VedderPrice

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Investment Services Regulatory Update

New Rules, Proposed Rules, Guidance and Alerts

NEW RULES

SEC Delays Form N-PORT EDGAR Filing Requirement by Nine Months

On December 8, 2017, the SEC adopted a temporary rule (the Temporary Rule) delaying by nine months the requirement that registered investment companies file reports on new Form N-PORT[1] on the EDGAR system. Under the Temporary Rule, larger fund groups that previously would have been required to submit their first reports on Form N-PORT on EDGAR for the period ending June 30, 2018 (due no later than July 30, 2018) will submit their first reports on Form N-PORT on EDGAR by April 30, 2019. Smaller fund groups will begin submitting reports on Form N-PORT on EDGAR by April 30, 2020. Notably, larger fund groups must begin collecting and maintaining information required to be included on Form N-PORT by the original June 1, 2018 compliance date, notwithstanding that the information will not be submitted to EDGAR. The Form N-PORT information collected and maintained during this nine-month delay period (the Delay Period) will be subject to all applicable recordkeeping rules and requirements, including being subject to examination by the SEC staff. Smaller fund groups will not be required to collect and maintain Form N-PORT information during the Delay Period.

In order to ensure investors receive the same information that they currently receive during the Delay Period, the Temporary Rule also extends the requirement to file reports on Form N-Q through the March 31, 2019 reporting period for larger fund groups and through the March 31, 2020 reporting period for smaller fund groups. The Temporary Rule does not affect any requirements relating to the new annual Form N-CEN, which will continue to be required for fiscal years ending on or after June 1, 2018.

The adopting release for the Temporary Rule states that the SEC recognizes "the importance of sound data security practices and protocols for sensitive, nonpublic information, including information that may be competitively sensitive" and, in this connection, notes recent efforts directed by SEC Chairman Jay Clayton to assess and strengthen the SEC's cybersecurity risk profile. Certain of these measures, the adopting release explains, "which will

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1 The SEC approved new Form N-PORT as part of a broader set of reporting reforms adopted on October 13, 2016. See Investment Company Reporting Modernization, Investment Company Act Release No. 32314 (available at: https://www.sec.gov/rules/final/2016/33-10231.pdf). Form N-PORT requires all registered management investment companies (other than money market funds and small business investment companies) and unit investment trusts that operate as exchange-traded funds to report information about their monthly portfolio holdings to the SEC in a structured data format no later than 30 days after the close of each month using the SEC's EDGAR system. In general, reports on Form N-PORT for every third month of each fiscal quarter will be available to the public 60 days after the end of the fiscal quarter.

be designed to improve EDGAR's functionality and security, could negatively affect EDGAR's ability to validate and accept Form N-PORT filings in a timely manner, in particular during peak filing periods." Thus, the SEC determined it was appropriate to delay the Form N-PORT filing requirement to allow for completion of the SEC's internal data security review and implement and test any resulting modifications.

The adopting release for the Temporary Rule is available at: https://www.sec.gov/rules/final/2017/33-10442.pdf

The SEC staff previously prepared responses to certain questions related to the investment company reporting modernization reforms. These FAQs are available at: https://www.sec.gov/investment/investment-company-reporting-modernization-faq

OTHER REGULATORY DEVELOPMENTS

ICI Supplements Request for Delay of Liquidity Risk Management Program Rule Compliance Date

On November 3, 2017, the Investment Company Institute (ICI) issued a letter to the SEC (the Supplemental Letter), supplementing the ICI's July 20, 2017 letter, requesting that the SEC delay the compliance date of, and ease compliance with, the liquidity risk management program rule (the Liquidity Rule) and its related reporting requirements. The Supplemental Letter provides the results of an ICI member survey as well as findings from vendors' asset classification (i.e., "bucketing") of sample portfolios as additional support for the ICI's request that the SEC "adjust the compliance schedule for the liquidity rule's asset classification and related requirements as soon as possible, for the amount of time the SEC needs to ease compliance with the rule's bucketing requirements, including through targeted rule amendments." At a minimum, the ICI requests that the SEC delay these requirements by at least one year. In this regard, the ICI notes that its recommendations are consistent with the Treasury Department's recent report, which advised that the SEC "take appropriate action to postpone the currently scheduled December 2018 implementation of Rule 22e-4's bucketing requirement."[2]

