Investment Services Regulatory Update

April 2021

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

NEW RULES

Compliance Date Set for SEC's New Adviser Marketing Rule

On March 5, 2021, the SEC's new "Marketing Rule," which overhauls the Investment Advisers Act's existing Advertising Rule and Cash Solicitation Rule, was published in the Federal Register. The Marketing Rule becomes effective on May 4, 2021. Following an 18-month transition period, the compliance date will be November 4, 2022.

The new Marketing Rule represents a significant change to investment adviser practices with respect to advertising, cash solicitation and recordkeeping. Investment advisers will need to adopt new policies and procedures to comply with the Marketing Rule. Attorneys in Vedder Price's Investment Services Group have prepared a detailed summary of the Marketing Rule, which is available here.

Vedder Price recently hosted a webinar panel discussion about the new Marketing Rule, which featured Joseph M. Mannon and Robert M. Crea of Vedder Price, as well as Julie Dixon, Founder and CEO of Titan Regulation, as panelists. A full recording of the webinar, entitled *Impacts of the SEC's Updates to the Advertising and Cash Solicitation Rules*, is available here.

GUIDANCE AND ALERTS

SEC's Division of Examinations Issues 2021 Examination Priorities

On March 3, 2021, the SEC's Division of Examinations (formerly the Office of Compliance Inspections and Examinations (OCIE)) issued its examination priorities for 2021. In addition to broadly reiterating its continued focus on advisers' fiduciary duties to their clients, the protection of retail investors and compliance with Regulation Best Interest and Form CRS; knowledgeable and empowered CCOs; conflicts of interest; environmental, social and governance (ESG) matters; and technology and cybersecurity in general, the Division also identified examination priorities that will be of particular interest to managers of both private and registered funds.

- **Cybersecurity Matters Related to COVID-19.** Cybersecurity matters will continue to be a focus, especially those that may be exacerbated by remote work arrangements caused by the COVID-19 pandemic, including with respect to data protection, oversight of vendors, phishing, mobile and remote application access, books and record maintenance, and business continuity and disaster recovery plans.

- **Financial Technology (FinTech) and Innovation.** The Division will focus on whether firms are operating consistently with their representations, handling customer orders in accordance with instructions received and complying with applicable requirements in connection with trade recommendations made in mobile applications. The Division also will focus on how advisers to private and registered funds utilize "alternative data," or data gleaned from non-traditional sources, including whether an adviser has appropriate controls around the creation and use of that data.

- **Digital Assets.** Digital assets and blockchain technology will be scrutinized by the Division, including whether those assets are in the best interest of investors, as will the trading, custody and valuation of those assets.

- **Anti-Money Laundering.** The Division will continue to prioritize compliance with AML obligations of registered broker-dealers and investment companies, including customer identification programs and their Suspicious Activity Report (SAR) filing obligations.

- **Compliance Programs.** The effectiveness of advisers' compliance policies continues to be a focus of the Division, including whether those policies are reasonably tailored to the advisers' business, if sufficient resources are devoted to compliance and other priorities identified in its risk alert issued November 19, 2020 (as summarized here).

- **LIBOR Transition.** The Division will continue to assess firms' understanding of exposure to LIBOR and their preparation for its discontinuation and the transition to an alternative reference rate.
- **Dually Registered Advisers.** The Division will continue to prioritize examinations of advisers that are dually registered as or affiliated with broker-dealers, including whether the conflicts of interest associated with this arrangement are adequately disclosed.
- **Examination of Registered Funds.** The Division will prioritize examinations of mutual funds or ETFs that have not been previously examined, focusing on their compliance programs, financial condition and compliance with exemptive relief, particularly with respect to non-transparent actively-managed ETFs.
- **Private Fund Advisers Concentrated in Structured Products.** In addition to familiar priorities with respect to private fund advisers, including conflicts of interest, valuation and the effect on fee calculations, cross-trades, principal investments and distressed sales, the Division also will focus on advisers to private funds with a high concentration in structured products, such as collateralized loan obligations or mortgage-backed securities.

The Division of Examinations' 2021 examination priorities are available here.

SEC Staff No-Action Letter Permits Funds to Self-Custody Certain Loan Interests

On January 29, 2021, the staff of the SEC's Division of Investment Management issued no-action relief permitting a registered fund to self-custody its loan interests consistent, but not in strict compliance, with Section 17(f) of and Rule 17f-2 under the Investment Company Act of 1940 subject to certain requirements.

