Investment Services Regulatory Update

January 2020

Vedder Price

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes Amendments to Auditor Independence Rules

On December 30, 2019, the SEC proposed amendments to Rule 2-01 of Regulation S-X, which sets forth the qualifications and independence standards for public company auditors, in order to carve out certain fact patterns identified by the SEC staff over the years since the initial adoption of the auditor independence framework in 2000 that are deemed less likely to threaten an auditor's objectivity and impartiality.

If adopted, the proposal would amend the auditor independence rules to, among other things:

- limit the range of audit client affiliates from which an auditor must maintain its independence (1) by amending the definition of "affiliate of the audit client" to carve out affiliates under common control with the client (i.e., sister entities) that are not material to the controlling entity and, (2) with respect to the audit of an investment company (which would include a registered investment company, business development company and certain private funds), investment adviser or sponsor, by providing that the auditor and audit client would look solely to the definition of "investment company complex" to identify audit client affiliates and by amending the definition of "investment company complex" to, among other things, carve out affiliates under common control that are not material to the controlling entity;
- shorten the look-back period for assessing compliance with independence requirements for domestic first-time filers to match the one-year look-back period for first-time filers that are foreign private issuers by amending the definition of "audit and professional engagement period";
- add certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships;
- narrow the range of persons with which an auditor may not have a direct or material indirect business relationship from "substantial stockholders" of the audit client to "beneficial owners with significant influence" over the audit client; and
- address certain inadvertent violations of the auditor independence rules that may result from a merger or acquisition through amendments to the transition and grandfathering provisions.

Comments on the proposal are due on or before March 16, 2020.

The SEC's proposing release is available here.

SEC Proposes New Rule Governing Funds' Use of Derivatives

On November 25, 2019, the SEC proposed a new exemptive rule under the Investment Company Act of 1940—Rule 18f-4—intended to overhaul the current regulatory framework governing the use of derivatives by registered investment companies. The SEC initially proposed a derivatives rule in December 2015, and this proposal contains several significant changes from the 2015 proposal. The new rule would supersede historical guidance provided by the SEC and its staff relating to the use of derivatives by registered funds.

The proposed rule would permit a fund to engage in derivatives transactions, notwithstanding the prohibitions and restrictions on the issuance of "senior securities" under Section 18 of the 1940 Act, subject to the following conditions:

- **Derivatives Risk Management Program.** A fund would be required to adopt a written derivatives risk management program (DRMP) with, among other things, risk guidelines reflecting how the fund's use of derivatives may affect its investment portfolio and overall risk profile. A fund would also be required to appoint a derivatives risk manager (DRM) to administer the DRMP.
- **Limit on Fund Leverage Risk.** A fund engaging in derivatives transactions would be required to comply with an outer limit on leverage based on a comparison of the fund's value at risk (VaR) to the VaR of a "designated reference index" for that fund. If the fund's DRM is unable to identify an appropriate designated reference index, the fund's VaR could not exceed 15% of the value of the fund's net assets—referred to as the "absolute VaR test."
- **Board Oversight and Reporting.** A fund's board of directors would be required to approve the fund's DRM.

The fund's DRM would be required to report to the fund's board on the implementation and effectiveness of the DRMP and the results of the fund's stress testing. In general, the responsibilities that would be imposed on fund boards by this proposal are substantially less onerous than those that would have been required under the 2015 proposal.

Other elements of the proposal include:

- **Exception of Limited Derivatives Users.** Limited derivatives users—i.e., a fund that either (1) limits its derivatives exposure to 10% of its net assets or (2) uses derivatives transactions solely to hedge certain currency risks—would be excepted from the DRMP requirement and from the VaR-based limit on fund leverage risk.
- **Alternative Requirements for Certain Leveraged/Inverse Funds.** An exception on the limit on fund leverage risk would be provided for certain leveraged/inverse funds in light of a proposed new sales practices rule that requires broker-dealers and investment advisers to exercise due diligence on retail investors before permitting transactions in these types of funds.

Comments on the SEC's proposal are due March 24, 2020.

Members of Vedder Price's Investment Services Group have separately published a summary of the proposed rule. That summary is available here.

SEC Proposes Expanding Access to Private Funds

On December 18, 2019, the SEC issued proposed amendments to broaden the definition of "accredited investor" under Regulation D of the Securities Act of 1933. The proposal would add new categories of qualifying natural persons and entities and make certain other modifications to the existing definition that would expand the pool of eligible investors for private funds based on, among other things, the SEC's view that wealth should not be the sole means of establishing financial sophistication and demonstrating the requisite ability to assess an investment opportunity.

