All times are Eastern.

WEDNESDAY, MARCH 3

10:00 a.m. - 6:00 p.m. Exhibit Hall Open

11:00 a.m. - 12:00 p.m. **Optional Session: Ethics for Advisers – Part 1**
This session is approved for one hour of IACCP® continuing education ethics credit.
An adviser's code of ethics reflects its fiduciary obligation to its clients. Discuss codes of ethics, and related policy issues and scenarios, and best practices for monitoring, testing, administering and enforcing these policies.

- Kevin Ehrlich, *Manager, U.S. Regulatory Affairs & CCO*, Western Asset Management Company
- Gretchen E. Lee, *Chief Compliance Officer*, Clifford Swan Investment Counselors
- Kurt Wachholz, *Executive Consultant and Director of Education*, National Regulatory Services
- Sara Crovitz, *Partner*, Stradley Ronon Stevens & Young, LLP, Moderator

12:05 - 12:15 p.m. **Welcome Remarks**

- Jon K. Hadfield, *Chief Compliance Officer*, Vanguard Global Advisers, LLC, Conference Chair
- Karen L. Barr, *President & CEO*, Investment Adviser Association

12:20 - 1:05 p.m. **GENERAL SESSION: Hot Topics from Inside the Beltway**
Hear about what's happening on Capitol Hill, the change in Administration, and noteworthy regulatory developments.

- Rana Wright, *Partner, Chief Administrative Officer and General Counsel*, Harris Associates, L.P.
- Langston Emerson, *Partner*, Mindset DC
- Neil Simon, *Vice President, Government Relations*, Investment Adviser Association
- Karen L. Barr, *President & CEO*, Investment Adviser Association, Moderator

1:05 - 1:30 p.m. *Break*

1:30 - 2:15 p.m.	**GENERAL SESSION: Investment Management: A Conversation with SEC Acting Division Director Sarah ten Siethoff**, *with Gail Bernstein, IAA General Counsel* *Followed by a Conversation with* **Dr. Alexander Schiller**, *Assistant Director of the Office of Asset Management*, SEC Division of Economic and Risk Analysis
2:20 - 2:50 p.m.	**Diversity, Equity, and Inclusion in the Investment Management Industry** Featuring a panel of IAA members sharing stories and suggestions for how we can all contribute to making the profession more diverse, equitable, and inclusive. Robert E. Burks, Jr., *Chief Compliance Officer*, Brown Capital Management, LLC Carlotta King, *General Counsel and Corporate Secretary*, Diamond Hill Capital Management, Inc. Hope L. Newsome, *Managing Partner*, Virtus LLP, Moderator
2:50 - 3:15 p.m.	*Break*
3:15 - 4:15 p.m.	**Concurrent Breakout Sessions**

Choose one of four sessions to attend. Video recordings of these breakout sessions will be available online to conference attendees shortly after the conference.

1. **Risk Management for Larger Firms**
   Hear how compliance and legal professionals at larger firms can learn the advisory business from portfolio managers, traders, and other operations colleagues. Learn tips for working with business managers – your first line of defense – and becoming better partners in strategic risk management. Discuss dealing with tension between different risk appetites. Consider circumstances that contribute to or mitigate CCOs' personal liability. Gain ideas for handling flat or shrinking compliance budgets in an era of extended market volatility and contracting revenues.
   - Jon K. Hadfield, Chief Compliance Officer, Vanguard Global Advisers, LLC
   - Rosa Licea-Mailloux, *Vice President, Director of Corporate Compliance*, MFS Investment Management
   - Melissa Schiffman, *Compliance Manager and Vice President*, J.P. Morgan Asset Management
   - Carlo di Florio, *Partner and Global Chief Services Officer*, ACA Compliance Group
   - Karen A. Aspinall, *Partner*, Practus, LLP, Moderator

2. **Risk Management for Smaller Firms**
   Hear how compliance and legal professionals at smaller firms can learn the advisory business from portfolio managers, traders, and other operations colleagues. Learn tips for working with business managers – your first line of defense – and becoming better partners in strategic risk management. Discuss dealing with tension between different risk appetites. Consider circumstances that contribute to or mitigate CCOs' personal liability. Gain ideas for handling flat or shrinking compliance budgets in an era of extended market volatility and contracting revenues.
   - Geoffrey Edelstein, *Co-Founder, Principal & Portfolio Manager*, Granite Investment Partners, LLC
   - Sarah Ronnenberg, *Compliance Director*, Horizon Investments, LLC

- Neshie Tiwari, *Chief Compliance Officer and Counsel*, Ellevest, Inc.
- Linda Paullin-Hebden, *Partner*, Warner Norcross & Judd LLP, Moderator

3. ERISA Updates

The Department of Labor has been very active in adopting rules and guidance that impact investment advisory firms, not without controversy. Topics will include the DOL's ESG and proxy voting rulemakings, the new fiduciary exemption, and other ERISA issues facing investment adviser fiduciaries.

- Kimberly H. Novotny, *Senior Associate General Counsel*, Franklin Templeton
- Kathy D. Ireland, *Consultant*, K.D. Ireland Consulting, LLC
- Bradford P. Campbell, *Partner*, Faegre Drinker Biddle & Reath LLP
- Sarah Buescher, *Associate General Counsel*, Investment Adviser Association, Moderator

4. International Developments

Explore hot topics on the international front, including Brexit implications, the EU's new ESG regulatory framework, the EU Shareholder Rights Directive, and EU delegation rules. Hear compliance strategies to help firms operating in multiple countries.

- Tracy Soehle, *Senior Vice President and Senior Counsel*, Affiliated Managers Group, Inc.
- Daniel Worthington, *Vice President, Legal Counsel*, T. Rowe Price
- Michelle Kirschner, *Partner*, Gibson, Dunn & Crutcher UK LLP, Moderator

4:20 - 5:00 **Virtual Happy Hour**

THURSDAY, MARCH 4

10:00 a.m. - 6:00 p.m. Exhibit Hall Open

11:00 a.m. - 12:00 p.m. **Optional Session: Ethics for Advisers – Part 2**

This session is approved for one hour of IACCP® continuing education ethics credit.

An adviser's code of ethics reflects its fiduciary obligation to its clients. This panel will discuss the protection of material nonpublic information (MNPI) and prevention of insider trading, whistleblower policy issues and scenarios, and best practices for monitoring, testing, administering and enforcing these policies.

- Eric C. ("Rick") Oppenheim, *General Counsel & Chief Compliance Officer*, Telemus Capital, LLC
- L. Allison Charley, *Senior Principal Consultant*, ACA Compliance Group
- Kurt Wachholz, *Executive Consultant and Director of Education*, National Regulatory Services
- Genna Garver, *Partner*, Troutman Pepper Hamilton Sanders LLP, Moderator

GENERAL SESSION: Conversations with the Division of Examinations Director and the Division of Enforcement's Asset Management Unit Co-Chiefs, *with Gail Bernstein, IAA General Counsel*

12:05 - 12:35 p.m.
12:35 - 1:05 p.m.

- Peter Driscoll, *Director*, SEC Division of Examinations
- Adam S. Aderton, *Co-Chief, Asset Management Unit*, SEC Division of Enforcement
- C. Dabney O'Riordan, *Co-Chief, Asset Management Unit*, SEC Division of Enforcement

1:05 - 1:30 p.m. *Break*

1:30 - 2:30 p.m **GENERAL SESSION: Tips and Trends to Help Advisers Prepare for SEC Examinations**

In addition to going over the SEC exam process and providing tips for preparing to be examined, the panel will help you understand exam trends in the COVID environment, common deficiencies, recent focus areas, and what to expect when examiners look at Form CRS and LIBOR issues.

- Anil Abraham, *Associate General Counsel, Managing Director – Legal*, Focus Financial Partners, LLC
- Kristin A. Snyder, *Deputy Director, Co-National Associate Director and Associate Regional Director*, SEC Division of Examinations
- Michelle L. Jacko, CSCP, *Managing Partner and CEO*, Jacko Law Group, PC, and *Founder and CEO*, Core Compliance & Legal Services, Inc.
- Mark Perlow, *Partner*, Dechert LLP, Moderator

2:30 - 2:45 p.m. *Break*

2:45 - 3:45 p.m. **Concurrent Breakout Sessions**

Choose one of four sessions to attend. Video recordings of these breakout sessions will be available online to conference attendees shortly after the conference.

1. **ESG Investing and Implementation**
   Environmental, Social, and Governance investing has become a significant area of focus for regulators, investment advisers, and their clients. Topics will include recent regulatory activity related to ESG investing and issues advisers need to consider in developing an ESG strategy, including how to define ESG, understanding how your firm collects and discloses ESG data, and oversight of compliance policies and procedures.
   - Anthony Eames, *Director, Responsible Investment Strategy*, Calvert Research and Management
   - Sean Murphy, *Vice President*, EIG Global Energy Partners
   - Bob Toner, *Chief Legal Counsel – Investment Management*, William Blair Investment Management, LLC
   - Gwendolyn A. Williamson, *Partner*, Perkins Coie, Moderator

2. **Adapting Technology to Improve Compliance Efficiency and Results**
   Adding efficiency to often manually intensive efforts can be a more efficient use of resources and bring better results, including enhancing the review of communications. Hear how firms have adapted their use of technology to compliance in remote working environments, as well as how firms may be addressing data sharing and aggregation for clients. Panelists will identify "CompliTech" and "RegTech" uses that support the administration of compliance programs, such as trading oversight and overall workflow improvements. Learn also about the SEC's new Strategic Hub for Innovation and Financial Technology (FinHub).
   - Alexander C. Gavis, *Senior Vice President and Deputy General Counsel*, Fidelity Investments
   - Jennifer B. McHugh, *Senior Special Counsel*, SEC Division of Investment Management Disclosure Review and Accounting Office, and Division of Investment Management Delegate to FinHub
   - Keith Marks, *Executive Director*, Compliance Solutions Strategies
   - Michael S. Didiuk, *Partner*, Perkins Coie LLP, Moderator

3. **Trading, Best Execution, and the Future of Soft Dollars**
   Investment advisers' trading practices are evolving. Examine the increasingly complex legal and compliance issues related to the duty to seek best execution, soft dollars and the provision of research, MiFID II, trade aggregation and allocation, and principal and cross trading. Explore hot topics including the move to zero commissions and disclosure practices.
   - Lori Renzulli, *Chief Compliance Officer & Chief Counsel*, Harding Loevner LP
   - Ari Burstein, *President*, Capital Markets Strategies
   - Steven W. Stone, *Partner*, Morgan, Lewis & Bockius LLP
   - Monique Botkin, *Associate General Counsel*, Investment Adviser Association, Moderator

4. **COVID-19 Impacts**
   In light of COVID-19's unprecedented disruptions to advisory businesses, explore compliance lessons learned. This panel will address BCP, HR, tax, privacy, supervision, recordkeeping of virtual meetings and communications, vendor due diligence, office reopening issues, and policies governing employees who will remain working remotely.
   - Lee Faria, *Chief Compliance Officer and Vice President*, Columbia Management Investment Advisers, LLC

- Christopher Hayes, *Principal and Chief Compliance Officer*, 1919 Investment Counsel, LLC
- Jennifer L. Klass, *Partner*, Baker McKenzie
- Laura Grossman, *Associate General Counsel*, Investment Adviser Association, Moderator

3:50 - 4:30 **Virtual Happy Hour**

FRIDAY, MARCH 5

10:00 a.m. - 6:00 p.m. Exhibit Hall Open

11:00 - 11:50 a.m. **Optional Session: Service Provider Solutions**

Choose one of four sessions to attend. Video recordings of these breakout sessions will be available online to conference attendees shortly after the conference.

1. GameStop, Reddit, What's Next? Oh My! *Sponsored by Bates Group*

The frenzy in GameStop and AMC Entertainment Holding stocks has caused firms to pause and regulators to scrutinize practices to protect investors. Should we expect more online forum fueled frenzies? How should compliance prepare and address for this new reality?

Join us as we walk through the GameStop frenzy:

- What happened exactly?
- What are the after effects?
- What are regulators saying?
- What should investment advisers do to prepare and protect their firm and clients going forward?
  - Linda Shirkey, *Managing Director, Bates Compliance*, Bates Group
  - Alex Russell, *Managing Director & Practice Leader, White Collar, Regulatory & Internal Investigations*, Bates Group
  - Robert E. Burks, Jr., *Chief Compliance Officer*, Brown Capital Management, LLC
  - A. Valerie Mirko, *Partner*, Baker McKenzie LLP

2. Investment Advisory Firm Insights *from Broadridge Fi360 Solutions*

Attendees will receive information on insights, observations and trends based on key findings from our Centre for Fiduciary Excellence (CEFEX®) assessment data report on investment advisory firms. CEFEX® conducts hundreds of independent, third-party assessments of investment advisory firms annually. Topics covered will include the following:

- Investment strategies
- Investment philosophy
- Target date funds
- 3(38) investment manager
- Data security
  - Michael Muirhead, *Senior Director, Learning & Development*, Fi360, A Broadridge Company

3. SEC Hot Topic: Compliance Tips for Evaluating Your Firm's Advisory Fees and Expenses *Sponsored by Core Compliance & Legal Services, Inc.*

Advisory Fees and Expenses continue to remain a top SEC examination focus area. In its 2018 *Risk Alert*, "The Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers," the SEC provided guidance on compliance advisory fee issues identified in examinations, which remain a concern today. In this session, we will review highlights from the *Risk Alert*, including disclosure considerations and exam observations. We will review what to expect in terms of examination questions and document requests. Using a case study, we will explore best practices and forensic testing methods that compliance should consider in evaluating your firm's advisory fees and expense practices. We will also provide key takeaways and risk management tips to consider for 2021.

By attending this session, you will learn about:

- The SEC's guidance on the most common compliance issues involving advisory fees and expenses;
- Common exam document requests;
- Best practices and tips to consider for evaluating your firm's advisory fees and expenses; and
- The latest SEC exam questions related to advisory fee structures.
    - Michelle L. Jacko, CSCP, *Managing Partner and CEO*, Jacko Law Group, PC, and *Founder and CEO*, Core Compliance & Legal Services, Inc.
    - Janice Powell, *Senior Compliance Consultant*, Core Compliance & Legal Services, Inc.

4. Exam Deficiencies for Private Fund Advisers *Sponsored by Foreside*

Private fund advisers face unique regulatory risks. In this session we'll discuss common issues and deficiencies that fund advisers experience during SEC exams and practice tips to avoid them. Specific topics discussed will include conflicts of interest, allocation of fees/expenses, compliance programs, valuation, and Form ADV and Form PF filings.

- Curtis Flippen, *Senior Director*, Foreside Financial Group, LLC
- Craig Moreshead, *Managing Director*, Foreside Financial Group, LLC

12:00 - 12:30 p.m. **GENERAL SESSION: Fireside Chat with SEC Commissioner**

- The Honorable Hester M. Peirce, *Commissioner*, Securities and Exchange Commission
- Karen L. Barr, *President & CEO*, Investment Adviser Association

12:35 - 1:35 p.m. **GENERAL SESSION: Cybersecurity and Data Privacy**

Keep apprised of the latest cybersecurity and data privacy updates. What are the takeaways from the Division of Examinations' ransomware and credential stuffing Risk Alerts? In addition to California, what key state law developments should advisers watch out for? What are the prospects for national privacy legislation? What are some approaches to complying with a myriad of data privacy laws?

- Keith E. Cassidy, *Associate Director, Technology Controls Program*, SEC Division of Examinations
- Tess Macapinlac, *Privacy Legal Associate*, OneTrust
- Tim Villano, CISA, CISM, CGEIT, CRISC, *Chief Information Officer*, Artemis Global Security, LLC
- Kirk Nahra, *Partner*, WilmerHale, Moderator

1:35 - 1:50 p.m. *Break*

1:50 - 2:50 p.m. **Concurrent Breakout Sessions**

Choose one of four sessions to attend. Video recordings of these breakout sessions will be available online to conference attendees shortly after the conference.

1. **Individual Clients: Retail and Senior Client Matters**
   Obtain guidance on appropriate policies, procedures, and training in the areas of retail and senior clients. Discuss how to handle difficult situations involving problematic clients. Understand changes to solicitation and finders rules.

- Julius Leiman-Carbia, *Chief Legal Officer & Chief Compliance Officer*, Wealthfront Inc.
- David Wong, *Chief Financial Officer & Chief Compliance Officer*, Private Wealth Partners, LLC
- Joelle A. Simms, *Principal*, Bressler, Amery & Ross, P.C.
- Mari-Anne Pisarri, *Partner*, Pickard Djinis and Pisarri LLP, Moderator

2. Private Equity Funds Update

Address key regulatory issues for private equity fund advisers, including the impact of the new Marketing Rule, allocation of fees and expenses, conflicts of interest and disclosure, valuation, ESG, changes to solicitation and finders rules, and other legal and compliance issues unique to private equity fund advisers. Discuss initiatives in the Private Funds Unit of the Division of Examinations.

- Letti de Little, *Chief Compliance Officer*, Grain Management, LLC
- Alexandria Stuart, *Vice President, Head of Compliance & Senior Counsel, Private Equity*, Vista Equity Partners
- Igor Rozenblit, *Co-Head, Private Funds Unit*, SEC Division of Examinations
- Alpa Patel, *Partner*, Kirkland & Ellis LLP, Moderator

3. Registered Funds: The Latest Developments

Discuss SEC regulations and guidance affecting advisers and sub-advisers of registered funds, including the new fair valuation rule, the derivatives rule, and disclosure practices.

- J. Christopher Jackson, *Sr. Vice President & General Counsel*, Calamos Investments LLC
- Naseem Nixon, *Vice President and Associate Counsel*, Capital Group
- Brian M. Johnson, *Assistant Director*, SEC Division of Investment Management
- Nathan Briggs, *Partner*, Ropes & Gray LLP, Moderator

4. The Third Line of Defense: The Intersection of the Audit and Compliance Functions

Understand internal audit practices and how auditors look at compliance functions. Discover how compliance can facilitate working with internal and external auditors. Discussion will include auditing during the pandemic, PCAOB priorities, SEC initiatives including the new fair valuation rule, and actions against accountants.

- Steve Perazzoli, *Partner*, PricewaterhouseCoopers LLP
- John E. ("Jack") Thomas, Jr., *Senior Vice President & Audit Director*, Asset Management Group, PNC
- Daniel Goelzer, *Member*, Sustainability Accounting Standards Board, and *Retired Partner*, Baker McKenzie
- Paul Glenn, *Special Counsel*, Investment Adviser Association, Moderator

2:50 - 3:05 p.m. *Break*

3:05 - 4:20 p.m. **GENERAL SESSION: The New Marketing Rule for Advisers**

Panelists will walk through the significant elements of the overhauled Advertising and Solicitation Rules, what those changes mean for advisers, and strategies for coming into compliance with new communication and recordkeeping requirements.

- Pamela F. Pendrell, *Chief Compliance Officer/Partner*, GlobeFlex Capital, L.P.
- Melissa Harke, *Senior Special Counsel*, SEC Division of Investment Management
- Michael McGrath, *Partner*, K&L Gates LLP

	• Sanjay Lamba, *Associate General Counsel*, Investment Adviser Association, Moderator
4:20 - 4:30 p.m.	Closing Remarks and Conference Adjournment

SPEAKER BIOGRAPHIES

ANIL ABRAHAM is Associate General Counsel, Managing Director – Legal at Focus Financial Partners, LLC. Mr. Abraham assists Focus and its partner firms with legal and regulatory matters, including new business and strategic initiatives. Mr. Abraham has over 12 years of experience as a senior attorney at the Securities and Exchange Commission, including serving as a direct counsel to two SEC chairmen, to two additional SEC commissioners, and in the Enforcement and Investment Management Divisions. Mr. Abraham also served as counsel to an acting chairman of the Commodity Futures Trading Commission and spent a year as a financial advisor with Raymond James & Associates. He began his career with the law firm of Sidley & Austin and as a law clerk to Judge Jerry E. Smith on the United States Court of Appeals for the Fifth Circuit. Mr. Abraham earned his J.D. from Yale Law School and his B.A. *summa cum laude* from Dartmouth College.

ADAM S. ADERTON is Co-Chief of the SEC Enforcement Division's Asset Management Unit, a national specialized unit that focuses on misconduct by investment advisers, investment companies, and private funds. Mr. Aderton joined the SEC as an Enforcement staff attorney in 2008 and became an Assistant Director in 2013. Before joining the SEC, Mr. Aderton served as a law clerk to Judge J. Frederick Motz of the U.S. District Court for the District of Maryland and worked in the securities litigation and enforcement practice at Wilmer Cutler Pickering Hale and Dorr LLP. Mr. Aderton received his undergraduate degree from Truman State University and his J.D. from the University of Virginia.

KAREN ASPINALL is a partner at Practus LLP. With over 20 years of in-house and AmLaw experience, Ms. Aspinall is an authority on regulatory compliance matters involving SEC, DOL, CFTC and NFA regulations. Prior to joining Practus, Ms. Aspinall served as Executive Vice President and Deputy General Counsel for PIMCO. She also served as Senior Vice President for Nuveen Investments and was an associate at both Morgan Lewis & Bockius and Dechert.

KAREN L. BARR is President & CEO of the Investment Adviser Association. Before assuming this role in 2014, she served as the IAA's General Counsel for 17 years, with responsibility for the wide range of legal and regulatory matters affecting the Association and its members. Prior to joining the IAA, Ms. Barr was in private practice at Wilmer, Cutler & Pickering (now WilmerHale), where she represented clients in securities regulatory matters. Ms. Barr received her B.A. from the University of Pennsylvania and her law degree from the University of Michigan Law School. She is a frequent speaker on investment adviser issues.

GAIL C. BERNSTEIN is General Counsel of the Investment Adviser Association. She joined the IAA from the law firm of WilmerHale in Washington, DC, where she had been a Special Counsel in the Securities Department from 2008 until June 2017. Prior to that, Ms. Bernstein was first an associate and then a partner at Wilmer, Cutler & Pickering (now WilmerHale) in Washington, DC. While in private practice, Ms. Bernstein counseled clients on all aspects of financial and securities regulation, with a specific focus on the Dodd-Frank Act and securities and derivatives law and compliance. Ms. Bernstein grew up in South Africa and earned her B.A.

from the Hebrew University of Jerusalem in 1982 and her law degree from Harvard Law School in 1988. After law school, Ms. Bernstein clerked for the Honorable Douglas P. Woodlock of the U.S. District Court for the District of Massachusetts and was an associate at the Boston law firm of Mintz Levin from 1989-1990, when she moved to Washington.

MONIQUE S. BOTKIN is Associate General Counsel of the Investment Adviser Association. Prior to joining the IAA in 2004, Ms. Botkin was an associate in the financial services groups at Dechert LLP in Newport Beach, CA and Alston & Bird LLP in Washington, DC. While in private practice, Ms. Botkin represented investment advisers, registered investment companies, private funds, and broker-dealers in corporate, securities and investment management matters. Ms. Botkin also served as an attorney in the SEC's Division of Investment Management disclosure review office from 2013 to 2014. She earned her B.A. in government and politics from the University of Maryland at College Park and her J.D., *cum laude,* from Southwestern University School of Law in Los Angeles, where she was an editor of the Law Review.

NATHAN BRIGGS is a partner in Ropes & Gray LLP's asset management group. Mr. Briggs's practice focuses on advising registered investment companies, their independent directors, and investment advisers. Mr. Briggs works on a variety of matters regarding the establishment, registration, reorganization, and operation of retail and institutional investment products, including providing advice with respect to governance, regulatory and compliance issues of all kinds affecting investment management industry clients. Prior to working at the firm, Mr. Briggs interned at the Investment Adviser Association where he assisted and worked with its members in a variety of lobbying and industry-related issues. Mr. Briggs holds a B.A. from Towson University, an M.A. in international economic relations from American University, a J.D., *magna cum laude*, from American University Washington College of Law, and has passed Level I of the Chartered Financial Analyst examination.

SARAH BUESCHER joined the Investment Adviser Association in 2017 as Associate General Counsel. She is responsible for ERISA and pension issues as well as core Investment Advisers Act issues. Before joining the IAA, Ms. Buescher served as a Branch Chief in the Investment Adviser Regulation Office in the SEC's Division of Investment Management. She also worked in the SEC's Office of the General Counsel and started her legal career in the SEC's Division of Investment Management. Between 1999 and 2009, Ms. Buescher worked at Vanguard, first in the Legal Department as Associate Counsel and Senior Counsel, and later as Manager of International Compliance in Vanguard's Compliance Department. She earned her B.S. in Communication Studies from Northwestern University and her J.D. from the University of Notre Dame Law School.

ROBERT E. BURKS, JR. joined Brown Capital Management in 2019 as Chief Compliance Officer. Prior to joining the firm, Mr. Burks was a Compliance Officer in the Global Compliance Examinations department at Legg Mason Asset Management in Baltimore, where he conducted mock regulatory exams of Legg Mason's Investment Adviser affiliates. Before that, Mr. Burks spent more than a decade with Merrill Lynch, starting out as a Financial Advisor and then taking on a series of increasingly senior branch office management roles. He last served as Vice President, Administrative Manager of branch offices in Cincinnati, OH. Mr. Burks received a B.S. in Industrial Management from the University of Cincinnati.

ARI BURSTEIN is President of Capital Markets Strategies, representing financial services firms, including investment advisers, hedge funds, private equity firms, broker-dealers, securities exchanges and trade associations before regulators and policymakers, in the U.S. and globally.

He is also the co-founder of the ETFs Global Markets Roundtable, a global conference series focusing on ETFs and their impact on trading, market structure and the capital markets in general. Prior to starting Capital Markets Strategies, Mr. Burstein was Head of US Regulatory Affairs for Kreab, a leading global consulting firm. He also was Senior Counsel for capital markets issues for the Investment Company Institute (ICI) and ICI Global, the global trade associations for the regulated fund industry. Prior to joining ICI, Mr. Burstein was an attorney in the U.S. Securities and Exchange Commission's Division of Investment Management from 1997 to 1998 and the Division of Market Regulation from 1992 to 1997.

BRADFORD CAMPBELL, partner at Faegre Drinker Biddle & Reath LLP, advises financial service providers and plan sponsors on ERISA Title I issues, including fiduciary conduct and prohibited transactions. A nationally-recognized figure in employer-sponsored retirement plans, Mr. Campbell is the former Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration. As ERISA's former "top cop" and primary federal regulator, he provides his clients with insight and knowledge across a broad range of ERISA-plan related issues. He also serves as an expert witness in ERISA litigation. Mr. Campbell has been listed as one of the 100 Most Influential Persons in Defined Contribution by *401kWire* and has been listed as one of the top 15 ERISA attorneys in the country by a poll of the National Association of Plan Advisors. He has testified before Congress on employee benefits issues 11 times, including testimony before four different Congressional Committees regarding the effects of the Department of Labor's fiduciary regulation.

KEITH E. CASSIDY is Associate Director, Technology Controls Program, in the SEC's Division of Examinations. Mr. Cassidy began his career at the SEC as an Attorney Advisor in the Office of Legislative and Intergovernmental Affairs in 2010 before being promoted to Deputy Director in 2011 and Director of the office in 2016. In addition to his position at the SEC, Mr. Cassidy is an Infantry Officer in the United States Marine Corps Reserve. He currently serves as Operations Liaison Officer for B Company, 4th Reconnaissance Battalion and has earned numerous awards. Mr. Cassidy previously worked as Chief of Staff and Counsel at the Department of Justice's Office of Legislative Affairs, and as a legislative assistant in the United States Senate. Mr. Cassidy received his J.D. from the George Washington University Law School and his LL.M. in Securities and Financial Regulation from Georgetown Law Center, with distinction. He received his B.A. from the University of Virginia.

L. ALLISON CHARLEY joined ACA in July 2018 as a Senior Principal Consultant. In that role, Ms. Charley provides comprehensive compliance consulting services and conducts mock SEC examinations of investment advisers and investment companies. Prior to ACA, Ms. Charley worked in the U.S. Securities and Exchange Commission's Division of Investment Management in Washington, DC, as a securities compliance examiner and acting branch chief. Before the SEC, Ms. Charley was the enterprise chief compliance officer for MIP Global. Prior to that, she served as a senior compliance consultant with Financial Industry Technical Services (FITS). Before FITS, Ms. Charley was the chief compliance officer for Rydex Investments. Prior to Rydex, she held senior compliance roles at other firms in the Washington, DC area. Ms. Charley earned her Bachelor of Arts degree in Psychology from Hollins University.

SARA CROVITZ is a partner with Stradley Ronon where she provides counsel on all aspects of investment company and investment adviser regulation. Prior to joining the firm, Ms. Crovitz was Deputy Chief Counsel and Associate Director of the U.S. Securities and Exchange Commission's Division of Investment Management, and worked at the SEC for 21 years, including 17 years in the Division of Investment Management. While in the Division, Ms.

Crovitz supervised the provision of significant legal guidance to the investment management industry through no-action and interpretive letters, exemptive applications, IM guidance updates and other written and oral means. She received her B.A. from the University of Chicago and her J.D. from the University of Chicago Law School.

LETTI DE LITTLE is the Chief Compliance Officer for Grain Management, LLC, a private equity manager focused on the telecommunications sector and headquartered in Washington, DC. Prior to Grain, Ms. de Little was the Chief Compliance officer for Cartica Management, LLC. She has also served as Corporate Counsel at Charles Schwab & Co. Inc. where she covered alternative investments and private placements and capital markets matters and as Corporate Counsel and Compliance Associate at Partner Fund Management, LP. She graduated from the University of Virginia, received her J.D. from Tulane Law School and is a member of the New York State Bar.

CARLO DI FLORIO is the Global Chief Services Officer of ACA Compliance Group. At ACA, Mr. di Florio is responsible for defining and executing the vision for ACA's governance, risk, and compliance ("GRC") service offerings. His responsibilities include oversight, management, and strategic growth of ACA's global regulatory compliance, cybersecurity and risk, AML and financial crimes, and performance practices. Prior to joining ACA, Mr. di Florio worked for over 25 years in executive leadership roles at PricewaterhouseCoopers (PwC), where he was a Partner in the Financial Services Risk & Regulatory Practice; the Securities and Exchange Commission (SEC), where he was the Director of the Office of Compliance Inspections and Examinations (OCIE); and the Financial Industry Regulatory Authority (FINRA), where he was the Chief Risk & Strategy Officer. In these roles, Mr. di Florio led the design and implementation of large-scale regulatory compliance improvements, technology and data analytics transformations, and risk management program enhancements. Mr. di Florio also serves as Co-President and Governor of the Risk Management Association (RMA) NY Chapter and as Adjunct Professor at Columbia University, Master of Science program in Enterprise Risk Management. Mr. di Florio has been named one of the 100 Most Influential Leaders in Corporate Governance by the Association of Corporate Directors; one of the Top Trailblazers & Pioneers in Governance, Risk & Compliance by The National Law Journal; and one of the Most Influential People in Finance by Worth Magazine.

MICHAEL S. DIDIUK is a Partner in Perkins Coie's Investment Management practice. With over 18 years of experience at the U.S. Securities and Exchange Commission and in private practice, Mr. Didiuk represents asset managers on all aspects of the federal securities laws, with a particular in-depth knowledge on the Investment Advisers Act of 1940 and the Investment Company Act of 1940. Mr. Didiuk is also a core member of the firm's Blockchain industry group and helps startups, including fintech, blockchain, and cryptocurrency clients, navigate the federal securities laws and complex regulatory issues raised by fintech companies and blockchain technology in connection with the emergence of digital asset sales and digital securities. Prior to joining Perkins Coie, Mr. Didiuk worked in various roles at the SEC, including as senior counsel in the Office of Chief Counsel for the Division of Investment Management and as investment management counsel to two SEC commissioners at the SEC's headquarters in Washington, DC. Most recently, Mr. Didiuk worked in the Office of Compliance Inspections and Examinations in the SEC's San Francisco office, where he led examinations of registered investment advisers, robo-advisers, exempt reporting advisers, hedge funds, crypto asset funds, private equity funds, and venture capital funds. As a member of the SEC's fintech working groups, including one of the original members of the Distributed Ledger Technology Working Group, Mr. Didiuk contributed to the SEC's work on blockchain and robo-advisers.

PETER DRISCOLL, CPA, is Director of the U.S. Securities and Exchange Commission's Division of Examinations. He previously served as Acting Director, as the Office of Compliance Inspections and Examinations' first Chief Risk and Strategy Officer, and as its Managing Executive from 2013 through February 2016. He joined the SEC in 2001 as a staff attorney in the Division of Enforcement in the Chicago Regional Office and was later a Branch Chief and Assistant Regional Director in the Office of Compliance Inspections and Examinations' Investment Adviser and Investment Company examination program. Prior to the SEC, Mr. Driscoll began his career with Ernst & Young LLP and held several accounting positions in private industry. He received his B.S. in Accounting and law degree from St. Louis University. He is licensed as a certified public accountant and is a member of the Missouri Bar Association.

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HOPE NEWSOME is Co-Founder and Managing Partner at Virtus LLP. Ms. Newsome has served in several capacities within the financial services industry since 1999, including as general counsel and chief compliance officer of registered investment advisers, broker-dealers and public and private funds. Prior to founding Virtus LLP, she served as general counsel and chief compliance officer at a Winter Park, FL based private equity and asset management firm. She serves on the boards of the United Way of Central Florida, the Black Chamber of Commerce Central Florida and ATHENA Orlando Women's Leadership. She is a member of the Florida Bar and serves on its Professional Ethics Committee.

NASEEM NIXON is Vice President and Associate Counsel at Capital Group, where she has responsibilities within the firm's regulatory policy, retail and institutional client services, and fund governance efforts. Prior to joining Capital Group, Ms. Nixon served in the Division of Investment Management for several years, most recently as Senior Policy Advisor to the Director. She also practiced as an associate with Eversheds Sutherland in Washington, D.C. Ms. Nixon received her J.D. from Brigham Young University J. Reuben Clark Law School and her bachelor's degree in Public Policy Studies from Duke University.

KIMBERLY H. NOVOTNY is senior associate general counsel with Franklin Templeton. She serves as Corporate Secretary of Fiduciary Trust Company International, a New York state chartered trust company, and Vice President and Assistant Corporate Secretary of Fiduciary Trust International of the South, a Florida chartered trust company. In addition, she serves as Vice President and Assistant Secretary of Templeton Investment Counsel, LLC, a U.S. registered investment adviser, and Assistant Secretary of Franklin Resources, Inc. She handles legal matters relating to the firm's collective investment trusts, high net worth business, U.S. retirement business and the Franklin Templeton 401(k) plan. From 2006 to 2019, Ms. Novotny provided legal support for the Templeton mutual funds and institutional separate accounts as well as Fiduciary Trust's collective investment trusts, served as Corporate Secretary of Fiduciary Trust International of the South and oversaw Franklin Templeton's proxy voting team. She served as Vice President and Assistant Secretary to all of the Franklin, Templeton and Franklin Mutual Series U.S. registered investment companies from 2013 to 2020. Ms. Novotny has 22 years of experience working as an attorney in the investment management industry. Prior to joining Franklin Templeton in 2006, Ms. Novotny was a partner in the investment management practice of Bell, Boyd & Lloyd in Chicago, Illinois. Ms. Novotny received a J.D., with honor, from DePaul University College of Law and a B.M., *summa cum laude*, from DePauw University. She is a member of the Florida and Illinois State Bars.

ERIC C. OPPENHEIM is General Counsel and Chief Compliance Officer of Telemus Capital, LLC. He is responsible for all legal and regulatory compliance and administrative matters for the firm's investment management, wealth advisory, family office services and insurance businesses. He is also a director of Mi Bank and chair of its Audit Committee. Prior to joining Telemus Capital, Mr. Oppenheim was with TIAA-CREF where he headed the Asset Management and Trust Compliance Group and was later appointed Acting Chief Compliance Officer of TIAA-CREF's mutual fund complex. Previously, he was with Comerica Incorporated, a major regional financial services company. Mr. Oppenheim is a member of the State Bar of Michigan and the

Bar of the U.S. Supreme Court. He received a B.A. degree in Political Science from the University of Michigan and a J.D. degree from Wayne State University Law School.

C. DABNEY O'RIORDAN has been Co-Chief of the SEC Enforcement Division's Asset Management Unit since June 2016. The AMU is a national specialized unit that focuses on misconduct by investment advisers, investment companies, and private funds. Ms. O'Riordan joined the SEC in 2005, and has served in multiple roles including Senior Counsel, Counsel to the Director and Assistant Director. Before joining the SEC, Ms. O'Riordan served as a law clerk to Judge David R. Thompson of the U.S. Court of Appeals for the Ninth Circuit and worked in private practice in Los Angeles, California at the law firm Munger, Tolles & Olson LLP. Ms. O'Riordan received her undergraduate degree from Wellesley College, where she majored in environmental sciences, and her J.D. from the University of California, Los Angeles.

ALPA PATEL is a partner in the Investment Funds Group of Kirkland & Ellis LLP. Prior to joining Kirkland, she served as Branch Chief of the Private Funds Branch of the Investment Adviser Regulation Office in the SEC's Division of Investment Management. In this role, Ms. Patel was the key adviser on all private fund-related projects and priorities. For example, she was the lead counsel implementing private fund adviser reporting on Form PF and the rules related to private fund adviser registration. She also advised the Division of Corporation Finance on regulations related to the offering requirements of private funds, including general solicitation and bad actor rules. Ms. Patel also routinely advised the agency's Office of Compliance Inspection and Examinations (OCIE) regarding the application of Advisers Act rules and other Federal securities regulations to investment advisers, particularly with respect to the nuances associated with private fund advisers. Prior to joining the SEC, Ms. Patel was in private practice where she advised clients on the structuring, formation, and private offering requirements of onshore and offshore private funds, as well as provided counsel to investment advisers in regulatory, compliance, and corporate matters.

