



# Investment Services Regulatory Update

February 2020

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# New Rules, Proposed Rules, Guidance and Alerts

## PROPOSED RULES

### Agencies Propose Volcker Rule Amendments Relating to Covered Funds

On January 30, 2020, the Federal Reserve Board, FDIC, OCC, SEC and CFTC proposed amendments to certain Volcker Rule restrictions relating to banking entity activities with hedge funds or private equity funds (covered funds). Currently, the Volcker Rule restricts the ability of banking entities to hold an ownership interest in, sponsor or have certain other relationships with a covered fund. The proposed amendments are intended to improve and streamline the Volcker Rule's covered funds provisions to allow banking entities to provide comprehensive financial services in a manner consistent with the requirements and spirit of the Volcker Rule, but that are currently prohibited.

Key elements of the proposed amendments are as follows:

- **Foreign Funds.** The proposal would limit the extraterritorial impact of the Volcker Rule and streamline foreign fund restrictions. The Volcker Rule currently excludes foreign public funds from its covered funds provisions, subject to certain restrictions. The proposal would align these restrictions with those related to the exclusion for domestic registered investment companies. In addition, the proposal would exempt from certain covered funds restrictions foreign funds that are controlled by foreign banking entities and thereby subject to the more rigorous compliance obligations of banking entities.
- **Exclusions from the Covered Funds Provisions.** The proposal would also modify, expand and add exclusions from the covered funds provisions as follows:
  - The Volcker Rule currently excludes loan securitizations from the covered funds provisions. The proposal would codify existing staff-level guidance to allow loan securitizations to hold a small amount of non-loan assets.
  - The proposal would revise the exclusion for small business investment companies to clarify how the exclusion applies to a fund that surrenders its SBIC license during the wind-down phase of its life cycle. The proposal would also create

a new exclusion for venture capital funds. In addition, the proposal solicits comments on the application of the public welfare investment exclusion with respect to rural business investment companies and qualified opportunity zone funds.

- The proposal creates a new exclusion that would allow banking entities to invest in and have certain relationships with credit funds that extend credit that the banking entity may otherwise provide directly.
- The proposal would exclude entities created and used to facilitate customer transactions and investment strategies, and would exclude wealth management vehicles for family portfolios, with the aim of allowing banking entities to provide comprehensive financial services through a covered funds structure.
- **Transactions with Sponsored Covered Funds.** The proposal would amend the Volcker Rule to permit a banking entity to engage in certain covered transactions with a covered fund the banking entity sponsors or advises, which would allow banking entities to provide traditional banking services to related covered funds, such as standard payment, clearing and settlement services.
- **Ownership Interest Definition.** The proposal would modify the treatment of certain loans to covered funds, which loans are currently deemed to be ownership interests of the loaning bank entity. The proposal would provide a safe harbor to exclude bona fide senior loans or senior debt instruments from the definition of ownership interest in a covered fund. The proposal would also simplify the manner in which banking entities would calculate ownership interest in covered funds.

Comments to the proposal are due by April 1, 2020. A copy of the proposal is available [here](#).

## GUIDANCE AND ALERTS

### OCIE Publishes Cybersecurity and Resiliency Observations

On January 27, 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) published observations from its examinations of regulated entities, including funds and investment advisers, to assist those entities in cybersecurity preparedness and operational resiliency. OCIE noted that

addressing cybersecurity threats has become increasingly important, and is a key priority in its examinations. With the goal of improving cybersecurity, OCIE discussed the following:

- **Governance and Risk Management.** OCIE observed organizations that engage senior leadership in the process of establishing and overseeing cybersecurity and resiliency programs. OCIE further observed programs that include a risk assessment and written policies and procedures designed to address identified risks. OCIE noted programs that ensure effective implementation of policies and procedures, including periodic updates to address gaps or weaknesses.
- **Access Rights and Controls.** OCIE observed organizations that engage senior leadership in the process of establishing and overseeing cybersecurity and resiliency programs. OCIE further observed programs that include a risk assessment and written policies and procedures designed to address identified risks. OCIE noted programs that ensure effective implementation of policies and procedures, including periodic updates to address gaps or weaknesses.
- **Data Loss Prevention.** OCIE noted that organizations may prevent the loss of sensitive data by scanning systems for vulnerabilities, monitoring network traffic to detect threats and prevent harmful or unauthorized traffic, patching software vulnerabilities, encrypting data and securing current and legacy hardware.
- **Mobile Security.** OCIE observed organizations that have established and implemented specific policies and procedures to address the unique vulnerabilities posed by mobile devices. OCIE also noted organizations that have implemented mobile device-specific security measures and provide training on mobile security.
- **Incident Response and Resiliency.** OCIE observed organizations that have developed risk-based incident response plans for cyberattacks, which include procedures for addressing applicable reporting requirements, designating staff responsible for executing specific aspects of the plan and testing and assessing such plans. OCIE further noted organizations that have created a strategy for operational resiliency by identifying and prioritizing core business services, considering any

effects that a failure may have and adequately backing up data.

