SEI Trust Company Quarterly Update
September 30, 2023

LEGAL/REGULATORY UPDATE

In an effort to keep you updated on changing regulations, requirements and/or litigation that may affect our industry, we are providing you with a summary of recent legislation, legal decisions and/or regulatory guidance that may impact collective investment trusts ("CITs") and their service providers, such as banks and investment managers.

LEGAL UPDATE

The SEC Cracks Down on Firm's Hypothetical Performance Use Under its Marketing Rule

The Securities and Exchange Commission ("SEC") announced on September 11, 2023 that nine investment advisors were charged for violating the hypothetical performance requirements and the recordkeeping requirements set forth in Rule 206(4)-1 of the Investment Advisors Act of 1940, as amended (the "Marketing Rule") as a result of a recent series of sweep examinations specifically looking into Marketing Rule compliance by advisory firms.[1]

The Marketing Rule, which took effect May 4, 2021, addressed concerns surrounding potentially misleading information displayed through hypothetical performance materials. In the Marketing Rule's Final Rule Release, the SEC clarified that "advisers generally would not be able to include hypothetical performance in advertisements directed to a mass audience or intended for general circulation." The SEC believes that an advisor may not able to properly relay expectations catered to investors' unique investment objectives and/or the financial situations through hypothetical performance materials circulated to a mass audience. Therefore, registered investment advisors are no longer able to circulate hypothetical performance information to a mass audience and can only present such information to certain types of clients and must adhere to certain policies and procedures put into place to ensure that only the acceptable sub-set of clients and prospects receive such hypothetical performance information.

Additionally, Rule 204-2(a)(11) of the Investment Advisors Act of 1940 (the "Act") requires advisors to retain copies of each advertisement, including any performance information included in such advertisement. An advisor's website falls under the advertisement category, and therefore an advisor must maintain archives of its websites or have the ability to recreate content published on its website over a period of time.

The SEC stated that it has penalized nine advisors for failure to comply with the Marketing Rule as a result of the advisors' published hypothetical performance materials. Each firm posted the hypothetical performance to its website without implementing the necessary policies and procedures reasonably designed to ensure that the hypothetical performance material was displayed only to the target audience to which that information can be published. Further, not only did nine advisors publish hypothetical performance materials to a mass audience, two of these advisors received additional charges for failure to maintain appropriate records because they failed to appropriately archive the webpage, as part of its recordkeeping requirements listed above.

[1] Press Release, SEC, Sweep into Marketing Rule Violations Results in Charges Against Nine Investment Advisors (Sept 11, 2023), https://www.sec.gov/news/press-release/2023-173.

The combined $850,000 in penalties levied against the nine firms is the result of the SEC strictly enforcing the Marketing Rule's provisions relating to hypothetical performance. When using hypothetical performance, advisors should pay special attention to compliance with the new Marketing Rule requirements, including the following:

1. Appropriately labeling hypothetical performance;

2. Adopting policies and procedures to publish hypothetical performance materials to a "particular intended audience" as opposed to publishing this information to a mass audience;

3. Providing clear and concise information about the criteria used to make the calculations in the hypothetical performance along with the risks associated with using the information provided to make investment decisions; and

4. Adopting policies and procedures designed to capture hypothetical performance information in compliance with the Marketing Rule's recordkeeping requirements.

Given its announcement of the results of the sweep examination, and the announcement of penalties levied, it is clear that the SEC will continue to make investment advisor's compliance with the Marketing Rule a priority for their enforcement division for some time to come.

REGULATORY UPDATE

Temporary Relief for Certain Plans from Requiring Roth Only Catch Up Contributions for Certain Highly Paid Participants

Enacted in 2022, the SECURE 2.0 Act of 2022[2] ("SECURE Act 2.0") requires that certain "High Paid Participants"[3] in a 401(k), 403(b) or governmental 457(b) plan who are permitted to make catch-up contributions must do so on a Roth basis only, which eliminated the ability for those participants (those participants who are age fifty and above) to make pre-tax catch-up contributions to their 401(k) plan.

