Simpson Thacher

Registered Funds Regulatory Update

April 8, 2025

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SEC Rulemaking

SEC Issues Names Rules FAQs and Extends Compliance Dates

On January 8, 2025, the SEC Staff issued a series of FAQs related to the adoption of amendments in 2023 to Rule 35d-1 under the 1940 Act, the so-called "Names Rule," to address interpretive issues, including certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks. Concurrent with the issuance of the 2025 Names Rules FAQs, the Staff announced that it was withdrawing the Names Rule FAQs issued in 2001, which the Staff determined were superseded by or otherwise inconsistent with the 2023 Amendments.

Adopted in 2001, the Names Rule was proposed and implemented with a goal of reducing investor confusion and greenwashing in fund names. The SEC adopted amendments in September 2023 to expand the scope of the Names Rule to any fund whose name suggests an investment focus in a particular area or that such fund has certain characteristics (for example, thematic funds that include ESG characteristics in their names or "growth" or "value" funds). Under the 2023 Amendments, impacted funds will be required to adopt, and disclose criteria related to, a policy to invest 80% of their assets in investments suggested by the fund's name.

Notably, the 2025 Names Rules FAQs (i) clarified the circumstances under which a fund's adoption of, or amendments to, an 80% investment policy that is a fundamental policy of the fund would require shareholder approval; (ii) addressed specific terms commonly used in fund names, including: "Income," "High-Yield," "Tax-Sensitive," and "Money Market"; and (iii) provided guidance as to how tax-exempt funds satisfy their 80% investment policy requirements.

On March 14, 2025, the SEC announced a six-month extension of the compliance dates for the 2023 Amendments. The compliance dates were extended to June 11, 2026 and December 11, 2026 for larger fund groups and smaller fund groups, respectively. The SEC noted that the extension is designed to provide "additional time to implement the amendments properly, develop and finalize funds' compliance systems, and test their compliance plans." The SEC also aligned the compliance dates with the timing of certain annual disclosure and reporting obligations that are tied to the end of a fund's fiscal year.

2025 Names Rule FAQs (Jan. 8, 2025), available at: https://www.sec.gov/rules-regulations/staff-guidance/division-investment-management-frequently-asked-questions/2025-names-rule-faqs.

SEC Press Release, *SEC Extends Compliance Dates for Amendments to Investment Company Names Rule* (Mar. 14, 2025), available at: https://www.sec.gov/newsroom/press-releases/2025-54.

President Trump Issues Executive Order Freezing Regulatory Rulemakings

On January 20, 2025, upon taking office, President Trump issued an Executive Order to the heads of federal executive departments and agencies asking them to delay implementation of pending federal rules that had not yet taken effect to ensure that the President's appointees or designees had the opportunity to review "any questions of fact, law, and policy that the rules may raise." Federal agencies, including the SEC, were asked to withdraw previously adopted rules not yet published in the Federal Register and consider postponing for 60 days the effective dates of rules published in the Federal Register that have not yet taken effect. Federal agencies were also asked to consider reopening the comment periods on any pending rules.

Presidential Actions, *Regulatory Freeze Pending Review* (Jan. 20, 2025), available at: https://www.whitehouse.gov/presidential-actions/2025/01/regulatory-freeze-pending-review.

Industry Developments

Paul Atkins Sworn In as SEC Chair

On April 21, 2025, Paul S. Atkins was sworn in as the 34th Chair of the SEC. Atkins was nominated by President Donald J. Trump on January 20, 2025, replacing former-SEC Chair Gary Gensler, who stepped down that same day, and confirmed by the U.S. Senate on April 9, 2025. Atkins has taken over from SEC Acting Chair Mark Uyeda, who, among other actions, established the Crypto Task Force in January, dedicated to developing a comprehensive and clear regulatory framework for crypto assets.

Atkins, who served as an SEC Commissioner from 2002 to 2008 under President George W. Bush, is well known in the securities regulatory community. In a shift away from Gensler's approach, Atkins is expected to take a lighter regulatory approach, consistent with his prior tenure at the SEC. During his time as a Commissioner, Atkins emphasized the importance of capital market innovation and reducing regulatory burdens and advanced various reform efforts, such as modifying compliance requirements for smaller companies under the Sarbanes-Oxley Act.

Former Acting Chair Uyeda, who will continue on as an SEC Commissioner, and Commissioners Hester Peirce and Caroline Crenshaw have welcomed Atkins as a "veteran of our Commission." In connection with his swearing in, Chair Atkins stated that he will "work to ensure that the U.S. is the best and most secure place in the world to invest and do business."

SEC Statement, *Statement on Senate Confirmation of Paul Atkins* (Apr. 9, 2025), available at: https://www.sec.gov/newsroom/speeches-statements/commissioners-welcome-atkins-040925.

SEC Press Release, *Paul S. Atkins Sworn In as SEC Chairman* (Apr. 21, 2025), available at: https://www.sec.gov/newsroom/press-releases/2025-68.