LINDA PAULLIN-HEBDEN, an executive partner at Warner Norcross & Judd LLP, has spent over 30 years representing investment advisers both as compliance counsel and in assisting advisers in mergers and acquisitions. Ms. Paullin-Hebden helps advisers achieve their business goals while remaining compliant with applicable rules and regulations. Ms. Paullin-Hebden frequently represents clients in connection with SEC and state regulatory matters and also negotiates and drafts contracts for investment adviser/vendor relationships. Ms. Paullin-Hebden hosts quarterly chief compliance officer roundtables to help CCOs better understand the law as it pertains to their business and compliance program. Ms. Paullin-Hebden received a B.A. in political science and business administration from Alma College and a juris doctor from Wayne State University, *cum laude*.

HESTER M. PEIRCE was appointed by President Donald J. Trump to the U.S. Securities and Exchange Commission and was sworn in on January 11, 2018. Prior to joining the SEC, Commissioner Peirce conducted research on the regulation of financial markets at the Mercatus Center at George Mason University. She was a Senior Counsel on the U.S. Senate Committee on Banking, Housing, and Urban Affairs, where she advised Ranking Member Richard Shelby and other members of the Committee on securities issues. Commissioner Peirce served as counsel to SEC Commissioner Paul S. Atkins. She also worked as a Staff Attorney in the SEC's Division of Investment Management. Commissioner Peirce was an associate at Wilmer, Cutler & Pickering (now WilmerHale) and clerked for Judge Roger Andewelt on the Court of Federal Claims. Commissioner Peirce earned her bachelor's degree in Economics from Case Western Reserve University and her JD from Yale Law School.

PAMELA F. PENDRELL, IACCP®, is a partner and the Chief Compliance Officer of GlobeFlex Capital. She joined GlobeFlex in 2004 and became the Chief Compliance Officer in 2013, leading the firm's compliance effort. Prior to her role as CCO, Ms. Pendrell performed marketing and client service roles at GlobeFlex, including the oversight of performance and compliance reporting. Prior to GlobeFlex, Ms. Pendrell worked at Pacific Corporate Group in a marketing capacity. Her industry experience began with AllianceBernstein in New York supporting their client service and marketing efforts. Ms. Pendrell earned her B.A. at Colgate University, where she graduated *magna cum laude* with high honors in History. She obtained the IACCP® designation in 2015.

STEVE PERAZZOLI is a Partner in PwC's Asset & Wealth Management Group and has over 20 years of diverse experiences servicing a global and multi-disciplinary client base across the financial services industry. He has experience providing audit and advisory services to clients in the asset management industry and trustees for employee benefit and welfare plans. Mr. Perazzoli is focused on relevance as a business advisor in a rapidly changing global business and regulatory landscape and has a demonstrated track record in delivering value while managing relationships. He is a recognized resource on fair valuation topics and is a leading specialist on investment performance reporting.

MARK D. PERLOW is a partner in the San Francisco office of Dechert LLP. He represents mutual funds, hedge fund managers, fund independent directors, investment advisers and broker-dealers on a broad range of regulatory and transactional matters. He is also an adjunct lecturer at the University of California, Berkeley Law School where he teaches a course on capital markets and financial regulation. Having served as senior counsel in both the SEC's Office of the General Counsel and the Division of Enforcement, Mr. Perlow has considerable experience with SEC rule-making, submissions, enforcement, examinations and compliance activity. Mr. Perlow received a J.D. from Yale Law School, an M.A. from Oxford University and an A.B. from the University of California, Berkeley. He is a member of the California and District of Columbia Bars.

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JANICE POWELL, MBA, IACCP®, serves as a Senior Compliance Consultant at Core Compliance & Legal Services, Inc. With over 19 years of industry experience, Ms. Powell focuses on developing, implementing and maintaining a risk-based compliance program, including risk assessments, conflicts of interest inventories, and development of policies and procedures, supervisory structures and controls. Her experience in a multitude of business models from hybrid advisers, multi-family offices, dual registrants, bank-owned advisers and broker-dealers, advisers to mutual funds, trust companies and independent advisers provides for a broad knowledge of the Investment Advisers Act, Investment Company Act, Securities Exchange Act of 1934, Securities Act of 1933, ERISA, Non-Deposit Investment Products,

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LORI RENZULLI is Chief Compliance Officer, Counsel, and a Partner of Harding Loevner LP, a global asset manager based in Bridgewater, New Jersey. Her responsibilities include overseeing the day-to-day management of the firm's compliance program. Prior to joining Harding Loevner in 2006, Ms. Renzulli spent 17 years with subsidiaries of MetLife and Citigroup in various compliance and legal roles. She has also been a speaker at the SEC's National CCOutreach conference and several IAA Compliance Conferences. Ms. Renzulli has a J.D. from Seton Hall University School of Law and a B.A. in Psychology from Douglass College, Rutgers University.

SARAH RONNENBERG has spent over 20 years in the financial services industry with her most recent positions comprising of senior compliance roles. She joined Horizon Investments, LLC in 2017 as its Compliance Director and supports the oversight and administration of its compliance program. Prior to Horizon, Ms. Ronnenberg was a Compliance Officer on TIAA's Operations and Plan Compliance team, focusing on transaction compliance and vendor oversight, and served as the CCO for Piedmont Investment Advisers. Previous experiences span both the sell-side and the buy-side and include working on UBS' institutional ADR sales desk, working for Bear Stearns' equity research department, and working at Vardon Capital Management, a hedge fund registered with the SEC, where she held a number of responsibilities that supported the CCO in administering the firm's compliance program. Ms. Ronnenberg has attained her IACCP® designation and attended Vanderbilt University, graduating *summa cum laude* with a B.A. in English and French. She holds an M.A. in Anglo-American Literary Relations from the University College London.

IGOR ROZENBLIT is the Co-Head of the SEC's Private Funds Unit. The Private Funds Unit is part of the Division of Examinations and is responsible for developing expertise in and conducting examinations of advisers to private funds. Before joining the Private Funds Unit, Mr. Rozenblit was a private funds expert in the Division of Enforcement's Asset Management Unit. Prior to joining the SEC, Mr. Rozenblit managed the North American funds portfolio for a large European asset manager and worked at several private equity advisers. Mr. Rozenblit received his M.B.A. from the University of Chicago's Booth School of Business and a Bachelor of Science degree from the University of Michigan.

ALEX RUSSELL is the Managing Director of White Collar, Regulatory and Internal Investigations for Bates Group, where he is responsible for managing cases related to institutional disputes involving trust or banking entities, or cases related to investment banking or sales & trading, as well as those involving ultra-high net worth individuals. In addition, Mr. Russell is responsible for managing matters involving the assessment of economic damages. Mr. Russell also serves as the co-leader of Bates Group's Big Data Analytics segment, with a particular focus on the use of data analytics in market manipulation or fraud cases. Mr. Russell provides expert witness testimony related to valuation, economic damages, quantitative financial modeling, trading systems, and derivative strategies and products within both the retail and institutional securities litigation practice areas. He is an adjunct professor of finance at both Linfield College and in the Graduate School of Management at Willamette University. Mr.

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MELISSA SCHIFFMAN is a Compliance Manager and Vice President at J.P. Morgan Asset Management. In her role, she leads Compliance coverage for the managed account and advisory and core beta solutions businesses in the U.S. Prior to joining J.P. Morgan, Ms. Schiffman was a manager at Eagle Strategies LLC, a registered investment adviser of New York Life Insurance Company, where she had responsibility for investment adviser policies, Form ADV disclosures, the Code of Ethics and personal trading program, compliance training, as well as certain advisory account, best execution and social media surveillance activities. Ms. Schiffman received her B.S. *summa cum laude* from the Macaulay Honors College at Brooklyn College, CUNY, and holds a FINRA Series 7 license.

ALEXANDER SCHILLER is the Assistant Director of the Office of Asset Management, Division of Economic and Risk Analysis, at the Securities and Exchange Commission (SEC). The office provides economic and other interdisciplinary analysis in support of the Commission on issues related to the regulation of investment advisers, investment companies, hedge funds and other institutional investors. The office will also analyze proposals for new financial products, particularly involving exchange traded funds. Dr. Schiller received his PhD in financial economics from Carnegie Mellon University.

LINDA SHIRKEY is a Managing Director of the Bates Compliance team based in Houston, TX. As President and founder of The Advisor's Resource, Inc., she has provided compliance expertise to Registered Investment Advisers for over 20 years. A former institutional stock broker covering money managers and major corporations, Ms. Shirkey was with Charles Schwab & Co., Inc., for 10 years. Prior to her position with Charles Schwab, Ms. Shirkey worked in banking and legal services in product development, marketing and corporate finance. A *magna cum laude* graduate of Case Western Reserve University in Cleveland, Ohio, Ms. Shirkey is a former Board member of the National Society of Compliance Professionals ("NSCP") and currently serves on their Strategic Planning Committee. She also holds a leadership role with the Houston Compliance Roundtable and is a member of the DFW Compliance Roundtable. She is often invited to speak as an expert in applying current compliance requirements effectively and efficiently, and she has led workshops and seminars for the NSCP Regional and National Meetings, IA Watch, and the Investment Adviser Association.

JOELLE A. SIMMS, a Principal at Bressler, Amery & Ross, is located in the firm's Dallas, Texas and Fort Lauderdale, Florida offices. Her practice is focused on the representation of investment professionals and financial institutions in state and federal courts and in arbitration proceedings throughout the United States, including expungement actions. Ms. Simms also represents business owners in employment, commercial, and tort matters. In addition, Ms. Simms co-manages the firm's Senior and Vulnerable Investor Group and advises, trains, and defends corporate clients who confront issues in this space.

NEIL A. SIMON is Vice President for Government Relations for the Investment Adviser Association. He has a leading role in the formulation and communication of IAA's views on legislative and regulatory issues important to the investment advisory profession and is responsible for advocacy before the U.S. Congress. Before joining the IAA, he was Director of Government Relations for the Financial Planning Association. From 1998 to 2003, he served as

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KRISTIN A. SNYDER is the Deputy Director and Co-National Associate Director of the Investment Adviser/Investment Company examination program in the SEC's Division of Examinations. In addition, Ms. Snyder serves as the Associate Regional Director for Examinations in the SEC's San Francisco Regional Office, where she leads a staff of approximately 50 accountants, examiners, attorneys, and support staff responsible for the examination of broker-dealers, investment companies, investment advisers, and transfer agents across Northern California and the Pacific Northwest. Ms. Snyder has worked at the SEC for more than 13 years, and previously served as a Branch Chief and a Senior Counsel in the San Francisco office's enforcement program. Prior to joining the SEC staff, Ms. Snyder practiced with Sidley Austin Brown & Wood LLP in San Francisco. She earned her law degree from the University of California Hastings College of the Law and received her bachelor's degree from the University of California at Davis.

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NESHIE TIWARI is the former Chief Compliance Officer & Compliance Counsel at Ellevest, Inc., a digital investment platform, private wealth management and financial planning service provider, co-founded by Sallie Krawcheck, dedicated to helping women invest to close the gender investing gap. Ms. Tiwari has over 20 years of experience which includes previously serving as VP Compliance & Chief Compliance Officer at BNY Mellon, Chief Compliance Officer at Financial Engines, and Counsel with Charles Schwab. Ms. Tiwari holds a J.D. from New York Law School and B.A. from the University of Florida. She is a member of the California Bar and NY State Registered in House Counsel.

BOB TONER is Chief Legal Counsel of William Blair's Investment Management division. He has over 20 years of legal experience in the investment management industry. Prior to joining the firm in 2015, Mr. Toner was a Managing Director and Counsel at Wellington Management & Company LLP for nearly eleven years. At Wellington, he provided legal and regulatory guidance on investment adviser, investment company and broker-dealer matters. Before his time with Wellington, Mr. Toner spent five years at Eaton Vance Management where he provided legal and regulatory guidance on investment adviser, investment company and broker-dealer matters. He also served as sole counsel for the firm's international funds, collateralized debt and charitable giving products. Earlier in his career, Mr. Toner worked at Putnam Investments and the law firm of Goodwin Procter each for two years. At those firms, he advised clients on a broad range of mutual fund and other legal and regulatory matters.

TIM VILLANO, CISA, CISM, CGEIT, CRISC, is Chief Information Officer at Artemis Global Security, LLC. He is a technology expert dating back to the early 1980s utilizing DEC systems and VAX/VMS operating systems. Mr. Villano has managed IT security for several businesses, conducting security risk assessment engagements based upon well-defined and accepted COBIT5® standards. He works on custom and NIST Cybersecurity Framework implementations at private and public critical infrastructure providers. He is a co-founder of Havoc Defense, LLC, a Managed Security Service Provider (MSSP) where he assists with network infrastructure and cybersecurity. Mr. Villano also has a background in analysis of equity, commodity and currency markets and has been published in several industry periodicals, including Barron's. He has conducted risk analysis and served as portfolio manager for hedge funds and private clients. Mr. Villano's industry and personal experience serves as a bridge to IT security and regulatory issues for critical infrastructure firms. He has a B.A. in English from Yale University and a M.F.A. from Columbia University.

KURT WACHHOLZ has been in the financial services industry for almost three decades. As an executive consultant, Mr. Wachholz counsels firms on code of ethics and compliance program administration. As director of education, Mr. Wachholz oversees the design and operation of two compliance professional development programs: the Investment Adviser Core Compliance certificate program and the Investment Adviser Certified Compliance Professional® designation. Both professional development programs are co-sponsored with the Investment Adviser Association. Mr. Wachholz has served on several industry organizations, including the National Society of Compliance Professionals, in various capacities through the years. He has developed and taught "Ethics in Leadership", an MBA program module for the Goizueta Business School at Emory University. He has developed and taught "Regulatory Jeopardy", an elective course for the Securities Industry Institute® in partnership with SIFMA and the Wharton School at the University of Pennsylvania. He is a contributing author and member of the editorial board for *Modern Compliance: Best Practices in Securities and Finance* and an editorial board member for the *Journal of Financial Compliance*. Mr. Wachholz earned his BA from the University of Wisconsin and his Investment Adviser Certified Compliance Professional designation from the Center for Compliance Professionals. Mr. Wachholz has also been a CTO, COO, CCO, OSJ/registered principal, investment adviser representative, and licensed insurance agent.

GWENDOLYN A. WILLIAMSON, a partner at Perkins Coie LLP, represents registered investment companies and business development companies and their independent directors, as well as investment advisers, family offices and nonprofit organizations. She advises clients on governance and compliance responsibilities under the federal securities laws, including the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Ms. Williamson's 15 years of experience in the asset management industry includes work with: registered fund launches and liquidations; fund and adviser compliance and vendor oversight programs; SEC registrations, examinations and investigations; annual compliance and risk assessments; routine and special shareholder disclosures; conflict of interest issues; cybersecurity oversight and monitoring; annual fund contract renewals and independence evaluations; large-scale fund and adviser changes in control; applications for exemptive relief; reporting under the federal securities laws; and negotiating advisory agreements, fund selling and servicing agreements, credit facilities, securities lending arrangements and other contracts germane to the asset management industry. An active speaker and writer, Ms. Williamson serves on the Editorial Board of The Investment Lawyer.

DAVID WONG is the Chief Financial Officer and Chief Compliance Officer of Private Wealth Partners with responsibility for all the financial and operational affairs of the firm. Prior to

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RANA J. WRIGHT serves as the Partner, Chief Administrative Officer and General Counsel of Harris Associates, where she is responsible for managing the legal, compliance, risk and regulatory functions of Harris Associates globally. Prior to Harris, Ms. Wright served as associate general counsel and managing director at Bank of America, where she was the chief legal officer for BofA Global Capital Management, the asset management affiliate of Bank of America and chief counsel overseeing Merrill Lynch's distribution of registered investment products. Ms. Wright led the team that was responsible for providing counsel, both strategic and legal, to business partners in the product, sales and marketing functions. She began her career at the global law firm Reed Smith LLP, where she represented mutual funds, broker-dealers and investment advisors, counseling them on a panoply of regulatory, strategic and transactional issues. While at Reed Smith, Ms. Wright was the vice-chair of the firm's Global Diversity and Inclusion initiative. She earned a B.A. from the University of Pittsburgh and a J.D. from Duquesne University School of Law.

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IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE
EFFECTIVE STRATEGIES & BEST PRACTICES

Ethics for Advisers – Part 1

Sara Crovitz, Stradley Ronon Stevens & Young, LLP
Kevin Ehrlich, Western Asset Wealth Management Company
Gretchen E. Lee, Clifford Swan Investment Counselors
Kurt Wachholz, IACCP, National Regulatory Services

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021
EFFECTIVE STRATEGIES & BEST PRACTICES

Agenda

- Overview of Rules
- Structure of Code
- Access Persons
- Current Key Issues
- Questions

Overview of Rules

- Advisers Act Rule 204A-1
- Investment Company Act Rule 17j-1

Structure of Code – Polling Question

Does your firm's code of ethics include your firm's gift and entertainment policy?

- Yes, our firm's code of ethics includes our gift and entertainment policy.
- Our firm's code of ethics refers to the firm's gift and entertainment policy, but doesn't provide details on the policy.
- No, our firm's code of ethics does not discuss our firm's gift and entertainment policy.
- Don't know or not applicable.

What to Consider When Drafting a Code

- Pros and cons of including other policies
- Source of policy
- Escalation policy
  - Violations
  - Interpretive Questions

Access Persons

Polling question: How frequently do you review your list of access persons?

- Review is based on changes in personnel
- Review is based on changes in business and product offerings
- Annually
- Quarterly
- More frequently than quarterly
- Not applicable because all employees are presumed to be access persons
- Don't know or not applicable for other reasons

Current Key Issues

- Employee Training
- Market Volatility
- Beneficial Ownership
- Digital Assets

Number of Trades – Polling Question

Does your firm limit the number of employee trades in reportable securities each quarter?

- No
- Yes
- Don’t know or not applicable

Trading Policies

- Number of trades
- Frequency of trades
- Restricting short sales or trading on margin

Scenario – Beneficial Ownership

- An employee tells you that her mother plans to move in with the employee for several months and her mother's accounts are held at a broker that's not listed as an approved broker in your firm's code. The employee wants to know if her mother's trades must be reported, and if her mother will need to transfer to another broker.

Scenario - Beneficial Ownership

- Code requirements
- Beneficial owner definition

Digital Assets

- More questions from employees
- Considerations for code

Scenario – Managed Accounts

- An employee has inherited securities that are held in a trust that is managed by a third party. He tells you that, since he doesn't manage the trust, he assumes that he doesn't have to pre-clear trades in the trust. What questions would you ask?

Managed Accounts

- Code requirements
- Control over the account
- IM Guidance

Key Takeaways & Questions

Ethics for Advisers

Investment Adviser Association Compliance Conference March 3-5, 2021

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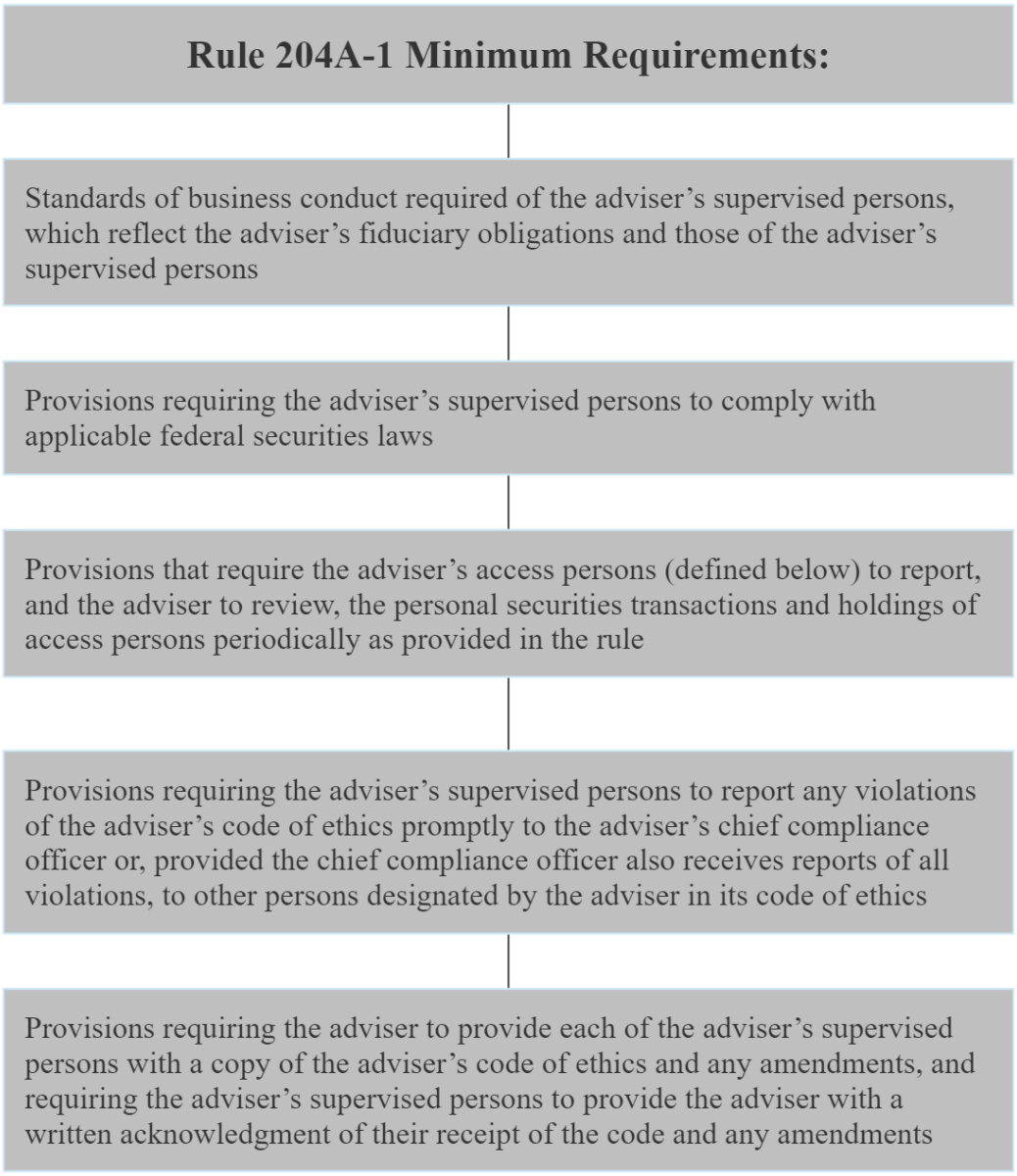
This outline describes requirements for investment adviser codes of ethics, additional policies and procedures used by investment advisers, statements by SEC staff on codes of ethics, and selected enforcement actions.

Rule 204A-1:

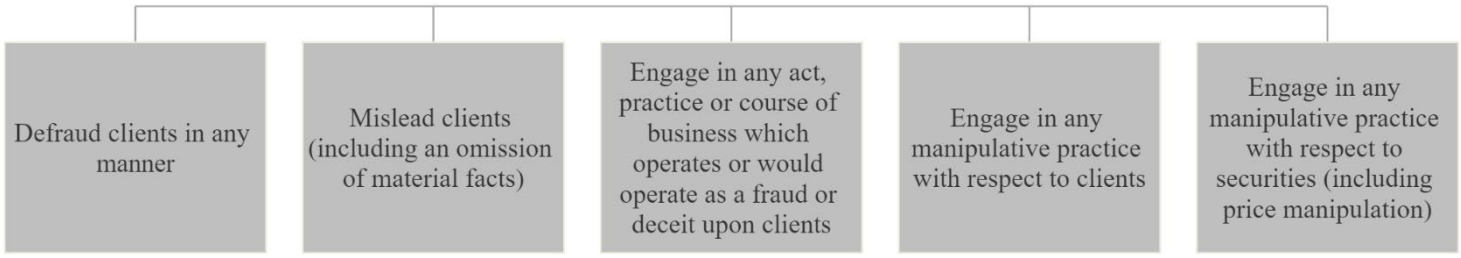
- The SEC adopted Rule 204A-1 under the Investment Advisers Act of 1940 ("Advisers Act") in 2004. This rule requires investment advisers to establish, maintain and enforce written codes of ethics.
    - Rule 204A-1 requires, at a minimum, an investment adviser's written code of ethics to include:



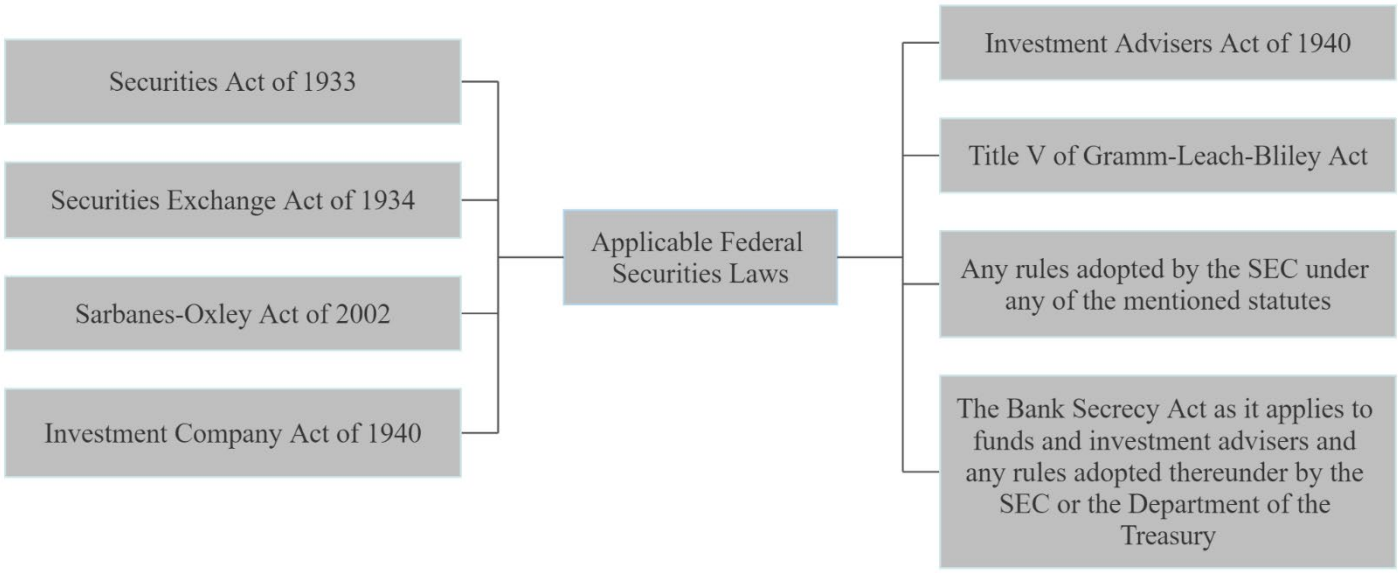
Below we address some of these requirements in more detail.

Standard of Business Conduct

- An adviser's code of ethics must include standards of business conduct and requirements for all "supervised persons" to comply with federal securities laws.[1] The standards must reflect the adviser's and their supervised persons' fiduciary obligations. Codes of Ethics should set out the ideals for ethical conduct premised on fundamental principles of openness, integrity, honesty and trust.
    - In the code of ethics, Advisers should consider specifying that supervised persons are not permitted, in connection with the purchase or sale, directly or indirectly, of a security held or to be acquired by a client to:



    - All supervised persons must comply with all applicable federal securities laws, which are defined to include:



Reporting of Personal Securities Holdings and Transactions

- **Access Persons**
    - Adviser's access persons must periodically report their securities holdings and transactions to the adviser's Chief Compliance Officer or other designated person. An access person is defined as:

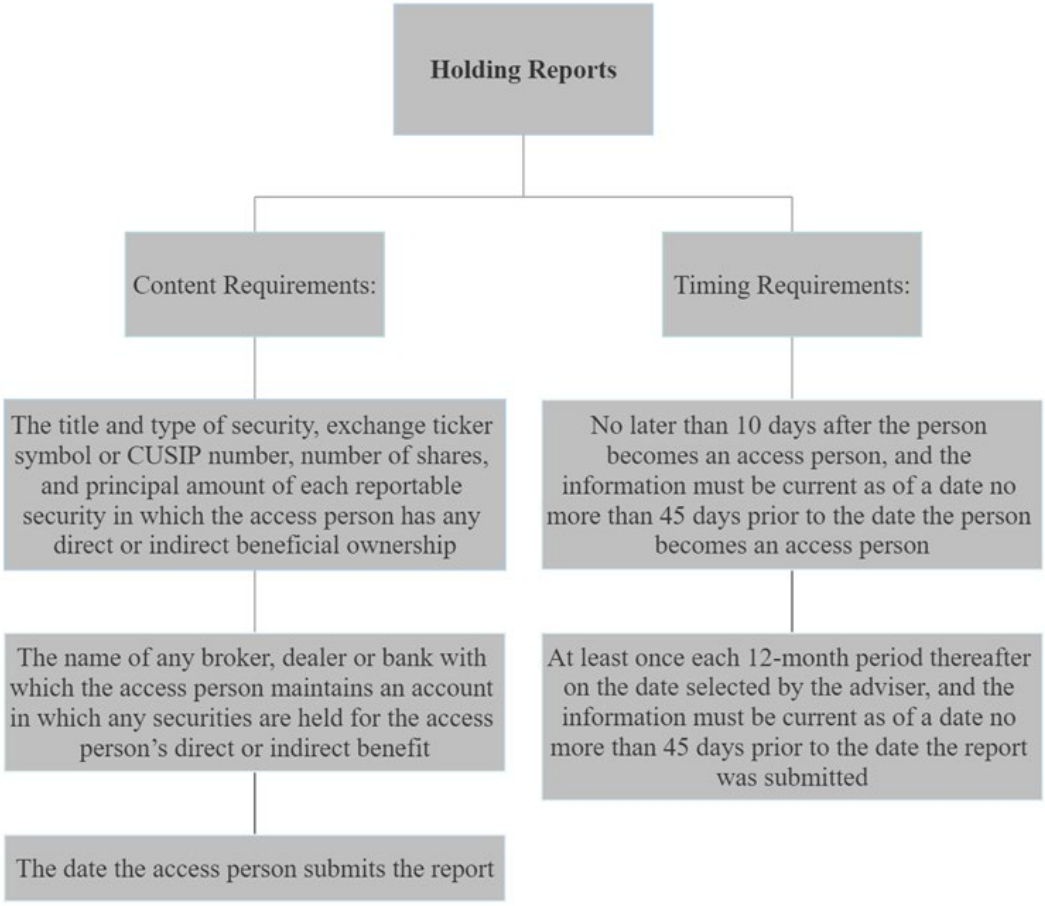
[1] Supervised persons are defined as "any partner, officer, director, (or other person occupying a similar status or performing similar functions), or employee of an investment adviser or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser."

- Any supervised person:
  - Who has access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund; or
  - Who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic.
- If providing investment advice is the organization's primary business, all of its directors, officers, and partners are presumed to be access persons.

o In evaluating who is an access person, advisers also should consider consultants, contractors and other third parties. The SEC has found violations of Section 204A of the Advisers Act where advisers did not establish or maintain policies and procedures for identifying whether outside consultants involved in portfolio management should be subject to the adviser's policies or procedures, including the adviser's code of ethics.[2]

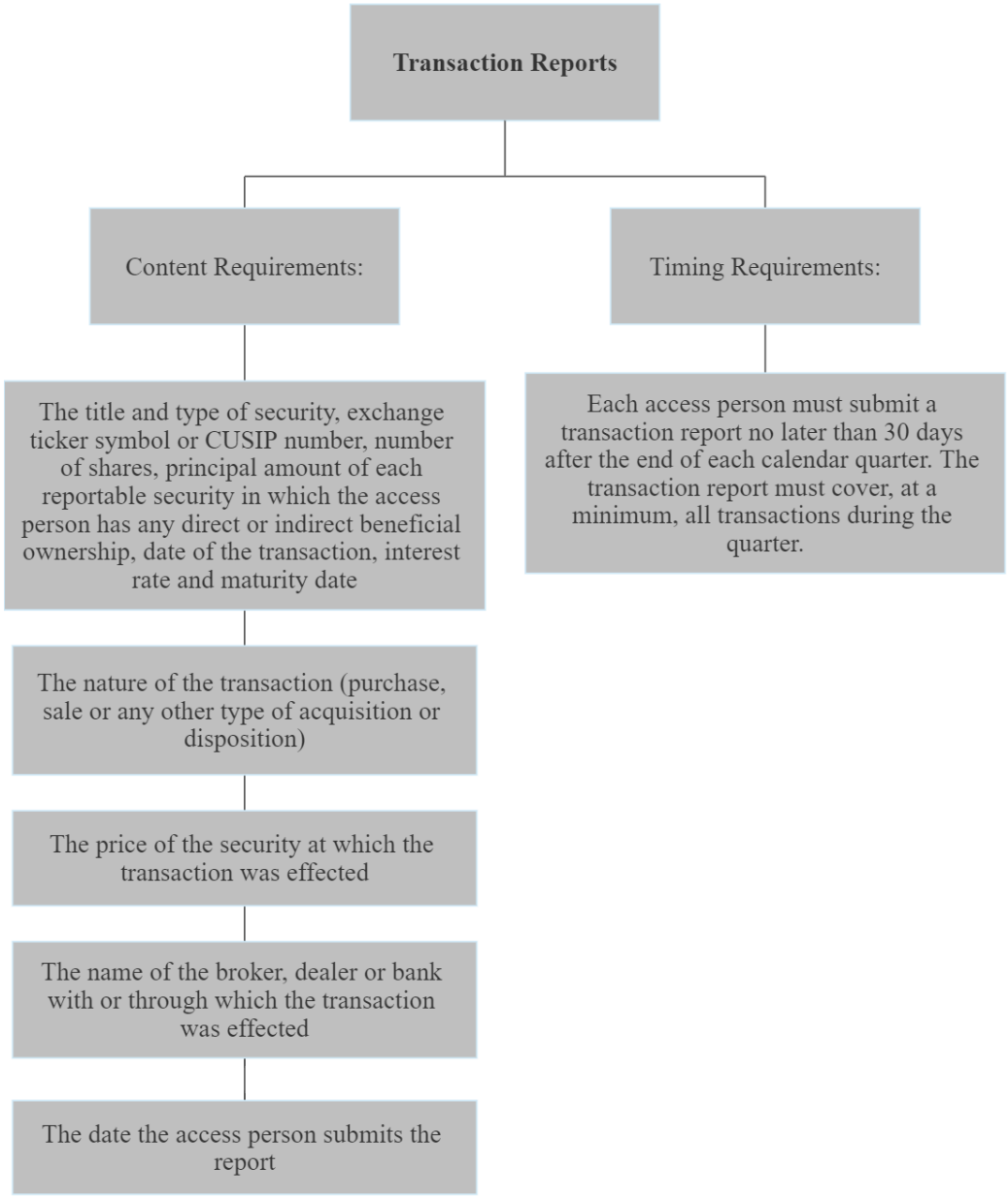
- **Holdings Reports**

o An adviser's code of ethics must require the adviser's access persons to submit to the adviser's chief compliance officer, or other persons designated in the code of ethics, initial and annual holdings reports that meet the following requirements:



[2] *In the Matter of Federated Global Investment Management Corp.* (May 27, 2016), available at: https://www.sec.gov/litigation/admin/2016/ia-4401.pdf.

- **Transaction Reports**
  - An adviser's codes of ethics must require the adviser's access persons to submit quarterly securities transaction reports to the adviser's chief compliance officer or other persons designated in the adviser's code of ethics. These quarterly reports are required to include:[3]



- **Beneficial Ownership**
  - For purposes of holdings and transaction reports, Rule 204A-1 provides that beneficial ownership is interpreted in the same manner as under Rule 16a-1(a)(2) under the Exchange Act, and that any report required by Rule 204A-1(b) may contain a statement that the report will not be construed as an admission that the person making the report has any direct or indirect beneficial ownership in the security to which the report relates.

[3] Rule 204A-1 defines "purchase or sale of a security" to include, among other things, the writing of an option to purchase or sell a security.

- **Exceptions from Reporting Requirements**
  - Under Rule 204A-1, no reports are required with regard to the following:
    - Any report with respect to securities held in accounts over which the access person had no direct or indirect influence or control.
    - For transaction reports, with respect to transactions effected pursuant to an automatic investment plan.
    - For transaction reports if the report would duplicate information contained in broker trade confirmations or account statements that the adviser holds elsewhere so long as the adviser receives the confirmations or statements no later than 30 days after the end of the applicable calendar quarter.
- **Reportable Security**
  - Access persons must submit holdings and transactions reports for any "reportable security." All securities are treated as reportable securities under Rule 204A-1 except:
    - Transactions and holdings in direct obligations of the U.S. Government;
    - Money market instruments - Bankers' acceptances, bank certificates of deposit, commercial paper and high quality short-term debt instruments, including repurchase agreements;
    - Shares issued by money market funds;
    - Transactions and holdings in shares issued by open-end funds other than reportable funds; and
    - Transactions in units of a unit investment trusts if the unit investment trust is invested exclusively in unaffiliated mutual funds.
  - SEC Staff also provided no-action relief to permit an investment adviser not to treat an access person's transactions and holdings in a 529 Plan as reportable securities if the adviser or its control affiliate does not manage, distribute, market, or underwrite the 529 plan or the investments and strategies underlying the 529 plan.[4]
- **Reportable Fund**
  - A reportable fund is a fund for which the adviser serves as investment adviser or any fund whose investment adviser or principal underwriter controls, is controlled by or is under common control with the adviser.
- **Pre-Approval Requirements:**
  - An adviser's code of ethics must require the adviser's access persons to obtain prior written approval before they directly or indirectly acquire beneficial ownership in any security in an initial public offering or a limited offering.[5]

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[4] *Wilmer Hale, LLP*, SEC No-Action Letter (July 28, 2010), available at https://www.sec.gov/divisions/investment/noaction/2010/wilmerhale072810.htm.