This change, scheduled to take effect January 1, 2024, has posed significant administrative challenges and hurdles. The Internal Revenue Service ("IRS") acknowledges the transitional challenges presented to the plan sponsors, payroll and record-keepers, which include:

- the continued struggle to develop and implement processes that can accurately identify participants that should be considered High Paid Participants;
- modifications to the payroll systems and/or plan recordkeeping systems to effectuate this change;
- communication to timely and effectively notify High Paid Participants of the limitation of making catch up contributions only in the form of Roth contribution; and
- Potentially adding a Roth contribution feature for all employees.

Due to the serious hurdles plan sponsors, payroll and plan record-keepers are facing, IRS has announced highly anticipated relief surrounding the mandatory requirement regarding Roth catch-up contributions.[4] Under the guidance, the IRS has now provided a two year administrative transitional period through December 31, 2025. This will allow the applicable plans to continue offering pre-tax catch-up contributions to High Paid Participants while also allowing plans that do not have Roth features to continue to allow catch-up contributions to be made. Additionally, the IRS has issued a preview of future guidance that might follow:

- In an effort to accurately determine whether an individual is considered a High Paid Participant, employers in a plan maintained by unrelated employers can look only to wages that are earned

[2] https://www.congress.gov/bill/117th-congress/house-bill/2617/text
[3] High-Paid Participants for a particular year are those participants whose Internal Revenue Code (Code) Section 3121(a) wages from the employer exceeded $145,000 (as indexed) for the preceding year.
[4] See IRS Notice 2023-62.

with each individual employer and will not be required to aggregate those participants' wages with unrelated participating employers in the plan.

- An individual will not be considered a High-Paid Participant if they do not have Code Section 3121(a) wages in the prior year with an employer sponsoring the plan.[5]

The IRS guidance now provides plans and their service providers the requisite time to change their plan documents, policies, procedures and systems to require the new "Roth only" catch-up contributions for those Highly Paid Participants by the beginning of the 2026 plan year.

New Requirements for Private Fund Advisors (the "Private Fund Rules")

The Securities and Exchange Commission ("SEC") has historically had limited oversight in regards to private fund managers. However, on August 23, 2023 the SEC voted to implement new final rules (the "Private Fund Rules")[6] to address rising concerns that the existing regulatory structure surrounding private funds (or the lack thereof) subjects investors to harmful risks related to conflicts of interest, lack of transparency and a lack of governance mechanisms.

The Private Fund Rules focus on six areas of private fund administration: (1) side letters; (2) quarterly statements; (3) activity related limitations (e.g., charging the fund for investigation-related expenses where a court finds there to have been a violation certain legal requirements); (4) adviser-led secondary protections; (5) annual financial statement audits, and (6) recordkeeping.

With respect to the practice that certain private funds have with issuing side letters (here where a private fund sponsor or manager negotiates better terms for one investor than offered to the others), the SEC has raised concerns that large investors may be able to negotiate more favorable terms than smaller investors, and this often comes at the expense of smaller investors. Under the Private Fund Rules, managers are now required to provide written notice to prospective investors detailing specific information relating to any material economic term it has granted other investors in the past. Private fund managers are also prohibited from granting redemption rights that may negatively impact other investors except in certain circumstances (such as law and regulatory requirements to redeem investors subject to the Employee Retirement Income Security Act of 1974, as amended ["ERISA"]). Managers are also now prohibited from providing customized information relating to portfolio holdings or exposures if this will have a negative impact on other investors.

The SEC is also now requiring managers to produce quarterly statements which will contain detailed information relating to fees and expenses, portfolio fees, and performance information. These quarterly statements will specifically include:

- a fee table listing all fees related to compensation and other monetary amounts paid to the manager and third parties;
- a detailed accounting of all other fees not mentioned above, broken down into categories;
- disclosure of offsets or rebates that the fund is carrying which will be deducted from future fees;
- accounting of portfolio investment compensation allocated to related third parties and the manager; and
- performance information specifically calculated over a set period of time using a standardized calculation method.

The Private Fund Rule also outlines certain "restricted activities," which are either per se prohibited, or require disclosure to and consent from investors before engaging in such activity. For example, unless the Private Fund Rule permits these activities after investor disclosure and consent:

1. Managers may not reduce the amount of any adviser clawback by actual, potential, or hypothetical taxes applicable to the adviser, its related persons, or their respective owners or interest holders.