SEC Enforcement

SEC Settles With Another Twelve Firms for Recordkeeping Failures

The SEC recently settled charges against another nine registered investment advisers and three broker-dealers for recordkeeping failures related to employee use of personal devices in connection with firm business. Since 2021, off-channel communications have been a top SEC compliance priority, demonstrated in real-time, for example, by more than $600 million in civil penalties assessed against companies for off-channel messaging in 2024 alone.

According to the Orders, from at least 2019, 2020 or 2021, various firm employees, across levels of authority, including at senior levels, conducted business through personal text messages and other messaging platforms, such as WhatsApp, without maintaining or preserving the substantial majority of such written communications in violation of the federal securities laws. During the periods of time in question in the Orders, many of the firms received and responded to SEC subpoenas for documents and records in several SEC investigations, which the Orders noted likely impeded the SEC's investigations and ability to carry out its regulatory functions. The Staff uncovered the firms' misconduct, with the exception of one firm, after commencing a risk-based initiative to investigate the proper retention of business-related communications via personal devices. The other firm voluntarily reported the communications discovered in relation to its broker-dealer business to the Staff and, as a result, paid a significantly lower civil penalty.

Each firm was charged with violating certain recordkeeping provisions of the Advisers Act and the Exchange Act, as applicable, and failing to reasonably supervise its employees with a view to preventing and detecting violations as required. Each firm agreed to, among other things, a cease-and-desist order, a censure, and civil monetary penalties totaling $63.1 million (with penalties ranging from $4 million to $12 million, with the exception of the self-reporting firm, which paid $600,000).

SEC Press Release, *Twelve Firms to Pay More Than $63 Million Combined to Settle SEC's Charges for Recordkeeping Failures* (Jan. 13, 2025), available at: https://www.sec.gov/newsroom/press-releases/2025-6.

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Memoranda

Delaware Enacts Sweeping Corporate Law Amendments

March 28, 2025

Delaware Governor Matt Meyer has signed bipartisan legislation (the "New Legislation") amending Sections 144 and 220 of the Delaware General Corporation Law ("DGCL"). The New Legislation statutorily enshrines common-sense protections for directors, provides clearer standards for controlling stockholder transactions and limits vexatious books and records demands. It applies to all corporate acts and transactions after March 25, 2025, and is retroactive except for stockholder lawsuits or books and records processes pending before February 17, 2025.

The New Legislation provides welcome clarity and greater predictability in Delaware law regarding director independence, controlling stockholders, and when *MFW*-like protections[1] are necessary to secure business judgment deference. While some academics and members of the class action bar have predicted dire consequences from the New Legislation, any suggestion that it will end stockholder class action litigation is hyperbole. We believe the New Legislation will give boards and transaction planners greater confidence in navigating Delaware law.

Introduced on February 17, 2025, the New Legislation reached Governor Meyer's desk in less than 40 days. The New Legislation passed Delaware's House on March 25 by a 32-7 vote after clearing the Senate on March 13 with a 20-0 approval. This is the second year in a row that state lawmakers have amended the DGCL in response to concerns about the state's corporate law.[2] Many have commented that the speed of enactment reflects Delaware's growing concern about challenges to its position as the nation's preeminent state of incorporation for public companies. Beyond social media criticism and noted high-profile reincorporations, states like Nevada and Texas have been increasingly courting companies to incorporate in their jurisdictions and are considering legislation of their own as part of such regulatory competition. The Governor acknowledged such concerns in signing the New Legislation: "Delaware is the best place in the world to incorporate your business, and Senate Bill 21 will help keep it that way, ensuring clarity and predictability, balancing the interests of stockholders and corporate boards."

[1] In *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW*"), the Delaware Supreme Court held that the business judgment standard of review applies to a controlling stockholder transaction if the transaction "is conditioned *ab initio* upon the approval of both an independent, adequately-empowered [s]pecial [c]ommittee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders." The New Legislation simplifies *MFW*'s requirements, eliminating the "*ab initio*" requirement and setting ground rules for committee composition and process.

[2] For more on the 2024 DGCL amendments, see our memo Delaware Governor Signs Corporate Law Amendments Into Law.

The New Legislation Sets Clearer Standards for Directors and Controllers

HEIGHTENED PRESUMPTION OF DIRECTOR INDEPENDENCE

Delaware law has long reflected a presumption of director independence. The New Legislation crystallizes that presumption as a burden of pleading and proof in litigation.

Under the New Legislation's "heightened" presumption, a director of a NYSE- or NASDAQ-listed corporation shall be presumed to be disinterested, with respect to an act or transaction to which that director is not a party, if the board has determined that the director satisfies the applicable criteria for determining director independence from the corporation or a controlling stockholder under the exchange's rules, which shall only be rebutted by "substantial and particularized facts" that the director has a material interest[3] in the act or transaction or material relationship[4] with a person with a material interest in the act or transaction.

By centering the presumption around exchange definitions, the New Legislation provides more consistent standards for public companies in considering director appointment and committee service.