[5] Limited offering is defined in Rule 204A-1 as an offering that is exempt from registration under Section 4(a)(2) or 4(a)(5) of the Securities Act of 1933 or pursuant to Rules 504 or 506 under the Securities Act. Initial public offering is also defined in Rule 204A-1.

- Best practices:
  - Advisers typically require prior written approval of all personal securities trades by access persons.
  - Advisers should consider whether to prohibit investment personnel from acquiring any securities in initial public offerings to preclude any possible conflict. Similarly, in determining whether to pre-clear limited offerings, advisers should consider potential conflicts with clients.
  - Advisers should consider appropriate compliance software to assist in automating the pre-clearance process.

- **Best Practices Regarding Personal Securities Transactions**
  - The following is a list of issues that the adopting release for Rule 204A-1 recommends advisers consider incorporating into codes of ethics:[6]
    - Restricted Lists
      - Advisers may maintain a list of securities that the firm is analyzing or considering for client transactions and prohibit their access persons from personal trades in those securities.
      - Advisers may also maintain lists of issuers about which they have inside information and prohibit any trading (personal trading or trading on behalf of clients) in securities of those issuers.
    - Blackout Periods
      - Advisers may include blackout periods during which access persons are not permitted to engage in personal trading when client securities are being traded or recommendations are being made. Such blackout periods help to guard against employees trading ahead of clients or on the same day client trades are placed.
    - Short-Term Trading and Frequent Trading
      - Advisers may prohibit or restrict short-term trading or frequent trading in the same security and require disgorgement of any profits on short-term trades.
    - Brokerage Accounts
      - Advisers may require access persons to trade only through certain "approved" brokers or limit the number of brokerage accounts permitted.
    - Confirmations and Account Statements
      - Advisers may require access persons to provide duplicate trade confirmations and account statements in connection with holdings and transaction reports.

[6] Securities and Exchange Commission, Investment Adviser Codes of Ethics; Advisers Act Release No. 2256 (July 2, 2004), available at: https://www.sec.gov/rules/final/ia-2256.htm.

Other Policies

- The following are additional topics advisers should consider addressing in their code of ethics or related policies. Some of these are specified in the adopting release for Rule 204A-1 as provisions many advisers included in codes of ethics at the time the Rule was adopted.
  - Gifts and Entertainment
    - Advisers should place appropriate restrictions on giving and receiving gifts as well as business entertainment.
      - Advisers may limit the dollar amount of gifts and entertainment provided or require pre-clearance of gifts and entertainment.
      - Supervised persons may be required to report all gifts and entertainment for a conflicts of interest review.
      - Some advisers flatly prohibit the giving and receiving of gifts and entertainment.
  - Anti-Bribery
    - Advisers may incorporate anti-bribery policies that address compliance issues related to the Foreign Corrupt Practices Act and doing business outside the United States.
  - Political Contributions
    - Advisers Act Rule 206(4)-5 includes a number of prohibitions in connection with political contributions by investment advisers.
  - Outside Business Activities
    - Advisers should consider whether to prohibit supervised persons from serving on boards of public companies to avoid a conflict of interest. Advisers could either prohibit all supervised persons from serving on boards or they can require supervised persons to obtain authorization from the adviser before being allowed to join a board.
  - Review of Code and Reports and Testing
    - Advisers should periodically review the code of ethics and any reports made pursuant to the code of ethics to determine if updates are appropriate. Similarly, advisers should consider how to compliance test the code of ethics.
  - Code of Ethics Education
    - While an adviser's code of ethics must require the adviser to provide each supervised person with the code and receive a written acknowledgment of the receipt, there is no explicit education requirement. Advisers typically provide periodic employee training to highlight the types of conflicts of interest that may arise.
  - Insider Trading
    - Advisers should consider including a summary of insider trading law and procedures designed to prevent insider trading in their code of ethics.

Recordkeeping

- Rule 204-2(a)(12)-(13) requires investment advisers to maintain certain records related to the code of ethics.
  - Rule 204-2(a)(12) requires advisers to maintain the following:
    - A copy of the adviser's code of ethics adopted and implemented that is in effect or at any time within the past five years was in effect;
    - A record of any violation of the code and of any action taken as a result of the violation; and
    - A record of all written acknowledgements required by Rule 204A-1(a)(5) for each person who is or within the past five years was a supervised person of the adviser.
  - Rule 204-(2)(a)(13) requires advisers to maintain the following:
    - Reports of holdings and transactions made by access persons, including trade confirmations and account statements of access persons provided in lieu of such reports;
    - Names of current access persons and those who were access persons within the past five years; and
    - Any decision, and the reasons supporting the decision, to approve the acquisition of securities by access persons in initial public offerings or limited offerings, for at least five years after the end of the fiscal year in which the approval is granted.

Form ADV Disclosure

- Item 11 of Part 2A of Form ADV requires an adviser to describe its code of ethics and disclose that the adviser will provide a copy of its code to any client or prospective client upon request.

OCIE Reports

- On November 9, 2020, OCIE issued a Risk Alert explaining its findings from examining advisers who manage multiple branch offices that are dispersed from the adviser's principal office.[7] One of the areas OCIE focused on was a multibranch adviser's deficiency in enforcing its code of ethics. Advisers were cited because they failed to:
  - Comply with the reporting requirements by not submitting transactions and holding reports as often as required or not submitting these reports at all.
  - Review transactions and holdings reports.
  - Properly identify access persons.
  - Include all the necessary provisions in their codes of ethics.
    - The list of excluded provisions included: requiring a review and approval process before a supervised person can invest in limited or private offerings, submitting initial and annual holdings report, and submitting quarterly transaction reports.

[7] SEC Office of Compliance Inspections and Examinations, *Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices* (Nov. 9, 2020), available at Risk Alert - Multi-Branch Risk Alert.pdf (sec.gov)

- On June 23, 2020, OCIE issued a Risk Alert addressing three areas of deficiencies for private fund advisers, including code of ethics and misuse of material non-public information.[8] OCIE observed that some private fund advisers were not including or enforcing code of ethics provisions reasonably designed to prevent the misuse of material non-public information. For example:
    - Advisers were not enforcing the trading restrictions rules that are in their codes of ethics.
    - Advisers did not have policies and procedures in place for adding or removing securities for the restricted list.
    - Advisers did not enforce requirements in their codes of ethics relating to gifts and entertainment.
    - Advisers did not require access persons to submit transaction and holding reports timely or to submit personal security transactions for pre-clearance.
    - Advisers did not identify certain access persons which caused them not to review their personal securities transactions.
- On February 7, 2017, OCIE issued a Risk Alert highlighting compliance topics most frequently identified in deficiency letters sent to investment advisers.[9] The following are typical examples of deficiencies or weaknesses:
    - Certain advisers did not identify all their access persons for purposes of reviewing personal securities transactions.
    - Certain codes of ethics were missing required information. Certain codes did not specify review of the holdings and transaction reports, or did not identify specific submission timeframes.
    - Certain access persons submitted transactions and holdings less frequently than required.
    - Certain advisers did not describe their code in Part 2A of Form ADV and did not indicate that their code is available to any client or prospective client upon request.

Recent Efforts by Organizations on Ethics Enforcement

- North American Securities Administrators Association, Inc. ("NASAA")
    - On July 2, 2020 NASAA released a model rule that would require state-registered investment advisers to establish, maintain, and enforce written policies and procedures tailored to the investment adviser's business model.[10] The model rule would require state-registered investment advisers to include a written codes of ethics in their policies and procedures. The code of ethics would need to clarify:
        - Standards of business conduct the investment adviser requires of its supervised persons;
        - Require supervised persons to adhere to applicable state and federal securities laws;

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[8] SEC Office of Compliance Inspections and Examinations, *Observations from Examinations of Investment Advisers Managing Private Funds* (June 23, 2020), available at (Private Fund Risk Alert_0.pdf (sec.gov)

[9] SEC Office of Compliance Inspections and Examinations, National Exam Program Risk Alert, *The Five Most Frequent Exam Topics Identified in OCIE Examinations of Investment Advisers* (Feb. 7, 2017), available at Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers (sec.gov)

[10] North American Securities Administrators Association, Inc. *Notice of Request for Public Comment Regarding A Proposed Model Rule For Investment Adviser Written Policies And Procedures Under The Uniform Securities Acts of 1956 And 2002* (July 2, 2020), available at Policies & Procedures Model Rule - Request for Public Comment (nasaa.org)

- Require access persons to report personal securities transactions and holdings on a periodic basis and the investment adviser to review such reports;
- Require supervised persons to report violations promptly to the chief compliance officer or other appropriate persons designated in the code of ethics; and
- Require advisers to provide a copy of its code of ethics to its supervised persons.

- Certified Financial Planner Board of Standards ("CFP")
  - During the summer of 2020, CFP began enforcing violations of its recently adopted code of ethics and standards of conduct on its licensed financial planners.[11] Advisers that have CFP designation should ensure that they meet the requirements of the code, including enhanced disclosure requirements.

Recent Enforcement Actions

- *In the Matter of Creative Planning, Inc. and Peter A. Mallouk*, Advisers Act Release No. 5035 (Sept.18, 2018): [12]
  - The SEC found that the adviser failed to enforce its code of ethics by not reporting and reviewing the adviser's president and majority owner personal securities accounts and transactions in accounts. The SEC found that the firm violated Section 204A and Rule 204A-1 which requires advisers to establish, maintain, and enforce a written code of ethics that includes a standard of business conduct of the advisers supervised persons and requires access persons to report and advisers to review personal securities holdings transactions.

[11] Certified Financial Planner Board of Standards, *Code of Ethics and Standards of Conduct,* available at Code of Ethics and Standards of Conduct | CFP Board

[12] *In the Matter of Creative Planning, Inc. and Peter A. Mallouk*, Advisers Act Release No. 5035 (Sept. 18, 2018), available at https://www.sec.gov/litigation/admin/2018/ia-5035.pdf.

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MARCH 3-5, 2021 / VIRTUAL CONFERENCE
EFFECTIVE STRATEGIES & BEST PRACTICES

Risk Management for Larger Firms

Carlo di Florio, *ACA Compliance Group*
Jon Hadfield, *The Vanguard Group, Inc.*
Rosa Licea-Mailloux, *MFS Investment Management*
Melissa Schiffman, *J.P. Morgan Asset Management*
Karen Aspinall, *Practus LLP* MODERATOR

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EFFECTIVE STRATEGIES & BEST PRACTICES

Discussion Topics

- Risk Management vs. Compliance
- Cross Functional Collaboration
- Identifying and Assessing Risks
- Mitigating Risks
- CCO Liability
- Resource Constraints
- Recent SEC Activity
- Questions

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Risk Management vs. Compliance

- Risk management is a firm-wide program to identify, assess and mitigate risk. Broader than compliance-related risk.
  - Large firms typically have greater complexity when it comes to risk management than smaller organizations (different business lines, global businesses, multiple regulators, etc.)
- Program should be designed to avoid violations from occurring, detecting violations that have occurred, and correcting any such violations.
- Policies and procedures and other control functions are important to mitigate risk.
- In large firms, there tend to be many functional areas that focus on risk identification, assessment and mitigation, including legal and compliance, which requires thoughtful and intentional collaboration.

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Cross Functional Collaboration

- Executive Management – tone at the top
- Compliance/CCO
- Applicable Committees
- Risk managers – e.g., liquidity, derivatives or investment risk managers
- Business Units
- Outside vendors
- Others

Identifying and Assessing Risks

- Identifying Risks:
  - Need a seat at the table
  - Partnering with the business
  - Understand external risk environment
- Mature risk management and compliance programs routinely assess and re-evaluate risk and tailor risk assessments to the business
- Appetite for risk may vary (and possibly differ): management, business partners, compliance, auditors

Mitigating Risks

- Eliminate (difficult) vs. mitigate (difficult but possible)
- Adopt new policies and procedures or modify existing policies and procedures if they fail to adequately address risk
- Map Controls
- Monitoring
- Testing
- Education

CCO Liability

- SEC actions against CCOs
- Focus of Commissioner Peirce and NY Bar Association on clearly articulated standards
- New SEC Chair / potential change in enforcement posture

Resource Constraints

- Must do more with less (less staff, less dollars)
- Utilize outside resources/offshoring
- Increased use of technology
- Other?

Recent SEC Activity

- Recent Risk Alert on investment adviser exam observations
  - Inadequate compliance resources
    - CCO's with multiple duties
    - Lack of resources
    - Growing adviser that fails to add resources
- Insufficient authority of CCOs
- Annual review deficiencies
- Failure to implement actions required by policies and procedures
- Failing to update or maintain policies and procedures

Recent SEC Activity – Continued

- New SEC rules requiring risk management programs
  - Liquidity Risk Management
  - Derivatives Risk Management
- Departure from simply requiring policies and procedures under Rule 206(4)-7


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& BEST PRACTICES
Questions?


EFFECTIVE STRATEGIES & BEST PRACTICES
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MARCH 3-5, 2021
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RISK MANAGEMENT FOR LARGE INVESTMENT ADVISERS[*]
INVESTMENT ADVISER ASSOCIATION
2021 VIRTUAL COMPLIANCE CONFERENCE

MARCH 5, 2021

I. Introduction

This outline, in conjunction with the associated panel, will explore risk management practices of large investment advisers. Large advisers are expected to have very thorough and detailed risk and compliance programs. Due to the typical business complexity of large advisers, oftentimes the success of those who are in any type of risk management role (be it compliance, enterprise risk, etc,) is dependent in part on the quality of relationships of the risk and compliance professionals with senior management and other applicable business partners. However, even where there are excellent lines of communication between risk, compliance and the business, there can still be internal disagreements on appropriate levels of risk taking and whether risks are suitable given a firm's overall risk profile. The panel will explore these issues and will discuss how some firms can approach these situations. Moreover, compliance and other risk professionals are trying to perform their critical risk oversight roles in a time of contracting compliance budgets and generally fewer overall resources, all with the backdrop of potential personal liability for the design and implementation of the compliance program. The panel will discuss ways to manage these competing interests and discuss potential best practices in seeking to managing risk and compliance.

I. Duties of Investment Advisers

A. Fiduciary Duty

a. We begin with a high-level review of an adviser's duties to its clients when providing investment advice. The overarching principle governing an investment adviser's conduct is fiduciary duty. Although not expressly provided for in the Advisers Act, the Supreme Court held that Section 206 of the Investment Advisers Act of 1940, as amended (the "Advisers Act") imposes a fiduciary duty on investment advisers when rendering investment advice as an operation of law.[1]

i. Section 206(1) of the Advisers Act prohibits fraud and deceptive practices.

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[*] This outline was authored by Karen Aspinall, Partner at Practus, LLP. This outline provides general information on the subject matter discussed and does not necessarily reflect the views of Practus or any of its clients and should not be relied upon for legal advice on any matter. Further, this outline does not necessarily reflect the views of the firms or any participant on the live panel.

[1] *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

ii. Section 206(2) of the Advisers Act prohibits conduct that would operate as a fraud or deceit upon a client or a prospective client. An adviser can violate this Section if it does not act with the utmost good faith when dealing with its clients or does not otherwise disclose all material facts and conflicts of interest to its clients.[2]

b. In July of 2019, the U.S. Securities and Exchange Commission ("SEC" or "Commission") issued a comprehensive interpretation of the fiduciary duties an investment adviser owes to its clients.[3] The intention of the Interpretation was to consolidate previous guidance on this topic and reaffirm/clarify some aspects of an adviser's fiduciary duties under Section 206 of the Advisers Act.[4] Under the Interpretation, the SEC reaffirmed that an adviser's fiduciary duty encompasses the duty of care and the duty of loyalty and these duties require the investment adviser to act in the best interest of its clients at all times.

i. The duty of loyalty requires an adviser to eliminate or otherwise provide "full and fair disclosure" of conflicts of interest.

ii. The duty of care requires an investment adviser, at all times, to serve the best interest of its clients based on the client's objectives. The Interpretation states that the duty of care includes, among other things, the duties to (i) provide advice that is in the client's best interest, (ii) seek best execution where the adviser has discretion to select broker-dealers to execute client trades, and (iii) provide advice and monitoring over the course of the relationship.[5]

B. Duty to Supervise

a. An investment adviser is required to supervise the activities of its employees and other persons who act on its behalf to ensure compliance with applicable law.[6]

b. The SEC has used the duty to supervise (or failure thereof) as a basis for numerous enforcement actions where the investment adviser did not have adequate policies and procedures.[7]

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[2] *Id.* (The Court found that "[f]ailure to disclose material facts must be deemed fraud or deceit within its intended meaning.")

[3] *See* Commission Interpretation Regarding Standards of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (June 5, 2019) (the "Interpretation"), available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

[4] *Id.* at 3-4.

[5] Interpretation at 12.

[6] *See* Section 203(e)(6) of the Advisers Act (authorizing the Commission to sanction an investment adviser that has failed to reasonably supervise another person who commits a violation of applicable law if such person is subject to the adviser's supervision).

c. Adopting robust policies and procedures that are applicable to an investment adviser's business is not only consistent with an adviser's responsibilities, but it can provide an adviser with an affirmative statutory defense under the Advisers Act where the adviser has been charged with a failure to supervise. In such an action, an investment adviser would seek to demonstrate that it has established and complied with procedures that are reasonably designed to prevent and detect the violation at issue.

C. Risk Management and Compliance Programs

a. Neither the SEC nor the Advisers Act provide a definition of "risk management." That said, the SEC and its staff have continued to evolve and expand the expectations around risk management and its role in compliance programs.[8]

b. In 2003, the SEC adopted Rule 206(4)-7, which requires investment advisers to adopt policies and procedures reasonably designed to prevent violation of the Advisers Act (the "Compliance Program Rule").[9] The Compliance Program Rule is arguably one of the SEC's more significant rules for investment advisers in terms of providing a framework for compliance officers to identify, assess, and seek to mitigate risk. In the adopting release for the Compliance Program Rule, the SEC stated that "[r]equiring … investment advisers to design and implement a comprehensive internal compliance program will serve to reduce the risk that …advisory clients are harmed."[10]

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[7] The Commission has repeatedly sanctioned investment advisers that did not establish and implement such procedures. *See* In re Scudder Kemper Investments, Inc., Advisers Act Rel. No. 1848 (Dec. 22, 1999) (adviser failed to reasonably supervise employee by not having policies and procedures designed to detect and prevent employees' unauthorized trading in client accounts); In re Nicholas-Applegate Capital Management, Advisers Act Rel. No. 1741 (Aug. 12, 1998) (adviser failed to reasonably supervise employee by not having policies and procedures designed to detect and prevent employees from engaging in improper personal trading); In re Van Kampen American Capital Asset Management, Inc., Advisers Act Rel. No. 1525 (Sept. 29, 1995) (adviser failed to reasonably supervise employee by not having policies and procedures designed to detect and prevent employees from mispricing fund securities).

[8] *See infra* n.18. Importantly, not all risks are compliance risks. Compliance risk can be defined by reference to "any risk that is either directly associated with a law or regulation or is compliance-related in that it is associated with other standards, organizational policies, or ethical expectations and guidelines." *See* Committee of Sponsoring Organizations of the Treadway Commission, Compliance Risk Management: Applying the COSO ERM Framework (Nov. 2020), available at https://www.coso.org/Documents/Compliance-Risk-Management-Applying-the-COSO-ERM-Framework.pdf. Inherently, organizations face many important risks that need to be addressed that may not be compliance related, such as industry competition risk, investing risk, financial risk, among many others. While some of these risks may not be applicable to an adviser's compliance program, all assessments of organizational risks can assist compliance in performing its role.

[9] *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. 2204 and Investment Company Act Rel. No. 26299 (Dec. 24, 2003) (the "Compliance Program Release"), available at https://www.sec.gov/rules/final/ia-2204.htm.

[10] *Id.*

c. Under the Compliance Program Rule, investment advisers are (i) required to adopt and implement written policies and procedures that are reasonably designed to prevent violation of the Advisers Act and the rules thereunder by the adviser or its supervised persons; (ii) conduct an annual review of such written compliance policies and procedures on an annual basis; and (iii) designate a Chief Compliance Officer to administer the policies and procedures.[11] While the Compliance Program Rule is designed to address compliance-related risks, many of the same principles are used when identifying, assessing and mitigating organizational risk more broadly.[12]

i. Risk Assessment – before discussing policies and procedures it is important to first review the significance of conducting a thorough risk assessment of the investment adviser's business. While the Compliance Program Rule does not specifically require an investment adviser to conduct a risk assessment, the SEC staff has made clear that advisers should conduct a comprehensive risk assessment of the firm's business to identify conflicts of interest and risks to the interests of the firm and its clients.[13] Accordingly, a risk assessment is truly foundational to any effective compliance or other risk management programs.

1. Some investment adviser risks can be straightforward in terms of identification and mitigation. Wouldn't it be great if all risks were created equally?

2. Many other risks can be opaque to a compliance or risk professional without further explanation from the business of a strategy or other practice. This is where strong business partnerships and open dialogues between compliance, risk officers and the business can be a critical part of the risk

[11] *Id.*

[12] For example, the Internal Organization for Standardization (the "ISO") adopted ISO 31000:2018 Risk Management – Guidelines (the "ISO Guidelines"), which provides a framework for organizing a firm's risk management practices. Many aspects of the framework in the ISO Guidelines are very similar to those that are part of an investment adviser compliance program (e.g., leadership and commitment, integration, design, implementation, evaluation and improvement). The ISO Guidelines are available at https://www.iso.org/obp/ui#iso:std:iso:31000:ed-2:v1:en.

[13] Compliance Program Release, *supra* n. 9. (stating that advisers should "identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures to address those risks"); Gene Gohlke, Associate Director, Office of Compliance Inspections and Examinations, Remarks at the Managed Funds Association Educational Seminar Series 2005 – A Job Description for CCOs of Advisers to Private Investment Funds (May 5, 2005) (stating that the risk identification process and assessment is an important starting point for establishing effective compliance programs); Lori A. Richards, Director, Office of Compliance Inspections and Examinations, Remarks before the National Society of Compliance Professionals 2004 National Membership Meeting – Instilling Lasting and Meaningful Changes in Compliance (Oct. 28, 2004) (stating that firms must be proactive in identification of risk areas and in endeavoring to mitigate or eliminate those risks).

assessment process. A risk assessment cannot be effective if it fails to capture any number of significant risks.

3. In addition, particularly with respect to large investment advisers, it is often the case that there are many others in the organization (in addition to risk and compliance) that are involved in the identification and assessment of risks. This could include work performed by enterprise risk managers, investment risk management professionals, internal audit, various business partners throughout the firm, or third parties, such as consulting firms, among others. These are very important partnerships for compliance and risk professionals to leverage any other relevant information that may bear on the mitigation of risk within the firm.

ii. Policies and Procedures. Historically, compliance officers have been afforded a fair amount of latitude in adopting policies and procedures that are tailored to the adviser's business. While the Compliance Program Rule does not prescribe the content of an adviser's policies and procedures,[14] they must be reasonably designed to (i) prevent violations from occurring; (ii) detect violations that have occurred; and (iii) correct any violations that have occurred.[15] Successful policies and procedures that seek to mitigate organizational risk cannot be adopted and imposed on the company by compliance and risk professionals without a culture that supports this framework. In this way, the organization must provide:

1. The support of executive management (tone-at-the top), which should be consistently communicated among all levels of managers throughout the organization;

2. A clear articulation of the organization's risk appetite. This can be very difficult in large organizations where there are different business lines and reporting structures; and

3. Empowerment of CCOs and other risk professionals and support for these individuals in their roles, including adequate resources.

d. Annual Review. On at least an annual basis (or more frequently if prudent given the nature of the adviser's business and risk environment) an adviser

[14] The Compliance Program Rule does not specify any provisions that must be included in an adviser's policies and procedures but the SEC notes that such policies and procedures should be tailored to "take into consideration the nature of the firm's operations." Compliance Program Release, *supra* n. 9.

[15] Compliance Program Release, *supra* n. 9.

must review its compliance policies and procedures for their adequacy and effectiveness.[16]

e. Designation of CCO. Under the Compliance Program Rule, a Chief Compliance Officer must be designated to administer the firm's compliance policies and procedures. Such a person must be of sufficient seniority and authority within the organization to enforce the policies and procedures. While CCOs are very important organizationally, in larger firms, compliance design, implementation and monitoring are typically performed by numerous people within the organization. Accordingly, this can create concerns regarding CCO liability for any compliance-related failures. These issues are discussed in more detail in Section III, below.

D. Recent SEC Focus on Risk Management Programs

a. The SEC staff over the last few years has completed a very fulsome rulemaking agenda for investment advisers and for mutual funds that are governed by the Investment Company Act of 1940, as amended (the "Investment Company Act").[17] With respect to mutual funds, and among the many rules that have been finalized, the SEC adopted a liquidity risk management rule and a derivatives risk management rule that each require certain funds to adopt a "risk management program" pertaining to the subject matter of the rule as part of the funds' overall compliance with the rule.[18] Therefore, each rule has required risk elements of the program that must be tracked and monitored in addition to the typical administration of policies and procedures.

b. While the mutual funds are the regulated entities that are subject to these rules, oftentimes an investment adviser's personnel is responsible for compliance with the rule's requirements.[19] While the SEC has not adopted

[16] The ISO standards also provide a similar risk management monitoring and review framework, which is designed "improve the quality and effectiveness of process design, implementation and outcomes." ISO Guidelines, *supra* n. 12.

[17] SEC Press Release, Dalia Blass to Conclude Tenure as Director of the Division of Investment Management – Under Director's Blass's Leadership, the Division Undertook Numerous Initiatives Benefitting Main Street Investors (Dec. 22, 2020).

[18] *See e.g.*, Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Rel. 34084 (Oct. 28, 2020) (the "Derivatives Rule") (Rule 18f-4(c)(1) under the Investment Company Act requires certain funds to adopt a derivatives risk management program that consists, in part, of policies and procedures that are reasonably designed to manage the fund's derivative risks); *see also*, Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32315 (Oct. 13, 2016) ("Liquidity Risk Management Rule") (Rule 22e-4 under the Investment Company Act requires certain funds to adopt a written liquidity risk management program designed to assess and manage a fund's liquidity risk).

[19] For example, under the Liquidity Risk Management rule a board can designate the fund's investment adviser or an officer or officers (not including a portfolio manager of the fund) as the party responsible for administering a fund's liquidity risk management program. *See* Liquidity Risk Management Rule, *surpa* n. 18, at 249. In

any new rules for investment advisers that contain "risk management program" elements similar to the Liquidity Risk Management Rule or the Derivatives Rule, it will be interesting to see if the SEC will continue to build risk management program elements into future rules, particularly in light of an impending new SEC Chair and the selection of a new Director of the Division of Investment Management.

II. Sufficiency of Resourcing to Manage Risks

A. The Compliance Program Rule went into effect over 16 years ago so at this point, the SEC expects large investment advisers to have adopted and implemented mature, robust, and well-thought-out compliance programs. However, in a recent Risk Alert issued by the Office Compliance Inspections and Examinations ("OCIE")[20] it was noted that deficiencies "related to the Compliance Program Rule are among the most common deficiencies cited by OCIE" and a lack of resources devoted to compliance was among the deficiencies highlighted.[21]

B. Obtaining adequate resources to fund a sophisticated risk management program can be challenging for CCOs and other risk professionals in the current environment and many such professionals are being asked to stretch their budgets further and do more with less. In a 2019 speech by Pete Driscoll, Director of the Division of Examinations, he discussed the staff's concern "when [they] hear directly from industry participants and read press reports that compliance resources and budgets are being cut or are not keeping up with a firm's risk profile."[22] The SEC staff has consistently emphasized that investment advisers must ensure adequate compliance resources are available to compliance programs at all times, including the most challenging times.[23]

   a. Even with these warning, the Risk Alert states that a lack of resources is a significant weakness that the Division staff continues to observe in exams.[24] Some of the observations regarding lack of compliance resources include:

      i. CCOs who had other professional responsibilities within the organization or with other affiliates and who could not devote sufficient time to their

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addition, under the Derivatives Rule, a natural person who is an officer of the fund's investment adviser must be designated as the fund's derivatives risk manager. *See* Derivatives Risk Management Rule, *surpa* n. 18, at 49.

[20] The Office of Compliance Inspections and Examinations recently changed its name to the Division of Examinations (the "Division"). Any references to OCIE are due to the timing of the name change to the Division.

[21] Risk Alert, Office of Compliance Inspections and Examinations, OCIE Observations: Investment Adviser Compliance Programs (Nov. 19, 2020) (the "Risk Alert"), available at https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf .

[22] Peter Driscoll, Director, OCIE, Remarks at the NRS Spring 2019 Compliance Conference, Orlando Florida (Apr. 29, 2019), available at https://www.sec.gov/news/speech/speech-driscoll-042919.

[23] *See e.g.*, Lori Richards, Director, OCIE, Open Letter to CEOs of SEC-Registered Firms (Dec. 2, 2008), available at https://www.sec.gov/about/offices/ocie/ceoletter.htm (reminding CEOs of SEC-registered firms that their fiduciary responsibility requires a constant commitment to investors. That means sustaining their support for compliance during this market turmoil, and beyond….")

[24] *See* Risk Alert, *supra* n. 21.

CCO responsibilities, including being unable to enhance their own education of the Advisers Act.

ii. Some firms were observed to have not devoted enough resources to develop and implement an effective compliance program. Some examples cited were insufficient compliance members and lack of training.

iii. Other firms had grown significantly in terms of size or complexity but were observed in some cases to not have expanded their compliance resources.

b. While the SEC staff has made these observations, many large investment advisers have sought to garner efficiencies in allocating their resources, such as:

i. Utilizing greater amounts of technology to streamline processes. Greater efficiencies may result in a decrease in necessary personnel to perform otherwise manual functions, for example.

ii. Large advisers also may seek to outsource certain activities– this could be a process or it could be an entire function. In these circumstances, adviser personnel may be able to reduce the adviser's resources necessary to perform the outsourced tasks, however, it is important for the adviser to account for appropriate resources to oversee the vendor, which is another potential source of risk for the adviser.[25] This risk may be increased when such services are delegated to firms whose personnel are located in a different country from the adviser's operations or situations where the vendor's personnel are not otherwise familiar with the regulated environment of the funds or advisers they serve.

III. What is a CCO's Potential Liability for Compliance Failures? Is it Personal?

A. So what if the SEC finds that you have an inadequate compliance program? Who's fault is it? The Company? Someone else? Could they investigate the CCO, who may not be involved in the compliance failure? These are certainly concerning questions for a CCO.

B. Historically, the vast majority of compliance program failure cases do not involve allegations or charges against CCOs but there is precedent that a CCO can be held personally responsible for the design and implementation of the firm's policies and procedures.[26]

[25] Utilizing third parties to perform required functions for funds or investment advisers introduces additional risk of having the appropriate level of oversight of the vendor and its processes. Funds and advisers must employ robust oversight of such service providers as part of their obligations under the Compliance Program Rule (including Rule 38a-1 under the Investment Company Act).

[26] Blackrock Advisors, LLC, Exchange Act Rel. No. 4065 (Apr. 20, 2015) (holding Blackrock's CCO personally liable because he "was responsible for the design and implementation of Blackrock's written policies and procedures" and "knew and approved of numerous outside activities" by Blackrock's employees, but nonetheless "did not recommend written policies and procedures to assess and monitor those outside activities and to disclose conflicts of interest.)

C. The analysis of potential CCO liability related to a compliance failure is complex and is evaluated on a case-by-case basis. However, the SEC has not provided any formal guidance laying how a CCOs conduct will be evaluated in the event of a compliance failure. This absence of guidance is a source of significant angst for the well-intentioned compliance professional and the compliance community.

D. Some SEC Commissioners and industry organizations have been concerned about the standards applied to CCO conduct and what certain enforcement actions signal to CCOs.[27] Judging CCO conduct in hindsight without providing more concrete standards has led to many concerns that the lack of guidance will result in a chilling effect on the CCO community and may deter diligent compliance officers from joining or remaining in the industry.

   a. In a recent speech by SEC Commissioner Hester Peirce, [28] she was critical of the lack of clarity that has been provided to CCOs in this area. She also pointed to the historical enforcement approach to CCO personal liability as previously outlined in a speech by Andrew Ceresni, former Director of the Division of Enforcement, where he described three categories of cases where the Commission charged a chief compliance officer:

      i. Cases where the compliance officer participated in the underlying misconduct unrelated to his or her compliance duties.[29] Commissioner Peirce in her speech, agreed with this approach and reiterated that in these cases, compliance personnel should be held liable on the same terms and to the same extent as any other bad actor.

      ii. Cases where compliance officers obstructed or misled Commission staff.[30] Commissioner Peirce noted that conduct that undermines the

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[27] N.Y.C. Bar, Report on Chief Compliance Officer Liability in the Financial Sector (Feb. 2020), available at https://s3.amazonaws.com/documents.nycbar.org/files/Report_CCO_Liability_vF.pdf; *see also* Daniel M. Gallagher, Statement on Recent SEC Settlements Charging Chief Compliance Officers With Violations of Investment Advisers Act Rule 206(4)-7 (June 18, 2015), available at https://www.sec.gov/news/statement/sec-cco-settlements-iaa-rule-206-4-7.html ("Both settlements illustrate a Commission trend toward strict liability for CCOs under Rule 206(4)-7."); and Letter from Lisa D. Crossley, Executive Director, National Society of Compliance Professionals, to Andrew Ceresney, Director, SEC Division of Enforcement (Aug. 18, 2015), available at https://www.finracompliance.com/wp-content/uploads/2015/08/NSCP_CCO_Liability_Letter_August_18_2015.pdf

[28] Remarks of SEC Commissioner Hester M. Peirce, When the Nail Fails – Remarks before the National Society of Compliance Professionals (Oct. 19, 2020), available at https://www.sec.gov/news/speech/peirce-nscp-2020-10-19. *See also* Andrew Ceresney, 2015 National Society of Compliance Professionals, National Conference: Keynote Address (Nov.4, 2015), available at https://www.sec.gov/news/speech/keynote-address-2015-national-society-compliance-prof-cereseney.html.

[29] AlphaBridge Capital Mgmt. LLC, Advisers Act Rel. No. 4135 (July 1, 2015) (finding the CCO/Portfolio Manager liable for several violations of the Advisers Act where he committed fraud in pricing the fund that he also managed).

[30] *See e.g.*, In the Matter of Parallax Investments, LLC, John P. Bott, II, and F. Robert Falkenberg, Advisers Act Rel. No. 4159 (Aug. 6, 2015) (SEC charged a CCO for compliance-related violations where he altered documents provided to the SEC during an exam to deceive the staff about whether the firm had conducted the required annual compliance review).

examination process must be addressed, particularly where it is knowing and intentional misconduct.

iii. Cases where the CCO has exhibited a wholesale failure to carry out his or her responsibility. Commissioner Peirce stated that these are the types of cases that present the most difficulty. She described these as cases where the SEC charges the compliance officer with aiding and abetting the company's violations and the evidence must show that the compliance officer must have engaged in reckless conduct,[31] meaning there was "a danger so obvious that the [compliance officer] must have been aware of the danger."[32]

b. Commissioner Peirce indicated that she may develop a draft framework "detailing which circumstances will cause the Commission to seek personal liability and which circumstances will militate against seeking personal liability" for discussion with her colleagues and has welcomed the input of the compliance community on what factors would be relevant to the decision about whether to charge compliance personnel. She believes that providing greater clarity on this issue will not only eliminate uncertainty but also inspire good compliance practices.

[31] *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004).

[32] I*d*. at 1143.

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MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

Risk Management for Smaller Firms

Geoffrey Edelstein, Granite Investment Partners, LLC

Sarah Ronnenberg, Horizon Investments, LLC

Neshie Tiwari, Ellevest, Inc.

Linda Paullin-Hebden, Warner Norcross + Judd LLP

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EFFECTIVE STRATEGIES & BEST PRACTICES

Roadmap for Today

- Risk Management
- Responsibility for Risk Management
- Strategic Risk Management
- Evaluating and Responding to Risks
- Implementing Controls
- Recent Trends
- CCO Liability
- Shrinking Compliance Budgets
- Questions

What is Risk Management?

- A firm-wide program to identify, assess and mitigate risk.
- A program which aligns to the size and type of the advisory business.
- To avoid violations from occurring, detecting violations that have occurred, and correct any violations that have occurred.
- Areas of concern: investment management, disclosures, fees, cybersecurity, soft dollars compensation, trade execution, personal trading, vendor management, succession plan and private funds.
- Identify control functions: finance, investment management, operations, marketing and human resources.
- Quantify risks: probability, severity, mitigating factors and controls.

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EFFECTIVE STRATEGIES & BEST PRACTICES

Why is Risk Management Important

Know your audience:

- Regulators
- Clients and prospects
- Third-party business partners
- Board of directors/managers
- Reputation including online
- Limitation of liability

Who is Responsible

- Compliance/CCO
- Risk Committee
- Other departments or business teams
- Outside vendor
- Others on the front line
- Tone from the top; support from senior leadership
- *Empowerment, seniority and authority*
- *Different levels of approval based upon risk*

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EFFECTIVE STRATEGIES & BEST PRACTICES

Strategic Risk Management

- Types of risks to consider: Operational, compliance, compliance, reputational, strategic, liquidity, pandemic and other risks.
- Appetite for Risk: management, compliance, client and other factors.
- Identifying Risks:
  - Talking to the business group
  - Understanding the process
  - Follow the money
  - Testing

Triggers for Risk Assessment

- Regulatory updates
- SEC deficiency letters
- Division of Examinations risk alerts
- New products

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EFFECTIVE STRATEGIES & BEST PRACTICES

Business Triggers for Risk Assessment

- Succession planning
- Financial changes
- Changes to investment process
- Loss of key personnel
- Mergers & Acquisitions
- Growth or contraction (market or client decision)
- Client concentration

Evaluating Risks

- Identify the policies and procedures related to each risk.
- Evaluate whether the policies and procedures adequately address the risks, or whether there are any gaps.
- Ascertain level of risk to firm and clients.
- Any conflicts of interest identified during this process should be separately reviewed.