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[5] It is important to note that the statements made regarding future guidance from the IRS are not final and are subject to change.
[6] See, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, https://www.sec.gov/files/rules/final/2023/ia-6383.pdf.*

2. Managers cannot require a fund to bear the cost of compliance, regulatory or other exam-related fees unless written notice is provided within 45 days of the expense being incurred.

3. Funds may not reimburse managers for expenses related to investigations where a court or other governmental entity imposes sanctions for one or more violation(s) of the Act.

4. Managers are no longer allowed to borrow money, securities or other private fund assets from a fund unless the manager requests consent from, and receives consent from, a majority of the fund's interests (excluding related party interest holders), after providing a description of the material terms of such borrowing to the investors.

The SEC is also requiring that managers obtain a fairness opinion from an independent provider to alleviate concerns surrounding the ability for investors to choose between either selling all or even a portion of their interest in a fund, or converting such interest into an interest in another fund managed by the same manager. In addition to the fairness opinion, managers are also required to provide investors with a written summary of any material business relationships the advisor has had in the two years immediately prior to the fairness opinion. Further, fund managers are now required to take steps to ensure that any funds that they are managing and/or advising have financial audit statements that comply with the Act Rule 206(4)-2 (generally referred to as the "Custody Rule").

The Private Fund Rules have been met with significant controversy since they were proposed. There has already been one suit filed by a set of industry groups alleging that the SEC overstepped its regulatory authority with respect to the Private Fund Rules, although most industry groups do not believe that such challenges will succeed in court.[7] The expectation is that investors in private funds will be requesting information regarding how the underlying funds comply with the new rules, and private fund sponsors should be taking stock of how their funds' current operations, practices, policies and procedures will need to change once the rules take effect.[8]

<u>The SEC Approves Changes to the Fund Names Rule</u>

The SEC has adopted amendments (the "Amendments") to current Rule 35d-1 (the "Names Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"). These Amendments will have a significant impact on existing funds such as those with naming conventions including the funds strategy (i.e. "value, "growth", etc.) and will likely require consideration on whether changes will be required to existing names.

It is no surprise that the SEC has routinely wanted to ensure that funds are named consistently with their investment strategy, so that investors have a clear understanding of how the registered investment company (fund) will be managed when making investments into mutual funds. The Amendments focus on expanding the Names Rule's application and disclosures by now requiring that the fund focus on "particular characteristics" within the strategy in addition to focusing on particular types of securities. It is important to note that the SEC does not define the term "particular characteristics" but stated that they can be recognized as any feature, quality, or attribute that suggests an investment focus, including but not limited to:

- Growth;
- Environmental, Social, governance factors; and
- "Thematic" funds.

Funds would now also be required to adopt a policy to ensure that the fund invests at least 80% of the fund's assets in the manner suggested by the fund's name (an 80% Policy"). Further, if a fund's name suggests a multitude of investment focuses, then the fund name must address each element of the investment focus. It is important to note that each element of the investment focus does not need to

[7] See, https://www.complianceweek.com/regulatory-policy/experts-lawsuit-against-secs-private-fund-rules-unlikely-to-cause-delay/33568.article#:~:text=The%20lawsuit%2C%20filed%20in%20the,estimated%20to%20exceed%20%2426%20trillion.

[8] The SEC set varying compliance dates for the new rules depending on the rule and size of the advise.

independently meet the 80% threshold. When calculating compliance with the 80% Policy, a fund of funds is permitted to include the entire value of its investment in an acquired fund as long as the acquired fund also has an 80% Policy. Funds will continue to be able to determine if an investment falls under the fund's 80% Policy. However, under the additional Amendments a fund is now also required to perform quarterly reviews of its holdings to continuously assess compliance with its 80% Policy at the end of each quarter.

Another significant notable change is that funds will now generally be required to use a derivatives instrument's notional amount rather than its market value when deciding the fund asset's value for purposes of its 80% Policy. The Amendments require the inclusion of any derivative instrument that provides investment exposure to investments suggested by the fund's name in the fund's 80% calculation.