- **Vendor Management.** OCIE observed organizations that have established due diligence procedures for ensuring that third-party vendors meet security requirements. OCIE noted organizations that ensure all parties have the same understanding of how contract terms address risk and security and monitor each third-party vendor's compliance with security requirements.
- **Training and Awareness.** OCIE observed organizations that train staff to implement policies and procedures and periodically assess the effectiveness of such trainings.

OCIE concluded by noting the availability of additional resources for addressing cybersecurity threats, including, among others, the SEC's Cybersecurity Spotlight page and the Cyber Infrastructure Security Agency's periodic cybersecurity alerts.

OCIE's Cybersecurity and Resiliency Observations are available [here](#).

## FINRA Announces 2020 Exam Priorities

On January 9, 2020, FINRA released its 2020 Risk Monitoring and Examination Priorities Letter for its member firms. The exam priorities are organized into four categories: (1) sales practice and supervision; (2) market integrity; (3) financial management; and (4) firm operations. Within these groupings are several issues of potential interest, including among others, the following:

- **Regulation Best Interest and Form CRS.** FINRA will begin evaluating firms' compliance with Regulation Best Interest and Form CRS, compliance with both of which is required by June 30, 2020. Examinations conducted before the compliance date will review firms' preparedness for the new rules while examinations conducted after the compliance date will review for compliance. FINRA noted it will take the following factors into consideration when conducting examinations after the compliance date:
  - (1) whether firms have procedures and training in place to assess recommendations of securities, account types and monitoring using a best interest standard;
  - (2) whether firms

and associated persons consider the new elements of care, skill and costs when making recommendations to retail customers; and (3) whether firms have procedures in place to comply with the disclosure and conflict of interest obligations and the filing, updating and delivery of Form CRS.

- **Sales of Initial Public Offering Shares.** FINRA will review firms' compliance with Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings) and Rule 5131 (New Issue Allocations and Distributions). FINRA notes that it may consider whether firms have procedures and controls in place to detect instances of both "flipping" and "spinning" and how firms prevent allocations of new issues to restricted persons.
- **Consolidated Audit Trail (CAT) Reporting.** FINRA reminds certain firms that CAT reporting requirements will begin in April 2020. Any broker-dealer that is a member of a national securities exchange or FINRA and receives, originates or handles orders in NMS securities, which includes NMS stocks and listed options, or over-the-counter equity securities, will be subject to this requirement.
- **Best Execution.** FINRA is reaffirming the importance of firm compliance with best execution obligations. FINRA will focus on whether firms use reasonable diligence to determine whether customer orders are directed to the best market, given an order's characteristics. FINRA specifically mentioned it will focus its efforts on routing decisions, odd-lot handling, U.S. Treasury securities and large block executions in options.
- **Digital Assets and Liquidity Management.** Regarding digital assets, FINRA is reviewing digital asset activities and focusing on how firms market these activities to outside investors. Regarding liquidity management, FINRA will focus on issues of compliance addressed in Regulatory Notice 15-33.

The 2020 Risk Monitoring and Examination Priorities Letter is available [here](#).

## OCIE Announces 2020 Examination Priorities

On January 7, 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) announced its 2020 examination priorities for regulated entities, including investment advisers and registered funds. The examination priorities are organized into the following eight categories:

1. retail investors, including seniors and individuals saving for retirement;
2. information security;
3. financial technology and innovation, including digital assets and electronic investment advice;
4. additional focus areas involving registered investment advisers (RIAs) and registered funds;
5. additional focus areas involving broker-dealers and municipal advisors;
6. anti-money laundering (AML) programs;
7. market infrastructure; and
8. matters concerning Financial Industry Regulatory Authority (FINRA) and the Municipal Securities Rulemaking Board (MSRB).

Within the foregoing categories, OCIE will focus on several issues of potential interest to funds and their investment advisers, including the following:

- **Standards of Care/Regulation Best Interest.** Before the June 30, 2020 compliance date for Regulation Best Interest and Form CRS, OCIE will engage with broker-dealers during examinations on their progress on implementing the new rules. After the compliance date, OCIE will assess implementation of the requirements of Regulation Best Interest, including policies and procedures regarding conflict disclosures, and for both broker-dealers and RIAs, the content and delivery of Form CRS.
- **Mutual Funds and ETFs.** OCIE will prioritize examinations of mutual funds and ETFs, the activities of their RIAs and oversight practices of their boards. Examinations will assess industry practices and regulatory compliance in various

areas, including a focus on: (1) RIAs that use third-party administrators to sponsor mutual funds they advise or are affiliated with; (2) mutual funds or ETFs that have not been previously examined; and (3) RIAs to private funds that also manage a registered investment company with a similar investment strategy.