Generally, Section 17(f) and Rule 17f-2 govern the conditions and procedures under which registered funds may maintain custody of their own investments. Particularly, Rule 17f-2(b) requires that documents evidencing a fund's investments "shall be deposited in the safekeeping of, or in a vault or other depository maintained by, a bank or other company whose functions and physical facilities are supervised by Federal or State authority." Additionally, Rule 17f-2(d) imposes restrictions on which persons may have access to a fund's investments, and Rule 17f-2(e) requires that each person withdrawing or depositing a fund's investments sign a notation confirming the transaction. In lieu of strictly complying with the foregoing requirements, the staff determined that it would not recommend enforcement action if a fund were to maintain custody of its own interests in corporate loans if the following conditions are met:

- The fund permits only a limited number of personnel to provide instructions to the fund's custodian and the administrative agents for the loans;
- The fund requires passwords or other security procedures to ensure only properly authorized personnel can submit those instructions;
- The fund reconciles settled loan interests with the records of the applicable administrative agents on a regular basis;
- Loan interests are titled or recorded at the administrative agents in the name of the fund and not in the name of the fund's investment adviser;
- The fund and its investment adviser are not affiliated with the administrative agents; and
- The fund adopts policies and procedures reasonably designed to prevent violations of provisions of the conditions set forth above.

In reaching this conclusion, the SEC staff recognized that the conditions set forth above are consistent with the protections that Section 17(f) and Rule 17f-2 were intended to provide. Particularly, the staff recognized that when Rule 17f-2 was adopted, nearly all loan interests were issued in certificated form, whereas now most loan interests are uncertificated and may not be held physically, rendering the physical safekeeping requirement under Rule 17f-2(b) largely inapplicable and burdensome.

Lastly, the SEC staff stated that it would not recommend enforcement action against a fund that does not comply with the requirement under Rule 17f-2(f) that a fund be subject to at least three annual examinations by an independent public accountant. The staff conditioned this relief on a representation that the fund be subject to one annual audit, conducted in accordance with applicable requirements, during which an independent public accountant confirms the fund's loan interests and reconciles them to the fund's account records.

The SEC staff's no-action letter is available here.

OTHER DEVELOPMENTS

SEC Staff Seeks Industry Feedback on Cross Trade Practices

On March 11, 2021, the staff of the SEC's Division of Investment Management issued a statement soliciting industry feedback on the regulatory regime governing registered fund cross trading following the adoption of the new valuation rule in December 2020. Fund cross trades must be effected in accordance with Rule 17a-7 under the Investment Company Act. Absent further SEC staff guidance or SEC action, however, Rule 17a-7 may no longer be available for cross trades in fixed income securities beginning in September 2022, as a result of the new valuation rule's definition of "readily available market quotations."

Background

Funds engaging in cross trades with certain of their affiliates must do so in accordance with the conditions of Rule 17a-7. These conditions include, among others, that the trade be effected for "no consideration other than cash payment against prompt delivery of a security for which *market quotations are readily available.*"

Within new Rule 2a-5 under the Investment Company Act—the Valuation Rule—the SEC adopted a formal definition for the term "readily available market quotations." The adopting release for the Valuation Rule makes clear that the new definition of readily available market quotations applies to all portions of the Investment Company Act and the rules thereunder, including with respect to cross trades under Rule 17a-7. (For more information on the new Valuation Rule, please see our alert here.)

Readily Available Market Quotations

Under the Valuation Rule, a market quotation is readily available only when that "quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable." This language is consistent with how Level 1 securities are valued under U.S. GAAP. Importantly, the adopting release for the Valuation Rule states that evaluated prices, indications of interest and accommodation quotes would not be readily available market quotations for purposes of the Valuation Rule because they are not based upon unadjusted quoted prices from active markets for identical investments. The unadjusted quote requirement would essentially prohibit any fixed income cross trades as such instruments are not exchange traded.