Key aspects of the proposal are as follows:

- **New Categories of Natural Persons Who Would Qualify as Accredited Investors.** One new category would include holders of professional certifications and designations that demonstrate an individual's background and understanding in the areas of securities and investing, including a Series 7, 65 or 82 license. Another new category would include "knowledgeable employees" of private funds, which generally would include the private fund's executive officers, directors, general partners, advisory board members and employees (other than those performing solely clerical, secretarial or administrative functions).
- **Clarification of "Joint Net Worth" and Addition of Spousal Equivalents.** The proposed amendments would add the term "spousal equivalent"—a cohabitant occupying a relationship generally equivalent to that of a spouse—to the accredited investor definition for use in calculating joint income and would include spousal equivalents when determining net worth so that both spouses and spousal equivalents may pool their finances for the purpose of qualifying as accredited investors. An individual currently qualifies as an accredited investor if, among other things, the individual: (1) has, individually or jointly with such investor's spouse, a net worth exceeding $1 million (excluding the value of the individual's primary residence); and (2) had income in excess of $200,000, or joint income with that person's spouse in excess of $300,000, in each of the two most recent years, and has a reasonable expectation of reaching the same income level in the current year. The SEC's proposal retains the current net worth and income thresholds.
- **New Categories of Entities That Would Qualify as Accredited Investors.** These would include registered investment advisers; limited liability companies with total assets exceeding $5 million; rural business investment companies; family offices with more than $5 million in assets under management whose investments are directed by a person who has knowledge and experience in financial and business matters that the family office is capable of evaluating the merits and risks of the prospective investment; any "family client" as defined under the Investment Advisers Act of 1940; and various other entities, including Native American tribes, labor unions, governmental bodies and funds, and foreign entities, that own investments in excess of $5 million and that are not formed for the specific purpose of acquiring the securities being offered.

- **Clarification of the Ownership Look-Through.** Currently under Regulation D, an entity qualifies as an accredited investor if all of the equity owners of that entity are accredited investors. Because an equity owner of an entity may itself be an entity, the proposed amendments would clarify that, in determining accredited investor status, one may look through various forms of equity ownership to the natural person that owns the entity.
- **Conforming Amendments to Rule 144A and "Qualified Institutional Buyer" (QIB) Status.** The proposal would amend the QIB definition to permit certain institutional accredited investors to automatically qualify as QIBs when they satisfy the dollar-amount threshold—i.e., owning and investing on a discretionary basis an aggregate of at least $100 million.

Comments on the proposal are due by March 16, 2020.

The SEC's proposing release is available here.

NEW RULES

SEC Issues New Rules for Security-Based Swaps

On December 18, 2019, the SEC adopted certain rule amendments to enhance the framework for regulating cross-border security-based swaps. Through this effort, the SEC established a broad security-based swap regulatory regime and triggered the compliance date for security-based swap entities to register with the SEC and the implementation period for other previously adopted rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Together, these rules establish a regime for regulating margin, capital, segregation, recordkeeping and reporting and business conduct for security-based swap activity.

The key effects of the rule amendments areas are as follows:

- transactions that have been arranged, negotiated or executed by persons located in the United States will now serve as a trigger for U.S. regulation of security-based swap activity;
- security-based swap dealers and major security-based swap participants (collectively known as SBS Entities) located outside the United States will be required to provide a certification and opinion of counsel regarding the ability of the SEC to access information and conduct on-site examinations;
- certain statutory disqualification provisions will have cross-border applicability; and
- registered SBS Entities will be required to maintain certain questionnaires or employment applications for non-U.S. associated persons.

The foregoing rule amendments were designed in consultation with the CFTC, as many market participants are active in markets regulated by both the SEC and the CFTC and may use instruments regulated by the SEC to hedge risks in products regulated by the CFTC (and vice versa).

In addition, the SEC adopted rules under the Dodd-Frank Act requiring the application of risk mitigation techniques to portfolios of uncleared security-based swaps. New Rules 15Fi-3, 15Fi-4 and 15Fi-5 under the Securities Exchange Act of 1934 establish requirements for registered SBS Entities to:

- periodically reconcile outstanding security-based swaps with counterparties;
- engage in certain portfolio compression exercises; and
- enter into written trading relationship documents with each counterparty no later than the time a security-based swap transaction is executed.

The SEC also adopted amendments to Rule 3a71-6 under the Exchange Act to allow SBS Entities that are not U.S. persons to use substituted compliance (i.e., compliance with local rules) to satisfy the SEC's requirements regarding portfolio reconciliation, compression and trading relationship documentation. Finally, the SEC amended recently adopted recordkeeping, reporting and notification rules to incorporate records relating to these new risk mitigation requirements.

The adopting releases for the new rules are available here and here.

GUIDANCE AND ALERTS

OCIE Releases Risk Alert Summarizing Observations from Fund Exams and Recent Initiatives

On November 7, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert outlining its top compliance observations from examinations of nearly 300 registered funds conducted over a two-year period, as well as issues identified from OCIE's exam initiatives focusing on money market funds (MMFs) and target date funds (TDFs).

From the registered fund exams, the risk alert categorized the compliance deficiencies among four broad categories: (1) the fund compliance rule; (2) disclosure to investors; (3) the Section 15(c) contract review process; and (4) the fund code of ethics rule. OCIE's observations and illustrative examples are summarized below.