- **FinTech Innovation.** For “robo-advisers,” focus areas include: (1) SEC registration eligibility; (2) cybersecurity policies and procedures; (3) marketing practices; (4) adherence to fiduciary duty, including adequacy of disclosures; and (5) effectiveness of compliance programs.
- **RIAs Subject to Prioritized Examinations by OCIE.** OCIE will prioritize examinations of the following types of RIAs: (1) dually registered firms or those affiliated with broker-dealers or that have supervised persons who are registered representatives of unaffiliated broker-dealers; (2) firms that use the services of third-party asset managers to manage clients’ investments and the extent of these firms’ due diligence practices, policies and procedures; (3) previously examined RIAs that have not been examined for several years, with a focus on whether the RIAs’ compliance programs have been appropriately adapted in light of any substantial growth or change in their business models; and (4) RIAs to private funds that have a greater impact on retail investors, such as firms that provide management to separately managed accounts side by side with private funds.
- **Information Security.** OCIE will assess RIAs’ protection of clients’ personal financial information with particular focus on: (1) governance and risk management; (2) access controls; (3) data loss prevention; (4) vendor management; (5) training; and (6) incident response and resiliency. OCIE will also focus on: oversight practices related to service providers and network solutions, including cloud-based storage; controls surrounding online access and mobile application access to customer brokerage account information; and safeguards around the proper disposal of retired hardware that may contain client information and potential network information that could create an intrusion vulnerability.
- **Retail Investors.** OCIE will focus on recommendations and advice given to retail investors, higher risk products, including private placements and securities of issuers in new and emerging risk areas, such as those that: (1) are complex or

non-transparent; (2) have high fees and expenses; or (3) where an issuer is affiliated with or related to the registered firm making the recommendation.

- **Conflicts of Interest and Fiduciary Duties.** OCIE will focus on: (1) disclosures and supervision of outside business activities of employees and associated persons and any related conflicts; (2) fulfillment of RIAs’ duties of care and loyalty, including whether RIAs provide advice in the best interests of their clients and eliminate or disclose all conflicts of interest; (3) fee and compensation-based conflicts of interest, including, among other things, revenue sharing arrangements and direct or indirect compensation to advisory personnel for executing client transactions; and (4) aggregation of accounts for purposes of calculating fee discounts. OCIE will also focus on financial incentives provided to financial services firms and professionals that may influence the selection of particular mutual fund share classes.
- **New or Emerging Investment Strategies, including ESG.** OCIE has a “particular interest” in the accuracy and adequacy of disclosures provided by RIAs offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social and governance (ESG) criteria.
- **AML Programs.** OCIE will continue to prioritize examining broker-dealers’ and investment companies’ compliance with their AML obligations, including whether firms have established appropriate customer identification programs and whether they are satisfying their SAR filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs.

OCIE notes that this list of priorities is not exhaustive, and will not be the only issues addressed during examinations.

The examination priorities are available [here](#).

## OTHER DEVELOPMENTS

### SEC Issues Notice of Intention to Grant Exemption from Board's In-Person Meeting Requirement to Approve Sub-Advisory Agreements

On January 21, 2020, the SEC issued a notice of its intention to grant exemptive relief to a registered fund and its investment adviser that would permit the fund's board to approve new sub-advisory agreements and material amendments to existing sub-advisory agreements without complying with the in-person meeting requirement of Section 15(c) of the Investment Company Act of 1940. Under the requested relief, the independent board members could approve a sub-adviser change at a meeting at which members of the board could participate by any means of communication that allows them to hear each other simultaneously during the meeting.

In seeking exemptive relief, the applicants asserted that during the period between board meeting dates, market conditions may change or investment opportunities may arise such that the fund's investment adviser may wish to make a sub-adviser change. The applicants asserted that in these instances it may be impractical and costly to hold an additional in-person board meeting, particularly given the geographic diversity of board members and the cost associated with holding an additional in-person meeting. The applicants also stated that the relief's condition requiring that board members be able to hear each other simultaneously during the meeting mitigates the concern with absentee approval of advisory agreements that Section 15(c) was intended to address.

Other conditions to the exemptive relief are as follows:

- **Meeting Materials.** Management must represent that the materials provided to the board for the meeting include the same information the board would have received if a sub-adviser change were sought at an in-person meeting;
- **Notice of Meeting and Right to Object.** Notice of the meeting must explain why the sub-adviser change needs

to be considered at a non-in-person meeting and, once notice is sent, board members will have the opportunity to object to considering the change at a non-in-person meeting. The board must then consider the sub-adviser change at an in-person meeting, unless the objecting board member rescinds the request for an in-person meeting.

- **Disclosure.** A fund's ability to rely on the requested relief must be disclosed in its registration statement.

The requested relief does not apply to the funds' investment advisory agreements.

The notice is available [here](#).

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# VedderPrice

## 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.