STATUTORY DEFINITIONS OF CONTROLLING STOCKHOLDER AND GROUPS

The New Legislation defines a "controlling stockholder" as one who, together with its affiliates:

- Owns or controls a majority in voting power of the corporation's outstanding stock, or the right to cause the election of directors with a majority of voting power on the board (a "Majority Stockholder"); OR
- Has the power "functionally equivalent" to a Majority Stockholder by virtue of owning or controlling at least one-third in voting power AND possessing the power to exercise managerial authority over the business and affairs of the corporation.

The New Legislation thus helps to address critiques that the law of controlling stockholders had departed from its traditional focus of majority control, or at least significant voting power combined with influence over management, by the adoption of a brighter-line test.[5]

[3] The New Legislation defines a "material interest" to mean "an actual or potential benefit, including the avoidance of a detriment, other than one which would devolve on the corporation or the stockholders generally, that (i) in the case of a director, would reasonably be expected to impair the objectivity of the director's judgment when participating in the negotiation, authorization, or approval of the act or transaction at issue and (ii) in the case of a stockholder or any other person (other than a director), would be material to such stockholder or such other person."

[4] The New Legislation defines a "material relationship" to mean "a familial, financial, professional, employment, or other relationship that (i) in the case of a director, would reasonably be expected to impair the objectivity of the director's judgment when participating in the negotiation, authorization, or approval of the act or transaction at issue and (ii) in the case of a stockholder, would be material to such stockholder."

[5] Lawrence A. Hamermesh, et al., *Optimizing the World's Leading Corporate Law: A Twenty-Year Retrospective and Look Ahead*, 77 Bus. Law. 321, 345 (2022); *see also* Elizabeth Pollman & Lori W. Will, *The Lost History of Transaction-Specific Control*, __ J. Corp. L. __ (forthcoming 2025).

The New Legislation Creates Clear Safe Harbors for Conflicted Transactions

The New Legislation amends Section 144[6] of the DGCL to provide safe harbor procedures.

DEALS INVOLVING A CORPORATION AND ITS DIRECTORS OR OFFICERS

The New Legislation provides safe harbors for acts or transactions involving directors or officers, where:

- A majority of the disinterested directors on the board or committee, or in certain circumstances a special committee, authorizes the act or transaction with knowledge or disclosure of all material facts; OR
- A majority of disinterested stockholders approves or ratifies the act or transaction by an informed, uncoerced vote; OR
- The act or transaction is adjudicated as fair as to the corporation and its stockholders.

DEALS INVOLVING CONTROLLING STOCKHOLDERS OTHER THAN GOING PRIVATE TRANSACTIONS

The New Legislation provides safe harbors for acts or transactions involving controlling stockholders, other than going private transactions (discussed below), where:

- A majority of a committee of disinterested directors, with full authority to negotiate and reject the transaction, and with knowledge or disclosure of all material facts, approves the transaction ("Special Committee Approval"); OR
- A majority of disinterested stockholders, who are informed and uncoerced, approve or ratify the transaction, and such approval or ratification is made a condition of the transaction before such vote ("Unaffiliated Stockholder Approval"); OR
- The transaction is adjudicated as fair as to the corporation and its stockholders.

The statutory changes thus dramatically simplify the circumstances in which a dual commitment to both Special Committee Approval *and* Unaffiliated Stockholder Approval are necessary to obtain business judgment review.[7]

GOING PRIVATE TRANSACTIONS

The New Legislation provides safe harbors for controlling stockholder going private transactions, where:

- There is BOTH Special Committee Approval AND Unaffiliated Stockholder Approval; OR
- The transaction is adjudged as fair as to the corporation and the corporation's stockholders.

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[6] Section 144 was originally adopted for the limited purpose of protecting certain transactions–those in which the directors and officers of a corporation have an interest–from *per se* voidability under the common law. The New Legislation expands the provision to address equitable relief such as fiduciary duty claims and other actions for damages.

[7] The legislation thus overturns the Delaware Supreme Court's decision in *In re Match Group, Inc. Derivative Litigation*, 315 A.3d 446 (Del. 2024), which applied entire fairness to all conflicted controller transactions unless *MFW* was followed.

A “going private transaction” for a public company is defined as “a Rule 13e-3 transaction (as defined in 17 CFR § 240.13e-3(a)(3).”

The New Legislation Limits Access to Books and Records

The New Legislation expands the rules applicable to books and records access by increasing the burden on stockholders to access formal materials (*e.g.*, stock ledger, financial statements, board minutes and books) through a “reasonable particularity” standard; creates a higher “compelling need” standard for access to any informal materials like emails and text messages; and provides that companies can impose reasonable restrictions on books and records access and that produced books and records will be incorporated by reference into legal complaints.

If you have any questions, please reach out to your regular Simpson Thacher contact

SEC Staff Letter Could Open the Door to More General Solicitations for Private Funds

March 17, 2025

In a letter issued last week, the SEC staff opened the door to far greater use of the so-called "general solicitation" offering exemption of Regulation D under the Securities Act of 1933. Rule 506(c) of Regulation D permits the use of general solicitation–meaning fund marketing activity that utilizes public means–if, among other conditions, the issuer takes "reasonable steps to verify" the accredited investor, or "AI," status of the purchasers. Many fund sponsors have avoided general solicitations because the AI verification process can be onerous, and some intermediaries are not willing to give assurances with respect to that process. The letter appears to provide a new, very practical route to verifying that status essentially through reliance on minimum investment amounts and investor self-certifications.