Fund Compliance Rule

- **Failure to Tailor Compliance Programs to Funds' Business Activities or Specific Risks.** Absence of policies and procedures (1) to prevent funds from violating their own investment guidelines and limitations, (2) to review the appropriateness and accuracy of methods used to price securities or (3) to ensure advertisement disclosures are accurate and not misleading.
- **Failure to Follow or Enforce Policies and Procedures.** Failure to follow or enforce policies and procedures requiring board approval or ratification of fair valuation determinations and to obtain multiple broker quotes in connection with cross trades.
- **Inadequate Service Provider Oversight.** Failure of policies and procedures to provide for any ongoing monitoring or due diligence of outsourced valuation and pricing services; failure to have policies and procedures of sub-advisers approved by a fund's board.
- **Failure to Perform Annual Reviews or to Address the Adequacy of Funds' Policies and Procedures.** Absence of documentation to substantiate the annual review of compliance programs; annual reviews that were conducted without addressing the adequacy of funds' policies and procedures and the effectiveness of their implementation.

Disclosure to Investors

- **Incomplete or Potentially Misleading Disclosures.** Inclusion of incomplete or potentially materially misleading descriptions in prospectuses, statements of additional information and shareholder reports of fund practices actually observed in staff exams; failure to disclose the payment of fees made to service providers or changes in investment strategy; identification of certain principal investment strategies in disclosures that had not been implemented or that were not expected to be implemented for the funds.

Section 15(c) Process

- **Reasonably Necessary Information Not Requested or Considered.** Fund boards that may not have requested or considered information reasonably necessary to evaluate a fund's investment advisory agreement; apparent failure by certain boards to consider relevant information related to the adviser's profitability, economies of scale or peer group comparisons for the advisory fee; receipt by boards of incomplete responses to information requests and failure to request the omitted information.
- **Inadequate Discussion Forming the Basis of Board Approval.** Shareholder reports that did not discuss adequately the material factors and conclusions that formed the basis for the board's approval of an investment advisory contract; failure to retain copies of written materials the board considered in approving advisory contracts; lack of supporting documentation, such as board minutes, to enable OCIE staff to assess what information fund boards requested and considered.

Fund Code of Ethics Rule

- **Failure to Implement Code of Ethics.** Lack of adequate procedures to prevent access persons from misusing material nonpublic information; failure to designate the proper individuals as access persons.

- **Failure to Use Reasonable Diligence to Prevent Violations.** Failure to collect or review securities holdings and transaction reports of access persons; failure to enforce pre-clearance and holding period restrictions.
- **Failure to Comply with Code of Ethics Approval and Reporting Obligations.** Failure to obtain initial board approval of the code; failure to provide boards with required annual reports regarding code of ethics violations and sanctions, or transmission of inaccurate reports to the board.

From the MMF initiative, the specific issues observed by OCIE staff fell within the following categories:

- **"Eligible Securities" and Minimal Credit Risk Determinations.** Failure to include in credit files one or more of the factors required to be considered in determining whether a security presents minimal credit risks for eligibility purposes; failure to document adequately the periodic updating of credit files to support the eligible security determination; failure to maintain records to adequately support required determinations for certain investments of government MMFs.
- **Summary of Significant Stress Testing Assumptions.** Failure to include the required summary of significant assumptions used in stress tests in reports provided to the board.
- **Policies and Procedures.** Failure to adopt and implement compliance policies and procedures reasonably designed to address certain requirements under the MMF rule and other areas, such as policies and procedures that did not address periodic board oversight of certain MMF information, including the MMF's net asset value deviation methods and the amount of the deviation.
- **Website and Advertising Materials.** Failure to post on websites all information required by rule or posting of inaccurate information; failure to include all required legends in advertisements.

From the TDF initiative, the specific issues observed by OCIE staff fell within the following categories:

- **Incomplete and Potentially Misleading Prospectuses and Advertisements**, including disclosures regarding asset allocations, glide path changes and the impact of these changes on asset allocations, and conflicts of interest, such as those resulting from use of affiliated funds and affiliated advisers.
- **Incomplete or Missing Policies and Procedures,** including those for monitoring asset allocations, overseeing implementation of changes to glide path asset allocations, overseeing advertisements and monitoring the accuracy of disclosures regarding glide path deviations.

OCIE's risk alert is available here

OTHER DEVELOPMENTS

The SECURE Act and Its Impact on Retirement Plans

On December 20, 2019, after months of uncertainty, the Setting Every Community Up for Retirement Enhancement (SECURE) Act was signed into law. The SECURE Act makes numerous changes to both the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA) that will impact retirement plan administration and documents.

Members of Vedder Price's Executive Compensation & Employee Benefits group have separately published a summary of the SECURE Act. That summary is available here.

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Investment Services Group

With significant experience in all matters related to design, organization and distribution of investment products, Vedder Price can assist with all aspects of investment company and investment adviser securities regulations, compliance issues, derivatives and financial product transactions, and ERISA and tax inquiries. Our highly experienced team has extensive knowledge in structural, operational and regulatory areas, coupled with a dedication to quality, responsive and efficient service.