Response to Identified Risks

- Risks can either be eliminated or mitigated and disclosed.
- Modify and update any policies and procedures that fail to adequately address risk.
  - Do the policies and procedures work?
  - Have you addressed past deficiencies?
  - Did you learn from the past deficiencies?

Tailoring Your Risk Assessment

- Conduct a risk assessment; there are no guarantees.
- Identify conflicts and compliance considerations that create risks specific to your firm.
- Ensure that policies and procedures are designed to address firm-specific risks.
- Prioritize addressing issues that pose the greatest risk.
- Risk management tools:
  - Risk assessment matrix
  - Questionnaires and attestations
  - Training and continuing education programs
  - Firm approach – compliance is everyone's business

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EFFECTIVE STRATEGIES & BEST PRACTICES

Implementing and Managing Controls

- Mapping risks to compliance controls.
- Implementing controls.
  - Client related controls (i.e., terminations)
  - Compensation and conflicts
  - Valuation process
  - Product Specific (third-party managers)
  - Trading (including personal trading)
  - Technology (remote work)

Map Risks to Policies and Procedures

ABC RIA 010113

Risk Matrix

Business Area		Responsible Person(s)	Corresponding Policies & Procedures	Identified Risk	Inherent Risk Level		Control Factors
Advertising & Marketing		Multiple Employees	Disclosure, Marketing & Valuation	possible use of misleading performance information or testimonials; misrepresentation of services offered	low		pre-clearance of all marketing items required by CCO as produced; annual review of all marketing materials; employee training
			Social Media	employees posting non-approved marketing materials on social websites	low		training; pre-clearance forms
Business Continuity		Controller	BCP Policy	loss of key personnel; natural disaster; interruption of services; BCP not tested	low		procedures provide for backup and cross training of employees who understand their backup duties
Cash/Check Handling		Ops	BEBC; Custody Policy	incoming mail not properly processed	low		mail opened & date stamped by Ops; checks for custodians logged to overnight custodian log sheet & sent to Ops; ABC checks logged in log book & given to controller; check log & overnight sheet reviewed by receptionist & Ops; bank reconciliation by PA
				deposit processing	low		deposit prepared by controller
		PA; Controller		bank reconciliation	low		bank statement delivered unopened to PA & performs reconciliation; controller then reconciles
Compliance		CCO	Charter; Compliance Review & Education; COE	employee transactions violate Code of Ethics & Insider Trading	med		semi-monthly review of employee blotter; quarterly transaction report; annual holdings report

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EFFECTIVE STRATEGIES & BEST PRACTICES

Recent Trends

- Inadequate compliance resources
  - CCO's with multiple hats
  - Lack of resources
  - Growing adviser that fails to add resources
- Insufficient authority of CCOs
- Annual review deficiencies
- Failure to implement actions required by WP&P
- Failing to update or maintain WP&P

Recent Trends – Continued

- COVID-19
  - Business continuity plan
  - Supervision of remote personnel
  - Avoiding an increase in errors
  - Protection of sensitive information

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EFFECTIVE STRATEGIES & BEST PRACTICES

CCO Liability

- SEC actions against CCOs
- The joint CCO/CEO dilemma
- The outsourced CCO
- Any impact from the new Biden administration
- Avoiding liability; best practices

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Shrinking Compliance Budgets

- Managing more with less
- Typical size of compliance budgets and budget process
- Buffers for anticipated new products
- Leveraging outside resources
- Training
- Technology
- Other best practices

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Questions for the Panel?


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

Warner Norcross + Judd LLP

RISK MANAGEMENT FOR SMALLER FIRMS[1]

Investment Adviser Association
Investment Adviser Compliance Conference
March 3-5, 2021

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I. Background – Obligations under the Investment Advisers Act and the Stages of the Risk Management Process

a. The Investment Advisers Act of 1940, as amended ("Act") does not include any substantive risk management requirements.

b. However, Rule 206(4)-7 ("Compliance Rule") requires every investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised persons, of the Act and the rules that the SEC has adopted under the Act.[3]

c. The Compliance Rule does not explicitly require an adviser to conduct a risk assessment. However, SEC staff have stated numerous times that they expect advisers to do so as part of their compliance with the Compliance Rule. The rule's adopting release states: "*Each adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks*."[4]

II. Establishing a Compliance Program

a. According to the adopting release for the Compliance Rule, policies and procedures should address the following areas (at a minimum):[5]

   i. Portfolio management processes;

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[1] This outline provides general information on the subject matter listed above and was prepared for educational use only. These materials are not designed to, and do not, constitute legal advice on any matter, should not be relied upon for that purpose and does not create an attorney-client relationship. Each advisory firm must tailor its risk assessment process to the firm's own operations and business.

[2] Diane Currie is a Senior Compliance Consultant and is not licensed to practice law.

[3] The rule also requires firms to designate a Chief Compliance Officer ("CCO") to administer the policies and procedures.

[4] *Compliance Programs of Investment Companies and Investment Advisers*; Inv. Adv. Rel. No. 2204 (Dec. 17, 2003).

[5] *Id.*

ii. Trading practices;
iii. Proprietary trading of the adviser and personal trading of supervised persons;
iv. Accuracy of disclosures to investors, clients, regulators, etc. including account statements[6] and advertisements;
v. Safeguarding of client assets from conversion or inappropriate use by advisory personnel;[7]
vi. Accurate creation of required records and maintenance of records in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
vii. Marketing advisory services, including use of promoters;
viii. Processes to value client holdings and assess fees based on those valuations;
ix. Safeguards for the privacy and protection of client records and information – Regulation S-P and Regulation S-ID;[8]
x. Business continuity planning.

b. Firms that operate out of multiple geographic locations should also have policies and procedures in place dedicated to the supervision of their branch office locations.[9]

c. Deficiencies related to the Compliance Rule are among the most frequent cited by the Department of Examinations (formerly OCIE).[10] The most common weaknesses include:
i. Inadequate compliance resources;
ii. Insufficient authority of the Chief Compliance Officer to implement policies and procedures;
iii. Inability to demonstrate that an annual review occurred, or failing to address significant risks when conducting the review;
iv. Failure to implement actions required by written policies and procedures, or train employees;
v. Failure to tailor policies and procedures to the firm;

d. Policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred, and correct violations promptly.

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[6] For more information about the specific compliance risks associated with advisory fees and expenses, see *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers* (Apr. 12, 2018). The disclosure clients receive related to an adviser's fees and expenses are critical to the client's ability to make an informed decision about whether to retain a particular adviser. An adviser that fails to adhere to the terms related to fees and expenses in its advisory agreements and Form ADV may violate the Act and its rules, including the anti-fraud provision.

[7] The Department of Examinations has detailed the specific risks associated with custody of client assets in *Risk Alert: Significant Deficiencies Involving Adviser Custody and Safety of Client Assets* (Mar. 4, 2013).

[8] See *Risk Alert: Cybersecurity: Safeguarding Client Accounts against Credential Compromise* (Sept 15, 2020) for more details on methods firms can use to protect client information, including (1) policies and procedures related to password requirements, (2) multifactor authentication, (3) CAPTCHA, and (4) monitoring for leaked user IDs and passwords.

[9] For more details of the specific risks associated with branch offices, see *Risk Alert: Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices* (Nov. 9, 2020). "[A]dvisers that do not monitor, review, and/or test their branch office activities may not be aware that the compliance controls they have adopted are not effectively implemented or do not appropriately address the intended risks and conflicts in these remote locations." *Id.*

[10] *Risk Alert: OCIE Observations: Investment Adviser Compliance Programs* (Nov. 19, 2020).

III. Conducting a Risk Assessment

a. Timing:
   i. An assessment of all the firm's risks does not have to be undertaken at once – it can be a rolling process conducted throughout the year.
   ii. Risks should be assessed regularly and in response to triggering events, such as:
      A. New products;
      B. Regulatory updates;
      C. SEC deficiency notices;
      D. Division of Examinations Risk Alerts.[11]

b. Who should be involved:[12]
   i. It is important to clearly designate the person or persons responsible for conducting and overseeing the assessment. Depending on the size and operations of the firm, the responsibility could fall to the CCO, a risk committee, or could be outsourced to an independent third party.
   ii. Regardless of who is responsible, that person(s) should involve the individuals who carry out the operations that are subject to the review. These individuals are the most likely to observe weaknesses in the system and can provide insight on how day-to-day operations are conducted.
   iii. Management should also be involved to set the "tone at the top" and make it clear that compliance is a priority in the firm.

c. Types of risks to consider:[13]
   i. Operational – risks related to the way the firm conducts its day-to-day operations.
   ii. Strategic – big picture risks related to the firm's strategic business decisions.
   iii. Financial – risk that firm may be unable to meet financial obligations; financial risks can be internal (ex: overhead costs) or external (ex: interest rates).
   iv. Compliance – risk that failure to comply with a law or regulation could result in adverse action taken against the firm.
   v. Personnel – risks associated with the conduct, attitude and personal decisions of individual firm employees.
   vi. Technology – risks related to adapting or failing to adapt to changing technology.

d. When in doubt, "follow the money." The pressure to increase income, profits, and assets could cause employees to place the interests of the firm ahead of clients, or to place the interests of some clients ahead of others.

e. Areas where risk could be present:
   i. Marketing/performance;
   ii. Form ADV/CRS and other disclosures;
   iii. Invoices/fees;
   iv. Cybersecurity;

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[11] A list of Risk Alerts is available on the Department of Examinations website (https://www.sec.gov/exams)

[12] See the Institute of Internal Auditors Position Paper, "*The Three Lines of Defense. In Effective Risk Management and Control*" dated January 2013.

[13] Kit Sadgrove, *The Complete Guide to Business Risk Management* (3d Ed. 2015).

v. Soft dollars;
vi. Compensation (ex: incentive based);
vii. Trade execution;
viii. Non-public information;
ix. Personal and proprietary trading;
x. Succession Plan;
xi. Vendor Management;
xii. Private funds.

f. Testing:[14]
   i. Transactional testing which includes monitoring a control in real time to determine whether all aspects of the control are operating effectively.
   ii. Forensic testing which includes reviewing a larger group of transactions at a later date for trends and patterns, and to identify transactions that should have been subject to a control but were not.
   iii. Tests can be targeted or conducted through random sampling.
   iv. Firms should conduct both transaction and forensic tests, and should do so through both targeted testing and testing random samples.

g. Evaluating risks:[15]
   i. After risks have been identified, they should be evaluated to determine the level of risk they pose to the firm.
   ii. When evaluating risks, consider the likelihood of occurrence and the impact of the occurrence.
   iii. The level of risk may change from year to year.
   iv. Any conflicts of interest that are discovered during the risk assessment process should be separately reviewed to determine whether they have been adequately disclosed.[16]
   v. There are heightened concerns surrounding sophisticated products like derivatives because risk may not be as easy to measure, and by extension they are more difficult to fully disclose to investors.
   vi. Consider use of a risk management heat map.

h. After risks have been identified and evaluated, firms should connect those risks to the controls that are designed to eliminate or mitigate them. This can be done through the creation of a "risk matrix."[17]

IV. The Annual Review

a. Risk assessments conducted throughout the year will drive the focus of the annual review.

b. The review should consider any compliance matters that arose during the previous year, any changes in the business activities of the firm (or its affiliates) and any

[14] For more detailed information on testing, see Patricia M. Harrison, *et al., New Year, New Beginnings for Firm Risk Assessment Programs*, NSCP Currents (Mar. 2020).
[15] See also, Sample Risk Management Heat Map attached as Exhibit A to this Outline.
[16] According to the SEC, full and fair disclosure of a conflict of interest includes: (1) the appropriate level of specificity, including the appropriateness of stating that an adviser "may" have a conflict, and (2) considerations for disclosure regarding conflicts related to the allocation of investment opportunities among eligible clients. *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Advisers Act Rel. No. 5248 (June 5, 2019).
[17] See Sample Risk Assessment Inventory attached as Exhibit B to this Outline.

changes in the Act or rules adopted under the Act that might suggest a need to revise policies and procedures.

c. If there have been changes to the Act or rules, it is a best practice to address those in the review even if they did not affect your firm. This demonstrates to the SEC that your firm was aware that changes have occurred.

d. The most critical aspect of the review is following-up with any exceptions identified during the review. Exceptions are expected, but they must be resolved.[18]

e. Summary report:
   i. A written report is not technically required by the Act, but it is a best practice that can be used to communicate with senior management and demonstrate to the SEC that the firm has thoroughly reviewed the its risks.
   ii. When drafting a summary report, keep in mind that the audience includes both internal firm employees, and external examiners.
   iii. The Compliance Rule requires firms to keep a copy of the policies and procedures in effect within the past five years and any records documenting the firm's annual review of those policies and procedures.

f. Common mistakes:
   i. The review is overly broad and not detailed enough.
   ii. The firm falls behind in conducting its risk assessment.
   iii. The firm fails to address concerns identified in the risk assessment, or in the annual reports from prior years.

V. Examinations[19]

a. During an examination, the SEC is likely to request the following:
   i. Risk inventory;
   ii. Documents mapping the risk inventory to controls/written policies and procedures;
   iii. Written guidance provided to employees regarding the risk assessment process and the procedures to mitigate and manage risks.

b. Preparing for a SEC examination is an ongoing process including:
   i. Ongoing testing;
   ii. Updates for new products;
   iii. Reviews and updates for SEC risk alerts;
   iv. Curing prior deficiencies.

d. CCO Liability:[20]
   i. CCO should be competent and knowledgeable;
   ii. Firm should empower the CCO;

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[18] The Department of Examinations has stated that one of the most frequent deficiencies associated with the Compliance Rule is a firm's failure to address the adequacy and effectiveness of its policies and procedures. *See Risk Alert: The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers* (Feb. 7, 2017).

[19] For more information on preparing for an examination, see Michelle L. Jacko, *Tips on How to Prepare for Your Next Examination: Part 1*, NSCP Currents (Mar. 2019), and Michelle L. Jacko, *Tips on How to Prepare for Your Next Examination: Part 2*, NSCP Currents (Apr. 2019)

[20] "*The Role of the CCO-Empowered Senior and With Authority*", Peter Driscoll, Director, Office of Compliance Inspections and Examinations (November 19, 2020).

iii. CCO should have a position of sufficient seniority and authority to compel others to adhere to the policies and procedures.

VI. COVID-19

a. The coronavirus pandemic has created new operational, technological, commercial and other challenges for firms and generated regulatory and compliance questions.[21]

b. At the outset of the pandemic, the Department of Examinations indicated that its priorities would be:[22]

i. Protection of investors' assets;

A. Consider changes in policies and procedures to reflect changes made to the process by which client checks and transfer requests are processed (for example, if client checks are mailed to the firm, but there is not someone in the office every day to check the mail).

B. Changes to policies and procedures may also be necessary to address clients taking unusual or unscheduled withdrawals from their accounts.[23]

ii. Supervision of personnel:

A. Consider how personnel can be effectively supervised when working from remote locations.

B. Consider whether policies and procedures effectively address communications or transactions occurring outside of the firm's systems.

iii. Practices relating to fees, expenses, and financial transactions:

A. The pandemic and the associated market volatility may have caused increased financial pressures on firms and clients.

B. Remote work also increases the possibility for calculation and valuation errors.

iv. Investment fraud:

A. The SEC has suspended trading for many issuers due to false and misleading claims such as development of or access to cures, vaccines, or personal protective equipment.

B. Firms that suspect fraud should report it to the SEC.

v. Business continuity:

A. Business continuity planning should be part of a firm's regular policies and procedures.

B. Security and support for facilities and remote sites may need to be modified or enhanced.[24]

vi. Protection of investor and other sensitive information:

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[21] See the Department of Examinations statement in response to the pandemic, *OCIE Statement on Operations and Exams – Health, Safety, Investor Protection and Continued Operations are our Priorities* (Mar. 23, 2020).

[22] *See also* *Risk Alert: Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers* (Aug. 12, 2020).

[23] *See, e.g.*, Congressional Research Services, *In Focus: Withdrawals and Loans from Retirement Accounts for COVID-19 Expenses* (updated March 27, 2020).

[24] For example, consider whether (1) additional resources and/or measures for securing servers and systems are needed, (2) the integrity of vacated facilities is maintained, (3) relocation infrastructure and support for personnel operating from remote sites is provided, and (4) remote location data is protected. *See supra* note *23*.

A. The use of videoconferencing and other electronic communication methods increase the potential for loss of sensitive information, including clients' personally identifiable information.
B. Consider paying particular attention to risks related to access to systems, investor data protection, and cybersecurity.

EXHIBIT A
Sample Risk Management Heat Map

-- SAMPLE DOCUMENT --
-- NO LEGAL ADVICE INTENDED --

Enterprise Risk Management Heat Map with Trend Info

	Year 1	Year 2	Trend
Compliance risk			
Personnel			
CCO	1	1	-
Tone at the top	1	1	-
Conflicts of Interest			
Trustee of client accounts	2	2	-
Fees/Billing	2	2	-
Investment Process			
Equity Discretionary Trading/Brokerage	1	1	-
Fixed Income Discretionary Trading/Brokerage	1	3	2
Proxy Voting	1	1	-
Other			
Due Diligence of Sub-advisers	2	3	1
Principal or cross transactions	2	2	-
Trade execution			
Best Execution	2	1	(1)
Soft dollars	1	1	-
Trade errors	1	1	-
Allocations and rotation	1	2	1
Policies and Reviews			
Policies and Procedures	1	1	-
Code of Ethics	1	1	-
Annual Review	1	1	-
Client Investment Policies	1	2	1
Advertising/Marketing			
GIPS	1	1	-
Print advertising	1	2	1
Sales and marketing activity	1	1	-
Gifts / Entertainment	1	1	-
Political Contributions	1	1	-
Registration and Reporting			
SEC	1	1	-
State (firm)	1	1	-
State (individuals)	1	1	-
Other (NASD, DOL)	1	1	-
Legal/Reputation			
Firm			
Industry presence	1	1	-
Firm principals	1	1	-
Litigation	2	2	-
Others			
Vendors	1	1	-
Affiliate relations	1	1	-
Recommendations of other service providers	2	2	-

-- SAMPLE DOCUMENT --
-- NO LEGAL ADVICE INTENDED --

Enterprise Risk Management Heat Map with Trend Info

	Year 1	Year 2	Trend
Operating Risk			
Systems			
Portfolio Accounting	1	2	1
Systems Documentation	1	1	-
Email archiving	1	1	1
Data Security	1	1	-
Business Continuity/Disaster Recovery			
Disaster Recovery plan and testing	1	1	-
Systems outages	1	1	-
Policies			
Client level reviews	1	2	1
Custody	2	2	-
Physical Security	1	1	-
Strategic Risk			
Financial Risk			
Client Retention	1	1	-
Investment Performance	1	1	-
Revenue Concentration	1	1	-
Professional Liability Insurance	1	1	-
Fraud	1	1	-
New Product Risk			
Starting a new product	1	1	-
Incubation of new product	1	1	-
Investment Personnel			
Compensation structure	1	1	-
Performance	1	2	1
Key Personnel	1	1	-
Investment Committee	1	1	-
Other Personnel Issues			
Marketing	1	1	-
Background checks	1	1	-
Retirement Plan	1	1	-
Employee withholding	1	1	-
Credit Risk			
Client Receivables	1	1	-
Vendor performance	1	1	-
Interest Rate/Market/Price			
Revenue Volatility	1	1	-
Corporate Governance			
Board Meetings			
Frequency	1	1	-
Meeting agenda	1	1	-
Sarbanes-Oxley	1	1	-
Operating Agreement	1	1	-

-- SAMPLE DOCUMENT --

-- NO LEGAL ADVICE INTENDED --

Enterprise Risk Management Heat Map with Trend Info

	Year 1	Year 2	Trend
Audits and exams			
External exams	1	1	-
Internal audits	1	2	1
HR policies			
Policy manual	1	1	-
Policy implementation	1	1	-
Human resources - non-investment personnel			
Compensation	2	2	-
Staffing and turnover	2	1	(1)

EXHIBIT B
Sample Risk Assessment Inventory

[RIA Firm]
Risk Assessment Inventory
Last Updated March 1, 2012

No.	Identified Risk	SEC Rule	Method to Mitigate Risk	Map to [RIA Firm] Policy and Procedure
1)	Portfolios are managed according to client investment objectives. Clients with similar investment styles do not have unexplainable superior or inferior performance.	275.206(4)-7	[RIA Firm] Portfolio Managers create Investment Policy Guidelines for all new clients. [RIA Firm] PMs generally offer to schedule an appointment at least once per year to meet with clients to understand and update their investment objectives. [RIA Firm] Portfolio Management has created Policy and Procedures 5.01 (Quarterly Portfolio Review Process) and 5.04 (Client Reviews) to manage accounts according to client investment objectives. [RIA Firm] has also created performance metrics that will be reviewed by both Portfolio Management and Compliance to investigate client accounts for outlier performance results.	8.01 Portfolio Management
2)	Investment opportunities are allocated fairly among clients.	275.206(4)-7	[RIA Firm] has written a comprehensive compliance policy and procedure that both references portfolio management policies procedures and operations tasks that describes the steps that [RIA Firm] personnel go through to allocate investment opportunities to their clients. The [RIA Firm] Investment Committee generally considers an investment purchase or sale across all client accounts, subject to client or cash restrictions. A chosen position percentage is then decided for all eligible accounts. [RIA Firm] does not participate in IPOs or limited offerings for its clients, and places restrictions (via the [RIA Firm] Code of Ethics) on those [RIA Firm] employees wishing to trade their own accounts.	8.09 Allocation of Investment Opportunities
3)	Client accounts are traded according to [RIA Firm] best execution disclosures in [RIA Firm] ADV Part II. Fairness of commission rates charged to clients.	275.206(4)-7	On a annual basis, [RIA Firm]'s CCO prepares a best execution analysis. A separate analysis is performed for its fixed income brokers. Existing and new brokers are evaluated according to best execution factors, and the [RIA Firm] best execution committee selects those brokers for the upcoming year to use.	8.05 Best Execution
4)	[RIA Firm] disclosures to regulators, clients, and others are accurate.	275.206(4)-7	[RIA Firm] generates its client holdings and performance from its Advent portfolio management system, with no outside the system modifications. [RIA Firm] Advent portfolio records are reconciled to custodial statements on a daily basis (monthly for non-Schwab accounts). Portfolio statistics generated for the SEC and public dissemination (such as its 13F filings) are generated directly from reconciled Advent data. [RIA Firm] Operations and the CCO both periodically reconcile custodial records to [RIA Firm] Advent month-end and quarterly reports.	8.13 Accuracy of Disclosures and Account Statements
5)	[RIA Firm] complies with other regulatory restrictions that may be applicable to [RIA Firm] operations (other than the Adviser Act). For [RIA Firm] this would include Regulation S-P and DOL ERISA rules.	Reg. S-P, others	[RIA Firm] gives its privacy notice to all new customers, and yearly provides it to all [RIA Firm] clients. [RIA Firm] has implemented comprehensive policies and procedures to protect customer confidential information and other [RIA Firm] information. In addition, [RIA Firm] has implemented policies and procedures to comply with Department of Labor ERISA rules and regulations and has distributed instructions to [RIA Firm] portfolio managers. [RIA Firm] has acquired an ERISA bond for its own PSP. [RIA Firm] also holds and ERISA bond for all ERISA plans under its management.	8.14 Other Regulatory Restrictions and 8.15 Privacy Policies and Procedures
6)	Trades are allocated to client accounts in a fair manner.	275.206(4)-7	[RIA Firm] has implemented operational procedures whereby all clients and access persons trading the same security on the same day receive the same average price (except in the potential case of some individual bond transactions). [RIA Firm] prints off allocation worksheets that are signed by each individual portfolio manager showing allocation of executed trades to client accounts. On a quarterly basis, the [RIA Firm] CCO reviews access persons accounts (some of which trade their accounts along with the [RIA Firm] block) to ensure that they do not receive a more favorable price execution than clients. [RIA Firm] does not typically trade in securities where a limited number of shares are allocable to client accounts. In the case of trades occurring over more than one day for the same security, clients and any access persons will receive a pro-rata allocation of their shares at the average price each day.	8.09 Allocation of Investment Opportunities

[RIA Firm]
Risk Assessment Inventory
Last Updated March 1, 2012

No.	Identified Risk	SEC Rule	Method to Mitigate Risk	Map to [RIA Firm] Policy and Procedure
7)	[RIA Firm] advertisements comply with SEC regulations. Accounts included in a composite are correctly gathered and calculated. Records to calculate performance are maintained and substantiable.	275.206(4)-1	[RIA Firm] has written a comprehensive compliance policy and procedure that describes the method by which its advertising composites are generated. [RIA Firm] accounts selected for the composites are strictly defined. Composites disclosures include appropriate language from the Clover no-action letter. [RIA Firm] composites are generated directly from Advent APX records and no outside the system adjustments are made. No manual records are used to generate composite numbers. Any other documents deemed to be advertising are reviewed by the [RIA Firm] CCO before being published (including quarterly investment perspectives and position papers). [RIA Firm] composites contained in electronic form are backed up offsite according to SEC books and records rule.	8.02 Performance Reporting
8)	Client assets are safeguarded from conversion or inappropriate use.	275.206(4)-2	All [RIA Firm] client assets are custodied at qualified custodians and receive custodial statements directly from the custodian on at least a quarterly basis, in accordance with the SEC's custody rule. [RIA Firm] has policies and procedures in place that instruct [RIA Firm] employees to refuse funds made directly out to [RIA Firm], and instruct [RIA Firm] employees what actions to take under various inadvertent receipt scenarios. [RIA Firm] does not have any authority outside of the deduction of its management fee to be deemed to have custody or possession of client assets. [RIA Firm] Operations and the CCO periodically reconcile custodial statements to [RIA Firm]'s separate client reports.	8.12 Safeguarding of Client Assets and Custody
9)	Personal trading of advisory personnel does not favor employees over clients. Access persons trading is more profitable than client trading. [RIA Firm] proprietary accounts outperform client accounts.	275.204A-1	[RIA Firm] has a Code of Ethics which is distributed and acknowledged by all supervised persons of the firm. All [RIA Firm] employees have been designated as access persons, and as such, are required to abide by the trading restrictions described in the [RIA Firm] Code of Ethics. The CCO reviews initial, annual, and quarterly access person reporting, to verify that all trading restrictions have been adhered to. In addition, access persons who wish to trade in the same security as clients on the same day must trade with the [RIA Firm] block and receive the same average pricing. [RIA Firm] also publishes a Research Focus List, which lists stocks [RIA Firm] access persons cannot trade unless with the [RIA Firm] block. [RIA Firm] has also developed forensic measures whereby the profitability of [RIA Firm] portfolio managers is compared to that of clients, and that client accounts are also reviewed for those substantially more or less profitable than the average..	8.06 Personal Securities, [RIA Firm] Code of Ethics
10)	Client account statements are accurate. Client fees are accurately calculated. Internal client account statements are accurately reconciled to custodial records.	275.206(4)-7	[RIA Firm] reconciles on a daily basis all accounts custodied with its primary broker/custodian with its internal Advent APX records. All reconciling items are investigated. On a monthly basis, all other accounts are reconciled. Before quarterly statements are produced, accounts must be completely reconciled to custodial records. Fee programs are run and PMs review all accounts under their management for accuracy. The [RIA Firm] CCO reviews on a quarterly basis the establishment of fee schedules for all new accounts, and also performs an independent audit of quarterly statements (including fee calculation), tracing all the way back to the custodial records.	8.11 Valuation of Client Holdings and Fee Assessment
11)	Books and records are maintained accurately and safeguarded.	275.204-2	[RIA Firm] has created a matrix of books and records which shows the method surrounding the creation, security, and maintenance, of its required books and records under the Advisers Act. This matrix is updated when changes occur. [RIA Firm] also transmits electronically a copy of its electronic records offsite. [RIA Firm] complies with Regulation S-P in terms of the protection of confidential client information, including having policies and procedures in place to protect confidential client and [RIA Firm] information. Outside service providers enter into privacy or confidentiality agreements with [RIA Firm].	8.08 Creation and Maintenance of Books and Records

[RIA Firm]
Risk Assessment Inventory
Last Updated March 1, 2012

No.	Identified Risk	SEC Rule	Method to Mitigate Risk	Map to [RIA Firm] Policy and Procedure
12)	Confidential client information is safeguarded.	Reg. S-P	This document describes [RIA Firm]'s policies and procedures in regards to protecting the privacy of consumer financial information and its procedures to guard nonpublic personal information. These policies and procedures are designed to comply with Regulation S-P and describe the physical, electronic, and procedural safeguards in place at [RIA Firm] to comply with Regulation S-P. A copy of [RIA Firm]'s privacy notice is also included in this document.	8.15 Privacy Policies and Procedures
13)	[RIA Firm] can continue to operate during disasters and interruptions.	275.206(4)-7	[RIA Firm] has written a comprehensive disaster recovery plan which is subject to complete revision on an annual basis and updated with major changes during the year, as necessary. [RIA Firm] employees receive annual training on disaster recovery and are provided with both a hardcopy and electronic copy of the DRP for their homes. [RIA Firm] has included in its DRP alternative worksite locations and methods to continue operations under various scenarios. The DRP also contains various phone trees, client lists, vendor lists, and alternate service providers. [RIA Firm] server data is transmitted offsite so that data can be recovered and operations restarted in case of disaster.	8.03 Disaster Recovery Plan
14)	Client proxies are voted appropriately and according to disclosures.	275.206(4)-6	[RIA Firm] has proxy voting policies and procedures whereby the adviser or his designee votes client proxies according to [RIA Firm] proxy voting guidelines. [RIA Firm] clients, when they open their custodial accounts, have the choice of delegating proxy voting to [RIA Firm]. A description of [RIA Firm]'s proxy voting policy is given to all [RIA Firm] clients. When voting client proxies, the adviser's delegate adheres to any client restrictions that have been communicated to [RIA Firm]. For most custodial accounts, [RIA Firm] uses a proxy tabulation service named ProxyEdge to vote and record proxy voting. The [RIA Firm] CCO also annually monitors proxy voting as part of his compliance reviews.	5.06 Proxy Voting
15)	[RIA Firm] supervised persons do not engage in insider trading and other improper trading behavior.	Section 204A	All [RIA Firm] supervised persons (access persons) are governed by [RIA Firm]'s Code of Ethics. The Code of Ethics contains various trading restrictions, including those prohibiting trading based on non-public information (insider trading). [RIA Firm] access persons are required to submit quarterly reporting of their securities transactions to the [RIA Firm] CCO. The [RIA Firm] CCO reviews all access persons trades against the public markets to look for instances where unusual price movements may have occurred. This review is noted on the quarterly transaction reports of access persons.	[RIA Firm] Code of Ethics
16)	Client trading errors are corrected in the best interest of clients.	275.206(4)-7	[RIA Firm] recognizes that it has a fiduciary duty to place orders correctly for client accounts. If a trade error is made by [RIA Firm], [RIA Firm]'s policy is that the client will be made whole. [RIA Firm] has published Policy and Procedure 8.10 on Trade Errors for [RIA Firm] employees to follow. When a trade error is made, its resolution is documented by [RIA Firm] Operations on the [RIA Firm] server, and if necessary, in paper format. The [RIA Firm] CCO, as part of his annual compliance review, reviews the trade error file and documents his findings.	8.10 Trade Errors
17)	Securities are accurately and fairly priced. Illiquid Securities are monitored.	275.206(4)-7	[RIA Firm] has developed policies and procedures, both compliance and operational, as well as how-tos, that instruct and describe how client securities are to be accurately and fairly priced. These procedures include daily and monthly reconciliation of [RIA Firm] Advent records to those of custodians. All reconciling items are investigated and corrected. [RIA Firm] does not generally trade in illiquid securities. There are a limited number of illiquid auction-rate securities with Nuveen that are monitored by the responsible portfolio managers. The portfolio managers documents the discussions with Nuveen.	8.11 Valuation of Client Holdings and Fee Assessment

[RIA Firm]
Risk Assessment Inventory
Last Updated March 1, 2012

No.	Identified Risk	SEC Rule	Method to Mitigate Risk	Map to [RIA Firm] Policy and Procedure
18)	[RIA Firm] client and other communications are monitored for potential irregularities and compliance with securities regulations and rules.	275.206(4)-7	[RIA Firm] has developed an E-Mail policy and procedure that describes to [RIA Firm] employees how e-mail should be used, and the steps that [RIA Firm] takes to retain and monitor e-mails. the firm has retained Smarsh as their e-mail archive provider. The CCO has developed e-mail review processes utilzing Smarsh whereby incoming and outgoing employee e-mails are reviewed for compliance irregularities. Reviewed e-mails are saved on the Smarsh system and any follow-up steps are documented by the CCO.	8.04 E-Mail Policies and Procedures
19)	[RIA Firm] reviews the adequacy of its compliance procedures, reviews any significant compliance issues, designates a CCO, and provides compliance training to its employees.	275.206(4)-7	The [RIA Firm] CCO performs an annual compliance review that reviews all significant compliance areas, discusses any problems encountered, and describes remedial actions taken and any improvements planned. [RIA Firm], in adherence to the SEC's Compliance rule, has designated a CCO. Each time a new compliance policy and procedure is created or updated (unless the updates are minor and immaterial), it is communicated to [RIA Firm] employees and any questions are addressed. Annual training and recertification is also given on the [RIA Firm] Code of Ethics.	8.16 Annual Compliance Review, CCO, and Training
20)	Compliance functions are performed on a timely basis and [RIA Firm] seeks to adhere to all applicable regulatory requirements.	275.206(4)-7	[RIA Firm] has created a compliance calendar which lists all the tasks that the [RIA Firm] CCO performs throughout the year. These tasks may include items that have due dates set by SEC rule, as well as deadlines set internally. Included in the compliance calendar are the issuance of any new compliance policies and procedures, as well as the updating of existing policies and procedures. The compliance calendar itself is subject to updating and revision. The CCO reviews adherence to the compliance calendar with his management.	8.17 Compliance Calendar
21)	[RIA Firm] acts appropriately in the case of class action suits for which [RIA Firm] clients may have affected securities.	275.206(4)-7	[RIA Firm] will analyze all class action notices received to determine the appropriate action to take for [RIA Firm] clients involved in the class action suit. In cases where [RIA Firm] clients may benefit from participating in the class action, [RIA Firm] may help clients to compile the necessary information to participate in the class action suit (including the employment of temporary help, if necessary, to compile such information). [RIA Firm] has in pending publication Policy and Procedure 8.18 to document the steps it takes regarding class action suits. [RIA Firm] also provides disclosure in its ADV Part 2 regarding class actions	8.18 Class Action Suits

Sample ERM Governance Structures

WILLKIE
WILLKIE FARR & GALLAGHER LLP

Type of Adviser	Advisory Subsidiary of Multinational Bank	Publicly Traded Investment Manager	Large Privately Owned Investment Manager	Small to Mid-Size Investment Manager	Small to Mid-Size Investment Manager	Small to Mid-Size Investment Manager
Risk Committee	Firmwide Risk Committee	Enterprise Management Group	Enterprise Risk Committee	Risk Management Committee	No Risk Committee	No Enterprise Risk Committee; Investment Risk Committee
Membership	CEO; CRO; COO; CFO; Treasurer/CIO; GC; Line of Business CEOs & CROs; Other Senior Mgrs. from Risk & Control Functions	CRO; Co-Head of Enterprise Op. Risk	CRO; CCO; CFO; CLO; Founding Principals; Heads of Sub-Comms; Heads/Co-Heads of Ops.; Head of Tech. Risk Comm.; Risk Mgmt. Team Personnel; Senior Portfolio Mgrs.	Managing Partners; CCO; CFO; COO; Senior Analysts	N/A	CIO; CEO; Lead PM
If no risk committee, individuals or groups responsible for ERM	N/A	N/A	N/A	N/A	Business units in the best position to monitor the specific risk	CEO, President and COO responsible for overall activities of the firm
Roles & Responsibilities	Escalation point for risk issues from committee members	Oversees risk mgmt. performed by each team	Oversees risk mgmt. of investments; reviews annually risk profile; reviews annually policies & procedures	Meets quarterly to review various investment-risk related matters	Annual risk assessment meetings and periodic informal meetings assessing potential compliance risks	Oversees risk mgmt. of investments
Role of Chief Compliance Officer	N/A	N/A	CCO a member of the Enterprise Risk Committee	CCO a member of the Risk Management Committee	Legal and Compliance departments meet formally at least annually to assess legal and compliance risks	CCO has no role on the investment risk committee, but is a member of the cybersecurity oversight group
Relationship to Portfolio Managers / Investment Team Members	Portfolio risk managed by PMs	Portfolio risk managed by PM teams	Risk oversight separate from general compliance activities & independent from PM teams	Escalation point for risk issues from compliance personnel	Portfolio risk managed by PM team	Portfolio risk managed by PMs (day-to-day) and by the investment risk committee

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

ERISA Updates

Sarah Buescher, Associate General Counsel, Investment Adviser Association
Bradford P. Campbell, Partner, Faegre Drinker Biddle & Reath LLP
Kathy D. Ireland, Consultant, K.D. Ireland Consulting, LLC
Kimberly H. Novotny, Senior Associate General Counsel, Franklin Templeton

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Agenda

- DOL ESG Rule
- DOL Proxy Rule
- Fiduciary Exemption
- Lifetime Income Disclosures
- Other Recent Issues
- Questions

DOL ESG Rule

- Overview
- Current Status
- Related Issues and Questions

DOL Proxy Rule

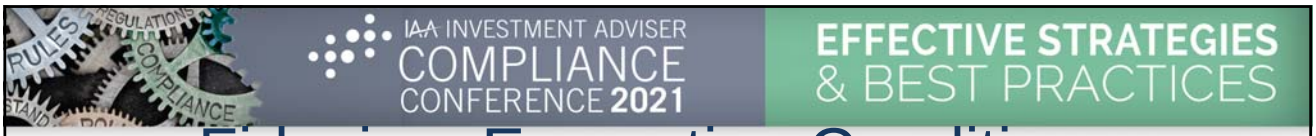
- Overview
- What it means for SEC-Registered Investment Advisers

Fiduciary Exemption

- Exemption plus interpretation of 5-part test
- Revokes Deseret
- Extension of Non-Enforcement Policy to Dec. 20, 2021

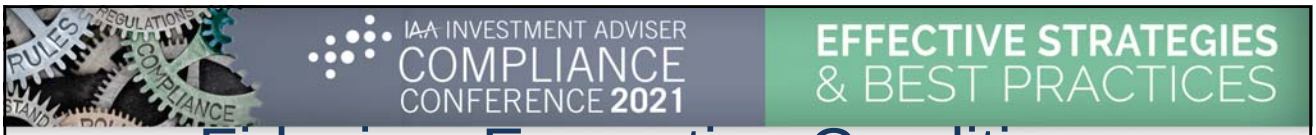
Fiduciary Exemption

- Applies to non-discretionary advice
- What does it mean for discretionary managers?
- Hire me discussions



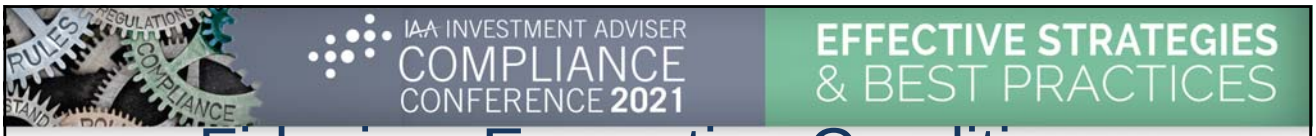
Fiduciary Exemption Conditions
Impartial Conduct Standards

- Best interest
- Reasonable compensation
- Best execution
- Statements may not be materially misleading



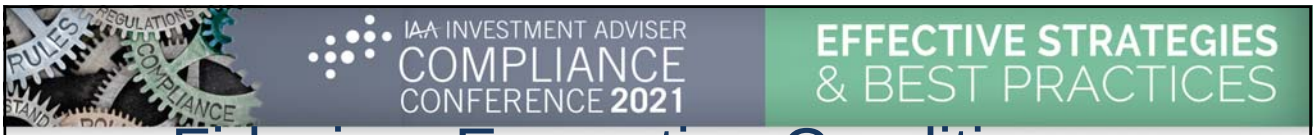
Fiduciary Exemption Conditions
Disclosures

- Fiduciary acknowledgement
- Model disclosures
- Services and conflicts
- Reasons for rollovers



Fiduciary Exemption Conditions Written Policies and Procedures

- Designed to ensure compliance with Impartial Conduct Standards
- Mitigate conflicts of interest
- Review process for investment products
- Rollover documentation



Fiduciary Exemption Conditions – Retrospective Review

- Compliance with Impartial Conduct Standards
- At Least Annually
- Certification

Rollover Considerations

- Fees and expenses of plan and IRA
- Whether the employer pays for some or all of the plan's administrative expenses
- Different levels of services and investments available under plan and IRA
- Written disclosure on why rollover is in investor's best interest

Other Recent Issues

- Lifetime Income Illustrations
- Private Equity Information Letter
- Missing Participant Guidance


IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
EFFECTIVE STRATEGIES
& BEST PRACTICES

Questions


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

ERISA Updates
Investment Adviser Association Compliance Conference
March 3-5, 2021

This outline describes the DOL ESG Rule, Proxy Rule, Fiduciary Exemption, and Lifetime Income Illustrations.