The letter is impactful because it could allow fund sponsors to generate publicity about funds they are launching without fear that they will lose the fund offering's exemption from registering under the Securities Act. While the letter provides very welcome relief, it does not answer all questions, and we continue to analyze its application to various scenarios. Reversing course from a general solicitation approach back to a traditional Regulation D offering is not ideal; accordingly, we recommend fund sponsors take great care before launching into a general solicitation offering in reliance on the letter's guidance.

With that note of initial caution, here is our take on the letter:

Key Takeaways

- ***Minimum investment thresholds can satisfy AI verification requirements.*** The letter permits verification of AI status to be satisfied under Rule 506(c) if certain minimum investment thresholds are required and investors make certain self-certifications. The minimum thresholds are:
    - **Individuals** (individual investors in their own capacity): $200,000
    - **Entities** (including family office investors if the investor is an entity): $1 million
        - Each investor (individual or entity) in an entity "formed for the purpose" of making the investment must meet the minimum threshold, and the entity must make representations as to each of those investors
        - The minimum amount must not be met with borrowed funds (amounts in excess of the minimums may be borrowed)
- ***Private fund sponsors should benefit.*** Many private fund offerings already qualify for these minimum investment thresholds. Accordingly, some practices prohibited by general solicitation restrictions could become more commonplace–reference to funds on sponsor websites or in speeches or other public forums, for example.

    - Any references to funds in public statements, however, will naturally result in more scrutiny on whether the statements are accurate, materially complete in the context given and compliant with the SEC marketing rule under the Advisers Act.
    - In addition, fund sponsors should consider requirements of non-U.S. jurisdictions before engaging in any publicity that could be perceived as targeting investors in those jurisdictions.
- ***Retail vehicles relying on Regulation D might require further guidance.*** Our initial take is that many retail offerings relying on Regulation D may not have sufficiently high minimum investment requirements, for commercial and (in some cases) regulatory reasons. The same may be true with respect to bank-sponsored feeder vehicles formed to facilitate high net worth investors' access to a specific private fund. It does not appear that the letter was informed by retail vehicle needs, but the letter suggests an overall openness to making general solicitation feasible, and we may engage the staff on issues specific to retail vehicles that rely on Regulation D.
- ***Reg S offerings are not impacted, but fund sponsors need to consider other jurisdictions' requirements.*** The letter and procedures therein apply to Regulation D offerings only. Regulation S (non-U.S.) offerings are not impacted. Fund sponsors should check with local counsel in non-U.S. jurisdictions before engaging in marketing activity in those jurisdictions. Non-U.S. jurisdictions may well have rules affecting general solicitation-style marketing.

Detailed Summary of the Letter

Rule 506(c) permits the use of general solicitation in exempt Regulation D offerings if (among other conditions) the issuer takes "reasonable steps to verify" the AI status of the purchasers. The rule provides a list of non-exclusive and non-mandatory methods to satisfy the verification requirement, but many fund sponsors have found these methods to be unworkable.

THE LETTER PERMITS THE USE OF INVESTMENT MINIMUMS TO VERIFY AI STATUS

The letter permits issuers to satisfy the Rule 506(c) requirement to take "reasonable steps to verify" the AI status of purchasers by requiring minimum investment amounts of at least $200,000 for natural persons and at least $1,000,000 for legal entities. Such minimum investment amounts must be coupled with written representations from each purchaser that: (i) it is an AI, and (ii) the minimum investment amount is not financed in whole or in part by a third party for the specific purpose of making the investment.

- The letter will permit an issuer to satisfy the verification requirement by:
    - Having minimum investment amounts of at least $200,000 for natural persons and at least $1,000,000 for legal entities; ***and***
    - Receiving written representations that:
        - the purchaser is an AI; and

  - the purchaser's minimum investment amount is not financed in whole or in part by any third party for the specific purpose of making the particular investment in the issuer.

- A purchaser must enter into an agreement to make the required minimum investment, which could be made pursuant to a binding commitment to invest at least the minimum cash amount in one or more installments, as and when called by the issuer.
- The SEC staff has also made related updates to its Compliance and Disclosure Interpretations (so-called, C&DIs) regarding Rule 506(c).