The ICI asserts that the requested compliance adjustments to the Liquidity Rule—which "has no real antecedent in industry practice or regulation, either in the US or globally"—are "justified and reasonable and well within the SEC's discretion" in view of:

> (i) the lack of a statutory deadline for implementation of any aspect or component of the liquidity rule or any of its related reporting requirements; (ii) the limited nature of the requested compliance adjustments and absence of any risk of harm to the public from those adjustments; (iii) the impracticability of complying with the bucketing and related reporting requirements by December 1, 2018 (the relevant compliance date for most funds); and (iv) the public interest in reexamining the requirements in light of their associated compliance burdens and limited utility.

2 With respect to the liquidity rule, the Treasury Department's report "reject[ed] any highly prescriptive regulatory approach to liquidity risk management, such as the bucketing requirement" and, instead, "supports the SEC adopting a principles-based approach."

Background

On October 13, 2016, the SEC adopted the Liquidity Rule, which will require registered open-end investment companies (including open-end exchange-traded funds (ETFs) but excluding money market funds) to adopt and implement written liquidity risk management programs reasonably designed to assess and manage the fund's liquidity risk.

The Liquidity Rule will require that a fund's liquidity risk management program incorporate elements relating to (i) assessment, management and review of fund liquidity risk, (ii) liquidity classification of portfolio investments, (iii) highly liquid investment minimum, (iv) illiquid investments, and (v) redemptions in kind.[3]

The Liquidity Rule establishes additional board responsibilities, and requires the board to appoint either the fund's investment adviser or one or more fund officers as being responsible for administering the liquidity risk management program. The Liquidity Rule also establishes additional disclosure and recordkeeping responsibilities. Currently, the Liquidity Rule requires that funds in groups of related investment companies with $1 billion or more in net assets as of the end of the most recent fiscal year comply with the Rule's requirements by December 1, 2018; funds in groups of related investment companies with less than $1 billion in net assets as of the end of the most recent fiscal year are currently required to comply by June 1, 2019.[4]

On July 20, 2017, the ICI issued a letter to SEC Chairman Jay Clayton expressing "deep concerns" about the fund industry's ability to meet the compliance deadlines for the Liquidity Rule. The letter requested that the SEC take the following actions: (1) adjust the compliance schedule for the Liquidity Rule's asset classification and related requirements as soon as possible, allowing the SEC time to make "targeted rule amendments"; (2) adopt amendments to the Liquidity Rule allowing funds to formulate their own policies and procedures for how to classify the liquidity of investments; (3) adjust the compliance schedule for the Liquidity Rule and related reporting requirements by at least one year, even if the SEC does not pursue the recommended rule amendments; (4) require quarterly, instead of monthly, reporting of portfolio holdings on Form N-PORT until the SEC addresses information security concerns adequately; and (5) even if the SEC retains the monthly reporting requirement for portfolio holdings, delay the compliance dates for Form N-PORT and Form N-CEN for at least six months.

ICI's Supplemental Letter

The ICI's Supplemental Letter explains why the bucketing requirements have "proven to be—by far—the most costly and vexing piece of the rule to implement," including, among other things, because the rule would require funds to take into account "a number of complex and interrelated fund-, market-, trading-, and investment-specific factors and make judgment calls" and would necessitate "uniform output from these inputs." The ICI also asserts that "bucketing systems capable of doing these things are far from complete" and "systems likely will require several more months before they are mature enough for meaningful evaluation, testing, and all other necessary product- and firm-specific due diligence." Given the foregoing complexities and challenges, the Supplemental Letter notes that the ICI has extensively engaged its members on rule implementation and, to this end, surveyed members to have a better understanding of (1) their ability to comply with the Liquidity Rule by the current compliance date; and (2) the associated costs.