DOL ESG Rule:

In October 2020, the DOL adopted amendments to its ERISA investment duties regulation regarding ESG investments. The DOL made significant changes to the rule as originally proposed but the preamble to the final rule reflected the DOL's concern at that time that ESG investing "raises heightened concerns under ERISA." The rule became effective on January 12, 2021, except for the QDIA provision described below which has a later compliance date. However, the Biden administration included this rule in a list of agency actions for review in connection with an executive order on public health and the environment, and it is likely that the rule will be revisited.

The final rule requires a fiduciary's evaluation of an investment or investment course of action to focus solely on *pecuniary factors*, except in tie-breaker situations discussed below. The rule also prohibits plan fiduciaries from sacrificing investment return or taking on additional investment risk to promote non-pecuniary benefits or goals. Fiduciaries also "may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives."

Below are some additional points on the rule:

No References to "ESG": There are no references to "ESG" in the rule text.

Definition of "Pecuniary Factor": The definition of "pecuniary factor" is "a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy established pursuant to section 402(b)(1) of ERISA."

Comparison Requirement: As proposed, fiduciaries would have been required to consider how an investment or investment course of action "compares to available alternative investments or investment courses of action" with regard to certain factors. In response to comments, the DOL has updated the comparison requirement to state that the consideration of risk of loss and the

opportunity for gain (or other return) of an investment or investment course of action should be "compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks." The DOL stated in the preamble that "a fiduciary is required only to compare alternatives that are reasonably available under the circumstances." It also clarified in the preamble that, in evaluating investments, fiduciaries are not required to always select the investment with the lowest cost. The comparison requirement, like the rest of the investment duties regulation, applies across investments and is not specific to ESG.

Tie-Breaker/All Things Being Equal Test: If a fiduciary is unable to distinguish among investments on the basis of pecuniary factors alone, it may use non-pecuniary factors as the deciding factor if it documents certain points, including why pecuniary factors were not sufficient to select the investment, how the investment compares to alternatives with regard to certain factors, and how the chosen non-pecuniary factor(s) are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan. This provision also applies to selecting investment options for individual account plans.

Participant-Directed Individual Account Plans and QDIA: The same duties that apply to evaluating and selecting investments under ERISA apply when a fiduciary is evaluating and selecting designated investment alternatives. A Qualified Default Investment Alternative (**QDIA**) may not include an investment if its investment objectives or goals or principal investment strategies "include, consider, or indicate the use of one or more non-pecuniary factors." Plans have until **April 30, 2022** to make any changes to QDIAs to comply with the rule.

Effective Date: As mentioned above, the rule became effective on January 12, 2021. However, the rule will only apply prospectively to investments made and investment courses of action taken *after* the effective date. According to the preamble, "Plan fiduciaries are not required to divest or cease any existing investment, investment course of action, or designated investment alternative, even if originally selected using non-pecuniary factors in a manner prohibited by the final rule; however, after the effective date, all decisions regarding such investments, investment courses of action, or designated investment alternatives, including decisions that are part of a fiduciary's ongoing monitoring requirements, must comply with the final rule (footnote omitted)."

See Financial Factors in Selecting Plan Investments.

DOL Proxy Rule:

Shortly after the DOL adopted the ESG Rule it adopted further amendments to the ERISA investment duties regulation in the Proxy Rule. The rule became effective on January 15, 2021, but the preamble to this rule expressed significant skepticism about ESG investing and the Proxy

Rule may be revisited along with the ESG Rule. The DOL also withdrew its 2016 guidance on proxy voting. That guidance had resulted from concern that then-existing guidance dissuaded fiduciaries from exercising their shareholder rights.

The final rule took a more principles-based approach than the proposal and key elements of the new rule are discussed below.

*Movement to a More Principles-Based Approach***:** The most significant change from the proposal was the removal of language that would prohibit a fiduciary from voting a proxy unless it determined that the matter would have an economic impact on the plan, and, conversely require a fiduciary to vote if it determined that the matter would have an economic impact on the plan. The DOL was persuaded that the complexity of this binary determination would be costly to implement and that a more principles-based approach is a "more workable framework."

Skepticism on ESG Voting and Related Engagement: The rule provides that, when deciding whether to vote proxies or exercise other shareholder rights, and when exercising those rights, "fiduciaries must carry out their duties prudently and solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan."

Regarding engagement on ESG issues, the DOL stated in the preamble that "the use of plan assets by fiduciaries to further policy-related or political issues, including ESG issues, through proxy resolutions would violate the prudence and exclusive purpose requirements" of ERISA and the final rule "unless such activities are undertaken solely in accordance with the economic interests of the plan and its participants and beneficiaries."

ERISA Fiduciaries are Not Required to Vote Every Proxy: Notably, the DOL explicitly confirmed that ERISA fiduciaries are not required to vote every proxy or exercise every shareholder right to comply with ERISA, calling the contrary view a "misplaced belief."

Requirements for Plan Fiduciaries: The rule requires plan fiduciaries, when making decisions on proxy voting and other exercises of shareholder rights, to meet the following requirements:

- *Act solely in accordance with the economic interest of the plan and its participants and beneficiaries:* The DOL cautioned fiduciaries "from applying an overly expansive view" of what is an economic interest, stating that "vague or speculative notions that proxy voting may promote a theoretical benefit to the global economy that might redound, outside the plan, to the benefit of plan participants would not be considered an economic interest under the final rule."

- *Consider any costs involved:* What costs need to be considered by fiduciaries depends on the facts and circumstances, although the DOL provided several examples, including: direct costs to the plan, such as: "expenditures for organizing proxy materials, analyzing portfolio companies and the matters to be voted on; determining how the votes should be cast; and submitting proxy votes to be counted." The DOL also mentioned unusual costs, such as those associated with voting shares of certain foreign issuers. Opportunity costs, such as "foregone earnings from recalling securities on loan" could also be relevant.

- *Not subordinate the interests of plan participants and beneficiaries to any non-pecuniary objective, or promote non-pecuniary benefits or goals unrelated to those financial interests of the plan's participants or beneficiaries:* The rule prohibits ERISA fiduciaries from subordinating the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to any non-pecuniary objective. They also may not promote non-pecuniary benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan.

- *Evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights.*

- *Maintain records on proxy voting activities and other exercises of shareholder rights*: The DOL intends that the recordkeeping obligations for SEC-registered investment advisers be applied "in a manner that aligns to similar proxy voting recordkeeping obligations under the Advisers Act." The Advisers Act recordkeeping rule requires advisers to maintain a number of records in connection with proxy voting, including "a copy of any document created by the adviser that was material to making a decision how to vote proxies on behalf of a client or that memorializes the basis for that decision."

- *Exercise prudence and diligence in the selection and monitoring of persons providing proxy voting-related services:* ERISA fiduciaries must exercise prudence and diligence in the selection and monitoring of any persons selected to advise or otherwise assist with exercises of shareholder rights, such as providing research and analysis, recommendations regarding proxy votes, administrative services with voting proxies, and recordkeeping and reporting services.

Use of an Investment Manager or Proxy Voting Firm: A fiduciary that delegates the authority to vote proxies or exercise shareholder rights to an investment manager or a proxy advisory firm must "prudently monitor the proxy voting activities" of the investment manager or proxy advisory firm and determine whether the activities are consistent with other provisions of the rule. The DOL notes that the records related to proxy voting that must be maintained by

investment advisers under the Advisers Act recordkeeping rule, discussed above, "may be helpful to responsible plan fiduciaries" in satisfying this monitoring requirement.

Recommendations of Proxy Advisory Firms: A fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that the firm or service provider's proxy voting guidelines are consistent with all of the requirements for plan fiduciaries described above.

Safe Harbors

The final rule includes two safe harbors for fiduciaries to satisfy their fiduciary responsibilities on whether to vote proxies. The safe harbors are optional, and may be used independently or in conjunction with each other. They are:

- A policy that voting resources will focus only on particular types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the plan's investment.

- A policy of refraining from voting on proposals or types of proposals when the plan's holdings are small. The fiduciary would need to prudently determine that the size of the plan's holdings in the stock subject to the vote are below quantitative thresholds that, considering the plan's percentage ownership of the stock and other relevant factors, is sufficiently small that the matter being voted upon is not expected to have a material effect on the investment performance of the plan's portfolio (or assets under management in the case of an investment manager).

Fiduciaries must periodically review proxy voting policies adopted pursuant to the safe harbors. The DOL expects that fiduciaries will conduct this review with "roughly the same frequency" as the "general industry practice . . . to review investment policy statements approximately every two years."

Using a safe harbor policy does not prohibit a plan fiduciary from voting (or not voting) in a particular case if the fiduciary determines that the vote would (or would not) have a material effect on the value of the investment or the investment performance of the plan's portfolio after taking into account the costs involved.

Interpretive Provisions: The rule includes "longstanding interpretive positions" that the responsibility for exercising shareholder rights lies exclusively with the plan trustee, except where the trustee is subject to the direction of a named fiduciary or where the power to manage, acquire, or dispose of the relevant assets has been delegated to one or more investment managers.

Investment Managers of Pooled Investment Vehicles: The DOL adopted as proposed obligations of investment managers of pooled investment vehicles that hold assets of multiple plans that may have conflicting investment policy statements. The investment manager must vote (or not vote) the relevant proxies in proportion to each plan's interest in the pooled investment vehicle, or it can require participating plans to accept the investment manager's investment policy statement.

Pass-Through or Participant-Directed Voting: The rule clarifies that it does not apply where proxy voting, tender, and similar rights are passed through to plan participants.

Effective Date: Although the rule became effective on January 15, 2021, it also includes the following compliance dates:

- Fiduciaries that are *not* SEC-registered investment advisers have until January 31, 2022 to comply with the requirements to evaluate material facts that form the basis for a proxy vote or other exercise of a shareholder right, and to maintain records on proxy voting activities and other exercises of shareholder rights. Because the DOL believed that these requirements are consistent with SEC requirements and guidance, SEC-registered investment advisers were not provided additional time, and must comply with those requirements as of the effective date**.**

- All fiduciaries have until January 31, 2022 to comply with the requirements that they review service provider proxy voting guidelines prior to following their recommendations to determine that the guidelines are consistent with their obligations under the final rule, and the requirements pertaining to review of proxy voting policies of pooled investment vehicles.

See Fiduciary Duties Regarding Proxy Voting and Shareholder Rights.

DOL Fiduciary Exemption

In December 2020, the DOL adopted a prohibited transaction class exemption to allow investment advice fiduciaries, including investment advisers, to receive compensation for providing fiduciary investment advice, including advice about rollovers, and to engage in certain principal transactions. Like the DOL's 2016 fiduciary rule that was vacated, this exemption covers only non-discretionary advice, so its primary application for advisers providing discretionary management likely will be with respect to advice about rollovers. The rule was scheduled to go effective on February 16, 2021, and the DOL recently confirmed that effective date. There is a transition period in that the temporary enforcement policy in FAB 2018-02 for

investment advice fiduciaries that work diligently and in good faith to comply with the Impartial Conduct Standards will remain in place until December 20, 2021.

The exemption is designed to align with the SEC's fiduciary duty interpretation for investment advisers and Regulation Best Interest, or Reg BI, for broker-dealers. The DOL adopted the exemption largely as proposed.

Reinstatement of Five-Part Test: When the DOL proposed this exemption it reinstated the five-part test for defining an investment advice fiduciary adopted in 1975, as well as an earlier interpretation – Interpretive Bulletin 96-1 – regarding participant investment education.

Rollovers as Fiduciary Investment Advice: The DOL concluded that, consistent with the proposal, "[a] recommendation to roll assets out of a[n ERISA] plan is advice with respect to moneys or other property of the plan and, if provided by a person who satisfies all of the requirements of the five-part test, constitutes fiduciary investment advice." In adopting this position, the DOL has formally withdrawn the "Deseret Letter," a 2005 position that until now has governed rollovers. Under the Deseret Letter, advice to take a distribution and roll assets out of a plan to an IRA has not generally constituted fiduciary investment advice. To allow time for firms to come into compliance, the DOL will not pursue claims related to rollover recommendations made between 2005 and February 16, 2021 if the recommendations would have been considered non-fiduciary conduct under the Deseret Letter.

While "a single instance of advice to take a distribution from a[n ERISA] Plan and rollover the assets would fail to meet the regular basis prong" of the five-part test, advice to roll over plan assets "can also occur as part of an ongoing relationship that an individual enjoys with his or her investment advice provider," and this would/could be considered a regular basis. As for the prong that requires that the parties have a mutual understanding of the fiduciary nature of the advice, the DOL states that it "intends to consider marketing materials in which Financial Institutions and Investment Professionals hold themselves out as trusted advisers, in evaluating the parties' reasonable understandings with respect to the relationship."

Hire Me: The DOL stated in the preamble that it does not believe that there should be significant concerns about "hire me" conversations and it did not intend to suggest that marketing activity like that described in the preamble "would be treated as investment advice covered under the five-part test." However, the DOL goes on to say that, if "the marketing of advisory services is accompanied by an investment recommendation, such as a recommendation to invest in a particular fund or security, the investment recommendation would be covered if all five parts of the test were satisfied."

Wide Range of Compensation Covered: The DOL explains that, if they meet the conditions of the exemption, "Financial Institutions and Investment Professionals can receive a wide variety of payments that would otherwise violate the prohibited transaction rules, including, but not limited to, commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue sharing payments from investment providers or third parties."

Exclusions: The does not apply in the following situations:

- For investment advice generated solely by an interactive website, *i.e.*, with no human interaction component;

- If the investment professional, financial institution, or any affiliate is the employer of employees covered by the plan or is a named fiduciary or plan administrator that was selected to provide advice to the plan by a fiduciary who is not independent of the financial institution, investment professional, and their affiliates; or

- The investment professional is acting in a fiduciary capacity other than as an investment advice fiduciary.

Impartial Conduct Standards: The exemption requires financial institutions and investment professionals to comply with the following Impartial Conduct Standards:

- Investment advice must be in the **best interest** of the retirement investor. The DOL intends that this standard be "interpreted and applied consistently with" the fiduciary duty interpretation for investment advisers and Reg BI for broker-dealers;

- **Compensation** received, directly or indirectly, by the financial institution, investment professional, their affiliates, and related entities **may not exceed reasonable compensation**;

- The financial institution and investment professional must, as required by the federal securities laws, seek to obtain **best execution**; and

- Statements made must not be materially misleading.

Disclosures: The exemption requires financial institutions to provide the following disclosures to investors in writing prior to engaging in a transaction:

Fiduciary Acknowledgement: A financial institution must disclose that it and its investment professionals are fiduciaries under ERISA and the Internal Revenue Code, as applicable, with

respect to any fiduciary investment advice provided by the financial institution or investment professional to the retirement investor. The DOL has provided the following model language that firms may use to satisfy this requirement:

> When we provide investment advice to you regarding your retirement plan account or individual retirement account, we are fiduciaries within the meaning of Title I of the Employee Retirement Income Security Act and/or the Internal Revenue Code, as applicable, which are laws governing retirement accounts. The way we make money creates some conflicts with your interests, so we operate under a special rule that requires us to act in your best interest and not put our interest ahead of yours.

The DOL adds that, although not required by the exemption, financial institutions and investment professionals "could more fully explain the exemption's terms" with the following additional model disclosure:

> Under this special rule's provisions, we must:
>
> Meet a professional standard of care when making investment recommendations (give prudent advice);
>
> Never put our financial interests ahead of yours when making recommendations (give loyal advice);
>
> Avoid misleading statements about conflicts of interest, fees, and investments;
>
> Follow policies and procedures designed to ensure that we give advice that is in *your* best interest;
>
> Charge no more than is reasonable for our services; and
>
> Give you basic information about conflicts of interest.

Services and Conflicts: Financial institutions also must disclose the services to be provided and the financial institution's and investment professional's material conflicts of interest in a way that is accurate and not misleading. The "conflicts associated with proprietary products, payments from third parties, and compensation arrangements" are examples of material conflicts of interest that must be disclosed, according to the preamble. The DOL also confirms that firms "may rely, in whole or in part, on other regulatory disclosures to satisfy certain aspects of this disclosure requirement," and includes Form ADV as an example of other regulatory disclosures.

Disclosure required by the exemption also may be included with or accompanied by disclosure required under ERISA Rule 408b-2.

Disclosure Regarding Reasons for Rollovers: A financial institution will now be required, prior to engaging in a rollover, to disclose to the retirement investor the specific reasons that the rollover recommendation is in the investor's best interest. This requirement applies to a rollover from a plan to another plan or IRA, from an IRA to a plan, from an IRA to another IRA, or from one type of account to another, including, for example, from a commission-based account to a fee-based account.

In its discussion of documenting rollover recommendations, the DOL states that financial institutions and investment professionals should consider and document the following factors:

- The retirement investor's alternatives to a rollover, including leaving the money in his or her current employer's plan, if permitted, and selecting different investment options;
- The fees and expenses associated with both the plan and the IRA;
- Whether the employer pays for some or all of the plan's administrative expenses; and
- The different levels of services and investments available under the plan and the IRA.

The DOL goes on to explain that "[f]or rollovers from another IRA or changes from a commission-based account to a fee-based arrangement, a prudent recommendation would include consideration and documentation of the services that would be provided under the new arrangement."

Policies and Procedures: Financial institutions are required to have written compliance policies and procedures prudently designed to ensure compliance with the Impartial Conduct Standards. Policies and procedures also must mitigate conflicts of interest, "to the extent that a reasonable person reviewing the policies and procedures and incentive practices as a whole would conclude that they do not create an incentive for a Financial Institution or Investment Professional to place their interests ahead of the interest of the Retirement Investor."

The DOL also expects that financial institutions have a review process for investment products that may be recommended to retirement investors. This "should include procedures for identifying and mitigating conflicts of interest associated with the product or declining to recommend a product if the Financial Institution cannot effectively mitigate associated conflicts of interest."

As discussed above, firms must document their reasons for rollover recommendations. They also must document reasons that recommendations to change from one type of account to another, such as from a commission-based to a fee-based account, are in the best interest of the retirement investor.

Retrospective Review: Financial institutions must conduct a retrospective review of compliance with the Impartial Conduct Standards at least annually. Preparation of the first report will need to begin by one year after the exemption's effective date and the report will need to be completed by six months after that. The certification of the retrospective review can be made by any "Senior Executive Officer," as defined in the exemption.

Self-Correction Provision: The DOL added a self-correction provision to the final exemption so that certain violations will not cause a loss of the exemption. The following requirements apply:

- The violation does not result in investment losses to the retirement investor or the financial institution makes the retirement investor whole for any losses;

- The financial institution corrects the violation and notifies the DOL of the violation and the correction via e-mail within 30 days of the correction;

- The correction occurs no later than 90 days after the financial institution learns of the violation; and

- The financial institution notifies the person responsible for conducting the retrospective review during the applicable review cycle, and the violation and correction are specifically included in the written report of the retrospective review.

Eligibility: Investment professionals and financial institutions will be ineligible to rely on the exemption for 10 years following a conviction of a crime arising out of investment advice to retirement investors, unless the DOL grants a petition. They also would be ineligible for the exemption if they: "engag[ed] in a systematic pattern or practice of violating the conditions" of the exemption; "intentionally violat[ed] the conditions" of the exemption; or "provid[ed] materially misleading information" to the DOL in connection with the exemption.

See Prohibited Transaction Exemption 2020-02, Improving Investment Advice for Retirement Workers.

Lifetime Income Illustrations

In August 2020, the DOL issued an interim final rule with request for comments (**IFR**) regarding **lifetime income illustrations**, as required by the SECURE Act. The SECURE Act

updated the contents of participant benefit statements to include disclosure on lifetime income streams, or the amount that a participant would receive each month based on the participant's accrued benefits. Administrators of defined contribution plans will be required to include two lifetime income illustrations of a participant's account balance on pension benefit statements at least once each year. The two required illustrations are called a single life annuity and a qualified joint and survivor annuity.

Although the IFR uses the term "annuity," the illustrations would apply to all types of investments in defined contribution plan accounts. The IFR describes the assumptions that plan administrators must use in calculating the illustrations, including the assumed commencement date, interest rate, participant age, and participant mortality. Special rules are provided for certain annuities. Also included in the IFR is model language that administrators may use to explain the illustrations.

Regarding liability, the IFR provides "that no plan fiduciary, plan sponsor, or other person will be liable under ERISA for providing a lifetime income illustration that satisfies the requirements of the IFR," as long as the plan administrator uses the assumptions in the IFR and the IFR's model language or language "substantially similar" to the model language. This is to address "the concern of plan fiduciaries that participants might sue them if actual monthly payments in retirement fall short of illustrations provided prior to retirement."

The IFR will be effective on September 18, 2021, but the DOL may issue a final rule ahead of the IFR's effective date, which would supersede the IFR.

See Pension Benefit Statements – Lifetime Income Illustrations

INVESTMENT ADVISER ASSOCIATION

RETIREMENT ACCOUNT ROLLOVER RECOMMENDATION CHECKLIST

This Checklist is not intended to provide comprehensive treatment of each issue an SEC-registered investment adviser may need to address under the Employee Retirement Income Security Act of 1974 (ERISA) or the Investment Advisers Act of 1940 (Advisers Act), and it is not a substitute for legal advice. Each advisory firm must tailor its procedures to the firm's own operations, business, and clients. Although the IAA may update this Checklist to reflect additional information, the IAA undertakes no responsibility to provide such an update.

IAA Members with questions should contact the IAA Legal Team at iaalegalteam@investmentadviser.org or (202) 293-4222

IAA RETIREMENT ACCOUNT ROLLOVER RECOMMENDATION CHECKLIST

This Checklist is not intended to provide comprehensive treatment of each issue an SEC-registered investment adviser may need to address under the Employee Retirement Income Security Act of 1974 (ERISA) or the Investment Advisers Act of 1940 (Advisers Act) and it is not a substitute for legal advice. Each advisory firm must tailor its procedures to the firm's own operations, business, and clients. Although the IAA may update this Checklist to reflect additional information, the IAA undertakes no responsibility to provide such an update.

INTRODUCTION

As the SEC explained in its June 2019 Interpretation of the Advisers Act fiduciary duty, an adviser's fiduciary duty under the Advisers Act applies to all investment advice that an adviser provides to its clients, including advice about account type. Advice about account type includes advice about whether to roll over assets from one account (such as an account held in a 401(k) plan) into a new or existing account, such as an individual retirement account, or IRA, that the adviser or an affiliate of the adviser manages. These transactions are considered "rollovers."

If you recommend that a client or potential client roll over assets, you may want to document the specific reason(s) why this recommendation is considered to be in the best interest of the client or potential client. The SEC's Office of Compliance Inspections and Examinations (OCIE) may examine whether advisers have a reasonable basis for their retirement recommendations. See OCIE's June 2015 Risk Alert regarding its Retirement-Targeted Industry Reviews and Examinations (ReTIRE) Initiative and OCIE's annual examination priorities.

In order to make a recommendation, you will need information about the client's retirement plan, which may be available from the following sources:

- **Recent Plan Statements from the Client**. If the client directs his/her own investments under the plan, then the client will receive information on all of the investments available under the plan, including performance and fees, at least quarterly. The disclosures that are required to be provided to plan participants are summarized in a Department of Labor publication entitled *Maximize Your Retirement Savings –Tips on Using the Fee and Investment Information From Your Retirement Plan, available* at, https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/publications/maximize-your-retirement-savings.pdf. This information may also be available via a website maintained by an in-house plan administrator or the plan's third-party recordkeeper.

- **Summary Plan Description (SPD) from the Client**. This document may provide additional information on the plan and its investments.

- **Required Notice of Distribution Options**. This document is required under section 402(f) of the Internal Revenue Code and must be provided by the plan administrator to each recipient of an eligible rollover distribution. The 402(f) notice discusses the income tax implications of various distribution options and typically is "generic," but may provide some insight into the specifics of the plan.

- **Participant Request to Plan Administrator or Recordkeeper**. The client may need to ask the plan administrator or recordkeeper about the plan features and investments. Some plans will respond to inquiries from third parties, such as advisers, with client consent.

- If the adviser is unable to obtain the information even after full and fair disclosure to the participant of its significance, then the adviser may rely on alternative data sources. Such sources may include publicly available information via the plan's Form 5500 filings or reliable benchmarks for plans of the same type and size.

CHECKLIST

The following checklist details factors that your firm and employees should consider in making a rollover recommendation. Please note that these factors are not exclusive, and other factors may be relevant in formulating a recommendation for a particular client or potential client.

☐ **What are the client's alternatives to a rollover, including leaving the money in the current plan (if permitted under the plan, which may require cashouts of balances under a certain amount)?**

_____

_____

_____

_____

☐ **What are the fees and expenses that the client would pay under the plan versus the IRA, for example,**

- Does the employer pay for some administrative fees under the plan that the client would pay in an IRA?

_____

_____

_____

- What are the fees and expenses under the plan versus the IRA? Examples include fees for investment advice, including management or allocation, and transaction fees.

_____

_____

_____

- If alternative data sources were used to collect certain information, how have you determined that the benchmark or other data were reasonable, and are there any limitations related to the data?

_____

_____

_____

☐ **What are the services available under each option?**

- Does the plan provide access to investment advice, planning tools, telephone or online assistance, educational materials and workshops or other services that would not be available if the client left the plan?

_____

_____

_____

- Does the IRA provide investment advice and distribution planning or other services?

_____

_____

_____

☐ **What are the investments available under each option (using options that are reasonably foreseeable for the IRA)?**

(Attach chart comparing investment options, including related fees)

☐ **Would the client benefit from other features available in plans but not IRAs, or vice versa, e.g.,**

- Penalty-free withdrawals between 55 and 59-1/2?

_____

_____

- Plan loans?

_____

_____

- Protection from legal judgments?

_____

_____

- Beneficial tax treatment of employer stock?

_____

_____

- Availability and quality of advice within plan?

_____

_____

- The client's other accounts and impact on the assets at issue?

_____

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****

☐ **Based on the above, what is your recommendation and why is it in the best interest of the client?**

_____

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☐ **Have you documented, disclosed, and explained any financial or other incentives you have to recommend a particular account, investment, or share class?**

☐ **If your client is a retail investor, as defined in Form CRS, and you make a rollover recommendation, have you delivered (or re-delivered for an existing client) the most recent version of your Form CRS to the client?**

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE
EFFECTIVE STRATEGIES & BEST PRACTICES

International developments

Speakers:

Michelle Kirschner, *Gibson Dunn & Crutcher LLP*
Daniel Worthington, *T. Rowe Price*
Tracy Soehle, *Afflilated Managers Group*

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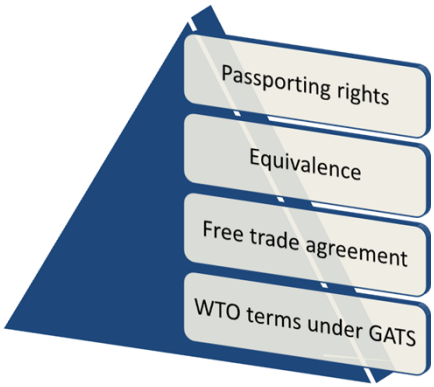
EFFECTIVE STRATEGIES & BEST PRACTICES

Brexit

- Transition period ended on 31 December 2020
- Trade & Cooperation Agreement & Joint Declaration on Financial Services Cooperation
- Memorandum of Understanding by end March 2021
- Equivalence?

Options for 3rd country firms for accessing EEA markets



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EFFECTIVE STRATEGIES & BEST PRACTICES

Equivalence?

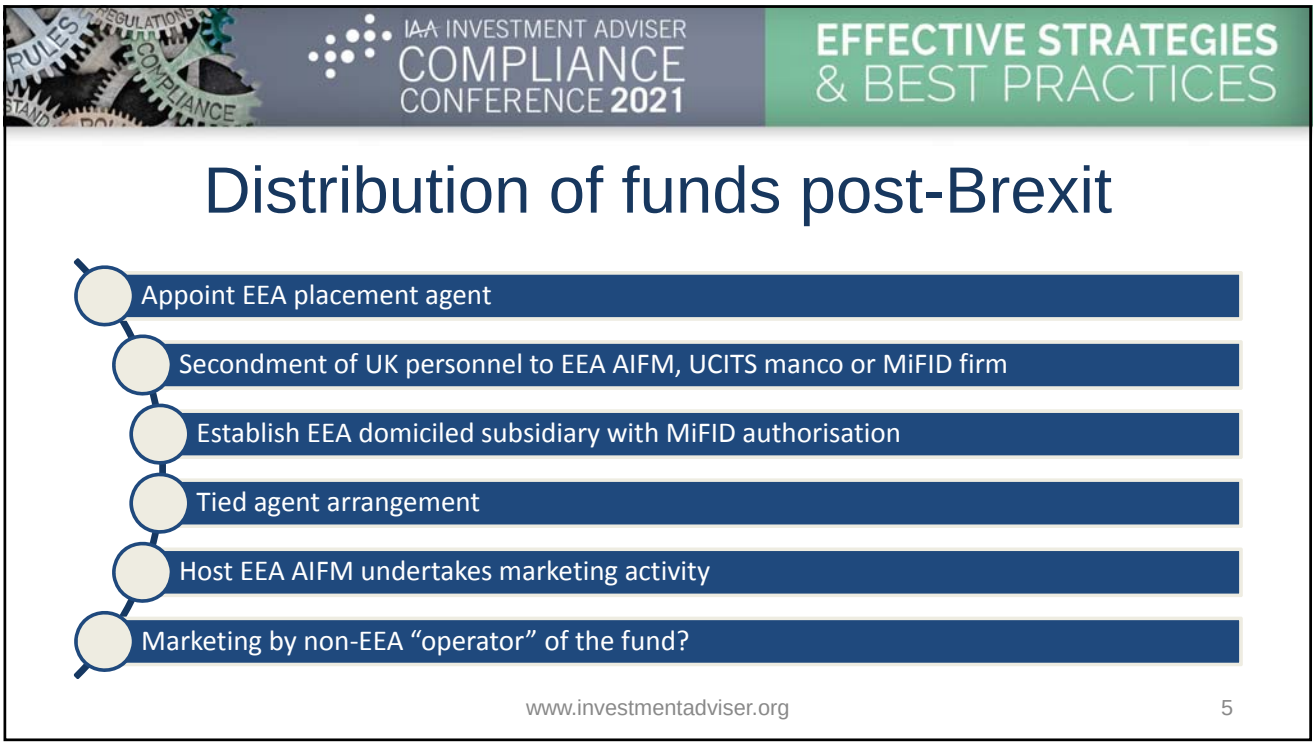
Preferential prudential treatment

- Enables EEA firms to apply the same preferential treatment to certain categories of exposure to entities in equivalent 3rd countries as they apply to exposures to EEA Member State entities

Market access

- Firms from equivalent 3rd countries can provide regulated services/activities into the EEA without seeking full authorisation in an EEA jurisdiction

- **Equivalence - key facts:**
  - No overall "equivalence regime"
  - Equivalence means different things in different areas
  - Equivalence can be withdrawn
  - Equivalence does not replace passport rights
  - Equivalence is not a guaranteed outcome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CONFERENCE 2021
EFFECTIVE STRATEGIES
& BEST PRACTICES
Distribution of funds post-Brexit
Appoint EEA placement agent
Secondment of UK personnel to EEA AIFM, UCITS manco or MiFID firm
Establish EEA domiciled subsidiary with MiFID authorisation
Tied agent arrangement
Host EEA AIFM undertakes marketing activity
Marketing by non-EEA "operator" of the fund?
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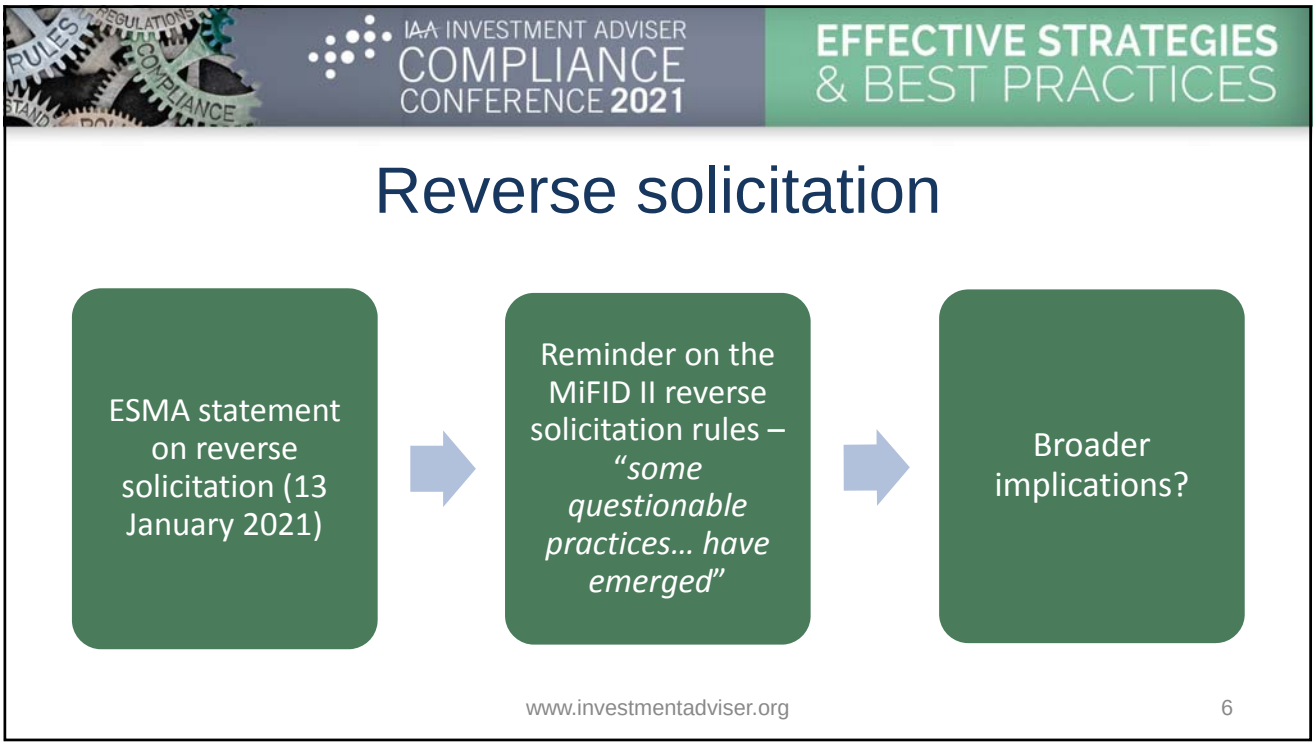
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CONFERENCE 2021
EFFECTIVE STRATEGIES
& BEST PRACTICES
Reverse solicitation
ESMA statement on reverse solicitation (13 January 2021)
Reminder on the MiFID II reverse solicitation rules – "some questionable practices… have emerged"
Broader implications?
www.investmentadviser.org
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Delegation