THE LETTER REQUIRES WRITTEN REPRESENTATIONS FROM THE INVESTOR

- A ***natural person*** must provide a written representation that he or she meets the income and/or net worth tests established in Rule 501(a)(5) or (a)(6) of Regulation D's definition of the term "accredited investor."
- A ***legal entity*** that is accredited by total assets must provide a written representation that it is an AI as defined in Rule 501(a)(3), (a)(7), (a)(8), (a)(9), or (a)(12).
- A ***legal entity accredited solely from the AI status of all of its equity owners*** must provide a written representation that:
  - It is an entity that is an AI, as defined in Rule 501(a)(8), in which all of the equity owners are AIs, as defined in Rule 501(a)(3), (a)(5), (a)(6), (a)(7), (a)(9), or (a)(12); ***and***
  - Each of the purchaser's equity owners has a minimum investment obligation to the purchaser of at least $200,000 for natural persons and $1,000,000 for legal entities. This obligation could be made pursuant to a binding commitment to invest at least a minimum cash amount in one or more installments, as and when called by the purchaser.
- The written representations can be contained in a standalone document, in a subscription agreement for the offering, in an affirmative written electronic communication from the purchaser, or any other written means as the issuer can reasonably determine under the circumstances of the offering.

SOME FINANCING PERMITTED (BUT NOT SOLELY FOR THE PURPOSE OF MAKING THE MINIMUM INVESTMENT)

- A purchaser could represent that its minimum investment amount is not financed in whole or in part if the purchaser obtains capital through one or more:
  - financing programs, including a secured credit facility, that has other purposes than solely making the particular investment in the issuer
  - binding commitments or financing to the purchaser that predate the commencement of the offering under Rule 506(c)
  - financing transactions conducted by the purchaser in which the purchaser, as an issuer, satisfied the conditions applicable to an issuer under the letter

- A formed-for-the-purpose entity must provide a written representation that the minimum investment amount of the purchaser and the minimum investment amount of each of the purchaser's equity owners is not financed in whole or in part by any third party for the specific purpose of making the particular investment in the issuer.
- The lack of financing requirement applies ***solely*** to the minimum investment amount but not to any greater investment amount.

NO BLINDERS PERMITTED

- The issuer must not have actual knowledge of any facts that indicate that any purchaser is not an AI or that any purchaser's minimum investment amount was financed in whole or in part by any third party for the specific purpose of making the particular investment in the issuer.

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SEC Expands Accommodations for Draft Registration Statements

March 6, 2025

On March 3, 2025, the Division of Corporation Finance of the SEC announced that, effective immediately, the SEC has expanded accommodations for its nonpublic review of draft registration statements.[8] The new guidance follows a series of prior accommodations for confidential review of registration statements by Emerging Growth Companies in 2012 and by all companies in 2017.

The accommodations are set forth as follows:

- ***Initial Exchange Act Registrations.*** Previously, the SEC permitted nonpublic review of draft initial registration statements submitted under the Securities Act of 1933, as amended (the "Securities Act"), and Section 12(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), provided that in each case the issuer confirms in a cover letter that it will publicly file its registration statement and nonpublic draft submissions at least 15 days prior to any road show or, in the absence of a road show, at least 15 days prior to the requested effective date of the registration statement. Under the expanded accommodations, issuers will now also be able to submit for nonpublic review the initial registration of a class of securities under Section 12(g) of the Exchange Act on the same basis, including registration statements on Forms 10, 20-F and 40-F. These modifications are anticipated to benefit, among others, companies that are looking to register one or more classes of securities under the Exchange Act but not have those securities listed on the New York Stock Exchange or the Nasdaq Stock Market.
- ***Subsequent Securities Act Offerings and Exchange Act Registrations.*** Previously, the SEC accepted draft registration statements for subsequent offerings only if submitted prior to the end of the twelve-month period following the effective date of an issuer's initial Securities Act registration statement or an issuer's Section 12(b) registration statement. Under the expanded accommodations, the SEC will accept draft registration statements for subsequent offerings and registrations regardless of the amount of time since the issuer became subject to Exchange Act reporting requirements, in each case limited to the initial submission, provided that the issuer confirms in a cover letter that it will publicly file its registration statement and nonpublic draft submissions at least two business days prior to the requested effective date of the registration statement. In addition, issuers will need to publicly file Exchange Act registration statements on Forms 10, 20-F and 40-F so that the full 30- or 60-day period, as applicable, will run prior to effectiveness.
- ***Draft Registration Statements Regarding De-SPAC Transactions.*** The SEC has expanded the nonpublic review process for a de-SPAC transaction as if it were the initial Securities Act registration statement in situations where the SPAC is the surviving entity, so long as the target would be independently

[8] The SEC's guidance is available here.

eligible to submit the draft registration statement. This follows the SEC's view that a de-SPAC is the functional equivalent of the target's IPO.

- ***Additional Accommodations Relating to Staff Processing of Registration Statements.*** Issuers may omit the names of the underwriters from initial draft registration statement submissions, when otherwise required by Items 501 and 508 of Regulation S-K, provided that they include the name of the underwriter(s) in subsequent submissions and public filings. In addition, the SEC reiterated that it will not delay processing of a draft registration statement if an issuer reasonably believes that omitted financial information will not be required at the time the registration is publicly filed. Finally, the SEC stated that it will consider an issuer's specific facts and circumstances in connection with requests made under Rule 3-13 of Regulation S-X to omit the inclusion of certain financial statements in registration statements otherwise required by Regulation S-X.

The new guidance will provide more flexibility to issuers as they plan for their IPOs, follow-on offerings and Exchange Act registrations, including spin-off transactions. We will continue to monitor any changes in guidance or practice by the SEC's Division of Corporation Finance in this area.

