Investment Services Regulatory Update

May 2020

Monthly Version

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NEW RULES, PROPOSED RULES, GUIDANCE AND ALERTS.

New Rules, Proposed Rules, Guidance and Alerts

PROPOSED RULES

SEC Proposes New Fair Valuation Framework for Registered Funds

Under the Investment Company Act of 1940, securities held by a fund for which market quotations are readily available are to be priced at current market value, and securities for which market quotations are not readily available are to be priced at fair value as determined in good faith by the fund's board. On April 21, 2020, the SEC proposed new Rule 2a-5 under the 1940 Act, which is intended to provide a framework for fund valuation and to provide clarity on how fund boards can satisfy their statutory obligations in the valuation process. Key elements of the proposal are as follows:

- **Assignment of the fair value determination.** Under Rule 2a-5, a fund's board would be permitted to assign the responsibility to make fair value determinations for some or all fund investments to the fund's investment adviser or to one or more sub-advisers. Assignment to the investment adviser or to a sub-adviser would trigger certain requirements, including the following:
  - the fund's board would be required to oversee the investment adviser's performance of the fair value function, and the adviser would be required to make periodic reports (at least quarterly) on fair valuation to facilitate the board's oversight;
  - the investment adviser would be required to make prompt (generally within three business days) written reports to the board on matters associated with the fair value process that materially affect, or could have materially affected, fair value determinations;
  - the investment adviser would be required to clearly specify responsibilities and duties among advisory personnel involved in the fair value process, including reasonably segregating (but not necessarily eliminating) portfolio managers from the process; and
  - the fund would become subject to certain additional recordkeeping requirements.
- **Determining fair value in good faith.** Rule 2a-5 would provide that determining fair value in good faith requires the performance by a fund's board or investment adviser of certain functions, including:
  - a periodic assessment of any material risks associated with fair value determinations, including material conflicts of interest, and the management of those risks;
  - the selection and consistent application of appropriate fair value methodologies and the periodic assessment of those methodologies;
  - periodic testing of the appropriateness and accuracy of fair value methodologies, and adjustments to methodologies where necessary;
  - oversight of any pricing services, including establishing both a process for approving, monitoring and evaluating pricing services and criteria for initiating price challenges;
  - adopting and implementing written policies and procedures to address fair value determinations that are reasonably designed to achieve compliance with Rule 2a-5's requirements; and
  - adequately documenting and retaining certain records relating to fair value determinations.
- **"Readily available" market quotations.** Under the 1940 Act, a fair value determination must be made when a market quotation for an investment is not readily available. Under Rule 2a-5, a market quotation would be "readily available" only when the quotation is a quoted price (unadjusted) in active markets for identical

investments that a fund can access at the measurement date. However, a quotation would not be considered readily available if it is unreliable, which would be the case if U.S. GAAP would require an adjustment to the quotation or the consideration of additional inputs to determine the value of the investment.

- **Board guidance.** In addition, the proposing release for Rule 2a-5 included guidance to fund board members regarding the SEC's expectations for board oversight of the valuation process. Under the guidance, a fund's board should play an active role in fair valuation oversight and take a skeptical and objective view of the fair valuation function that takes into account fund-specific valuation risks. The board should be mindful of subjective inputs used to fair value investments and should seek to identify and monitor, and take reasonable steps to manage, conflicts of interest. Finally, the guidance suggests that boards probe the appropriateness of the investment adviser's fair value process, periodically reviewing the adviser's financial resources, technology, staff and expertise, as well as the compliance capabilities that support the fair value process.

The public comment period on Rule 2a-5 will remain open until July 21, 2020. If Rule 2a-5 is adopted, the SEC would rescind previously issued guidance on the role of the board in determining fair values and certain accounting-related guidance.
The proposing release is available here.

The authors of this executive summary have prepared a comprehensive summary of the Proposed Rule available here.

GUIDANCE AND ALERTS

Priorities of the SEC Division of Enforcement's Coronavirus Steering Committee

In an address delivered on May 12, 2020, Steven Peikin, Co-Director of the SEC's Division of Enforcement, discussed the Staff's response and adjustment to the COVID-19 pandemic. During his remarks, Mr. Peikin discussed the Division of Enforcement's Coronavirus Steering Committee which was created with a mandate to "proactively identify and monitor areas of potential misconduct, ensure appropriate allocation of . . . resources, avoid duplication of efforts, coordinate responses as appropriate with other state and federal agencies, and ensure consistency in the manner in which the women and men of the Division address coronavirus-related matters." The Steering Committee consists of around 24 leaders from within the Division of Enforcement, including specialized units, Home Office and regional offices and the Office of Market Intelligence. The Steering Committee is also communicating with other entities such as state regulators, exchanges, other federal agencies, and SROs to maximize its ability to protect investors.

