Investment Services Regulatory Update

June 2021

Monthly Version

VedderPrice

New Rules, Proposed Rules, Guidance and Alerts

OTHER DEVELOPMENTS

Regulatory Agenda Highlights Potential SEC Rulemaking Topics

On June 11, 2021, the Office of Information and Regulatory Affairs—part of the Office of Management and Budget, within the Executive Office of the President—released the Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions, reporting on potential rulemaking topics that administrative agencies, including the SEC, will consider in the short and long term, including several areas of interest to funds, advisers and other fund service providers.

- **Short-Term Agenda.** The SEC's short-term agenda—i.e., topics designated in the "Final", "Proposed" or "Pre-Rule" stage—includes potential new rulemaking or amendments concerning:
  - modernized mutual fund shareholder reports and other fund disclosures;
  - requirements for funds and advisers related to environmental, social and governance (ESG) factors, including ESG claims and related disclosures;
  - Rule 17a-7 for cross-trades between a fund and its affiliates;
  - mutual fund liquidity and dilution management;
  - money market funds;
  - Form PF for private fund reporting; and
  - the investment adviser custody rule.

Notably, the agenda also indicates that the Division of Investment Management is considering recommending that the SEC seek public comment on the role of certain third-party service providers, such as index providers and model providers, and the implications for the asset management industry—a topic categorized in the "Pre-Rule Stage."

- **Long-Term Agenda.** Several topics of interest to the asset management industry are categorized in the "Long-Term Actions" stage of potential rulemaking, including:
  - stress testing requirements for large asset managers and funds;
  - fund securities lending arrangements;
  - amendments to the rules concerning custody under the Investment Company Act;
  - amendments to Rule 35d-1, the fund names rule; and
  - form and rule amendments to address the fund proxy system.

The SEC's rulemaking list is available here.

SEC Approves the First Security-Based Swap Data Repository and Sets the Compliance Date for Regulation SBSR

On May 7, 2021, the SEC announced its approval of DTCC Data Repository (U.S.), LLC (DDR) as the first security-based swap data repository (SDR)—meaning that the security-based swap market now has a centralized database to facilitate reporting and regulatory surveillance of transactions in security-based swaps (i.e., credit default swaps and other equity derivatives). DDR will operate as a registered SDR for security-based swap transactions in the equity, credit and interest rate derivatives asset classes.

The announcement also set November 8, 2021 as the first compliance date for Regulation SBSR, which regulates reporting and public dissemination of security-based swap transactions. Under Regulation SBSR, security-based swaps entered into or guaranteed by security-based swap dealers, major security-based swap participants or U.S. persons, as well as security-based swaps accepted for clearing by U.S. clearing agencies, must be reported to a registered SDR. Subject to certain exclusions and exceptions, the SDR must, in turn, publicly disseminate such information. The regulation stipulates that the first SDR can accept transaction reports in a particular asset class six months after the registration date. Regulation SBSR was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act to provide transparency to the security-based swaps market.

The SEC's order approving DDR's application for registration as a SDR is available here.

Litigation and Enforcement Matters

ENFORCEMENT MATTERS

SEC Settles Charges against Index Provider Related to Publication of Volatility-Related Index

On May 17, 2021, the SEC announced that it had settled charges against S&P Dow Jones Indices LLC for alleged violations of Section 17(a)(3) of the Securities Act of 1933 relating to the failure to disclose a feature of an index tracked by an exchange-traded note (ETN) that resulted in the publication of index values that did not accurately reflect the economic value of the ETN.

S&P Indices published the index in question, the S&P 500 VIX Short Term Futures Index ER, based on the price of certain volatility-based futures contracts, and entered into agreements to license the index to, among others, an issuer of an inverse ETN. S&P Indices designed the index with an "auto hold" feature such that if the index experienced a significant spike, the publication of new index values would be frozen and the prior index value would continue to be published until such time as the index value came back within those thresholds or personnel manually released the auto hold. The ETN also included a provision that would permit the issuer to accelerate redemption of the notes upon the breach of a key metric of volatility.

On February 5, 2018 the VIX experienced spikes that triggered the auto hold feature. As a result, during certain intervals between 4:00 p.m. and 5:08 p.m. Eastern Time, the published index value remained static and inaccurately reflected the economic value of the ETN. Had the correct index value been published, the issuer's right to accelerate redemption of the notes would have been exercisable. The continued publication of the stale index value created the impression that the issuer's redemption rights had not been triggered and resulted in investors purchasing ETNs at prices that were higher than the ETN's actual economic value.