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Texas District Court Finds ESG Elements of American Airlines' 401(k) Plans Violate ERISA Fiduciary Duties

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On January 10, 2025, the U.S. District Court for the Northern District of Texas issued its decision in a class action lawsuit against American Airlines and its employee benefits committee (together, "Defendants"), holding that Defendants breached their fiduciary duty of loyalty under the Employee Retirement Income Security Act of 1974 ("ERISA")[9] by hiring and retaining a third-party investment manager that ostensibly exercised shareholder rights on behalf of two American Airlines 401(k) plans (the "Plans") based on non-pecuniary environmental, social and governance ("ESG") factors because such manager was a large shareholder in American and pursued certain ESG factors that aligned with American's broader corporate policy on ESG.[10] The Court deferred ruling on questions of losses and remedies, including whether an injunction is warranted and if damages are appropriate, and requested further supplemental briefings from the parties on these questions by January 31.

Background and Decision

The class of plaintiff employees argued that Defendants breached their ERISA fiduciary duties of loyalty and prudence by mismanaging the Plans when selecting this investment manager on behalf of the Plans alleging that the manager's vocal public commitments to ESG-related goals, and actions taken to pursue those goals (including proxy voting) were harmful to the financial interests of retirement plan beneficiaries.

District Court Judge Reed O'Connor stated in the decision that Defendants "cross-pollinat[ed]" their corporate and fiduciary interests by failing to separate their corporate interests and their relationship with [the investment manager], including corporate commitments to ESG goals and a desire to comply with [the investment manager]'s ESG-related preferences[11], from their responsibility to act 'solely in the interest of the participants and beneficiaries' and for the 'exclusive purpose' of providing benefits," as ERISA's duty of loyalty requires.[12] In his analysis, Judge O'Connor cited the investment manager's role as a significant (over 5%) shareholder of American's stock, its public commitment to ESG goals and American's own corporate ESG commitments, including evidence and testimony provided demonstrating the interplay of these factors in American's pursuit of ESG-related goals and investments, stating that American's "incestuous relationship with [the investment manager] and its own corporate goals disloyally influenced administration of the [401(k)] Plan[s]."

The Court held that Defendants did not breach the duty of prudence because their actions in monitoring the 401(k) plans at issue were appropriately aligned with prevailing industry standards. However, in holding so, Judge O'Connor noted that although this conclusion is "is the result [of] a faithful application of what the law demands,"

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[9] Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 et seq.

[10] Findings of Fact & Conclusions of Law, *Spence v. Am. Airlines, Inc.* (N.D. Tex. Jan. 10, 2025) (4:23-cv-00552-O), available here.

[11] *Id.* at 55.

[12] *Id.* at 66 (internal citations omitted).

it is "problematic," and encouraged the legislature to amend ERISA "to avoid future unconscionable results like those here."[13]

American has not yet stated whether it will appeal the decision.

Key Takeaways

This case presents the following takeaways for ERISA plan sponsors and fiduciaries:

- *ESG issues present a variety of different types of concerns for ERISA plan fiduciaries*. This decision is a sobering reminder that risk to ERISA plan fiduciaries arising out of ESG is not limited to the selection of investments, and that there could also be risk from the incorporation of ESG factors when voting proxies and exercising other shareholder rights on behalf of an ERISA plan. Thus, the exercise of these rights on behalf of a plan, and oversight of that process, should be carefully evaluated in the context of ERISA's fiduciary duties and applicable DOL regulations.[14]
- *The hiring and retention of plan service providers on behalf of an ERISA plan is an ERISA fiduciary function*. If a plan sponsor is publicly-traded and included in many indices, there may be material mitigation of ERISA liability risk by appointing an independent fiduciary with responsibility for the hiring and monitoring of the plan's investment managers.
- *Employers may continue to have corporate policies on ESG—but proceed with care*. The decision, which points to employees' mixed motives and involvement in the company's corporate ESG programs and goals, emphasizes the fact that plan fiduciaries should be mindful to solely focus on complying with the plan's investment policy statement and other governing materials, all of which are subject to ERISA's fiduciary duty requirements.
- *Duty of Prudence, while not found to be violated here, remains a key concern*. The Plans' fiduciaries were generally found to have prudently managed the Plans, particularly in their appointment of, and reliance on, established outside advisers and consultants with respect to their monitoring investment managers' performance. The use of consultants willing to act as "3(21)" advisers to a plan fiduciary can be a useful tool in establishing sound plan governance and mitigating risk to the plan fiduciary.
- *The fact pattern in the case may feel familiar to many public companies*. In finding an "impermissible cross-pollination of interests and influence on management of the Plan,"[15] Judge O'Connor points to facts

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[13] *Id.* at 54.

