment opportunity in its entirety.

The current framework also creates some problems for private equity strategies as the exemptive relief might permit a regulated fund to participate in taking a control stake in a portfolio company but does not provide the relief needed under Section 17(a) of the 1940 Act to permit a regulated fund to participate in any subsequent principal transactions with a portfolio company controlled by the sponsor, such as a direct follow-on investment.

We encourage—in the strongest terms—the SEC to develop a new co-investment framework that provides the flexibility needed for regulated funds to participate in private markets co-investments. We strongly believe that such relief is needed to allow innovation in the regulated funds space and democratize access to private markets strategies.

AFFE Reform for BDCs

Another priority for the SEC's new leadership to take up is a much-needed change to disclosure requirements for acquired fund fees and expenses ("AFFE"). The SEC and Congress have taken initial steps toward reform, but have not yet finalized them.

The SEC requires registered funds that invest in other funds (including BDCs) to include a separate AFFE line item in the "Fees and Expenses" table contained in their SEC disclosure documents. This separate AFFE line item must include the registered fund's pro rata share of the "acquired fund's" expenses (including interest expense), which is then added to the registered fund's overall expense ratio.

The AFFE disclosure disproportionately harms BDCs, which are generally more expensive to operate than other registered investment companies and therefore have higher expense ratios. As a result, sponsors of mutual funds, closed-end funds, ETFs and other registered investment companies generally have avoided investing in BDCs and, as discussed in a prior [Alert](#), major index providers have removed BDCs from their indices (making BDCs ineligible investments for index funds). The SEC included some requests for comment regarding AFFE in the rule proposal for the recently adopted fund of funds rule (but AFFE was not addressed in the final rule) and the SEC is considering modifications to AFFE disclosure as part of its [Investor Experience Proposal](#). Under the Proposal, open-end funds that invest 10% or less of their total assets in other fund could disclose the fees and expenses associated with those investments in a footnote to the fee table, instead of reflecting those expenses as a separate line item in the fee table.

Separately, the U.S. House of Representatives introduced [legislation](#) in June 2020 that would require the SEC to adopt rules specifying that, when calculating the fees and expenses of an acquired fund, the term "acquired fund" does not include a BDC. However, the proposed legislation did not receive a vote under the previous Congress. It remains to be seen whether the SEC and/or Congress to finalize efforts to minimize the impact of the AFFE Rule on BDCs either by adopting the Proposal or through legislative efforts. The SEC, nonetheless, could show strong leadership by addressing the AFFE disclosure problems before Congress directs it to do so, either under the current Congress or a future one.

Is the SEC Returning to a "Broken Windows" Enforcement Environment?

In the second half of the Obama administration, the SEC pursued a "broken windows" enforcement philosophy in which it punished minor infractions as a means of deterrence. Under the leadership of former Chair Clayton, SEC enforcement activity remained vigorous but shifted away from this broken windows approach. While the SEC's enforcement division set new records in relation to the amount of disgorgement and penalties it obtained during his tenure, we saw a modest decrease in the number of SEC enforcement actions that involved minor infractions. Along this same line, our sense has been that the enforcement division took fewer referrals from SEC examination staff, based on the view that deterring a minor infraction through a deficiency letter, rather than through an enforcement action, is a more efficient use of the agency's resources.

This is expected to change under the leadership of Mr. Gensler. If confirmed by the Senate, we think Mr. Gensler likely will steer the SEC back in the direction of a broken windows approach to enforcement (though the SEC may avoid re-embracing the term “broken windows”). The SEC enforcement division probably will show a greater willingness to accept referrals from examination staff and to impose hefty penalties, as well as take a more aggressive approach to disgorgement in light of recent legislation extending the statute of limitations to ten years for disgorgement in cases involving intent-based violations. This, coupled with Mr. Gensler’s well-known focus on investor protection, could result in increased levels of enforcement activity against managers of regulated funds.

More generally, we expect the SEC, under Mr. Gensler’s direction, to move away from the agency’s recent focus on retail investors and to prioritize more aggressive oversight of the financial services industry. The asset management unit within the enforcement division probably will see its staffing levels increase and will be given more autonomy to pursue novel theories of potential misconduct, especially with Acting Chair Lee [recently restoring](#) the ability of senior enforcement staff to approve formal investigations, a power that was stripped away and limited to the co-directors of the division under the prior administration.

A Gensler-led SEC also likely will show a greater appetite for “sweep” examinations and investigations, *i.e.*, targeted examinations or investigations conducted by the SEC staff for the purpose of evaluating a perceived problem or to educate itself on current industry practices in a particular area. On the examination side, sweeps historically have been an important generator of SEC enforcement cases, but the SEC under Chair Clayton’s leadership generally disfavored sweeps. In all likelihood, some of the sweeps initiated during the Biden administration will focus on compliance issues specific to regulated funds.

In this Alert we have discussed just a few of the potential regulatory initiatives that might come to pass if Mr. Gensler is confirmed as the next chair of the SEC. We are closely watching to see which individuals end up filling out the SEC’s leadership positions, especially in the Division of Investment Management, and will continue to report on potential developments in future Alerts.

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- [1] The Biden administration has also called on the Department of Labor to review its recent “do-good” investing rule, which requires ERISA plan fiduciaries to put financial considerations above all other considerations when making investment decisions, and to assess whether the rule conflicts with the administration’s objectives relating to climate change. [Fact Sheet: List of Agency Actions for Review](#) (Jan. 20, 2021).
- [2] In its adopting release for recent amendments to Regulation S-K disclosure requirements, the SEC declined to add new requirements with respect to ESG and sustainability matters, opting instead to continue emphasizing the SEC’s 2010 guidance on disclosure related to climate change. [Management’s Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information](#), Release No. 33-10890; 34-90459; IC-34100; File No. S7-01-20 (Nov. 19, 2020).
- [3] According to former Chair Clayton, the examination division has already been reviewing disclosures regarding funds and products that pursue ESG investment mandates to ensure investors are receiving accurate and adequate information about the material aspects of those strategies. *See* [Public Statement of SEC Chairman Clayton](#) (Jan. 30, 2020). To date, however, the SEC has not announced a formal examination sweep on ESG issues.

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