- AIFMD review
- Questions whether delegation should be made more restrictive
- Questions whether to impose AIFMD standards on non-EU delegate portfolio managers
- Next steps

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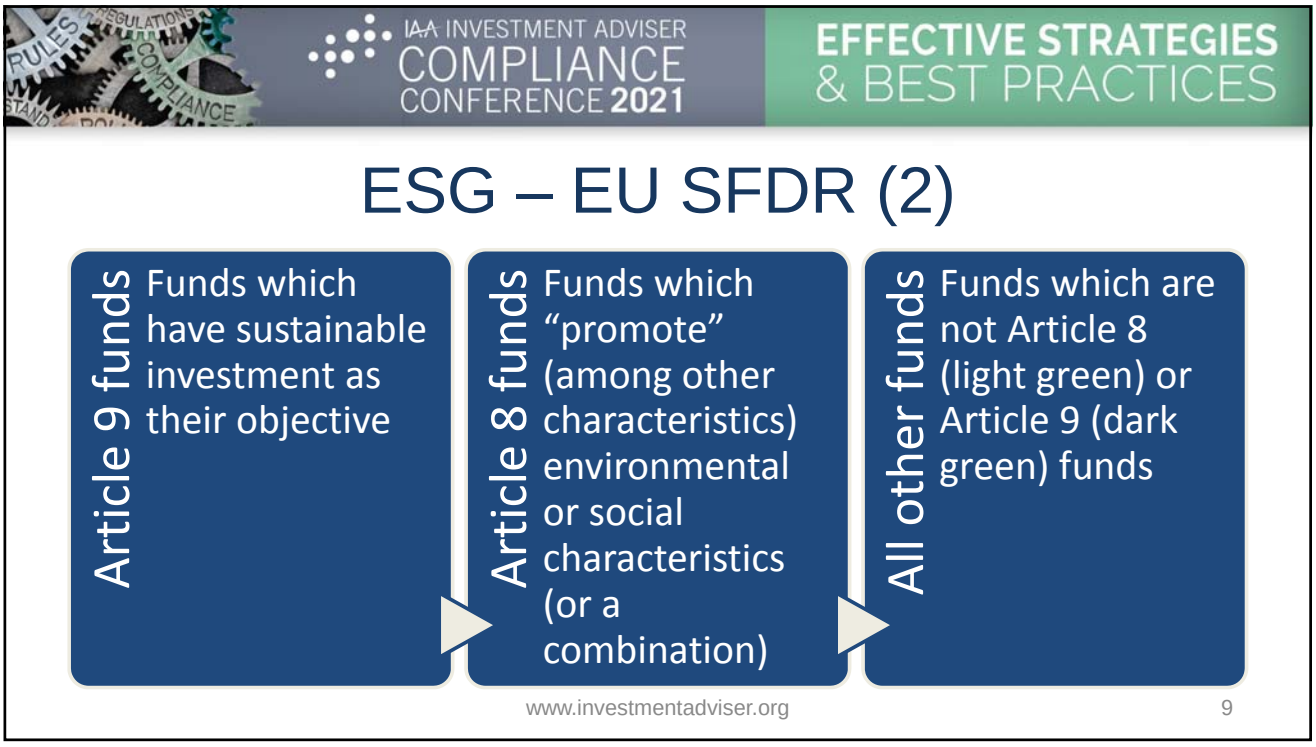
EFFECTIVE STRATEGIES & BEST PRACTICES

ESG – EU SFDR (1)

- Sustainable Finance Disclosure Regulation (NB. 10 March 2021)
- Taxonomy Regulation
- AIFMD/MiFID II proposed changes
- EU Commission Green Action Plan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CONFERENCE 2021
EFFECTIVE STRATEGIES
& BEST PRACTICES
ESG – EU SFDR (2)
Article 9 funds
Funds which have sustainable investment as their objective
Article 8 funds
Funds which "promote" (among other characteristics) environmental or social characteristics (or a combination)
All other funds
Funds which are not Article 8 (light green) or Article 9 (dark green) funds
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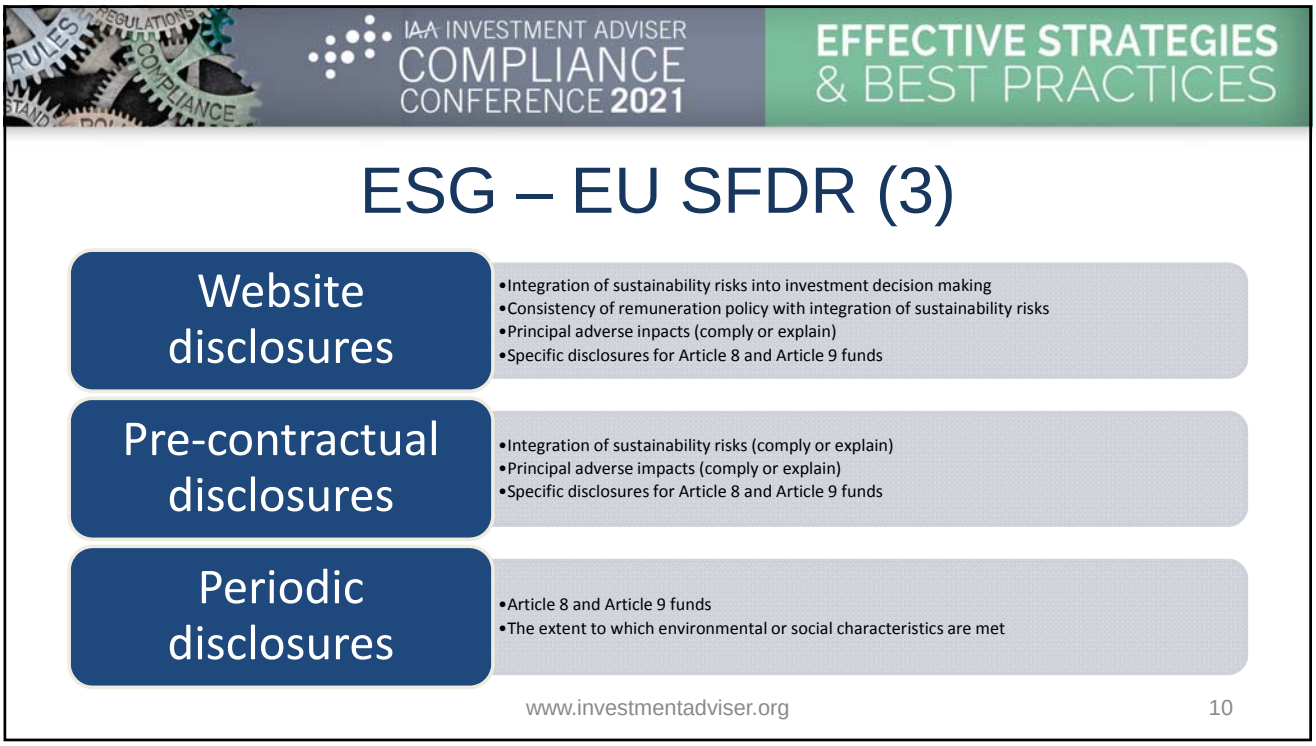
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CONFERENCE 2021
EFFECTIVE STRATEGIES
& BEST PRACTICES
ESG – EU SFDR (3)
Website disclosures
•Integration of sustainability risks into investment decision making
•Consistency of remuneration policy with integration of sustainability risks
•Principal adverse inpacts (comply or explain)
•Specific disclosures for Article 8 and Article 9 funds
Pre-contractual disclosures
•Integration of sustainability risks (comply or explain)
•Principal adverse impacts (comply or explain)
•Specific disclosures for Article 8 and Article 9 funds
Periodic disclosures
•Article 8 and Article 9 funds
•The extent to which environmental or social characteristics are met
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ESG – EU SFDR (4)

- Ongoing interpretative uncertainties for asset managers:
  - Scope issues: application to 3rd country AIFMs?
  - Article 8 funds – meaning of "promotion"?
  - Article 9 funds – how sustainable is sustainable?
- ESMA letter to European Commission

ESG - UK

- UK to make TCFD-aligned disclosures fully mandatory across the economy by 2025
  - Aim: to ensure that the right information on climate-related risks and opportunities is available across the investment chain – from companies, to financial services firms, to end-investors
- What is the Taskforce on Climate-related Financial Disclosures (TCFD)?
  - Set up by Financial Stability Board in 2015
  - Aim: to develop consistent climate-related financial disclosures to be used by industry participants in order to increase understanding of material risks
  - Published its Final Report in June 2017 which set out a number of recommended disclosures
- UK was one of the first countries to endorse the TCFD and the UK became the first country globally to mandate TCFD-aligned disclosures across the economy (by 2025)


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CONFERENCE 2021
EFFECTIVE STRATEGIES
& BEST PRACTICES
EU Shareholder Rights Directive II
SRD II came into force on 9 June 2017 and most of its provisions had to be implemented into national law by 10 June 2019
Placed certain obligations on fund managers, including in relation to engagement policies
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EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
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COMPLIANCE
STANDARDS
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CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

GIBSON DUNN

IAA's 2021 Investment Adviser Compliance Conference: International developments

1. Brexit

- The transition period for the UK's exit from the EU ended on 31 December 2020.
- The "passports" enjoyed by firms when marketing funds and/or providing investment services to clients in the EU from the UK and vice versa fell away at that time (subject to temporary transitional regimes for EU firms/funds).
- There are several ways in which firms have approached Brexit from a regulatory perspective, including (for example) establishing an EU authorised entity or the use of host providers.

2. Reverse solicitation

- On 13 January 2021, the European Securities and Markets Authority ("ESMA") issued a public statement which serves as a reminder to firms of the Markets in Financial Instruments Directive II (2014/65/EU) ("MiFID II") rules on reverse solicitation.
- In the statement, ESMA claims that: "*… some questionable practices by firms around reverse solicitation have emerged*". For example, some firms appear to be trying to circumvent the MiFID II requirements by including general clauses in the terms of business.
- A read-across can be made into other regimes. For example, third-country private fund sponsors admitting investors into alternative investment funds on the basis of reverse solicitation would be well-advised to reconsider whether they have demonstrable evidence that the investor approached the sponsor (or its agent) at its own exclusive initiative.

3. Delegation under the Alternative Investment Fund Managers Directive (2011/61/EU) ("AIFMD")

- On 22 October 2020, the European Commission launched a public consultation ahead of its review of the AIFMD. This follows the Commission's earlier report into the impact of the AIFMD to date, in addition to ESMA's recommendations (which suggest a number of changes to the regime).
- One area of particular focus is that of delegation. It was questioned whether the rules on delegation should be made more restrictive by limiting what can be delegated (such as by imposing quantitative limits and/or prohibiting delegation of certain "core" functions). Additionally the issue of whether delegate portfolio managers based outside the EU should be required to comply with AIFMD standards was raised.

4. Environmental, Social and Governance developments

- In the EU, the Sustainable Finance Disclosure Regulation ((EU) 2020/852) ("SFDR") imposes new transparency obligations and periodic reporting requirements on various financial services firms, at both a product and firm level. It is not, however, simply a case of making disclosures – strategic business decisions are required. Most of the provisions of the SFDR come into effect on 10 March 2021.

- Certain product level requirements of the SFDR may apply to non-EU fund managers when marketing funds in the EU under national private placement regimes. Further clarity on this was sought by the European Supervisory Authorities in a letter to the Commission on 7 January 2021.

- The Taxonomy Regulation ((EU) 2019/2088) establishes an EU-wide classification system to provide a common language (i.e. taxonomy) to define environmentally sustainable economic activities. It also supplements the disclosure requirements of the SFDR. It will be phased in from 1 January 2022.

- On 9 November 2020, the UK Government announced that it intends to make mandatory for a range of entities in the UK, including financial institutions, climate-related disclosures aligned with the recommendations of the Task Force on Climate-related Financial Disclosures ("TCFD"), by 2025. Most requirements are anticipated to be in place by 2023. The UK is the first country in the world to make TCFD-aligned disclosures mandatory. A Financial Conduct Authority ("FCA") consultation paper is expected in the first half of 2021.

- The UK will also implement a green taxonomy. This will take the scientific metrics in the EU taxonomy as its foundation and a UK Green Technical Advisory Group will be established to review these metrics to ensure they are appropriate for the UK market.

5. EU Shareholder Rights Directive (I and II) (2007/36/EC and (EU) 2017/828)

- EU member states had to implement the Shareholder Rights Directive ("SRD I") by 3 August 2009. The main aim of SRD I was to improve corporate governance in EU companies traded on EU regulated markets.

- The revised Shareholder Rights Directive ("SRD II") came into effect from 10 June 2019 and imposed new obligations on, among others, MiFID firms and alternative investment fund managers. Such firms are caught by SRD II if they invest in shares traded on an EEA regulated market on behalf of their investors. The FCA gold-plated this so that the SRD II rules apply to shares in companies admitted to trading on an EEA regulated market or on a comparable market outside the EEA.

- Among other things, these managers must either:
  - draft and publicly disclose an engagement policy that describes how they integrate shareholder engagement into their investment strategy and publicly disclose on an annual basis how their engagement policy has been implemented; or
  - publicly disclose a clear and reasoned explanation of why they have chosen not to comply with these requirements.

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GIBSON DUNN

January 14, 2021

UK FINANCIAL SERVICES REGULATION – 2020 YEAR-END REVIEW

To Our Clients and Friends:

In an unprecedented year for UK regulated firms and the Financial Conduct Authority ("**FCA**"), the regulatory agenda has at times seemed dominated by the global pandemic. However, regulated firms should be mindful of the regulatory direction of travel. This client alert assesses the regulatory landscape, now and in the coming years, through the prism of three areas of increasing regulatory focus: governance, culture and individual accountability; conduct and enforcement; and operational and financial resilience. This client alert provides practical guidance to firms to ensure continuing compliance with regulatory expectations in each of these three areas. The regulatory landscape has also been impacted as a result of the ending of the Brexit transition period on 31 December 2020. The FCA's actions over last year will be shown to be indicators of the type of regulator that the FCA may seek to be post-Brexit.

The Gibson Dunn UK Financial Services Regulation team looks forward to discussing the matters outlined in this alert in further detail. For more analysis, please join us for our upcoming complimentary webinar presentation on 27 January 2021: **UK Financial services regulatory update: what happened in 2020 and what to expect in 2021 and beyond** (to register, click here)**.**

Executive Summary

Governance, culture and individual accountability

- It is important that firms have strong governance frameworks that allow their culture and values to drive decision-making across the business.
- A key barometer that a firm is meeting the FCA's expectations is the effective implementation of the Senior Managers and Certification Regime ("**SMCR**"). In 2021 and beyond, we anticipate an increase in enforcement action from the FCA in this area, as we move away from the implementation phase of the SMCR for solo-regulated firms.

Conduct and enforcement

- Working from home poses particular challenges for firms when monitoring the conduct of staff. However, the FCA expects firms to have appropriate systems and controls in place to manage the enhanced conduct risks that arise in the context of the pandemic and it is likely that there will be a regulatory review of how firms treated clients at the time.

- The regulatory direction of travel has been to push firms to think more broadly in terms of what types of misconduct they need to tackle with an increased focus on non-financial misconduct and how this reflects the culture of the firm.

Operational and financial resilience

- These have been a particular area of FCA focus for some time. The pandemic is indicative of the type of scenario that firms must be prepared for, however, it is only one of many scenarios which the FCA would expect firms to factor into risk assessments and business continuity plans.

- We anticipate that the FCA will conduct a detailed retrospective review of firms' operational and financial resilience throughout 2021.

Post-Brexit UK regulatory outlook

- Prior to the conclusion of the EU-UK free trade agreement (discussed further below), the government produced a number of documents that indicate what a post-Brexit UK regulatory framework may look like. The UK approach is intended to "*to ensure that [the UK] regulatory regime has the agility and flexibility needed to respond quickly and effectively to emerging challenges and to help UK firms seize new business opportunities in a rapidly changing global economy*."

- The UK Government's willingness to diverge from the EU in certain regulatory matters raises important questions regarding the likelihood of any future EU equivalence decisions.

The year in review

2020 was an unprecedented year for both UK regulated firms and the FCA. Both had to adjust to a "new normal", which in most cases included initiating working from home contingency planning. The regulatory agenda for the year was in many ways dominated by the global pandemic. This is illustrated by the FCA's annual Business Plan[1], which was heavily influenced by tackling the impact of COVID-19. In response to the pandemic, the FCA delayed certain regulatory initiatives and indicated regulatory forbearance in a number of areas, while maintaining the emphasis on the importance of treating customers fairly[2].

However, the FCA continued to advance certain areas of regulatory focus. It is, therefore, possible to identify key themes that the FCA focused on during 2020 and is likely to pursue in the coming months and years. In particular, this client alert will focus on three important areas of regulatory interest: (1) governance, culture and individual accountability; (2) conduct and enforcement; and (3) operational and financial resilience. These key areas can be assessed in terms of the FCA's developments during 2020 but also what regulated firms need to be aware of in terms of each of these areas going forward.

(1) Governance, culture and individual accountability

> ***"The specifics of your culture, like your strategy, remain up to you as leaders. But there is a growing consensus that healthy cultures are purposeful, diverse and inclusive."***[3]

Governance, culture and individual accountability are inextricably linked. As the quote above from the FCA suggests, the FCA will not dictate what a firm's governance model or culture should be. Both are firm-specific, however, firms should be wary of the FCA's expectations.

The FCA's Approach to Supervision document[4] notes that the key cultural drivers in firms are: purpose; leadership; approach to rewarding and managing people; and governance. Last year the FCA reiterated the importance of these factors in its annual Business Plan and in a discussion paper on driving purposeful cultures.[5]

The importance of good governance, in particular, forms a common thread through the FCA's supervisory correspondence to key industry sectors. For example, the FCA has emphasised that it is "*important that firms have strong governance frameworks that allow their culture and values to drive decision-making across the business, including its approach to dealing with all kinds of misconduct. It is also critical that firms are headed by effective boards, with a suitable mix of skills and experience, to conduct appropriate oversight of the firms' risks, strategy, policies and controls*".[6]

A key barometer that a firm is meeting the FCA's expectations is the effectiveness of its implementation of the Senior Managers and Certification Regime ("**SMCR**"). The introduction of the SMCR was driven by a perceived lack of individual accountability and governance failings post-financial crisis. For the majority of solo-regulated firms, the SMCR has now applied for over a year, whilst a similar regime for banks and insurers has applied since 2016. The implementation of the SMCR is an iterative process. What constituted adequate implementation for 9 December 2019 will not necessarily be sufficient now. Firms should be considering how their implementation can be tested and enhanced.

Key practical steps for firms

- Take stock of the firm's current governance arrangements to identify any areas in which there is a need for improvement. For example:
    - are there clear accountabilities for those activities which affect outcomes, with appropriate delegation and escalation?
    - is a robust risk framework in place under which accountable individuals identify, monitor and mitigate key risks of harm?
    - is there strong and independent Board oversight and challenge?

- From a "firm culture" perspective, whilst the focus is now also on the "tone from above" (such as immediate line managers), it is clear that "tone from the top" still remains crucial. Firms should think about what their CEOs, business line heads and other senior individuals say – and what they do not say – in this context. Further, are messages from the top, including corporate purpose and values, translated in a meaningful way to the specific roles and responsibilities, targets and objectives at the individual and unit level across the firm?

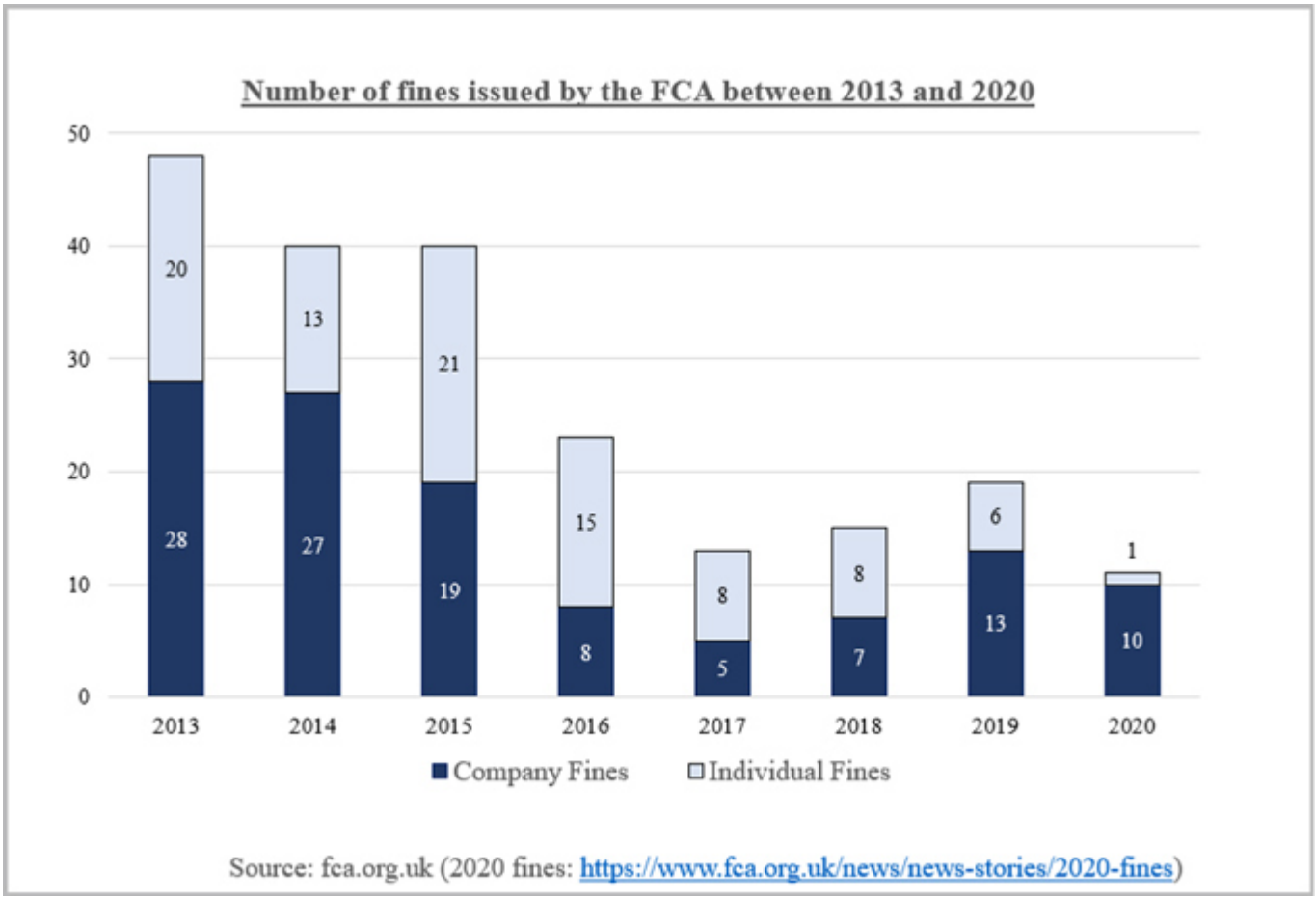
- One year on from the coming into force of the SMCR for solo-regulated firms, review the firm's implementation of the regime to identify any weaknesses and take any required remedial action.

(2) Conduct and enforcement

"We will remain vigilant to potential misconduct. There may be some who see these times as an opportunity for poor behaviour – including market abuse, capitalising on investors' concerns or reneging on commitments to consumers…Where we find poor practice, we will clamp down with all relevant force."[7]

A key indicator of a firm's culture is its practical response to compliance issues and, in particular, instances of potential misconduct. Market abuse (including the handling of confidential information)[8] and personal account dealing[9] remain perennial areas of regulatory focus. Working from home poses particular challenges for firms when monitoring the conduct of staff. However, the FCA expects firms to have appropriate systems and controls in place to manage the enhanced conduct risks that arise in the context of the pandemic.[10]

The pandemic undoubtedly had an impact on enforcement action, for example, instances of regulatory forbearance and the FCA holding back on searches / warrants. The FCA issued the lowest number of fines since its establishment in 2013:



However, the FCA took a number of high-profile enforcement actions against firms. For example, in 2020, the FCA continued to take action against firms for market misconduct[11], failures to show forbearance and due consideration to customers in financial difficulty[12] and took the first UK enforcement action under the Short Selling Regulation.[13]

The regulatory direction of travel has been towards an increased focus on non-financial misconduct and how this is tackled by firms. A increasing challenge for regulated firms is how to address non-financial misconduct and, in particular, non-financial misconduct that takes place outside of the workplace.[14] In response to the Me Too movement in 2018, firms introduced corrective responses to this important issue. However, in 2021 the FCA would expect a thorough and well-thought out response. Diversity and inclusion are now rightly integral to the FCA's assessment of a firm's culture.

Key practical steps for firms

- As required under the SMCR, check that the firm has a robust process to ensure that senior managers and certification staff are "fit and proper", both on joining and on an ongoing basis.

- Review the firm's processes for the handling and escalation of misconduct. For example, review the firm's whistleblowing procedures and make sure that staff are appropriately trained and have an understanding of their obligations to inform the firm of relevant matters.[15]

- Consider whether the firm's remuneration structure incentivises appropriate or inappropriate behaviour.

(3) Operational and financial resilience

"We expect all firms to have contingency plans to deal with major events and that these plans have been properly tested."

"…financial pressures could give rise to harm to customers if firms cut corners on governance or their systems and controls – for example, increasing the likelihood of financial crime, poor record keeping, market abuse and unsuitable advice and investment decisions."[16]

It will come as no surprise that the FCA focused on regulated firms' operational and financial resilience during 2020. For example, the FCA issued statements to firms outlining its expectations on financial crime systems and controls and information security during the pandemic.[17] In addition, in June and August 2020, the FCA issued a COVID-19 impact survey to help gain a more accurate view of firms' financial resilience. This mandatory survey was repeated in November 2020 to understand the change in firms' financial positions with time.[18]

However, the regulatory focus on operational and financial resilience goes beyond the pandemic. In December 2019 the FCA, alongside the Prudential Regulation Authority and the Bank of England, published a joint consultation paper on operational resilience.[19] The pandemic is indicative of the type of scenario that firms must be prepared for, but it is one of many scenarios for which the FCA would expect firms to factor into risk assessments and business continuity plans.

Similarly, the FCA's focus on financial resources is wider than in the context of the pandemic. The FCA has indicated that it will implement its own version of the Investment Firms Regulation and that the new regime will come into force on 1 January 2022. The FCA has also published final guidance on a framework to help financial services firms ensure they have adequate financial resources and to take effective steps to minimise harm.[20] In particular, the FCA notes that the guidance does not place specific additional requirements on firms because of COVID-19, but the crisis underlines the need for all firms to have adequate resources in place and to assess how those needs may change in the future.

Key practical steps for firms

- Review the firm's business continuity plan and risk assessment to ensure that they are comprehensive and stand up to scrutiny. For example, make sure any risks associated with "working from home" are incorporated and mitigated as far as possible.
- Re-visit the firm's assessment of its adequacy of financial resources, in light of the FCA's published guidance, referred to above.

Forward looking regulatory priorities

Looking to the future, it is very likely indeed that the FCA's priorities will, at least in part, mirror those areas of focus in 2020 (being: (1) governance, culture and individual accountability; (2) conduct and enforcement; and (3) operational and financial resilience).

(1) Governance, culture and individual accountability

Whilst the FCA has been relatively quiet from an enforcement perspective to date, firms should not be drawn into a false sense of security. This is particularly the case given that the extension of the regime brought within scope a significant number of firms (approximately 47,000). Additionally, a number of these firms are also more likely to be viewed as "low hanging fruit" by the FCA – some firms will perhaps have less sophisticated governance procedures in place (meaning potentially more breaches) and it will be much easier for the FCA to identify the decision-making processes of these solo-regulated firms when it is investigating breaches.

As at 17 August 2020, there were 25 open FCA investigations relating to senior managers. Of these, the majority related to retail misconduct, wholesale misconduct and senior manager conduct rule breaches.

It appears that resolution of these matters has been delayed by the pandemic but we expect to see some of these senior manager outcomes in 2021. We also anticipate an increase in new enforcement action from the FCA in this area, as we move away from the implementation phase of the SMCR for solo-regulated firms.

(2) Conduct and enforcement

As noted above, there is evidence to suggest that the pandemic has had some impact on enforcement action, for example, instances of regulatory forbearance and the FCA holding back on searches / warrants. However, it is likely that there will be a regulatory review of how firms treated clients during pandemic. As the FCA's pronouncements since March 2020 have indicated, regulatory forbearance in certain areas does not replace regulated firm obligations under the regulatory system and, in particular, to treat customers fairly. It is highly likely that the FCA will conduct a retrospective review of firms' conduct.|

This will likely include a review of firms' financial crime controls during the pandemic. In Guidance it issued in May, the FCA acknowledges operational issues faced by firms but was clear that firms should not adjust their risk appetites in the face of new risks.[21] There will undoubtedly be a focus on fraud and other crimes committed during the pandemic, and firms will face scrutiny if there were red flags that were missed or not escalated. Firms may wish to, therefore, take the opportunity now to review the efficacy of the controls they have in place, as a general "health check".

As at 17 August 2020, there were 571 open FCA investigations, with a significant focus on consumers, with retail misconduct accounting for 192 of these investigations. Other common areas responsible for investigations included: unauthorised business (103); insider dealing (60); financial crime (57); financial promotions (49) and wholesale conduct (33). We would, therefore, expect a number of these investigations to crystallise into final notices producing a series of messages around expected standards throughout the course of 2021.

Another potential area of regulatory focus in the conduct space is the transition from LIBOR. The FCA has already indicated that a member of senior management should be responsible for LIBOR transition, where applicable to the business.[22] Firms need to consider whether any LIBOR-related risks are best addressed within existing conduct risk frameworks or need a separate, dedicated program. Amongst other things, firms should keep appropriate records of management meetings or committees that demonstrate they have acted with due skill, care and diligence in their overall approach to LIBOR transition and when making decisions impacting customers.

(3) Operational and financial resilience

As noted above, whilst the pandemic firmly brought the operational and financial resilience of firms into the FCA's cross-hairs, this was a particular area of interest of the regulator pre-COVID-19. As stated by the FCA's Executive Director of Supervision: Investment, Wholesale and Specialist in December 2019, the "*[FCA's] intention is to bring about change in how the industry thinks about operational resilience – a shift in mindset as it were – informed and driven by the public interest*".[23]

The industry disruption caused by the pandemic, however, provides the FCA with an invaluable opportunity in a "real life" context, as opposed to simulated scenario, to kick the tyres of firms' policies and procedures in order to determine how they coped with the operational and financial stresses brought about during the unprecedented circumstances of 2020. Whereas in 2020, the focus of the regulator was much more reactive, in terms of (for example) issuing statements outlining its expectations on financial crime systems and controls, we anticipate that 2021 will be much more centred around retrospective reviews of firms – for example, through looking at their business continuity plans, amongst other things.

Post-Brexit UK regulatory framework

The route map

A long awaited free trade agreement between the UK and EU was agreed on 24 December 2020, governing their relationship post-Brexit transition period. The financial services industry is addressed in the agreement, albeit to a much lighter extent than for goods and other services. The contents of the

provisions on financial services are unlikely to come as a great surprise to the industry – amongst other things, the agreement does not provide for passporting rights nor address equivalence decisions. It is worth noting, however, that a joint declaration draft states that the parties will, by March 2021, agree a memorandum of understanding establishing the framework for structured regulatory co-operation on financial services. The aim of this is to provide for transparency and appropriate dialogue in the process of adoption, suspension and withdrawal of equivalence decisions.

In the months leading up to the eventual conclusion of the free trade agreement, the UK government produced a number of documents that indicate what a post-Brexit UK regulatory framework may look like. The Financial Services Bill[24] states that the UK Government has a number of objectives including: (1) enhancing the UK's world-leading prudential standards and promoting financial stability; (2) promoting openness between the UK and overseas markets; and (3) maintaining the effectiveness of the financial services regulatory framework and sound capital markets. The UK Government has also published the Phase II consultation of its Financial Services Future Regulatory Framework Review.[25] The UK Government's approach is intended to "*to ensure that [the UK] regulatory regime has the agility and flexibility needed to respond quickly and effectively to emerging challenges and to help UK firms seize new business opportunities in a rapidly changing global economy*."

In its response to the global pandemic, the FCA's actions are also indicative of the type of regulator it may be post-Brexit. Through its exercise of regulatory forbearance, for example, the FCA has proven itself to be more nimble and pragmatic.

Regulatory divergence

The UK approach in an environmental, social and governance ("**ESG**") setting is another sign as to what the industry might expect in a post-Brexit world. Rather than onshore the EU Sustainable Finance Disclosure Regulation, the UK has announced that it will introduce disclosure rules aligning with the recommendations of the Task Force on Climate-related Financial Disclosures ("**TCFD**").[26] This will make the UK the first country in the world to make TCFD-aligned disclosures mandatory. It was also announced that the UK will implement a green taxonomy – a common framework for determining which activities can be defined as environmentally sustainable. This will take the scientific metrics in the EU taxonomy as its foundation and a UK Green Technical Advisory Group will be established to review these metrics to ensure they are appropriate for the UK market.

Whilst this by no means signals a radical departure from the EU in terms of regulatory approach - indeed, the UK Government has flagged the need in the ESG sphere for, where possible, consistency between UK and EU requirements - the UK Government's willingness to diverge from the EU in certain regulatory matters raises important questions regarding the likelihood of any future EU equivalence decisions.

The global stage

Perhaps in common with the UK's desire to remain a key player on the global stage post-Brexit, despite not forming a part of the more influential EU, the FCA is also keen not to become isolated from other regulators across the world and to keep working closely on matters spanning different jurisdictions. By

way of an example, the TFS-ICAP final notice[27] (under which the FCA fined TFS-ICAP Ltd, an FX options broker, £3.44 million for communicating misleading information to clients), indicated that the FCA continues to work in tandem with overseas regulators (in this instance, the Commodity Futures Trading Commission in the United States).

Conclusion

Firms may be lured into a false sense of security that they can in some way "take the foot off the gas" from a regulatory perspective after having made it through a tumultuous 2020. However, this could not be further from the truth. Whilst 2020 was an unprecedented year, the FCA by no means gave firms carte blanche when it came to regulatory compliance, particularly in instances where there is a risk of customer detriment. It is in 2021 that we expect to see action from the FCA towards those firms who did not meet its expectations. This will be the case not just for firms but also, as we move away from the implementation phase of the SMCR for solo-regulated firms, individuals as well.

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[8] FCA Market Watch 63, May 2020 (https://www.fca.org.uk/publication/newsletters/market-watch-63.pdf)

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[13] https://www.gibsondunn.com/fca-fines-non-uk-asset-manager-in-the-first-uk-enforcement-action-taken-under-the-short-selling-regulation/

[14] https://www.gibsondunn.com/the-challenge-of-addressing-non-financial-misconduct-in-uk-regulated-firms/

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[18] FCA webpage, "Coronavirus (Covid-19) Financial Resilience Survey", updated 6 November 2020 (https://www.fca.org.uk/news/statements/coronavirus-covid-19-financial-resilience-survey)

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[20] FCA Finalised Guidance (FG 20/, "Our framework: assessing adequate financial resources", June 2020 (https://www.fca.org.uk/publication/finalised-guidance/fg20-1.pdf)

[21] https://www.gibsondunn.com/covid-19-uk-financial-conduct-authority-expectations-on-financial-crime-and-information-security/

[22] FCA Dear CEO letter, "Asset management firms: prepare now for the end of LIBOR", 27 February 2020 (https://www.fca.org.uk/publication/correspondence/dear-ceo-asset-management-libor.pdf)

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Gibson Dunn's UK Financial Services Regulation team looks forward to discussing the matters outlined in this alert in further detail in a client webinar in the near future, details of which will be provided shortly. Please feel free to contact the Gibson Dunn lawyer with whom you usually work, or any of the following authors:

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GIBSON DUNN

October 28, 2019

UK REGULATORS MAKE FURTHER STRIDES IN RESPONSIBLE STEWARDSHIP & INVESTING

To Our Clients and Friends:

The UK's Financial Reporting Council ("FRC")[1] published on 24 October 2019[2], a revised version of its stewardship code – the UK Stewardship Code 2020 (the " New Code") which takes effect in January 2020. On the same day, the UK Financial Conduct Authority ("FCA") published the results of the feedback from its joint initiative with the FRC, seeking views of the market on a minimum standards regulatory framework for stewardship for financial services firms that invest for clients and beneficiaries[3]. The New Code (which covers a broader asset class than just listed equity) firmly entrenches the UK as a leader in shareholder engagement and stewardship – with a strong focus on outcomes (and not just policy statements) of stewardship, and lays out new expectations on how investment and stewardship is integrated, including environmental, social and governance ("ESG") issues. The FCA has concluded that at this stage, given other recent new regulatory requirements, it does not propose to introduce further (stewardship-related) regulatory requirements on regulated asset managers and insurers, however it has flagged a number of key areas where it considers that barriers to effective stewardship remain and should be addressed.