[14] The DOL has issued regulations designed to guide ERISA fiduciaries in their exercise of shareholder rights in a manner that accords with ERISA's stringent fiduciary duties. *Cf. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 87 FR 73822 (currently in effect, as promulgated by the Biden Administration) *and Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*, 85 FR 81658 (Dec. 16, 2020) (as promulgated under the first Trump Administration, later superseded by the aforementioned rulemaking under the Biden Administration). We believe the incoming Trump Administration will seek to codify an ERISA standard for ESG and proxy voting related thereto through legislation of a Republican-controlled Congress and/or seek to reverse various rulemakings issued under the Biden Administration, including, but not limited to, the aforementioned regulation related to an ERISA fiduciary's requirements with respect to shareholder rights.

[15] Findings of Fact & Conclusions of Law, *supra* note 2, at 55.

that may apply to a broad range of plan sponsors: (1) a relationship with a retirement plan investment manager that itself (a) endorses (or endorsed) a sustainability-focused view of asset management, including having a record of proxy votes supporting certain ESG-related efforts, and (b) owns a substantial percentage of the plan sponsor's publicly-traded stock and/or debt; and (2) the existence of corporate ESG-related goals or programs that may broadly align with the views of the investment manager, which (3) those overseeing the retirement plan may have endorsed as part of a corporate or investment relations strategy. The decision states that it is this combination of factors, plus the failure to review, monitor and evaluate the investment manager's ESG-related positions, which "reveals Defendants' disloyalty."[16]

- *The fate of the DOL's pending ERISA "tie-breaker" rule is likely to be determined later this year.* The same Circuit Court in this case is slated to hear another argument relating to the intersection of ESG factors with retirement plans. In July 2024, the 5th Circuit (which includes the Northern District of Texas) remanded a suit led by 26 states against the Department of Labor, challenging the legality of its "tie-breaker" rule.[17] The tie-breaker rule, adopted under the Biden Administration, generally allows ERISA fiduciaries to consider climate change and other ESG-related factors when considering investment opportunities and those under consideration "equally serve the financial interests of the plan over the appropriate time horizon." The rule had overturned a prior rule disallowing such considerations that had been adopted by the first Trump Administration.

  The Northern District of Texas is now set to reconsider the suit in light of the Supreme Court's *Loper Bright* decision.[18] However, given next week's change of presidential administration, including a new Secretary of Labor nominee, the Department of Labor is unlikely to continue to defend its 401(k) tie-breaker rule.

ERISA plan fiduciaries should closely monitor how the incoming Trump Administration will shape policy with respect to sound plan governance requirements related to ESG investments and the exercise of shareholder rights related thereto. At a minimum, plan fiduciaries should continue to have a prudent process in evaluating plan investment options and seek to identify and mitigate potential conflicts of interest, if any, when hiring and monitoring plan service providers. Members of a plan committee should remain cognizant that their duties under ERISA to the plan participants and beneficiaries are separate and apart from broader company policies and goals. Such delineation between corporate policies and plan investment guidelines should be unambiguous and well documented.

More broadly and for companies and investment managers outside of the ERISA plan fiduciary context, the decision poses possible implications beyond 401(k) plans. Judge O'Connor's decision includes a lengthy discussion of what is, and is not, "ESG investing," calling on many of the principles underlying anti-ESG investing statutes that prohibit investment decisions based on non-pecuniary factors. The decision draws distinctions between

[16] *Id.* at 68.

[17] Non-Dispositive Published Opinion, *Utah v. Su* (5th Cir. July 26, 2024) (No. 23-11097).

[18] *Utah v. Su*, 2:23-cv-016-Z (N.D. Tex.).

making investment decisions based on an ESG factor due to the belief that a company has a responsibility to improve society, and decisions based on the same underlying factor because the manager believes it will reasonably reduce material risk. This distinction could be relevant to a variety of plan sponsors as well as to asset managers more broadly as they consider defenses to ESG-related decisions. The Court states, "Simply describing an ESG consideration as a material financial consideration is not enough. There must be a sound basis for characterizing something as a financial benefit."

The decision also points to a continuing and accelerating trend away from public ESG-related commitments and involvement in multi-stakeholder initiatives. The opinion discusses the involvement of American's retirement plan asset manager in various climate-related multi-stakeholder initiatives, including Climate Action 100+, as evidence of the firm's pursuit of ESG-related aims that are not appropriately grounded in pecuniary returns. As noted in the opinion, the investment manager subsequently departed from Climate Action 100+, marking a clear trend among financial institutions. The investment manager has also subsequently departed the Net Zero Asset Managers (NZAM) initiative, following which NZAM announced the suspension of its activities.[19] In recent weeks, three U.S. banks being investigated by Texas Attorney General Ken Paxton under the state's anti-boycott law, SB 13,[20] for alleged "boycotting" of the fossil fuel industry departed the Net-Zero Banking Alliance (NZBA), a UN-affiliated multistakeholder initiative promoting the achievement net-zero greenhouse gas (GHG) emissions within finance activities. Following the departure, the Texas AG closed his investigation of these institutions.[21]

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[19] *Update from the Net Zero Asset Managers initiative*, NET ZERO ASSET MANAGERS INITIATIVE (Jan. 13, 2025), available here.