Co-Director Peikin identified several areas that the Steering Committee is focused on. First, he emphasized the Staff's attention to microcap fraud, especially "efforts by microcap fraudsters to make specious claims of treatments, disaster-response capabilities, and the like." Second, he discussed a focus on insider trading and market manipulation which warrant enhanced scrutiny due to atypical levels of market volatility and "a regular stream of potentially market-moving announcements by issuers." The Steering Committee, in conjunction with the Market Abuse Unit, has been monitoring trading activity surrounding issuer announcements and also seeking to identify other suspicious market movements. Third, he identified financial statement/disclosure fraud as an area of particular focus because the current environment of financial stress can both "expos[e] pre-existing accounting or disclosure improprieties" or create new instances of improper conduct. To combat financial statement/disclosure fraud, the Steering Committee "has developed a systematic process to review

public filings from issuers in highly-impacted industries, with a focus on identifying disclosures that appear to be significantly out of step with others in the same industry." The Steering Committee is also concentrating on identifying attempts by issuers to cast pre-existing problems as coronavirus-related. Fourth, the Steering Committee is monitoring registrants for COVID-19-related misconduct including failures to honor redemption requests and improper marketing and sale of complex structured products to retail investors.

This transparent discussion of priorities is part of the Division of Enforcement's efforts to "provide visibility and transparency regarding enforcement initiatives to educate market participants and deter potential wrongdoers."

Regulation Best Interest Update – OCIE Risk Alert on Initial Examinations

On April 7, 2020, the Securities and Exchange Commission's (the "SEC" or the "Staff") Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert[1] to provide broker-dealers and their associated persons (collectively, "broker-dealers" or "firms") with information about the scope and content of initial examinations related to Regulation Best Interest ("Reg BI" or the "Rule").

Importantly, the Financial Industry Regulatory Authority ("FINRA") has stated it will take the same approach as the SEC when conducting its initial examinations for compliance with the Rule.[2] Firms should be aware that these initial examinations are likely to occur within the first year of Reg BI's June 30, 2020 compliance date, which the SEC has not extended in light of the COVID-19 pandemic.[3]

Moreover, not every broker-dealer is subject to Reg BI. The Rule establishes a new standard of conduct under the Securities Exchange Act of 1934 for broker-dealers when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer.

Also, even if a broker-dealer is subject to Reg BI, that firm's examination will be based on its unique profile, meaning OCIE will tailor its requests for information pursuant to a firm's business model. Accordingly, not every document listed in the OCIE Risk Alert or noted in the sample document request Appendix of the Risk Alert will be applicable to every firm.

Guidance on Examinations

According to the Risk Alert, initial examinations will focus on two main issues: (i) whether firms have made a good-faith effort to establish policies and procedures reasonably designed to achieve compliance with Reg BI and (ii) whether firms have made reasonable progress in implementing those policies and procedures. With respect to the second issue, OCIE or FINRA plans to send an initial document request prior to an examination and use the provided documents to determine whether the firm is in compliance with Reg BI.[4]

For example, a specific requirement of the Disclosure Obligation is to provide written disclosure of how a broker-dealer is compensated for its recommendations to retail customers. To monitor this requirement, OCIE will ask a firm for its disclosure documents AND a schedule of fees and charges assessed against retail customers. OCIE will then cross-reference the disclosure documents to ensure the firm has made proper disclosure of these fees and charges.

Pursuant to this approach, OCIE's Risk Alert identified the following areas of focus within Reg BI's four component obligations and the specific documents it may request to monitor a firm's compliance.

Disclosure Obligation

OCIE may assess how a firm has met the requirement to disclose all material facts relating to the scope and terms of its relationship with a retail customer, including: (i) the capacity in which the recommendation is being made, (ii) material fees and costs that apply to the retail customer's transactions, holdings and accounts and (iii) material limitations on the securities or investment strategies involving securities that may be recommended to the retail customer.

<u>Document Requests</u>

- Any and all disclosure documents provided to retail customers pursuant to the Disclosure Obligation, including disclosures related to account monitoring and material limitations on accounts or services recommended by the broker-dealer;

- Fee schedules and charges assessed against retail customers (e.g., custodian fees, account fees, mutual fund/variable annuity fees, transactional fees and specific product-level fees);
- Compensation methods or how registered personnel are paid, such as (i) when personnel make a recommendation, (ii) the source of payment (e.g., direct from investor or from a product sponsor) or (iii) when payment is associated with certain conflicts of interest (e.g., payments from proprietary products or from product menus); and
- Lists of proprietary products sold to retail customers.