3 For a more detailed discussion of the Liquidity Rule, please see the Vedder Price White Paper, "SEC Adopts New Rules Mandating Open-End Fund Liquidity Risk Management Programs and Permitting Swing Pricing," published on October 28, 2016 and available at: http://www.vedderprice.com/SEC-Adopts-New-Rules-Mandating-Open-End-Fund-Liquidity-Risk-Management-Programs-and-Permitting-Swing-Pricing-10-28-2016/

4 Note that the reporting requirements added to Form N-PORT by the Liquidity Rule have been delayed by the temporary final rule recently adopted by the SEC concerning compliance with investment company reporting modernization reforms. See the related summary under "*New Rules*" above.

The survey results, according to the ICI, "provide a strong foundation for the Commission to determine that a delay is necessary and appropriate," particularly in view of concerns with "vendor readiness." In this regard, a large majority of survey respondents (91%) indicated that they are considering utilizing vendors, and "most will seek help with bucketing in particular," and a majority of respondents (73%) "do not believe vendors' offerings will be sufficiently mature to make an informed selection until 2018." The Supplemental Letter suggests that only after vendor products are ready for client evaluation can firms then select a product, onboard the vendor, test the product and present a substantially complete liquidity risk management program to their board for approval—a process which is expected to take several months.

The Supplemental Letter also asserts that delaying the rule's compliance date would allow for enhancements to processes that would increase the utility of the information to be reported to the SEC. In this connection, the ICI cites its evaluation of sample output from vendors' current offerings, including the results of a bucketing exercise performed by five vendors as to three sample portfolios. According to the ICI, the results of the exercise demonstrated: (1) uniformity of results for small (i.e., $100 million) portfolios; (2) modest dispersion of results for mid-size (i.e., $1 billion portfolios); and (3) more pronounced dispersion of vendor results and percentages across buckets for large (i.e., $10 billion) portfolios. The foregoing, the ICI asserts, demonstrates the limited utility of bucketing data because, as to larger funds for instance, "it is highly likely that as overall portfolio size or fund position size scales up, liquidity will appear to diminish, even if the fund were to invest primarily or entirely in investments that market participants view as highly liquid." In fact, the ICI notes, "we can expect to see more dispersion across buckets and vendors as sizes increase" since vendors "will employ differing models and default assumptions with different sensitivities to certain factors." In sum, by delaying the compliance date, the ICI believes that funds and vendors could evaluate further the responsiveness of vendor models to variations in underlying assumptions and further refine their processes.

The ICI's July 20, 2017 letter is available at: https://www.ici.org/pdf/liquidity_sec_clayton_ltr.pdf

The ICI's Supplemental Letter is available at: https://www.ici.org/pdf/17_ici_sec_liquidity_ltr_supp.pdf

Public Statements

PUBLIC STATEMENTS

Chairman Clayton Discusses the SEC's Role in the Evolving Structure of the U.S. Treasury Market

In his remarks at the Third Annual Conference on the Evolving Structure of the U.S. Treasury Market on November 28, 2017, SEC Chairman Jay Clayton commented on three areas of continued focus relative to the market for Treasury securities, including (i) regulatory coordination and its importance to the Treasury market; (ii) the importance of Treasury market trading data to regulators; and (iii) the SEC's approach to future regulation of fixed-income markets and areas to be explored by the SEC's new Fixed Income Market Structure Advisory Committee.

Chairman Clayton discussed the importance of efficient and effective regulatory coordination, one of the eight principals he previously highlighted in his speech in July 2017 intended to "guide the work of the SEC" as it carries out its three-pronged mission of protecting investors, ensuring fair, orderly and efficient markets and facilitating capital formation. He recognized that the SEC is one of several regulators and governmental entities with responsibility to oversee the financial services area, including participants in fixed-income markets, and noted that coordination among these regulators is "essential to a well-functioning regulatory environment and, in turn, well-functioning markets." Chairman Clayton then discussed the specific importance of coordination among the various authorities tasked with oversight of the Treasury market, as well as the importance of coordination and communication between these authorities and the participants in the markets they oversee. Chairman Clayton stated that he instructed the SEC staff to seek to engage with and listen to investors and other market participants in order to enhance the SEC's ability to identify and understand new and changing risks, trading practices, technologies and competitive dynamics. Clayton pointed to the close regulatory coordination and cooperation on display in the Treasury market over the past several years, specifically noting the report of various regulators produced in the wake of unusually high market volatility on October 15, 2014 and the development and launch of TRACE reporting and the sharing of TRACE data and related analyses among regulators.