In the case where a fund's assets deviate from its 80% Policy, the new requirements allow for the fund to return to compliance as soon as reasonably possible and at least within 90 days from the date of noncompliance. It is important to note that this significant change cannot be waived by a fund's board and the only remedy is to seek exemptive relief from the SEC in an effort to maintain consistent protection of investors in the fund. However, funds may temporarily deviate from their 80% Policy in the case that:

- The fund has just recently launched, in which case there is a 180 day period to establish compliance;
- A restructuring or reorganization, in which there is no time period to establish compliance again; or
- Following notice of a change in fund policy being provided to shareholders.

The Amendments also provide guidance for index funds, clarifying that a fund that is invested 80% or more in an index included in the fund's name can still be materially deceptive or misleading in that the index's name may suggest an investment focus that the fund does not follow. In the words of the SEC, there must be a "meaningful nexus [] between the components of the underlying index, and the investment focus suggested by the index's name." An index fund's name is not, however, subject to an additional 80% Policy test to determine whether the terms in a market index that are referenced in an index fund's name invest at least 80% of assets in the index's components. The adopting release does conclude that index funds should also begin adopting policies and procedures surrounding the name of the underlying index to ensure that their selected indexes do not have materially deceptive or misleading names themselves. The SEC also further confirms that funds that are not subject to Rule 35d-1 will continue to be subject to Section 35(d)'s anti-fraud provisions of the federal securities law including disclosures to investors, as well as the prohibition of using misleading or deceptive names.

Fund names that are governed under the Names Rule will also be required to define the terms used within their name in their corresponding prospectus. They will also be required to disclose the criteria used to select the investments that the term is describing. Different portfolio managers or third-party data providers are allowed to use different definitions for the same term, as long as the shared term and differing definitions don't conflict with the "plain English" understanding. The SEC continues to encourage managers to avoid using excess detail, complex language, and legal terminology.

These Amendments have a significant impact on recordkeeping and reporting requirements. Funds required to maintain the 80% Policies, excluding money market fund and business development companies, will also need to report on their Form N-PORT for the third month of each quarter the following information:

- If an investment in the fund qualifies under the 80% Policy bucket;
- The value of the 80% Policy bucket, which will be listed as a percentage of the value of fund assets;
- The definitions of terms used in the fund's name as previously described above;
- Quarterly review and records of investments included in the 80% requirements along with the identification date and potential reason for departure;
- Reasons for any departures from a fund's 80% Policy; and
- If the fund no longer meets the 80% requirement, justification and a record of the date this was identified.

Certain information also has to be shared with investors in the fund.

The existing requirements allow for funds to adhere to an 80% policy or the fund will adopt a policy to provide the shareholders with a minimum of a 60 days' notice prior to any change in the policy. These new Amendments include additional notice requirements. Shareholders must be informed of the change in the name of a fund along with any change to the 80% Policy. There are also modifications being made to the electronic delivery requirements. The notice must include the following:

- The inclusion of the fund's old and new names;
- The effective date of any name change or change made to any investment policy; and
- A full description of the fund's 80% Policy and the nature of any change to this policy.

These Amendments are likely to have a significant impact on a variety of funds, which could lead to the creation of a substantial burden for registrants as well as SEC staff. All funds with an 80% Policy will need to review their current names and 80% Policies to determine if any changes are required to meet compliance. Even funds without an 80% Policy will need to review their current fund names to determine if in fact they are now required to adopt the 80% Policy or if a fund name change is necessary. The final rules become effective 60 days following the date the rules are published in the federal register (which appears to be October 11, 2023), and the SEC has provided a compliance period of 24 months for larger fund complexes (fund groups with at least $1 billion in net assets) and 30 months for smaller fund complexes (fund groups with less than $1 billion in net assets). This is an increase from the proposed one-year compliance period contained in the original proposal and does build out some time for firms to work on their compliance roll out for the new rules.

While not directly applicable to collective investment trusts ("CITs"), it is noteworthy to state that CITs continue to be subject to the anti-fraud provisions of the federal securities laws regarding disclosures to investors which underlie the Names Rule requirements. Therefore, CIT fund names should accurately describe the fund's investment strategy and characteristics of investment implementation at all times in a manner that does not deceive or mislead investors. Although compliance with the rules may not be specifically required, compliance with the rules may serve as "best practices" for CIT sponsors and investment managers.