Care Obligation

OCIE may assess how a firm exercises reasonable diligence, care and skill when making a recommendation to a retail customer, specifically related to the "Reasonable-Basis"[5] and "Customer-Specific"[6] components of the Care Obligation.

Document Requests

- Information the broker-dealer collected to develop a retail investor's investment profiles (e.g., new account forms, correspondence and any agreements);
- The broker-dealer's process in how it satisfies the Customer-Specific component (e.g., what factors are considered to assess the product against the customer's investment profile and whether the firm has a process regarding reasonably available alternatives);
- How the broker-dealer makes recommendations related to account rollovers and opening a brokerage account; and
- How the broker-dealer makes recommendations related to complex, risky or expensive products (e.g., inverse or leveraged ETFs, penny stocks or illiquid securities).

Conflict of Interest Obligation

OCIE may assess how a firm establishes, maintains and enforces written policies and procedures reasonably designed to address conflicts of interest associated with its recommendations.

Document Requests

- The firm's written policies and procedures. Upon receipt, OCIE will likely assess whether and how the policies identify and either mitigate or eliminate conflicts of interest;
- The mitigation of conflicts that create an incentive for associated persons to place their interests, or the interests of the broker-dealer, ahead of the retail customer;
- The mitigation of conflicts associated with material limitations (e.g., limited product menus, only offering proprietary products or offering products that involve third-party arrangements); and
- The elimination of certain conflicts of interest (e.g., sales contests, sales quotas, bonuses and non-cash compensation based on the sale of specific securities or specific types of securities within a limited period of time).

Compliance Obligation

OCIE may assess how a firm establishes, maintains and enforces written policies and procedures reasonably designed to achieve compliance with Reg BI as a whole.

Document Requests

- The firm's written policies and procedures. Upon receipt, OCIE will likely assess the procedures and evaluate any controls, remediation of noncompliance, training and periodic review and any testing requirements included within the procedures.

Conclusion

FINRA plan to tailor their requests for information pursuant to each firm's business model. In addition, the Risk Alert urges firms to engage with the Staff if there is an inability to comply with Reg BI by June 30, 2020 due to the effects of the COVID-19 pandemic. Chairman Clayton previously noted his expectation that the Staff would take such difficulties into account during SEC examinations and enforcement actions.

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[1] See, https://www.sec.gov/files/Risk%20Alert-%20Regulation%20Best%20Interest%20Exams.pdf

[2] See, https://www.finra.org/media-center/newsreleases/2020/finra-statement-secs-ocie-risk-alerts-reg-bi-and-form-crs

[3] On April 2, 2020, SEC Chairman Jay Clayton released a public statement noting the June 30, 2020 compliance date would not be extended in light of the COVID-19 pandemic (https://www.sec.gov/news/public-statement/statement-clayton-investors-rbi-form-crs)

[4] See the Appendix of the Risk Alert, which provides a sample list of information OCIE may request when conducting examinations of broker-dealers regarding Reg BI.

[5] A broker-dealer must understand the potential risks, rewards and costs associated with a recommendation and have a reasonable basis to believe the recommendation could be in the best interest of at least some retail customers.

[6] A broker-dealer must have a reasonable basis to believe the recommendation is in the best interest of a particular retail customer in light of that customer's investment profile and does not place the broker-dealer's interest ahead of the retail customer.

Form CRS Update – OCIE Risk Alert on Initial Examinations

Overview

On April 7, 2020, the Securities and Exchange Commission's (the "SEC" or the "Staff") Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert[1] to provide SEC-registered broker-dealers and investment advisers (collectively, "firms") with information about the scope and content of initial examinations related to Form CRS ("Form CRS" or the "Rule").[2] Firms should be aware that these initial examinations are likely to occur within the first year of the Rule's June 30, 2020 compliance date, which the SEC has not extended in light of the COVID-19 pandemic.[3] Broker-dealers should also be aware that the Financial Industry Regulatory Authority ("FINRA") has stated it will take the same approach as the SEC when conducting its initial examinations of broker-dealers for Form CRS compliance.[4]

Guidance on Examinations

According to the Risk Alert, initial examinations will focus on whether firms have made a good-faith effort to implement Form CRS. In carrying out this assessment, OCIE will likely focus on the following areas of the Rule: (i) delivery and filing; (ii) content; (iii) formatting; (iv) updates; and (v) recordkeeping, each of which is discussed in greater detail below.