Industry Input

Noting that cross trading practices have evolved over the past several decades, and that the staff has gained considerable experience with the operation of Rule 17a-7, including through a number of enforcement actions brought by the SEC, the staff's statement solicits industry feedback to help determine what, if any, recommendations the staff might make to the SEC in this area. Specific topics and questions that the staff expects to consider in formulating any recommendations to the SEC—and as to which industry engagement is welcome—include the following:

- **Current cross trading practices.** Under what circumstances do funds currently engage in cross trading? To what extent do funds' current cross trades not have readily available market quotations as defined in the Valuation Rule? What amount of cross trading occurs between two funds as compared to cross trading between a registered fund and another type of affiliate? What types of securities do funds currently cross trade? What types of securities do advisers believe they could cross trade under current Rule 17a-7, but choose not to rely on the Rule and instead to trade in the market? What types of securities would advisers like to cross trade but believe they cannot do so under the current Rule 17a-7?
- **Securities eligible to cross trade.** What are the advantages and disadvantages of the threshold requirement in Rule 17a-7 that a security have a "readily available market quotation"? What sources of independent current market prices are used to cross trade securities under Rule 17a-7? What are the liquidity characteristics of securities that funds currently cross trade? Are cross traded securities valued in the same manner under Rule 17a-7 as they are under Section 2(a)(41) of the 1940 Act? What other criteria for the transactions would protect against conflicts of interest or other risks of cross trades?
- **Controls.** What kinds of controls do advisers have in place to govern cross trading? What controls do advisers have in place to assess whether a cross trade is consistent with the adviser's fiduciary obligation to its clients and is in the best interest of both the buying and selling fund? What controls do funds have in place to assess whether a cross trade is consistent with the investment policy of both the buying fund and the selling fund?
- **Market transparency.** How does cross trading affect market transparency? How might transparency be enhanced for all market participants? To what extent might cross trades affect market efficiency because they are not publicly reported?

Appendix A to the staff's statement outlines additional general topics of interest to the staff. The statement and appendix are available here.

Takeaways

Once the Valuation Rule becomes effective in 2022, the application of the Rule's definition of readily available market quotations to cross trades under Rule 17a-7 represents a significant collateral consequence for asset managers accustomed to effecting cross trades for their funds. This outcome suggests that the SEC believes that the risks associated with cross trades, such as from conflicts of interest, outweigh the benefits. If that is the case, the SEC may not fully appreciate the significant benefits to registered funds from avoiding commissions and mark-ups involved with trading in the market. Moreover, unlike exchange-traded securities, which have enjoyed significant compression of commissions, fixed income securities have not.

Given the significant potential impacts for fixed-income funds, in particular, from a *de facto* prohibition on cross trades, industry participants are encouraged to respond to the SEC staff. For instance, industry participants may wish to share with the SEC staff information on the significant savings of cross trades for their funds. Although the staff requested feedback within 30 days after publication of the statement, the staff is still accepting feedback and we encourage concerned industry participants to respond.

If you are considering submitting feedback to the SEC staff and want assistance or simply want more detailed information concerning the contents of this alert, please contact Joe Mannon (jmannon@vedderprice.com), Kelly Pendergast Carr (kcarr@vedderprice.com) or a member of your Vedder Price team.

SEC Issues Statement and Request for Comment on Custody of Digital Assets by Special Purpose Broker-Dealers

An SEC statement and request for comment regarding the custody of digital asset securities by special purpose broker-dealers was published in the Federal Register on February 26, 2021. The reasons behind the statement and request were two-fold: first, to establish a five-year comment period to gain insight into the standards and practices of custodying digital asset securities before any future rulemaking; and second, to issue a statement detailing how broker-dealers can comply with Rule 15c3-3, the Customer Protection Rule, should they choose to custody digital asset securities during this period.

The SEC noted that broker-dealers who choose to custody digital asset securities will be subject to examination by FINRA and SEC staff. Further, any such broker-dealers will not be subject to an enforcement action and will be deemed to comply with the Customer Protection Rule if they take the following actions with respect to custodying a digital asset security:

- The broker-dealer must have access to the digital asset security and the capability to transfer it to the associated distributed ledger technology;
- The broker-dealer must limit its business dealings exclusively to digital asset securities;
- The broker-dealer must establish written policies and procedures reasonably designed to (1) conduct and document an analysis of whether a particular digital asset is a "security"; (2) evaluate a digital asset security's characteristics, ledger technology and associated network before undertaking custody; (3) demonstrate that it has exclusive control over the digital asset securities it holds in custody; and (4) identify the steps it will take in the wake of certain events that could affect the firm's custody (e.g., blockchain malfunctions, "51%" attacks and hard forks);
- The broker-dealer may not undertake custody of a digital asset security if the firm is aware of any material security or operational problems or weaknesses with the distributed ledger technology and associated network used to access and transfer the digital asset security;
- The broker-dealer must provide certain written disclosures to its customers regarding its compliance with the Customer Protection Rule and the risks of investing in or holding digital asset securities; and
- The broker-dealer must enter into written agreements with its customers that set forth the terms and conditions of receiving, purchasing, holding, safekeeping, selling, transferring, exchanging, custodying, liquidating and otherwise transacting in digital asset securities.

The statement and request for comment is available here.

SEC Position Allows Insurance Companies to Rely on Prior Mutual Fund Substitution Orders

On February 23, 2021, the SEC issued a statement taking the position that the substitution by an insurance company of mutual funds used as investment options for variable life insurance policies or variable annuity contracts will not provide a basis for an enforcement action if the insurance company does not obtain a substitution order, so long as the terms and conditions of the proposed substitution are substantially similar to those approved by a prior substitution order obtained by the company since January 1, 2004.

Prior to the SEC's statement, an insurance company was required to receive a substitution order under Section 26(c) of the Investment Company Act before substituting shares of mutual funds offered as investment options with the company's variable insurance products, regardless of whether such insurance company had received a similar substitution order in the past.

An insurance company intending to rely on the SEC's position must disclose the substitution in a prospectus supplement filed with the SEC and submit correspondence accompanying the filing that:

- indicates that the substitution is of the type discussed in the statement;
- identifies the prior order with terms and conditions similar to those in the substitution;
- confirms that the substitution is consistent with the terms and conditions of the identified prior order; and
- explains why each existing fund and corresponding replacement fund are substantially similar, including a comparison of the investment objectives, strategies and risks of each existing fund and its corresponding replacement fund.

If an insurance company has not obtained a substitution order since January 1, 2004, the insurance company will need to apply for one. An insurance company that has received a substitution order since January 1, 2004 is not required to rely on the SEC's position and may continue to apply for a new order.

The statement is available here.

SEC Requests Comment on Potential Money Market Fund Reform Options

On February 4, 2021, the SEC published a request for public comment on potential reform measures to improve the resilience of money market funds, including reforms highlighted in the December 22, 2020 report of the President's Working Group on Financial Markets (the Report). The Report observed that, despite prior reforms in 2010 and 2014 intended to make money market funds more resilient to credit and liquidity stresses, money market funds experienced, and began to contribute to, general stress in short-term funding markets in March 2020 amid economic concerns related to the onset of the COVID-19 pandemic. The Report concluded that more work is needed to reduce the risk that structural vulnerabilities in prime and tax-exempt money market funds will lead to or exacerbate stresses in short-term funding markets. The Report discussed the following potential reform measures to improve the resilience of prime and tax-exempt money market funds and broader short-term funding markets, but did not endorse any specific measure:

- Removing the tie between money market fund liquidity and fee and gate thresholds;
- Reforming rules regarding redemption gates;
- Instituting a "minimum balance at risk" to internalize the liquidity costs of investors' redemptions, thereby reducing the first-mover advantage for redeeming investors;
- Changing the liquidity management requirements, such as by creating new liquidity tiers;
- Creating countercyclical weekly liquid asset requirements;
- Requiring floating NAVs for all prime and tax-exempt money market funds;
- Requiring swing pricing;
- Requiring capital buffers;
- Creating and requiring membership in a "Liquidity Exchange Bank"; and
- Requiring explicit fund sponsor support.

The SEC is requesting public comment on the Report, including the effectiveness of the previously-enacted money market fund reforms and of implementing the potential reform measures described in the Report.

The SEC's request for comment is available here.