[20] Under SB 13, Texas governmental entities must divest from financial institutions found to be boycotting the fossil fuel entities. For additional information on this and other U.S. state-level anti-ESG developments, see our ESG Battlegrounds alert, updated monthly.

[21] Press Release, Office of the Attorney General of Texas, *Following Attorney General Ken Paxton's Urging, All U.S. Based Major Banks Withdraw from Anti-Oil and Gas Net-Zero Banking Alliance* (Jan. 7, 2025), available here.

Regulatory and Enforcement Alert

SEC Staff Provides Welcome Relief for Performance Information in Marketing Materials

March 20, 2025

The SEC staff released consequential new FAQs[22] earlier this week, providing some common-sense guidance for complying with the Marketing Rule for SEC-registered investment advisers (Rule 206(4)-1 under the Investment Advisers Act of 1940). The FAQs clarify the staff's views that:

i. an investment adviser can present "extracted performance" (*i.e.*, the performance of one investment or a group of investments from a private fund or other portfolio—the SEC staff refers to this as "extracted performance") on a gross basis without showing the net performance attributable to the investment or group of investments; and

ii. an adviser's marketing materials can present specific investment "characteristics," including common metrics related to fixed income securities (yield, for example), without presenting the characteristics on a net basis.

Both of these clarifications are welcome, but the relief in the FAQs is subject to several conditions, which we outline below.

1. Individual Investments and Other Extracted Performance

As a reminder, the SEC staff previously had provided guidance that if marketing materials display the gross performance of a single investment extracted from a portfolio, the materials must present an equally prominent net performance metric for each such investment. This prior guidance ran contrary to our interpretation of the Marketing Rule, and led to the creation of new, and mostly irrelevant presentations of "net returns" for individual investments—an exercise particularly confusing because many advisers calculate fees and expenses at the fund (or portfolio) level (and not at the investment level).

The newly revised FAQs alleviate the need to use these individual-investment net performance calculation methodologies. Under the new FAQs, advisers can show the gross performance of portfolio extracts (including individual investments) without also showing corresponding net performance for the extracts so long as:

[22] SEC Marketing Rule FAQs March 2025 (updated March 19, 2025).

i. the extracted performance is clearly identified as gross performance;

ii. the extracted performance is accompanied by a presentation of the total portfolio's gross and net performance consistent with the requirements of the rule;

iii. the gross and net performance of the total portfolio is presented *with at least equal prominence to*, and in a manner designed to facilitate comparison with, the extracted gross performance[23]; and

iv. the gross and net performance of the total portfolio is calculated over a period that includes the entire period over which the extracted performance is calculated (*i.e.*, the staff recognizes that a portfolio and an individual investment it has made will have different time periods).

Generally speaking, subject to some interpretive issues, this guidance represents a return to pre-Marketing Rule requirements for the presentation of investment-level returns and other "extracted performance" metrics, including, for example, the aggregate performance of all realized investments made by a single fund.

2. Yield and Other Portfolio "Characteristics"

The FAQs confirm that advisers can show performance characteristics—yield, coupon rate, contribution to return, volatility, sector or geographic returns, attribution analyses, Sharpe ratio, the Sortino ratio and other similar metrics—without showing a corresponding net figure for the characteristics. The staff conditioned the guidance on the following conditions:

i. the "gross" characteristic is clearly identified as calculated without the deduction of fees and expenses;

ii. the characteristic is accompanied by a presentation of the total portfolio's gross and net performance;

iii. the total portfolio's gross and net performance is presented with at least equal prominence, in a manner designed to facilitate comparison, with the gross characteristic; and

iv. the gross and net performance of the total portfolio is calculated over a period that includes the entire period over which the characteristic is calculated.

The staff declined to exhaustively identify what qualifies as a "characteristic" for purposes of the FAQ, other than those identified above. A footnote to the FAQ, however, states the staff's view that the following (regardless of how such metrics are labelled in the advertisement) are performance metrics requiring net performance to be shown with equally prominent gross performance: total return, time-weighted return, return on investment (ROI), internal rate of return (IRR), multiple on invested capital (MOIC), or Total Value to Paid-in Capital (TVPI).

[23] As a potentially interesting side note, Footnotes 6 and 11 of the FAQ state that the phrase "equal prominence, designed to facilitate comparison" does not necessarily mean on the *same page*. This could provide additional flexibility for designing marketing materials. For example, it would be sufficient if the adviser provides, with at least equal prominence the gross and net performance results of the total portfolio on slide pages before the extracted performance.

Conclusion

The new FAQs will likely alleviate some of the most challenging aspects of Marketing Rule compliance to date. Some open questions remain, however, including how market practice will develop regarding the presentation of performance the FAQs do not specifically address (*e.g.*, the presentation of performance metrics for multi-fund, sub-set composites). Advisers might wish to consider whether (and how) to un-wind performance presentations that were developed in response to the staff's prior guidance, including for funds that are currently fundraising, and how to comply with the conditions for reliance on the new guidance.

Advisers that choose to alter their current approach to performance calculations should bear in mind that all advertisements will remain subject to the general content requirements under the Marketing Rule, including the requirement to present all performance in a fair and balanced manner.

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