Chairman Clayton noted that the Treasury market is fundamental to the U.S. economy, serving as the primary means of financing the federal government. He also noted that it is "the deepest and most liquid government securities market in the world" and reviewed some of the key roles the Treasury market performs in the global financial system. He stated that because of this, the SEC and other authorities responsible for the Treasury market need "a clear and precise understanding of the trends, dynamics and risks in the Treasury market," which he noted can be provided, in part, through readily available Treasury market data. By way of example, Clayton noted a FINRA rule change, effective in July 2017, that requires broker-dealers to report transactions in Treasury securities to FINRA's TRACE system. He identified this as a significant step forward with respect to both the scope and timing of regulator access to Treasury market data. Chairman Clayton also reviewed the Treasury Department's Capital Markets Report, which he stated contained several thoughtful recommendations for the advancement of Treasury market data, including: (i) a requirement that the broker-dealers operating the major electronic inter-dealer Treasury platforms specifically identify proprietary trading firms in the trade reports that the platform operators submit to TRACE; (ii) support for the Federal Reserve Board's intention to collect data from banks for transactions in Treasuries; and (iii) a recommendation that the CFTC share with the Treasury Department data concerning Treasury futures transactions that it collects from CME Group.

Chairman Clayton discussed the SEC's new Fixed Income Market Structure Advisory Committee (FIMSAC). He stated that FIMSAC's initial focus will be on the "efficiency and resiliency" of corporate and municipal fixed-income markets in an effort to help the SEC identify opportunities for regulatory improvements. Chairman Clayton noted his long-held belief that there should be "additional regulatory focus on these important and growing markets," which are particularly significant to retail investors as well as U.S. companies and the national infrastructure. He expressed his expectation that FIMSAC will help ensure that the SEC's regulatory approach to these markets reflects both

where the markets are today and the needs of "Main Street" investors, companies and state and local governments. Chairman Clayton also reviewed topics and questions that FIMSAC may address, including (i) bond market liquidity, including the effects on liquidity of reductions in dealer inventories and the growth of exchange-traded products; (ii) the broader implications of the growth of fixed-income funds and exchange-traded products; (iii) whether the SEC should undertake efforts with respect to pre-trade transparency in fixed-income markets; and (iv) investor education regarding the basic principles of fixed-income markets.

The transcript of Chairman Clayton's remarks is available at: https://www.sec.gov/news/speech/clayton-2017-11-28

Other Developments

SEC Ratifies Prior Administrative Law Judge Appointments After DOJ Signals Shift In Position

In an order issued on November 30, 2017 (the Order), the SEC ratified the prior appointment of Chief Administrative Law Judge Brenda Murray and four other administrative law judges (ALJs). The ratification comes on the heels of a brief filed at the U.S. Supreme Court by the U.S. Department of Justice, which argued for the first time that ALJs are "inferior officers" for purposes of the Appointments Clause and thereby subject to formal appointment by the head of the SEC. The brief signals a shift by the Justice Department, which under the previous administration had maintained that ALJs were merely employees who were not subject to formal appointments.

The Order "put[s] to rest any claim that administrative proceedings pending before, or presided over by, Commission administrative law judges violate the Appointments Clause" by ratifying the previous appointments. The Order further requires the ALJs to reconsider the records of and actions taken in all pending administrative proceedings and set forth determinations regarding the ratification of those records and decisions by February 16, 2018 (which deadline may be extended upon a showing of good cause). The Order similarly remands for ratification all proceedings on internal appeal before the SEC in which an ALJ had issued an initial decision. Finally, the Order lifts the stays on those proceedings pending before an ALJ in which a respondent has the option to seek review in the Tenth Circuit. These stays were imposed in response to a prior Tenth Circuit decision holding that ALJs are inferior officers subject to the Appointments Clause.

The Order is available at: https://www.sec.gov/litigation/opinions/2017/33-10440.pdf

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