Important Developments in LIBOR Transition

LIBOR Cessation Dates Announced

Financial markets and market participants, including asset managers, among others, now have greater clarity on the timeline for transitioning away from LIBOR, the critically important and globally used benchmark and reference rate. On March 5, 2021, ICE Benchmark Administration (IBA), which administers LIBOR, announced that it will permanently cease to publish LIBOR beginning on January 1, 2022 for most LIBOR settings. Publication of the overnight and 12-month US dollar LIBOR settings will cease beginning on July 1, 2023. The UK's Financial Conduct Authority, IBA's regulator, promptly confirmed the IBA's statement in its own announcement on the same date. The FCA also indicated that it will consult with the IBA regarding the continued publication of certain "synthetic" LIBOR settings intended primarily to allow LIBOR transactions in affected currencies to mature. The FCA announcement made clear that these LIBOR settings "will no longer be representative of the underlying market and economic reality" after the cessation dates announced by the IBA.

The IBA's statement is available here. The FCA's statement is available here.

New York State Legislature Passes LIBOR Legislation

On March 24, 2021, the State of New York approved legislation that will be crucial in minimizing legal uncertainty and adverse economic impacts associated with the LIBOR transition, providing greater certainty to market participants as the financial system continues its move away from LIBOR. Many financial instruments referencing LIBOR do not envision a permanent or indefinite cessation of LIBOR. Certain "tough legacy" instruments either do not have fallback terms and conditions that adequately address a permanent LIBOR cessation, or have terms and conditions that could dramatically alter the economics of contract terms if LIBOR is permanently discontinued. Although existing contracts may be amended, such an amendment process might be challenging, if not impossible, for certain products. Senate Bill 297B/Assembly Bill 164B addresses those legacy contracts that mature after the mid-2023 cessation date of LIBOR that lack effective fallbacks. Because New York law governs many of the financial products and agreements referencing LIBOR, the new legislation will provide legal clarity for these instruments, and will reduce the burden on New York courts, as legal uncertainty surrounding the transition likely would have prompted disputes.

ESG in Focus

Recent Announcements by the SEC and DOL Highlight Emphasis on ESG Investing

Recognizing increased investor focus on environmental, social and governance (ESG) investing and reliance on ESG-related disclosure, the SEC has taken multiple steps recently that demonstrate a clear emphasis on climate and ESG-related investing. In addition, the Department of Labor (DOL) announced a non-enforcement policy relating to its recently finalized rules for investment duties and proxy voting for ESG investments.

SEC Announces New "Climate and ESG Task Force"

On March 4, 2021, the SEC announced the creation of a new "Climate and ESG Task Force" within the Division of Enforcement. The SEC stated that the task force will develop initiatives to proactively identify ESG-related misconduct, including through the use of sophisticated data analysis to mine and assess information to identify potential violations. The task force's initial focus will be to identify material gaps or misstatements in issuers' disclosure of climate risks under existing rules and to analyze disclosure and compliance issues relating to ESG strategies. In addition, the task force will evaluate and pursue tips, referrals and whistleblower complaints on ESG-related issues and provide expertise and insight to other SEC teams working on ESG-related matters.

The press release announcing the new task force is available here.

SEC Publishes Investor Bulletin and Launches Web Page on ESG Investing

On February 26, 2021, the SEC's Office of Investor Education and Advocacy published an investor bulletin highlighting potential considerations for investors considering purchasing an ESG fund. The bulletin is intended to educate investors about ESG funds, and to provide questions that investors should consider when deciding whether to invest in ESG funds. Additionally, the SEC recently launched a web page designed to create a central repository of the SEC's ESG-related efforts and the latest information about climate and ESG investing.

The investor bulletin is available here.

The web page is available here.

Department of Labor Announces Non-Enforcement Policy for ESG and Proxy Voting Rules

On March 10, 2021, the DOL released an enforcement policy statement indicating that the DOL will not enforce its recently published rules relating to investment duties and proxy voting for ESG investments. These rules were finalized in the final months of the prior administration and sought to constrain the ability of ERISA plan fiduciaries to select ESG funds for retirement plans by generally requiring fiduciaries to consider only "pecuniary factors" when selecting investment options. The DOL stated that, until further notice, it will not pursue enforcement actions against any plan fiduciary based on a failure to comply with the provisions of these rules. The DOL noted that it intends to revisit the rules but did not provide any guidance on how or when such rules may be revised or rescinded.

The policy statement is available here.

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Vedder Price's Investment Services Group has received a 2020 Go-To Thought Leadership Award from the National Law Review in recognition of the Group's regular securities law thought leadership contributions and outstanding analysis of issues affecting the asset management industry.

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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.