This alert summarises the key changes in the New Code impacting investors and asset managers, the outcomes from the FCA/FRC discussion paper and related recent and forthcoming UK and EU legal and regulatory developments.

A. The UK Stewardship Code – Background and Developments

The UK Stewardship Code was first published in 2010 following the 2009 Walker Review[4] on governance of financial institutions in the wake of the global financial crisis, with a view to enhancing the quantity and quality of engagement between investors and companies. At the time, it was the first and only Stewardship Code[5] calling for responsible and engaged investment behaviours by asset managers and owners. In 2012, following the Kay Review of UK equity markets[6], the Code was revised to expand the role of stewardship and require investors to engage with companies on strategy as well as corporate governance. Since the revision of the Code in 2012 (the "Current Code"), the UK has continued to be seen as a market which upholds high standards of corporate governance and therefore attract international investors. By 2016, there were 305 signatories to the Code however upon evaluation by the FRC of the signatories' statements against the Current Code, the FRC noted a huge variation in quality of the signatories' stewardship statements. In that year, the FRC introduced a two tier/ranking system – signatories to the Code in Tier 1 were recognised as having achieved the status of reporting well and those in Tier 2 were flagged as signatories whose statements required improvement.

Notwithstanding these enhancements and resulting improvements in stewardship, examples of poor governance practice, short-termism in equity markets and misalignment of incentives leading to under-performance and corporate failures persisted. The FRC has also recognised that the investment market has materially altered since the first Code was published with increased investment flows into assets other than listed equity and environmental (particularly climate change) and social factors becoming more material issues for investors, in addition to the pre-existing focus on governance. Alongside this, there have been a number of developments in the UK, EU and global level aimed at enhancing resources for stewardship, increasing transparency and engagement between asset owners and asset managers, enhancing climate change and other non-financial disclosures and incorporating ESG considerations into the mainstream. These drivers and developments collectively led to the FRC to consult on some fundamental revisions to the Current Code. It has done this in parallel with its related joint initiative with the FCA seeking views on how best to encourage the institutional investment community to engage more actively in stewardship, the outcomes of which are summarised in section C below.

The FRC issued its consultation paper in January 2019[7] and received 110 responses to its consultation which closed in March of this year. In preparing for the consultation it reached out and sought feedback from 170 members of the global investment community (including the UN PRI, ShareAction, the Investment Association and the UK Sustainable Investment and Finance Association). It also met with circa 240 stakeholders as part of and following the launch of the consultation process. The consultation responses reflected strong support for the key changes (summarised in section B below).

B. The New UK Stewardship Code 2020

Who does it apply to? Who should be interested in it? The New Code is a voluntary code which sets higher standards than minimum UK regulatory requirements for asset owners[8] and managers and for the service providers[9] who support them.

What does the New Code do/say? The New Code is structurally and substantially very different from the Current Code.

First and fundamentally, the New Code sets out a new definition of stewardship[10]. Stewardship is now defined as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society." This new definition links the primary purpose of stewardship to looking after the assets of beneficiaries entrusted to other, equating long-term value creation for this cohort with sustainable benefits to a wider group of interests (i.e., the "economy, environment and society).

The New Code consists of 12 "apply or explain" Principles for asset managers and asset owners (see Annex 1). These are supported by reporting expectations which indicate the information that should be publicly reported in order to become a signatory. The Current Code has seven "comply or explain" principles that are aimed at protecting and enhancing the value that accrues to the ultimate beneficiary.

There is a strong focus on the activities and outcomes of stewardship, not just policy statements. There are new expectations about how investment and stewardship is integrated, including ESG issues – note in particular Principle 7.

The New Code[11] asks investors to explain how they have exercised stewardship across asset classes. For these purpose, the New Code extends the scope across asset classes beyond listed equity for example fixed income, private equity, infrastructure investments, and in investments outside the UK.

The New Code also sets out six separate Principles for service providers. These now include principles addressing the assurance and the role service providers play in responding to market and systemic risks. The FRC has also used the New Code as an opportunity to be clearer about its expectations on the role played by service providers in the supporting their clients to meet their stewardship and investment responsibilities "taking into account material ESG issues, and communicating what activities have been undertaken".

When does it apply from? The New Code will take effect from 1 January 2020. Organisations will remain signatories to the UK Stewardship Code until the first list of signatories to the New Code is published. To be included in the first list of signatories, organisations must submit a final report to the FRC by 31 March 2021.

How do firms apply to become signatories and what happens upon becoming a signatory? The New Code contains various reporting requirements. Organisations who wish to become signatories should produce a single[12] Stewardship Report explaining how they have applied the New Code in the previous 12 months for approval by the FRC. The Report should be reviewed and approved by the organisation's governing body and signed by the chair, CEO or CIO. Existing signatories[13] to the Code will also need to submit a Stewardship Report that meets the reporting expectations in the New Code, in order to be listed as signatories to the UK Stewardship Code. Throughout 2020, the FRC has said that it will work with organisations seeking to be listed as signatories (in particular asset owners) to explain their expectations in relation to reporting.

Once an organisation has been accepted as a New Code signatory and the report is approved by the FRC, the report will be a public document and must be published on the organisation's website or in some other accessible form.

C. FCA & FRC Feedback On & Outcomes From the "Building a Regulatory Framework for Effective Stewardship" Discussion Paper

The FCA is the conduct regulator for 59,000 financial services firms and financial markets in the UK and the prudential regulator for over 18,000 of those firms. One of its primary objectives is to make markets work well – for individuals, for business, large and small, and for the economy as a whole. Specifically, the FCA aims to ensure that firms such as asset managers and life insurers deliver good outcomes for their customers. For many firms, the exercise of stewardship will be key to ensuring this outcome. The FCA has also stated that it expects "effective stewardship to have wider economic, environmental and social benefits".

In delivering on its regulatory responsibility to ensure effective stewardship, in January 2019, the FCA issued a Discussion Paper (closely co-ordinating with the FRC), 'Building a Regulatory Framework for Stewardship'. The objective of the Discussion Paper was to secure feedback on barriers to effective

stewardship, the minimum expectations on effective stewardship that should be imposed on financial services firms investing on behalf of clients and how to achieve them.

On 24 October, the FCA published the feedback from the Discussion Paper exercise[14]. In summary, the FCA agreed with the feedback from the majority of respondents that it would be premature to impose more stewardship obligations or requirements of asset managers and life insurers at this stage and that it should let firms first adapt to the FCA's new rules on shareholder engagement (implementing SRD II – see section D below) which took effect in June. Further, the FCA noted that many firms were already making significant investments to improve their stewardship capabilities with an enhanced focus on ESG matters.

Notwithstanding this general finding, the FCA also concluded that there were other things that it could do to address some "remaining barriers to effective stewardship", including: (i) examining how asset owners set and communicate their stewardship objectives; (ii) helping to address regulatory, informational and structural barriers to effective stewardship practices; (iii) considering further the role of firms' culture, governance and leadership in both the management of climate risks and the exercise of stewardship; and (iv) pursuing a number of actions to promote better disclosure of firms' stewardship practices and outcomes.

Some of the specific actions the FCA are proposing to take and/or areas they intend to give greater attention and focus to relate to the following:-

Climate-change related & other sustainability disclosures by issuers: The FCA is intending to consult in early 2020 on proposals for new 'comply or explain' rules requiring climate change-related disclosures by certain listed issuers aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Alongside this, the FCA will continue to consider whether issuer disclosures on other sustainability factors, beyond climate change, are adequate to support investors' business, risk and investment decisions.

Climate-change related disclosures by regulated firms: The FCA will consider how best to enhance climate change disclosures by regulated firms, such as asset managers and life insurers, so that they provide transparency on how their activities align with clients' sustainability objectives

ESG Data Service Providers: The FCA will assess the role played by specialist providers of ESG data services looking initially at the nature and quality of these services, how investors use them and how much reliance they place on them.

Tackling "Greenwashing": The FCA intends to do more to promote consumers' access to genuinely green products and services; will "challenge firms" where it sees potential evidence of misleading marketing or "greenwashing"; carry out further policy analysis on greenwashing and publish new guidance as appropriate.

D. Recent Related UK/ EU Developments

As noted above, one of the key drivers to the review undertaken by the FRC of the Stewardship Code and the FCA of stewardship more generally, has been the link to the growing interest in how companies and investment firms manage climate change and other ESG risks and opportunities and related legal and regulatory developments in this area. A brief overview of some of these developments are noted below:

UK Law Commission Review of Fiduciary Duties of Investment Intermediaries: In 2014, the Law Commission reviewed the legal concept of fiduciary duty with regards to investment. It stated that 'there is no impediment to trustees taking account of ESG factors where they are, or may be, financially material' and recommended that the government should clarify that it is part of trustees' duties to consider long-term systemic risks such as climate change. In 2017, the Law Commission issued a further report – 'Pension Funds and Social Investment' which identified a critical distinction between ESG and ethical factors, and began to explore options for regulatory reform.

Pensions Regulator & UK Department of Work & Pensions (DWP) Strengthen Pension Trustees Investment Duties: In 2016 and 2017, the UK Pensions Regulator updated its guidance for defined contribution and defined benefit schemes, advising that trustees need to take all factors that are financially material to investment performance into account, including ESG factors. Then in 2018, in response to the Law Commission's report, the DWP issued amendments to the Occupational Pension Schemes Regulations[15] requiring trustees of funds to document in their Statement of Investment Principles how they have taken ESG factors in making investment decisions and their policy towards stewardship.

Shareholders Rights Directive II ("SRD II"): The EU Shareholder Rights Directive 2007 (SRD) aimed to improve corporate governance in EU companies by setting minimum EU standards on shareholder rights in relation to general meetings (including viz notice periods, information rights, requisitions, voting) and other matter such as website disclosures and proxy appointments. SRD II substantially amends SRD broadening its scope and remit to include rules to encourage long-terms shareholder engagement and transparency between traded companies and investors. The key changes introduced by SRD II which recently came into force in the UK (June 2019) include provisions relating to identification of shareholders, transmission of information between companies and their shareholders via intermediaries, obligations on intermediaries to facilitate stewardship or the exercise of rights by shareholders, disclosure obligations on proxy advisers, obligations relating to related party transactions, rights of shareholders to vote on remuneration policies and remuneration reports and (of particular relevance to the work of the FRC and FCA outlined above) new provisions on the transparency of engagement policies of institutional investors and asset managers as well as their investment strategies.

In particular, SRD II includes three key requirements relevant to transparency of engagement policies and investment strategies. First, institutional investors and asset managers are required to develop and disclose a shareholder engagement policy, as well as disclosing annually how they implement the policy and how they have voted in general meetings of companies of which they hold shares. The matters to be covered by the engagement policy are extensive including how institutional investors and asset managers

integrate shareholder engagement in their investment strategy, monitor investee companies on relevant matters, conduct dialogues with investee companies, exercise voting and other rights, co-operate with shareholders, communicate with investee company stakeholders, and manage actual and potential conflicts of interest. In the UK, these rules apply to asset managers and insurers who have the UK as their home state regulator or investment firms authorized by the FCA.

Secondly, where an asset manager invests on behalf of an institutional investor, the institutional investor must disclose certain information regarding its arrangement with the asset manager (or explain why the information is not disclosed).The disclosure should include, for example, how the arrangement incentivises the asset manager to align its investment strategy and decisions with the profile and duration of the liabilities of the institutional investor, in particular long-term liabilities. This information must be made freely available on the institutional investor's website.

Thirdly, asset managers disclose annually to the institutional investors for whom they invest how their investment strategy and implementation of that strategy complies with the arrangement with the institutional investor; and contributes to the medium to long-term performance of the assets of the institutional investor or fund. The disclosure must include key material medium to long-term risks associated with investments. The disclosures can be made publicly (e.g. in annual reports) or otherwise provided directly to the institutional investor.

UK Government Greenhouse Gas & Plastics Commitments: The UK Government has made a legally binding commitment to achieve net zero greenhouse gas emissions by 2050. It has also signed up to the UK Plastics Pact aimed at achieving four world-leading plastic packaging elimination targets by 2025.

UK Government Green Finance Strategy: In July 2019, the UK Government published its Green Finance Strategy[16] to support, amongst other things, its economic policy for strong, sustainable and balanced growth and its domestic and international commitments on climate change, the environment and sustainable development.

European Commission Sustainable Finance Action Plan: In 2015, the European Commission committed to the UN 2030 Sustainable Development Goals agenda and to achieving the 2030 Paris Agreement targets (including a 40% cut in greenhouse gas emission). The EC recognised that substantial investment would be required to achieve these targets and fulfil on its commitments. Accordingly, in 2016, it established a High Level Expert Group on Sustainable Finance which made a series of recommendations as set out in a wide-ranging Sustainable Finance Action Plan[17] which was formally adopted in May 2018. This includes work on sustainable finance disclosures, sustainable climate benchmarks, and a taxonomy to promote a common understanding of what constitutes sustainable activity. In May 2018, the EC adopted a package of measures implementing several key actions announced in its action plan on sustainable finance (see Section E below) and in August 2018, the European Commission mandated the European Securities and Markets Association ("ESMA") to prepare technical advice on how to require asset managers and advisers to integrate ESG risks in their investment decisions or advisory processes, as part of their duties towards investors and/or clients.

E. Upcoming UK/ EU Developments of Note

In addition to the various initiatives that the FCA has outlined in its Feedback Statement on the New Regulatory framework for Effective Stewardship (see section C above) and the actions flowing out of the EU's Sustainable Finance Action Pan (as summarised in section D above) there are a number of other initiatives and developments underway both in the UK and at an EU level. Some developments to keep an eye out for include the following:

FCA Consultation on Extending the Remit of Independent Governance Committees ("IGCs")[18] ESG Duties: The FCA is currently consulting[19] on imposing a new duty for IGCs to report on their firm's policies on ESG issues, consumer concerns and stewardship, for the products that IGCs oversee. The FCA is also proposing related guidance for providers of pension products and investment-based life insurance products which sets out how these firms should consider factors such as ESG risks and opportunities that can have an impact on financial returns, and to non-financial consumer concerns, when making investment decisions on behalf of consumers.

EU Sustainable Finance Action Plan – Specific Upcoming Regulations. Under the EU's Action Plan a number of legislative proposals have been made. These include:

- ***ESG Taxonomy Regulation - A proposal for the establishment of a framework to facilitate sustainable investment****[20]*: This regulation establishes the conditions and the framework to gradually create a unified classification system or 'taxonomy' on what can be considered an environmentally sustainable economic activity. To be environmentally sustainable, an economic activity must: contribute substantially to one or more of six specified environmental objectives: (i) climate change mitigation; (ii) climate change adaption; (iii) sustainable use and protection of water and marine resources; (iv) transition to a circular economy, waste prevention and recycling; (v) pollution prevention and control; and (vi) protection of healthy ecosystems. Financial market participants offering financial products as environmentally-sustainable would be impacted by the proposed Taxonomy Regulation as they would have to disclose information on the criteria used to determine the environmental sustainability of the investment.

- ***ESG Disclosure Regulation - A proposal on disclosures relating to sustainable investments and sustainability risks****[21]:* This regulation will introduce disclosure obligations on how institutional investors and asset managers integrate ESG factors into their risk management processes. The proposed regulation would cover all financial products offered and services (individual portfolio management and advice) provided by the entities listed below, regardless of whether they pursue sustainability investment objectives or not. The rules would impact the following entities: (i) asset managers, regulated under the directive on undertakings for collective investment in transferable securities (UCITS), the alternative investment fund managers (*AIFM*) directive, the European venture capital funds (EuVECA) and European social entrepreneurship funds (EuSEF) regulations; (ii) institutional investors (being insurance undertakings regulated by Solvency II and occupational pension funds regulated by the institutions for occupational retirement provision directive; (iii) insurance distributors regulated by the insurance distribution

directive ("IDD"); and (iv) investment advisors and individual portfolio managers regulated by Markets in financial instruments directive ("MiFID II").

- ***ESG Benchmark Regulation - A proposal amending the benchmarks regulation****[22]*: This amendment will create a new category of benchmarks comprising two new categories: (i) a low-carbon benchmark - this is a filtered version of a standard benchmark in which the underlying assets are selected so that the resulting portfolio has lower carbon emissions than the 'parent' standard benchmark; and (ii) a positive carbon impact benchmark - this is a more sustainability-focused benchmark, in which the underlying assets are selected on the basis that their carbon emissions savings exceed their carbon footprint. In addition, the regulation will require benchmark administrators to methodologies for the assessment, selection and weighting of the underlying assets comprising their individual versions of these benchmarks, and explain how such benchmarks reflect ESG objectives.

MiFID II & IDD: The European Commission has also launched a consultation to assess how best to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients. The aim is to amend Delegated Acts under the Markets in Financial Instruments Directive (MiFID II)[23] and the Insurance Distribution Directive (IDD)[24]. The Commission is of the view that when assessing if an investment product meets their clients' needs, firms should also consider the sustainability preferences of each client, according to the proposed rules. This should help a broader range of investors access sustainable investments.

By way of reminder, under the existing MiFID II "suitability framework", firms providing investment advice and portfolio management services are required to obtain information from clients about their knowledge and experience, ability to bear losses, their investment objectives including risk tolerance, to ensure that such firms recommend and/or trade products that are suitable for the client. The proposed changes to MiFID II would incorporate ESG considerations in the suitability framework. This would mean that portfolio managers and investment advisers will have to take steps to ensure that their clients' ESG considerations are captured and embedded in their investment decision and recommendations framework. Although clients would not be obliged to provide or specify their ESG considerations, firms would be required to proactively seek this information from clients and accordingly they will need to give consideration as to how best to ascertain and capture this information.

Timing & Conclusion: The EC hopes that the first delegated act covering the climate change adaptation and mitigation objectives could be adopted by the end of this year. The objective would be to adopt the second and third delegated acts by mid-2021 and mid-2022 respectively covering other four other environmental objectives (protection of water and marine resources, circular economy and waste management, pollution prevention and control, protection of water and marine resources, healthy ecosystems). The EU environmental taxonomy (which is the bedrock of a number of the current and proposed new measures under the EU's Action Plan) would then be completed. In a timing set-back, late in September 2019, member states of the EU voted to delay the application of the taxonomy to end 2022 – almost two years later than the Commission originally planned. Whilst the full package of proposals will take a few years to develop and be fully implemented, asset managers and investors are advised to

start reviewing the impact of the new reporting and disclosure frameworks at an early stage to consider how these can be best embedded into existing frameworks and procedures.

ANNEX 1

UK Stewardship Code 2020 – New "Apply or Explain" Principles

Principles for Asset Owners and Asset Managers

Purpose and Governance

1. Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society

2. Signatories' governance, resources and incentives support stewardship.

3. Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first.

4. Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.

5. Signatories review their policies, assure their processes and assess the effectiveness of their activities.

Investment approach

6. Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.

7. Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.

8. Signatories monitor and hold to account managers and/or service providers.

Engagement

9. Signatories engage with issuers to maintain or enhance the value of assets.

10. Signatories, where necessary, participate in collaborative engagement to influence issuers.

11. Signatories, where necessary, escalate stewardship activities to influence issuers.

Exercising rights and responsibilities

12. Signatories actively exercise their rights and responsibilities.

PRINCIPLES FOR SERVICE PROVIDERS

1. Signatories' purpose, strategy and culture enable them to promote effective stewardship.

2. Signatories' governance, workforce, resources and incentives enable them to promote effective stewardship.

3. Signatories identify and manage conflicts of interest and put the best interests of clients first.

4. Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.

5. Signatories support clients' integration of stewardship and investment, taking into account, material environmental, social and governance issues, and communicating what activities they have undertaken.

6. Signatories review their policies and assure their processes.

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[1] The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for auditing, accounting and actuarial work. It monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries and enforces audit quality.

[2] Revised version of stewardship code, here.

[3] Results of feedback from joint initiative with the FRC, here.

[4] A Review of Corporate Governance in UK Banks and Financial Institutions (26 June 2009) led by Sir David Walker, here.

[5] NB: There are now over 20 stewardship codes globally many of which have been based on the original UK Code.

[6] The Kay Review UK Equity Markets and Long-Term Decision Making: Final Report June 2012, here.

[7] FRC consultation paper issued January 2019, here.

[8] These include pension funds, endowment funds and charities.

[9] These include investment consultants, proxy advisers and data and research providers.

[10] The Current Code states that the aim of stewardship is "promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole."

[11] Principle 12.

[12] The Code does not require disclosure of stewardship activities on a fund-by-fund basis or for each investment strategy but does require the report to indicate how stewardship differs across funds, asset class and geographies.

[13] For list of existing (i) asset manager signatories, click here; (ii) asset owner signatories, click here; and (iii) service provider signatories, click here.

[14] FCA published feedback from Discussion Paper exercise, here.

[15] Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (the "Amending Regulations")

[16] July 2019 UK Government Green Finance Strategy, here.

[17] Sustainable Finance Action Plan, here.

[18] IGCs provide independent oversight of the value for money of workplace personal pensions provided by firms such as life insurers and some self-invested personal pension operators. They also oversee workplace personal pensions in accumulation, i.e., before pension savings are accessed.

[19] The FCA is currently consulting on imposing a new duty for IGCs to report on their firm's policies on ESG issues, consumer concerns and stewardship, for the products that IGCs oversee, here.

[20] ESG Taxonomy Regulation - A proposal for the establishment of a framework to facilitate sustainable investment, here.

[21] ESG Disclosure Regulation - A proposal on disclosures relating to sustainable investments and sustainability risks, here.

[22] For text of EU Low Carbon Benchmarks Regulation published on 25 October 2019, click here.

[23] Draft Amending Delegated Acts under MiFID II, here.

[24] Draft Amending Delegated Acts under the Insurance Distribution Directive, here.

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GIBSON DUNN

November 3, 2020

EU SUSTAINABLE FINANCE FRAMEWORK TAKES SHAPE FOR PRIVATE FUND MANAGERS

To Our Clients and Friends:

> "*As our planet increasingly faces the unpredictable consequences of climate change and resource depletion, urgent action is needed to adapt to a more sustainable model…To achieve more sustainable growth, everyone in society must play a role. The financial system is no exception. Re-orienting private capital to more sustainable investments requires a comprehensive rethinking of how our financial system works. This is necessary if the EU is to develop more sustainable economic growth, ensure the stability of the financial system, and foster more transparency and long-termism in the economy*." (Press release, European Commission: Sustainable Finance: Commission's Action Plan for a greener and cleaner economy (8 March 2018)).

The European Commission's Sustainable Finance Action Plan[1] (the "**Action Plan**") proposed a package of measures including, amongst other initiatives, a regulation imposing sustainability-related disclosures on financial market participants ("**SFDR**"[2]) and a regulation to establish an EU-wide common language (or taxonomy) to identify the extent to which economic activities can be considered sustainable (the "**Taxonomy Regulation**"[3]). This briefing note provides an overview of the Taxonomy Regulation and the SFDR and discusses their impact on private fund managers, including non-EU managers who market their funds into the EU and/or the United Kingdom under the applicable national private placement regimes.

Each of the Taxonomy Regulation and the SFDR apply to "financial market participants", a term which is broadly defined and includes (amongst others): (i) alternative investment fund managers ("**AIFMs**"); and (ii) MiFID[4] investment firms that provide portfolio management services, and to "financial products" made available by them. "Financial products" include (amongst other things) alternative investment funds ("**AIFs**") managed by AIFMs and portfolios managed by MiFID firms.

The term "financial market participant" clearly includes AIFMs which are authorised under the AIFMD[5]. There is a lack of clarity for non-EU AIFMs in the text of both pieces of legislation. However, according to guidance on the Taxonomy Regulation, the disclosure requirements on financial market participants, which build on the obligations in the SFDR should "apply to anyone offering financial products in the European Union, regardless of where the manufacturer of such products is based". Consequently, it is clear that the disclosure obligations will apply to non-EU AIFMs that market their AIFs into the EEA (and the UK) pursuant to the national private placement regimes under Article 42 of the AIFMD.

SUSTAINABLE FINANCE DISCLOSURE REGULATION

The aim of the SFDR is to introduce harmonised requirements in relation to the disclosures to end investors on the integration of sustainability risks, on the consideration of adverse sustainability impacts, on sustainable investment objectives or on the promotion of environmental and/or social characteristics, in investment decision-making.

Many of the framework requirements under the SFDR will apply from 10 March 2021, although some of the requirements for funds with sustainable investment as an objective or which promote environmental and/or social characteristics will come into force on 1 January 2022 and 1 January 2023. In addition to the framework requirements, the SFDR is to be supplemented by more detailed requirements set out in the regulatory technical standards ("**RTS**") which are yet to be finalised. The RTS should have applied from 10 March 2021. However, the European Commission has recently, in a letter addressed to certain trade associations, confirmed that there will be a delay in the application of the RTS requirements, although no date has yet been announced for their future application (there is some expectation that the application date will be closer to 1 January 2022).

The European Commission has, however, made clear that all of the requirements and general principles contained in the SFDR itself will remain applicable to firms from 10 March 2021. Fund managers are, therefore, expected to take a principles-based approach to compliance with the SFDR and evidence this on a best efforts basis. It is considered by the European Commission that firms are already likely complying with certain product-level disclosure requirements as a result of existing sectoral legislation. This seems, however, to be an overly optimistic view, as (for example) much of the sectoral legislation does not go into the level of prescription set out in the SFDR.

The disclosures required by the SFDR include both manager-level disclosures (i.e. at the level of the AIFM or MiFID investment firm) and also product-level disclosures (i.e. at the level of the AIF or portfolio). The disclosures must be made in pre-contractual information to investors, in periodic investor reporting and publicly on the manager's website. Importantly, the SFDR does not apply only to managers of AIFs or portfolios with a sustainable investment objective or promoting environmental and/or social characteristics. While there are enhanced disclosures for such AIFs/portfolios, the SFDR requires disclosures to be made by all in-scope "financial market participants".

Manager-level disclosures

At the level of the manager, a financial market participant must disclose the following:

- *Information on its website about its policies on the integration of sustainability risks into its investment decision-making processes* - in order to comply, managers will need to ensure that they integrate an assessment of not only all relevant financial risks, but also all relevant sustainability risks that may have a material negative impact on the financial return of investments made, into their due diligence processes[6]. This will require firms to review all relevant investment decision-making processes and policies in order to understand how sustainability risks are currently integrated (if at all).

- *Information on its website regarding its consideration (or not) of principal adverse impacts of investment decisions on sustainability factors* - firms will need to make a commercial decision on whether or not they will consider the principal adverse impacts of investment decisions on sustainability factors. To the extent that a firm decides to consider such impacts, it will be required to publish a statement on its website on its due diligence policies with respect to those impacts. Those firms who choose not to consider adverse impacts of investment decisions on sustainability factors will be required to publish and maintain on their websites clear reasons for why they do not do so, including (where relevant) information as to whether and when they intend to consider such adverse impacts.[7]

- *Information in remuneration policy and on its website as to how its remuneration policy is consistent with the integration of sustainability risks* – firms will be required to revisit their existing remuneration policies and include in those policies and on their websites information on how the remuneration policies promote sound and effective risk management with respect to sustainability risks and how the structure of remuneration does not encourage excessive risk-taking with respect to sustainability risks and is linked to risk-adjusted performance.

Product-level disclosures

At the level of each AIF/portfolio (regardless of whether the AIF/portfolio has a sustainable investment objective or promotes environmental and/or social characteristics), the following must be disclosed:

- *Information in pre-contractual disclosures to investors about the manner in which sustainability risks are integrated into investment decision-making and the likely impacts of sustainability risks on the returns of the AIF/portfolio* – a financial market participant may decide at product-level that sustainability risks are not relevant to the particular AIF/portfolio. In such case, clear reasons must be given as to why they are not relevant.

- *Information in pre-contractual disclosures to investors as to whether and how the particular AIF/portfolio considers principal adverse impacts on sustainability factors* (by 30 December 2022) – a financial market participant may decide not to consider principal adverse impacts of their investment decisions on sustainability factors at the level of the AIF/portfolio. In which case, clear reasons must be provided as to why they are not taken into account.

- *Information in periodic reports on principal adverse impacts on sustainability factors* (from 1 January 2022).

For an AIFM, the pre-contractual disclosures mean the disclosures which an AIFM is required to make to investors before they invest in an AIF pursuant to Article 23 of the AIFMD and the periodic reports mean the annual report which is required to be produced pursuant to Article 22 of the AIFMD. In the context of a MiFID investment firm, the pre-contractual disclosures mean the information that is required to be provided to a client before providing services pursuant to Article 24(4) of MiFID. The periodic reports for MiFID firms refer to the reports required to be provided to clients pursuant to Article 25(6) of MiFID.

Disclosures for sustainable products

The SFDR identifies that products with "various degrees of ambition" have been developed to date. Therefore, the SFDR draws a distinction between financial products which have a sustainable investment objective and those which promote environmental and/or social characteristics. Different disclosure requirements apply to each.

Products promoting environmental and/or social characteristics

In relation to financial products promoting environmental and/or social characteristics (provided that the investee companies in which investments are to be made follow good governance practices[8]) ("**Article 8 AIFs/portfolios**"), the following must be disclosed at product level in the investor pre-contractual disclosures:

- information on how those characteristics are met;
- where an index has been designated as a reference benchmark, information on whether and how the index is consistent with those characteristics; and
- information as to where than index can be found.

Information is also required in the periodic reports for the AIF/portfolio on the extent to which the environmental or social characteristics are met. As this information relates to complete financial years, this requirement will apply from 1 January 2022.

In addition, this information must be published and maintained on the manager's website together with information on the methodologies used to assess, measure and monitor the environmental and/or social characteristics, including data sources, screening criteria for the underlying assets and the relevant sustainability factors used to measure the environmental or social characteristics.

Products with a sustainable investment objective

In the case of an AIF/portfolio with a sustainable investment objective ("**Article 9 AIFs/portfolios**") where an index has been designated as a reference benchmark, product-level pre-contractual disclosures must include:

- information on how the designated index is aligned with the investment objective; and
- an explanation as to why and how the designated index aligned with the objective differs from a broad market index.

Where no index has been designated, pre-contractual disclosures will include an explanation of how the sustainable investment objective is to be attained. Where the AIF/portfolio has a reduction in carbon emissions as its objective, the information to be disclosed must include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

Information is also required to be disclosed in the periodic reports for the AIF/portfolio on: (i) the overall sustainability-related impact of the AIF/portfolio by means of relevant sustainability indicators; and (ii) where an index is designated as a reference benchmark, a comparison between the overall sustainability-related impact with the impacts of the designated index and of a broad market index through sustainability indicators.

In addition, this information must be published and maintained on the manager's website together with information on the methodologies used to assess, measure and monitor the impact of the sustainable investments selected for the AIF/portfolio, including data sources, screening criteria for the underlying assets and the relevant sustainability factors used to measure the environmental or social characteristics.

TAXONOMY REGULATION

The Taxonomy Regulation establishes an EU-wide classification system to provide a common language (i.e. taxonomy) to define environmentally sustainable economic activities. It also sets out six environmental objectives, including climate change mitigation, climate change adaption and transition to a circular economy and provides that for an economic activity to be environmentally sustainable it must make a "substantial contribution" to at least one of the environmental objectives and not cause any significant harm to any of the others.

The Taxonomy Regulation also amends the SFDR in certain respects as regards disclosures required for financial products that have a sustainable investment objective or promote environmental characteristics and requires negative disclosure for those AIFs/portfolios which do not have such objectives/characteristics.

An economic activity is considered to be environmentally sustainable for the purposes of the Taxonomy Regulation if:

1) it makes a "substantial contribution" to one or more of the six environmental objectives;

2) it does "no significant harm" to any of the six environmental objectives;

3) it is carried out in accordance with certain minimum safeguards[9]; and

4) it complies with technical screening criteria[10].

The six environmental objectives are:

- climate change mitigation;
- climate change adaptation;
- sustainable use and protection of water and marine resources;
- transition to a circular economy;

- pollution prevention and control; and
- protection and restoration of biodiversity and ecosystems.

The Annex to this alert provides an overview of what "substantial contribution" and "significant harm" means for each of the six environmental objectives.

Amendments to the SFDR

The Taxonomy Regulation makes certain amendments to the SFDR in relation to the pre-contractual and periodic reporting requirements for Article 8 AIFs/portfolios and Article 9 AIFs/portfolios where they invest in an economic activity that contributes to one or more of the environmental objectives set out in the Taxonomy Regulation. Additional pre-contractual and periodic disclosures are required for such products, including: information on the environmental objective(s) which is contributed to and a description of how and to what extent the investments are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.

The Taxonomy Regulation also makes changes for other financial products too which are neither an Article 8 AIF/portfolio or Article 9 AIF/portfolio by requiring a negative disclosure using the following words: "The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities."

The amendments made to the SFDR by the Taxonomy Regulation will apply from 1 January 2022 in some cases and 1 January 2023 in others, depending on which environmental objective is contributed to by the AIF/portfolio.

BREXIT: IMPACT IN THE UK

The UK left the EU in January 2020 and the agreed transition period will expire on 31 December 2020. As the disclosure obligations under the SFDR and the Taxonomy Regulation will not apply until after the end of the transition period, they do not form part of the so-called "retained EU law" in the UK from 1 January 2021. In relation to the Taxonomy Regulation, for example, the UK government has stated that it will retain the taxonomy framework, including the high level environmental objectives, however the Regulation's disclosure requirements will not form part of this (given that they are set to apply as from a date post-transition period). As the delegated legislation containing the technical standards has not, so far, been published by the European Commission, the government has not yet been in a position to comment as to the extent of the UK's alignment with the EU on this after the transition period[11].

Also, with regard to the SFDR, the Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020 provide that the SFDR will continue to apply in part in the UK when the Brexit transition period ends, with key omissions relating, for example, to the upcoming technical standards and financial product-specific disclosure requirements.

ANNEX

Environmental objective	**"Substantial contribution"**	**"Significant harm"**[12]
Climate change mitigation	The process of holding the increase in the global average temperature to below 2°C and pursuing efforts to limit it to 1.5°C above pre-industrial levels, as set out in the Paris Agreement. The economic activity will substantially contribute to the stabilisation of greenhouse gas concentrations in the atmosphere, including through process or product innovation by, for example: • improving energy efficiency; • increasing clean or climate neutral mobility; or • establishing energy infrastructure that enables the decarbonisation of energy systems.	Significant greenhouse gas emissions.
Climate change adaptation	The process of adjustment to actual and expected climate change and its impacts. Broadly, this includes substantially reducing the risk of the adverse impact, or substantially reducing the adverse impact, of the current and expected future climate on (i) other people, nature or assets; or (ii) the economic activity itself, in each case without increasing the risk of an adverse impact on other people, nature and assets.	An increased adverse impact of the current and expected climate on people, nature and assets.

Environmental objective	**"Substantial contribution"**	**"Significant harm"**[12]
Sustainable use and protection of water and marine resources	The activity substantially contributes to achieving the good status of water bodies or marine resources, or to preventing their deterioration, through certain means, including, for example, through improving water management and efficiency.	Detriment to the good status, or where relevant the good ecological potential, of water bodies, including surface waters and groundwaters, or to the good environmental status of marine waters.
Transition to a circular economy	Maintaining the value of products, materials and other resources in the economy for as long as possible, enhancing their efficient use in production and consumption. The activity substantially contributes to the circular economy by (among other things): • improving the efficiency in the use of natural resources; • increasing the recyclability of products; and • preventing or reducing waste generation.	• Significant inefficiencies in the use of materials and the direct or indirect use of natural resources such as non-renewable energy sources, raw materials, water and land in one or more stages of the life-cycle of products, including in terms of durability, reparability, upgradability, reusability or recyclability of products. • Significant increase in the generation, incineration or disposal of waste, with the exception of incineration of non-recyclable hazardous waste. • Where long term disposal of waste may cause significant and long-term harm to the environment.

Environmental objective	"Substantial contribution"	"Significant harm"[12]
Pollution prevention and control	The economic activity will substantially contribute to pollution prevention and control by, for example, cleaning up litter and other pollution and preventing or reducing pollutant emissions.	Significant increase in the emissions of pollutants into air, water or land, as compared to the situation before the activity started.
Protection and restoration of biodiversity and ecosystems	The economic activity will substantially contribute to the protection and restoration of biodiversity and ecosystems by, for example, sustainable agricultural practices, sustainable forest management and nature and biodiversity conservation.	Detriment to a significant extent to the good condition and resilience of ecosystems or where that activity is detrimental to the conservation status of habitats and species, including those of community interest.

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[1] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions - Action Plan: Financing Sustainable Growth, 8 March 2018

[2] Regulation (EU) 2020/852 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

[3] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

[4] Markets in Financial Instruments Directive (Directive 2014/65/EU)

[5] Alternative Investment Fund Managers Directive (Directive 2011/61/EU)

[6] Recital 12 SFDR.

[7] Note that large financial market participants (broadly, those with an average number of 500 employees during the financial year) will not have the option. From 30 June 2021 they must consider adverse impacts of their investment decisions on sustainability factors.

[8] "Good governance practices" is not defined in the SFDR. It is clear from the text that the European legislators intended it to be interpreted widely. Examples of good governance practices include: sound management structures, employee relations, remuneration of staff and tax compliance.

[9] OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

[10] These technical screening criteria will be established by the European Commission in accordance with the provisions of the Taxonomy Regulation.