Delivery and Filing

Regarding this area of the Rule, OCIE may review for the following: (i) whether a firm has filed Form CRS (including any amendments) using Web CRD or the IARD, as applicable, and whether Form CRS is displayed on a firm's public website; (ii) the process by which Form CRS has been delivered (e.g., electronic delivery or paper format); and (iii) whether a firm has sufficient written policies and procedures that address the required delivery process and dates. In particular, OCIE may review the dates Form CRS was provided to validate whether a firm complied with the following delivery obligations for new and existing retail investors.[5]

Existing Retail Investors. Form CRS must be delivered by July 30, 2020[6] and before or at the time of the following:

- the opening of a new account that is different from the retail investor's existing account (for investment advisers and broker-dealers);
- a recommendation of a rollover of assets from a retirement account into a new or existing account or investment (for investment advisers and broker-dealers); ora recommendation of a new brokerage or investment advisory service or investment outside of an existing account (e.g., variable annuities or a first-time purchase of a direct-sold mutual fund through a "check and application" process) (for investment advisers and broker-dealers).

New Retail Investors. Form CRS must be delivered before or at the earliest of the following:

- the entering of an investment advisory contract with a retail investor (for investment advisers);
- a recommendation to a retail investor of an account type, a securities recommendation or an investment strategy involving securities (for broker-dealers);
- the placing of an order for a retail investor (for broker-dealers); or
- the opening of a brokerage account for a retail investor (for broker-dealers).

Content

OCIE may review the content of Form CRS to assess whether (i) it includes all required information as set forth in

the Form CRS Instructions;[7] and (ii) it contains true and accurate information and does not omit any material facts. In particular, OCIE noted it may review for the following information:

- how the firm describes the relationships and services it offers, including statements on account monitoring and investment authority;
- how the firm describes its fees and costs, such as the principal fees and costs retail investors will incur and other fees and costs (e.g., custodian fees, account fees, fees related to mutual funds and variable annuities and other transactional or product-level fees); importantly, OCIE may request certain documents such as fee schedules, advisory agreements and brokerage agreements to cross-reference against a firm's Form CRS to ensure proper disclosure of these fees and charges;
- how the firm describes the manner in which its financial professionals are compensated (e.g., cash and noncash compensation and any conflicts of interest associated with such compensation); and
- whether the firm accurately discloses any legal or disciplinary history of the firm or its financial professionals.

Formatting

OCIE may review Form CRS to assess whether it includes particular wording where required, uses text features where required and is written in plain English.

Updates

OCIE may review a firm's written policies and procedures for updating Form CRS to assess:

(i) how and whether a firm updates and files its Form CRS within 30 days after any information becomes materially inaccurate; (ii) how and whether a firm communicates these changes to retail investors within 60 days of the updates; and (iii) the firm's process for highlighting to retail investors the most recent changes and including an exhibit highlighting or summarizing material changes with any filed updates.

Recordkeeping

OCIE may assess the firm's records related to delivery of Form CRS and the policies and procedures regarding

record-making and recordkeeping to assess how the firm complies with the Rule's delivery and recordkeeping obligations.

Conclusion

Importantly, OCIE's Risk Alert also urged firms to engage with the Staff if there is an inability to comply with Form CRS by June 30, 2020 due to the effects of COVID-19. Chairman Clayton previously noted his expectation that the Staff would take such difficulties into account during SEC examinations and enforcement action.

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[1] See https://www.sec.gov/files/Risk%20Alert%20-%20Form%20CRS%20Exams.pdf

[2] Form CRS requires firms to deliver to retail investors a client relationship summary ("relationship summary") that provides specific information about the firm. Firms must also file their initial relationship summary, along with any amendments, with the SEC using Web CRD (in the case of a broker-dealer) or the IARD (in the case of an investment adviser). Firms must also post a current version of their relationship summary on their public website if they have one.

[3] On April 2, 2020, SEC Chairman Jay Clayton released a public statement noting the June 30, 2020 compliance date would not be extended in light of the COVID-19 pandemic (https://www.sec.gov/news/public-statement/statement-clayton-investors-rbi-form-crs).

[4] See https://www.finra.org/media-center/newsreleases/2020/finra-statement-secs-ocie-risk-alerts-reg-bi-and-form-crs

[5] Exchange Act Rule 17a-3(a)(24) and Advisers Act Rule 204-2(a)(14)(i) both require a registered broker-dealer or investment adviser to record the date Form CRS was provided to each retail investor.

[6] Broker-dealers and investment advisers are required to deliver Form CRS to existing customers and clients within 30 days after the date the firm must file the relationship summary with the SEC. Thirty days after the June 30, 2020 compliance date is July 30, 2020.

[7] See https://www.sec.gov/rules/final/2019/34-86032-appendix-b.pdf.

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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.