The SEC charged S&P Indices with violating Section 17(a)(3) of the Securities Act, under which it is unlawful for any person in the offer or sale of securities to engage in any transaction, practice or course of business that operates or would operate as a fraud or deceit upon the purchaser. Although S&P Indices was not the issuer of the ETN, the SEC based its Section 17(a)(3) claim on the failure to publicly disclose the auto hold feature in light of a provision in the index licensing agreement that required S&P Indices' express sign-off on the description of the index in the issuer's informational materials, including prospectuses and pricing supplements.

Without admitting or denying the charges, S&P Indices agreed to cease and desist from future violations of Section 17(a)(3) and to pay a civil penalty of $9 million.

The settlement order is available here; the SEC's press release relating to the settlement is available here.

Following the issuance of the settlement order, SEC Commissioner Hester M. Peirce, who dissented from the order, issued a public statement describing her concerns with the charges brought against S&P Indices. Commissioner Peirce stated that, in her view, S&P Indices' conduct was outside the reach of Section 17(a)(3) and that the order could set a precedent resulting in an expansion of the federal securities laws such that "any person who knows another party will use her product or service to build a security could be charged under Section 17(a)(3) for omissions or misstatements about that product or service." She also noted that this enforcement action may evidence a broader concern about index providers, which have grown integral to the securities markets but which are not subject to a specific regulatory regime. She stated that she would be open to exploring the need for such regulation but that she believed an enforcement action was not a substitute for establishing an appropriate regulatory framework.

Commissioner Peirce's public statement is available here.

Legislative Developments and Executive Orders

President Biden Issues Executive Order Amending Prohibition on Securities Investments related to Chinese Military Companies

On June 3, 2021, President Biden issued Executive Order 14032, Addressing the Threat From Securities Investments That Finance Certain Companies of the People's Republic of China. Executive Order 14032 generally prohibits U.S. persons from purchasing or selling securities of issuers identified as Communist Chinese Military-Industrial Companies (CCMC). It applies to investments in publicly traded securities of identified CCMCs and any publicly traded securities that are derivative of, or that provide investment exposure to, those securities. The Executive Order includes an annex that lists companies identified as prohibited CCMCs and tasks the Secretary of the Treasury, in consultation with the Secretaries of State and Defense, with the responsibility to identify future additions to the annex. The Executive Order will be effective at 12:01 a.m. Eastern Time on August 2, 2021, and U.S. persons will have until 12:01 a.m. Eastern Time on June 3, 2022 to divest themselves of securities of companies identified as CCMCs on the annex. Future additions to the annex will become effective 60 days following their identification, and U.S. persons will have 365 days from the date of identification to divest themselves of the securities of any such newly identified CCMCs.

Executive Order 14032 modifies a similar order issued by the previous administration (Executive Order 13959). The key differences between the two Executive Orders are as follows:

- The CCMCs identified in Executive Order 14032 differ from those identified in Executive Order 13959. U.S. persons will need to review current holdings against the new annex in order to ensure compliance with the new Executive Order.
- Under Executive Order 14032, the Department of Treasury is primarily responsible for identifying CCMCs to be added to the annex. Executive Order 13959 charged the Department of Defense with identifying CCMCs.
- Holding CCMC securities is no longer prohibited following the divestment period; however, purchases and sales of securities will be prohibited.
- Executive Order 14032 prohibits purchases and sales of "securities" as defined in the Securities Exchange Act of 1934. Executive Order 13959 was broader in scope and included instruments such as notes, drafts, bills of exchange or banker's acceptance with maturities at the time of issuance not exceeding nine months.

In connection with the issuance of Executive Order 14032, the Department of the Treasury's Office of Foreign Assets Control (OFAC) revised previously issued guidance related to Executive Order 13959. Under the new guidance, U.S. persons are not prohibited from providing investment advisory, investment management or similar services to a non-U.S. person, including a foreign entity or foreign fund, in connection with the non-U.S. person's purchase or sale of a CCMC security, provided that the underlying purchase or sale would not otherwise violate Executive Order 14032.

Executive Order 14032 is available here; Executive Order 13959 is available here.

The OFAC FAQs relating to the Executive Orders are available here.

Vedder Price's article discussing Executive Order 13959 and related guidance 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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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.