[11] Letter from John Glen, Economic Secretary to the Treasury, to Sir William Cash, Chair of the European Scrutiny Committee: 9355/18: Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment (28 May 2020)

[12] Further details regarding "no significant harm" to be set out in the technical screening criteria.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or the following authors in London:

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Reverse solicitation: a shot across the bow

Published 10-Feb-2021 by
Michelle Kirschner and Matthew Nunan, Gibson, Dunn & Crutcher

On January 13, 2021 the European Securities and Markets Authority (ESMA) issued a public statement (statement) which was billed as a reminder to firms of the Markets in Financial Instruments Directive II (MiFID II) rules on reverse solicitation. There is nothing new or particularly surprising contained in ESMA's statement, but it has caused considerable consternation to some firms in the UK market.

The UK exited the Brexit transition period on December 31, 2020 and from that time firms based in the United Kingdom are third-country firms and can no longer access the EU market on the basis of the MiFID II passports which they had enjoyed while the UK was a member of the EU. Firms in the United Kingdom have therefore had to find alternative ways in which to access the European markets in future. For some, that has involved establishing a physical presence within the EU (or expanding an existing presence). For others it has involved some navel gazing to determine to what extent the European market is significant for the business. Some have resolved that they can serve their EU clients on the basis of reverse solicitation.

The statement's main principles

The statement reiterates the following broad principles:

- Under Article 42 of MiFID II, where a firm provides investment services at the own exclusive initiative of a retail client or "elective" professional client, the firm does not trigger the authorisation requirement (including establishment of a branch) under Article 39 of MiFID II.
- Where a third-country firm provides services at the own exclusive initiative of the client under Article 42, the firm is not able to market additional categories of products or services to that client.
- Firms should be mindful of and follow the guidance set out in ESMA's Q&As on MiFID II and Markets in Financial Instruments Regulations (MiFIR) investor protection and intermediaries topics (ESMA Q&A) in relation to the application of the concept of "own exclusive initiative".
- Where a third-country firm solicits clients or potential clients or promotes or advertises investment services or activities in the EU, such services cannot be deemed to be provided at the own exclusive initiative of the client. This is true regardless of any contractual clause or disclaimer purporting the opposite (Recital 111 of MiFID II).

In the statement, ESMA claims that: "… some questionable practices by firms around reverse solicitation have emerged. For example, some firms appear to be trying to circumvent MiFID II requirements by including general clauses in the terms of business or through the use of online pop-up "I agree" boxes whereby clients state that any transaction is executed on the exclusive initiative of the client".

ESMA has already provided significant guidance in the ESMA Q&As in relation to the application of the concept of "own exclusive initiative" for the purposes of Article 42 of MiFID II. That guidance is unchanged by the occurrence of Brexit and applies equally to firms in the UK as it does to firms in any other third country. That guidance, in particular, refers to the fact that ESMA considers that every communication means such as press releases, advertising on the internet, brochures, telephone calls or face-to-face meetings should be considered to determine whether a (potential) client has been solicited or whether any investment service or financial product has been promoted or advertised.

Reverse solicitation is still a legitmate means of accessing the markets

The statement does not sound the death knell of reverse solicitation as a legitimate means of accessing the EU markets. It does demonstrate however is that ESMA is alive to potential misuse and overuse of reverse solicitation. It is highly likely that this will not be the last that we will hear from ESMA and the EU national competent authorities on this issue. It is clear that the EU will be focused on this issue and we can expect supervisory steps and action to be taken in the event that third-country firms are found to be over-relying upon reverse solicitation in circumstances where the firm has, in fact, solicited the client or advertised or otherwise promoted its investment services in the EU.

The statement does not require firms to take any positive steps or to cease to rely upon reverse solicitation but those firms who are relying upon reverse solicitation would be well-advised to review their arrangements and assess whether (on a client-by-client, transaction-by-transaction basis) they are comfortable with relying upon reverse solicitation. Firms should ensure they have demonstrable evidence to show that the client approached the firm at the client's own exclusive initiative (or at the very least that there is no evidence to the contrary).

Firms should also consider their marketing efforts in the EU. The globally accessible internet poses particular challenges for firms in terms of determining whether their marketing efforts are capable of being viewed in and have effect in particular jurisdictions and even

more traditional media can cause issues. For example, an advert placed in a German language newspaper is clearly aimed at the German market, whereas an advert placed in the Financial Times is less clear yet potentially has global distribution.

Closing thoughts

The authors note that the statement only mentions the concept of "own exclusive initiative" for the purposes of Article 42 of MiFID II. The concept also applies under Article 46(5) of MiFIR within the third country regime for per se professional clients and eligible counterparties. The MiFIR third-country regime is not yet in operation, but the statement will become relevant to that regime to the extent that equivalency decisions are made in relation to any third-country under Article 47 of MiFIR.

While it is clear that the statement is relevant to firms providing MiFID services on a reverse solicitation basis, a read-across into other regimes is sensible. For example, third-country private fund sponsors admitting investors into alternative investment funds on the basis of reverse solicitation would be well-advised to reconsider whether they have demonstrable evidence that the investor approached the sponsor (or its agent) at its own exclusive initiative since it is highly likely that the European regulators will have a heightened sensitivity on these issues in the coming period.

Complaints Procedure

GIBSON DUNN

January 21, 2021

URGENT CLARIFICATION SOUGHT BY EUROPEAN SUPERVISORY AUTHORITIES ON THE APPLICATION OF THE SUSTAINABLE FINANCE DISCLOSURE REGULATION

To Our Clients and Friends:

On 7 January 2021, the Joint Committee of the European Supervisory Authorities ("**ESAs**") wrote to the European Commission, requesting "urgent" clarification on several important areas of uncertainty in the application of Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the "**SFDR**") prior to the application of the majority of its requirements on 10 March 2021.

One such area raised, which will be of particular importance to a number of fund managers, is whether the SFDR will apply to non-EU alternative investment fund managers ("**AIFMs**") when marketing funds in the EU under applicable national private placement regimes.

Application to non-EU AIFMs

To date, the industry has generally taken the view that non-EU AIFMs will be caught by the product level disclosure requirements of the SFDR, when marketing their funds in the EU. This is primarily as a result of the cross-reference in the SFDR to Article 4(1)(b) of the Alternative Investment Fund Managers Directive (2011/61/EU), which itself includes non-EU AIFMs.

The posing of this question by the ESAs, however, casts doubt on the presumption by many non-EU AIFMs that they will fall within the scope of the SFDR. The industry will be watching very closely in the coming days and weeks to see how the European Commission responds. In the interim, this uncertainty clearly presents a challenge for non-EU AIFMs, which will need to think about whether to continue with implementation for now, on the assumption that they will be caught, so as not to be on the "back foot" should the European Commission confirm they are within scope.

Other key priority areas identified

The ESAs have also asked for clarification in relation to a further four areas (set out below at a high level):

- **application of the 500-employee threshold for principal adverse impact reporting on parent undertakings of a large group** – this is particularly significant in light of the fact that where the threshold is met, from 30 June 2021, firms will have to consider adverse impacts of their investment decisions on sustainability factors (rather than use a "comply or explain" approach);

- **the meaning of "promotion" in the context of products promoting environmental or social characteristics** – the ESAs noted that, in general, clarification on the level of ambition of the characteristics through the provision of examples of different scenarios that are within, and outside, the scope of Article 8 of the SFDR would assist with the orderly application of the SFDR. Fund managers will need to determine whether the fund falls within Article 8, as additional disclosure obligations apply where that is the case;

- **the application of Article 9 of the SFDR** – the ESAs asked for further clarification on what would constitute an Article 9 product. For example, they asked whether a product to which Article 9(1), (2) or (3) of the SFDR applies must only invest in sustainable investments as defined in Article 2(17) of the SFDR. If not, is a minimum share of sustainable investments required (or would there be a maximum limit to the share of "other" investments)? As above, in relation to Article 8 products, fund managers will need to make additional disclosures if the fund in question falls within Article 9 of the SFDR; and

- **the application of the SFDR product rules to portfolios and dedicated funds** – one question asked by the ESAs was whether, for portfolios, or other types of tailored financial products managed in accordance with mandates given by clients on a discretionary client-by-client basis, the disclosure requirements in the SFDR apply at the level of the portfolio only or at the level of standardised portfolio solutions. This is clearly another area in which further clarification from the European Commission would be very welcome.

Conclusion

It is, to say the least, far from ideal that there is so much uncertainty surrounding the application of the SFDR so close to 10 March. This is particularly the case given that these areas are by no means peripheral – there will, for instance, be a significant number of non-EU AIFMs holding their breath at the moment. The industry will be waiting with great interest to see how the European Commission responds.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above – whether issues raised or potential solutions – please contact the Gibson Dunn UK Financial Services Regulation team:

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IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

Ethics for Advisers – Part 2

L. Allison Charley, ACA Compliance Group

Genna Garver, Troutman Pepper Hamilton Sanders LLP MODERATOR

Eric C. Oppenheim, Telemus Capital, LLC

Kurt Wachholz, IACCP, National Regulatory Services

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Agenda

- Insider trading regulatory landscape
- Best practices for preventing insider trading
- SEC whistleblower program
- Best practices for encouraging and triaging internal reports
- Questions

Polling Question

How concerned is your firm about insider trading?

- ✓ Very concerned
- ✓ Somewhat concerned
- ✓ Not losing sleep on it—we have policies and procedures in place
- ✓ Not concerned at all

Insider Trading Regulatory Landscape

- What is “insider trading”?
- What regulations/requirements apply to investment advisers?
  - Investment Advisers Act § 204A. Prevention of Misuse of Nonpublic Information
  - Securities Exchange Act § § 10(b) and 21A and Rule 10b-5
  - Investment adviser codes of ethics (17 C.F.R. § 275.204A-1)
  - Books and records (17 C.F.R. § 275.204-2)

Polling Question

What procedures do you rely on to prevent the misuse of MNPI?

- ✓ Restricted lists/watch lists
- ✓ Information barriers
- ✓ Prohibit use of expert networks
- ✓ All of the above

Preventing Insider Trading

- Where does MNPI come from?
- How do you identify MNPI?
- Who is responsible for making the determination?
  - Role of legal
  - Role of compliance

Polling Question

What policies do you have in place to restrict personal securities transactions?

- ✓ Pre-approval for all personal transactions
- ✓ Pre-approval for personal transactions in issuers also held by clients
- ✓ Pre-approval required for IPOs and private placements
- ✓ Black out dates and/or time limits

Preventing Insider Trading

- How do you handle MNPI?
- What policies do you have in place to restrict personal securities transactions, including cryptocurrencies?
- Case studies: Failing to implement and enforce policies and procedures reasonably designed to prevent the misuse of MNPI.
  - *Cannell Capital*
  - *Ares Management*

SEC Whistleblower Program

- SEC whistleblower incentives program
  - Success of the program
- Anti-retaliation provisions
- Advisory firms as a source of information

Internal Reporting Best Practices

- Internal reporting procedures and systems
- Encouraging (or rewarding) internal reporting
- Taking whistleblowers seriously
- Managing confidentiality issues with internal reporting

Key Takeaways & Questions

Thank You

- **L. Allison Charley**, Senior Principal Consultant, ACA Compliance Group
- **Genna Garver**, Partner, Troutman Pepper Hamilton Sanders LLP
- **Eric C. Oppenheim**, General Counsel & Chief Compliance Officer, Telemus Capital, LLC
- **Kurt Wachholz**, IACCP, Executive Consultant and Director of Education, National Regulatory Services


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

Ethics for Advisers – Part 2
Thursday, March 4 – 11:00am-12:00pm

An adviser's code of ethics reflects its fiduciary obligation to its clients. This panel will discuss the protection of material nonpublic information (MNPI) and prevention of insider trading, whistleblower policy issues and scenarios, and best practices for monitoring, testing, administering and enforcing these policies.

- Eric C. ("Rick") Oppenheim, General Counsel & Chief Compliance Officer, Telemus Capital, LLC
- L. Allison Charley, Senior Principal Consultant, ACA Compliance Group
- Kurt Wachholz, IACCP, Executive Consultant and Director of Education, National Regulatory Services
- Genna Garver, Partner, Troutman Pepper Hamilton Sanders LLP, MODERATOR

OUTLINE

1. **Introduce topic and panelists**

2. **Protection of material nonpublic information (MNPI) and prevention of insider trading**

    a. Legal Landscape of Insider Trading

        i. Insider Trading

            1. What regulations/requirements apply to investment advisers?

                a. Investment Advisers Act § 204A. Prevention of Misuse of Nonpublic Information

                b. Securities Exchange Act §§ 10(b) and 21A and Rule 10b-5

            2. What is "insider trading"?

                a. Elements and review of recent case law through *Martoma II* and *Blaszczak*

        ii. Regulatory/Compliance Requirements

            1. Investment adviser codes of ethics (17 C.F.R. § 275.204A-1)

            2. Books and records (17 C.F.R. § 275.204-2)

        iii. Practical Application (Recent Enforcement Cases)

1. *Cannell Capital, LLC* (2020) – CCL violated Section 204A of the Investment Advisers Act of 1940 by failing to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.

2. *Ares Management LLC* (2020) – Ares Management LLC, a Los Angeles-based private equity firm and registered investment adviser, has agreed to pay one million dollars to settle charges that it failed to implement and enforce policies and procedures reasonably designed to prevent the misuse of material nonpublic information.

b. Best practices for monitoring, testing, administering and enforcing these policies

i. Policies and Procedures

1. Code of Ethics & Standards of Business Conduct

2. Protection of Material Nonpublic Information

ii. Internal Reporting

1. Reporting code violations

2. Recordkeeping requirements

iii. Managing difficult legal & compliance determinations

1. Determining whether information is MNPI

2. Managing information barriers

3. Determining when to remove an issuer from a restricted list—when is it safe to trade?

3. Whistleblower policy issues and scenarios

a. SEC Whistleblower Program

i. Incentives Program

ii. Anti-retaliation Provisions

iii. Application: success of the program and advisory firms as a source of information

1. *See* InvestmentNews, *Whistleblowers' big bucks come with big risks for financial advisers*)

2. *See* Law.com, *Whistleblower Lands $1.8M for Exposing Alleged Morgan Stanley Misconduct*

b. Best practices for monitoring, testing, administering and enforcing these policies

    1. Code of Conduct and Training

    2. Encouraging (or Rewarding) Internal Reporting

    3. Internal Reporting Procedures and Accessible Reporting Systems

    4. Triaging and Investigating Credible Tips (Taking Whistleblowers Seriously)

c. Managing confidentiality issues with internal reporting

4. Questions

Insider Trading

Elements of Insider Trading

Insider trading occurs when an individual violates a duty of trust or confidence by trading securities while in possession of material nonpublic information ("MNPI")

Would a reasonable investor likely consider the information important in their investment decision?

Material

Has the information been broadly communicated to the investing public?

Nonpublic informatio

(about the security)

May include duties owed by corporate or temporary insiders, duties imposed by law, duties due to a confidentiality agreement, a verbal or implied agreement to keep information confidential, etc.

In breach of a duty

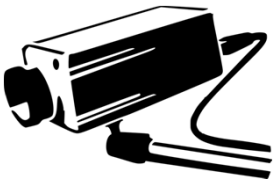
Penalties for Insider Trading

The following penalties apply both for trading on or communicating MNPI:

- Jail sentences
- Civil injunctions
- Disgorgement of profits or losses avoided
- Criminal fines up to 3x profit gained or loss avoided per trade – even without benefitting from the violation
- Bar from serving as an officer or director or being associated with a regulated entity
- Serious sanctions by XYZ, including potential dismissal

How Does the SEC Catch Insider Trading?

- Electronic trading surveillance by SEC, FINRA, CBOE
- Wiretaps by DOJ and FBI
- Referrals to SEC by companies seeking to limit corporate liability
- Referrals by angry ex-spouses and ex-business partners
- Referrals by bounty hunters seeking up to 30% of an SEC judgment
- SEC review of email and phone records
- Testimonial evidence as part of a plea deals
- Referrals by financial institutions under money laundering rules



Potential Sources of MNPI

- Meetings with senior management of public issuers
- Contact with investment bankers and other sources of idea generation (e.g., research analysts, traders, underwriters)
- "Value-added" investors
- Participation on boards of directors and creditor committees
- Execution of confidentiality agreements
- Idea sharing with other advisers (co-investors)
- Political intelligence consultants or lobbyists

Government Officials and MNPI

- Political intelligence firms may obtain and share information that could potentially be MNPI
- This has been a recent area of regulatory focus – advisers can be held accountable if they ignore "red flags" from research providers
- The STOCK Act: insider trading rules apply to government officials and their employees as well as to you!

SEC Focus on Political Intelligence

SEC Order Alleged:

- One PM engaged in Insider Trading by causing one Fund to trade in securities of a company in advance of two separate generic drug approvals by the Office of Generic Drugs ("OGD")
  - The information was obtained from a former OGD official, who was retained as a consultant and who continued to provide MNPI to the Adviser's PMs
- Another PM caused Funds to trade based on MNPI he received from a political consultant about an impending CMS announcement concerning certain Medicare reimbursement rates for home healthcare services
- Adviser failed to enforce policies and procedures reasonably designed to prevent the misuse of MNPI
- Adviser's Compliance Manual failed to adequately address policies and procedures regarding research firms
- There were multiple emails circulated around between employees of the Adviser that indicated the analysts were receiving MNPI (e.g., an email from the political intelligence analyst about a forthcoming regulation that was forwarded to traders, portfolio managers, and the CCO/general counsel)
- Adviser based trading decisions off of the MNPI they received, and made $3.9 million for certain of its Funds

Source: Advisers Act Release No. 4749; August 21, 2018.

SEC Focus on Political Intelligence (cont.)

Undertakings and Sanctions:

- Adviser willfully violated Section 204A of the Advisers Act
- Cease and desist from committing or causing any violations and any future violations of Section 204A of the Advisers Act
- Disgorgement of $714,110 and prejudgment interest of $97,585
- Civil penalty of $3,946,267

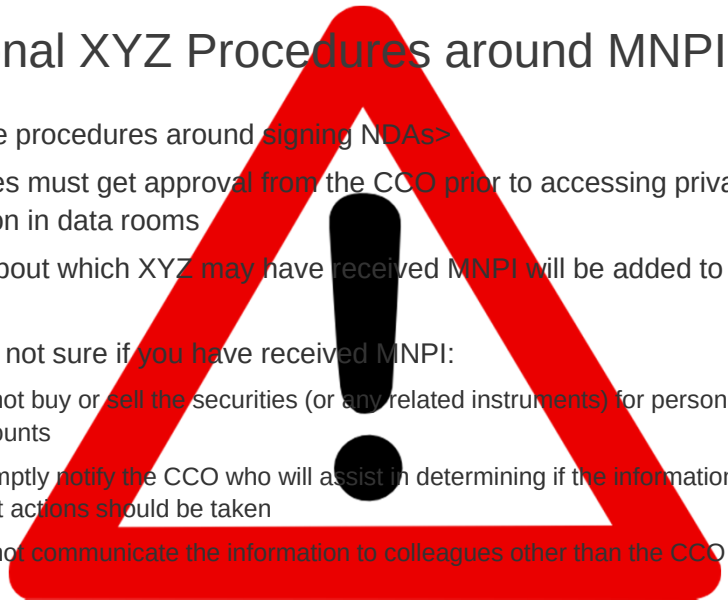
XYZ's Policies on Using Expert Networks

- CCO must review and approve any agreement between XYZ and the sponsor of an expert network
  - XYZ expects that sponsors of expert networks have compliance controls in place
- Use of expert networks is limited to portfolio managers and analysts and is only for business use
- Users cannot consult with experts who are currently or were employed by a public company within the last 6 months about that company
  - Communication with current or recently-employed public company experts requires Compliance pre-approval
- Communications with experts will be via specified bridge lines and XYZ will periodically monitor calls
- Current approved expert network: Guidepoint Global, LLC

Corporate Insiders and MNPI

- 17% of respondents to ACA's 2017 Alternative Fund Manager Survey indicated they had inadvertently received MNPI through corporate access events or other direct interactions with senior executives of public issuers
- Best practices include:
  - Meeting with C-suite individuals and investor relations personnel
  - Crafting questions to avoid asking for information that could be considered MNPI
- <Notify the CCO of any meetings with public company insiders>
- Note that you may have contact with corporate insiders through personal or charitable activities as well and want to avoid receipt of MNPI in those situations
- SEC exam staff has cited advisers for not having policies and procedures to address interactions with corporate insiders

Additional XYZ Procedures around MNPI



- <Describe procedures around signing NDAs>
- Employees must get approval from the CCO prior to accessing private-side information in data rooms
- Issuers about which XYZ may have received MNPI will be added to the Restricted List
- If you are not sure if you have received MNPI:
  - Do not buy or sell the securities (or any related instruments) for personal or client accounts
  - Promptly notify the CCO who will assist in determining if the information is MNPI and what actions should be taken
  - Do not communicate the information to colleagues other than the CCO

Key Takeaway:

Consult with Compliance immediately if you have any questions/concerns about MNPI and insider trading

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Articles & Publications

SEC Still Observing Deficiencies Involving Private Fund Fees and Expenses and Conflicts Disclosure

06.26.20

On June 23, 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert highlighting the following three general areas of deficiencies OCIE identified in examinations of private fund advisers: (1) conflicts of interest, (2) fees and expenses, and (3) policies and procedures relating to material nonpublic information (MNPI). OCIE hopes this latest risk alert will assist private fund advisers in reviewing and enhancing their compliance programs, and also will provide investors with information concerning private fund adviser deficiencies.

General Areas Deficiencies	Specific Practices Observed
Conflicts of Interest	• Preferential allocations of investments • Multiple clients investing in the same portfolio company • Undisclosed financial relationships (*e.g.*, investors making seed investment or providing credit) between investors and or clients and the adviser • Preferential liquidity rights to certain investors through side letters • Private fund adviser interests in recommended investments (*e.g.*, preexisting ownership interests or other financial interests, such as referral fees or stock options in the investments) • Undisclosed process, and failure to follow disclosed process, for allocations of co-investments • Service providers (*e.g.*, advisers with incentives for portfolio companies to use certain service providers, such as incentive payments from discount programs, but failed to disclose the incentives and conflicts to investors) • Inadequate disclosures on fund restructurings and stapled secondary transactions • Cross-transactions (*e.g.*, advisers had established the price at which securities would be transferred between client accounts in a way that disadvantaged one of the clients)
Fees and Expenses	• Inaccurate allocation of fees and expenses (*e.g.*, broken-deal, due diligence, annual meeting, consultants, and insurance costs, among the adviser and its clients, including private fund clients, employee funds, and co-investment vehicles) • Misleading investors about who would bear the costs associated with operating partners' services and potentially causing investors to overpay expenses • Inappropriately over-valuing client assets causing clients to overpay management fees • Undisclosed monitoring, board and deal fees, and inaccurate management fee offsets
MNPI Policies and Procedures	• Section 204A (*e.g.*, policies and procedures did not address, or were not enforced with respect to, interactions with insiders of publicly traded companies, "expert network" firms, investors who are corporate insiders, access to MNPI in connection with PIPEs, and access to office space or systems that possessed MNPI) • Code of Ethics Rule (*e.g.*, unenforced trading restrictions; undefined policies and procedures for adding securities to, or removing securities from, restricted lists; unenforced gifts and entertainment policies; failures to require submission of timely transactions and holdings reports timely or preclearance requests; and failure to identify correctly certain individuals as "access persons")

Déjà vu?

This is not the first OCIE guidance reminding private fund managers to review their policies and procedures to avoid these types of deficiencies. Shortly after the initial round of exams following the Dodd-Frank wave of private fund manager registrations in 2012, OCIE observed a high rate of deficiencies involving private fund manager fees and expense allocations. Since 2015, OCIE has often included in its annual exam priorities roster private fund fees and expenses, disclosure of conflicts of interest, as well as actions that appear to benefit the adviser at the expense of investors.[1]

The SEC followed through on its exam priorities. The SEC has initiated multiple actions against private fund managers since 2015 on violations such as expense allocation, undisclosed fees, and undisclosed conflicts of interest, including with respect to broken deal expenses, accelerated monitoring fees, and affiliated consulting fees.[2]

OCIE has similarly reminded advisers to review compliance programs for MNPI deficiencies. In February 2017, OCIE published a risk alert listing the five most frequent compliance topics identified on investment adviser examinations completed within the past two years — Code of Ethics rule violations made the list. Representative violations of the Code of Ethics Rule centered on the advisers' failure to satisfactorily provide information about the advisers' codes of ethics. Among other things, the staff observed that advisers failed to comprehensively identify their "access persons," neglected to timely disclose information pertaining to holdings and transactions reports, and failed to properly describe their codes of ethics in Form ADV filings.

Again, on April 12, 2018, OCIE released a risk alert identifying the most frequently cited compliance deficiencies relating to fees and expenses charged by SEC-registered investment advisers to their clients. In particular, the 2018 risk alert highlighted OCIE's observation of fund managers

misallocating marketing expenses, regulatory filing fees, and travel expenses to fund clients instead of the adviser, in contravention of the applicable advisory agreements, operating agreements, or other disclosures. OCIE's stated objectives in issuing the risk alert were to encourage advisers to assess their advisory fee and expense practices and related disclosures to ensure that they are complying with the Investment Advisers Act, the relevant rules, and their fiduciary duty, and review the adequacy and effectiveness of their compliance programs.

We have already observed recent private fund exam document request letters lasering in on these issues and anticipate more to come. If history has its way and repeats itself, we may be in store for another round of private fund enforcement actions related to expense allocation, undisclosed fees, and undisclosed conflicts of interest.

Compliance Takeaways

Private fund managers should take heed of OCIE's guidance and assess their advisory fee and expense practices, related disclosures, and MNPI policies and procedures. In particular, firms should consider the following takeaway tips for reviewing these compliance matters:

- Review your firm's current compliance policies and procedures to confirm consistency with the terms of your fund governing documents and Form ADV disclosure.
- Review your general ledgers to confirm expenses have been properly allocated as between the adviser and the funds you advise. A best practice is to have the fund governing documents expressly enumerate the line items allocated to the fund.
- Periodically test to confirm the fees charged were properly calculated and the expenses allocated to the fund were authorized under the fund documents.
- Review breach logs to ensure any detected violations are remediated and procedures updated to prevent future violations.
- Confirm your fund investors are on the same page as you about fund fees and expenses (particularly any management fee based on values) by making periodic disclosures to your LPAC/investors about the fees and expenses paid by the fund.
- Check out our recent client advisory discussing the "Do's and Don'ts" of insider trading/MNPI issues while working from home.

For more information on private fund fees and expenses, please check out this podcast on fund fees and expense trends, as well as the article "Fund Fees and Expenses-A Tale of Four Surveys: Trends 2014-2018", from Julia D. Corelli of Pepper Hamilton. The field surveys for the 2020 Fees and Expenses Benchmarking Survey sponsored by Pepper Hamilton, Private Equity International, Withum, and PEF Services are complete and the results will be released in the fall. Please email Brian Dolan (dolanb@pepperlaw.com) if you want to receive the results once they are available.

[1] See, http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf; https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf; and https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf.

[2] See, http://www.sec.gov/litigation/admin/2016/ia-4493.pdf; http://www.sec.gov/litigation/admin/2015/ia-4219.pdf; http://www.sec.gov/litigation/admin/2015/ia-4131.pdf; http://www.sec.gov/litigation/admin/2015/ia-4253.pdf; https://www.sec.gov/litigation/admin/2018/ia-5079.pdf; https://www.sec.gov/litigation/admin/2016/ia-4529.pdf; http://www.sec.gov/litigation/admin/2014/ia-3927.pdf; http://www.sec.gov/litigation/admin/2016/ia-4494.pdf; http://www.sec.gov/litigation/admin/2015/34-74828.pdf; http://www.sec.gov/litigation/admin/2014/33-9551.pdf; https://www.sec.gov/litigation/admin/2015/ia-4258.pdf and https://www.sec.gov/litigation/admin/2020/ia-5485.pdf.

Authors

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Related Practices and Industries

Corporate

Investment Funds

Protecting Your Company From COVID-19 Insider Trading

04.06.20

The Securities and Exchange Commission (SEC) has advised that it will actively pursue COVID-19 related insider trading and antifraud violations in light of the unique opportunities the pandemic has created for individuals and companies to profit from material, nonpublic information. As a result, it is vital that companies evaluate and reassess their insider trading policies to minimize the likelihood of an ensuing SEC investigation or enforcement action regarding either insider trading itself or allegedly insufficient insider trading corporate policies.

Businesses around the globe are struggling with the economic effects of COVID-19, as companies are forced to shut down or drastically alter their business models in response to government regulations aimed at decreasing the virus's spread. To provide relief for companies as they attempt to determine what material impact COVID-19 may have on their financial statements and public disclosures, the SEC has issued an exemptive order offering public companies a 45-day extension to file disclosure reports, such as Forms 10-K and 10-Q, which would typically be filed between March 1 and July 1 of this year.

Though undoubtedly helpful for many companies, the SEC's 45-day filing extension, combined with the significant impact COVID-19 has had on most businesses, creates an environment ripe for insider trading and other antifraud violations. For public companies that choose to take advantage of the SEC's filing extension, their insiders will have access to — and the ability to trade on — material corporate information for an extended time before that information is made available to investors. Further, company insiders are likely to have nonpublic information regarding both how COVID-19 might impact their own companies' financials as well as how the pandemic might impact the financials of other entities, including customers, vendors and third parties. Given the severe impact that COVID-19 has had on all industries, much of the nonpublic information regarding its impact is likely to be material and, therefore, subject to mandatory disclosure in SEC filings. Together, these factors create unique and unprecedented opportunities for insider trading.

In addition to fostering opportunities for insider trading, the COVID-19 pandemic has created an environment where, unfortunately, individuals may have a heightened motive to benefit from material, nonpublic information. As states continue to impose more and more stringent restrictions on businesses — including mandating the closure of many "nonessential" businesses — companies and individuals are feeling the economic strain. Entire industries have been shut down, and unemployment filings have reached unprecedented levels. Indeed, while the scope of the pandemic's impact on the global economy remains unclear, many portfolios and retirement accounts are likely to be decimated. Given this adverse and uncertain economic environment, the temptation to trade on material, nonpublic information may prove particularly strong.

The SEC's Division of Enforcement has recognized the potential for individuals and companies to profit from COVID-19 insider trading and has indicated increased efforts to maintain market integrity during the pandemic. Specifically, the SEC has noted that its "Enforcement Division is committing substantial resources to ensuring that our Main Street investors are not victims of fraud or illegal practices in these unprecedented market and economic conditions." Accordingly, while the SEC has been sensitive to the needs of public companies during this crisis, the risk of being the target of an SEC investigation or enforcement action appears to have increased.

To protect themselves from the threat of an SEC insider trading investigation or enforcement action, companies should take this opportunity to evaluate their insider trading policies. Companies should ensure that these policies clearly prohibit trading on material, nonpublic information and adequately address the increased opportunities for such trading that have been created by the current pandemic. Companies must also monitor their employees' compliance with these policies, making sure that all employees are both aware of and abiding by the company's insider trading guidelines. Companies should consider disseminating to their workforce clear advisory communications to remind employees of their obligation to refrain from sharing or trading on material, nonpublic information that they learn of through their employment.

The COVID-19 pandemic will inevitably lead to economic losses, both personal and corporate. Individuals who have access to material information about their own or other companies may not, however, sell stock in these companies to make up for losses without first disclosing this material information to the investing public. Further, when preparing their disclosure documents, companies should review and follow the COVID-19 disclosure guidance recently issued by the SEC's Division of Corporation Finance. Companies should carefully assess the impact that COVID-19 and related government restrictions will have on their business before making their required disclosures and should remind directors, officers and employees to refrain from trading on material information before these disclosures are filed.

Troutman Pepper is actively working with companies on COVID-19 disclosure issues, as well as in evaluating and monitoring insider trading policies. Please feel free to contact any of the authors with any questions regarding this issue.

Authors

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Related Practices and Industries

Coronavirus (COVID-19) Task Force

White Collar and Government Investigations

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Articles & Publications

Insider Trading in the Time of COVID-19: Risks and Best Practices

05.26.20

INSIGHTS: The Corporate & Securities Law Advisor (Volume 34, Number 5, MAY 2020) is published monthly by Wolters Kluwer.

The corporate world is facing financial upheaval and an unprecedented earnings season, with the novel coronavirus and COVID-19 disrupting the securities markets in unique and wide-ranging ways. In this time of economic uncertainty, opportunity and motive to engage in COVID-19-related insider trading has increased significantly. The Enforcement Division of the Securities and Exchange Commission (SEC) already has advised that, in its effort to maintain market integrity during the COVID-19 pandemic, it will scrutinize more closely the securities trading of corporate insiders. Further, insider trading allegations often form a basis for private securities class actions and derivative litigation, filings of which also are likely to rise in the coming weeks and months.

Consequently, it is vital that public companies reflect on the ways in which the current pandemic has expanded opportunities for corporate executives, and others, to trade on material, nonpublic information. This article addresses the ways in which the current pandemic has heightened opportunities and motives to engage in insider trading, the potential adverse effects of such transactions, and best practices for preventing trading on material nonpublic corporate information during these challenging times.

Increased Opportunity and Motive for Insider Trading

In an effort to both stem the tide of the pandemic and soften its impact, several federal and local governmental bodies have issued orders placing restrictions on and providing relief for businesses and individuals. Together, these restrictions and relief actions have increased significantly both the

opportunity and motive for individuals to trade on material nonpublic corporate information, thereby heightening the risk that companies will face government investigations or SEC enforcement actions related to COVID-19 insider trading.

Businesses around the globe are struggling with the economic effects of COVID-19, as companies have been forced to shut down for significant periods or drastically alter their business models in response to government regulations aimed at decreasing the virus's spread. To provide relief for companies as they attempt to determine what material impact COVID-19 may have on their financial statements and public disclosures, the SEC has issued an exemptive order which provides public companies with a 45-day extension to file periodic disclosure reports, such as Forms 10-K and 10-Q, which customarily would be filed between March 1 and July 1 of this year.[1]

Though undoubtedly helpful for many companies, the SEC's 45-day filing extension, combined with the significant impact COVID-19 has had on most businesses, creates an environment ripe for insider trading and other anti-fraud violations. Insider trading occurs when individuals rely on material nonpublic corporate information to buy or sell stock. For public companies that take advantage of the SEC's filing extension, their corporate insiders likely will have access to—and the ability to trade on—material corporate information for an extended time before that information is made available to investors. Further, company insiders are likely to have nonpublic information not only regarding how COVID-19 might impact their own companies' financials, but also regarding how the pandemic might impact other entities, including customers, vendors, and other third parties with which their companies interact. Given the severe impact that COVID-19 has had on virtually all industries, much of the nonpublic information regarding its impact is likely to be material. Together, these factors create unique and unprecedented opportunities for insider trading.

Pandemic restrictions have resulted in additional opportunities for insider trading, beyond those created by the SEC's recent filing extension. Remote working also presents unique opportunities for disseminating—advertently or inadvertently—material nonpublic information. As of this writing, 95 percent of the American population has been instructed to stay home under various state executive orders and proclamations.[2] Quarantine restrictions also have resulted in many adult children temporarily moving back in with their parents, allowing families to stay together during the pandemic.[3] As a result, business conversations that typically are conducted in a private office setting are now being held in makeshift home offices, sometimes with several family members within earshot. With family members forced to conduct all of their business activities in confined spaces, the opportunities for non-insiders to overhear—and then trade on—confidential corporate information have increased.

Even before the current pandemic, the SEC staff focused on, and filed, civil enforcement actions involving cohabitating individuals who allegedly traded on material nonpublic information overheard from corporate insider family members. In one recent case, a New York-based banking consultant settled insider trading charges with the SEC after trading on material nonpublic information he obtained while eavesdropping on the phone conversations of his then-fiancé, an investment banker, in their shared apartment.[4] Similarly, spouses regularly have been charged with

insider trading for trading on material nonpublic information overheard in confined spaces, including in cars during long road trips.[5] The conditions created by the current quarantine restrictions—with business activity being conducted in confined spaces—are ripe for insider trading opportunities and resulting SEC investigations. Moreover, if an insider were to disclose material nonpublic information to a family member in confidence, and the family member were to then trade on that information, the insider would be jointly and severally liable with the individual who made the illegal trade, and also could face additional sanctions.

In addition to fostering unprecedented opportunities for insider trading, the COVID-19 pandemic has created an environment where, unfortunately, individuals may have a heightened motive to benefit from material nonpublic information. As businesses continue to navigate stringent government restrictions—including the mandated closure of many "nonessential" businesses—companies and individuals are feeling the economic strain. Entire industries have been shuttered, and unemployment filings have reached unprecedented levels.[6] Indeed, while the scope of the COVID-19 pandemic's impact on the global economy remains unclear, many portfolios and retirement accounts are likely to be decimated. Given this adverse and uncertain economic environment, the temptation to trade on material nonpublic information may prove particularly strong.

SEC Insider Trading Investigation and Enforcement

As opportunity and motive for COVID-19-fueled insider trading increases, so too does the risk of government investigations and SEC enforcement actions. On March 23, 2020, Stephanie Avakian and Steven Peikin, Co-Directors of the SEC's Division of Enforcement, issued a statement advising that the Agency will actively pursue COVID-19 related insider trading and anti-fraud violations in light of the unique opportunities the pandemic has created for individuals and companies to profit from material nonpublic information.[7] As a result, companies would be wise to evaluate and reassess their insider trading policies to minimize the likelihood of an ensuing SEC investigation or enforcement action regarding either insider trading itself, or allegedly insufficient insider trading corporate policies.

As noted above, the SEC's Division of Enforcement has indicated increased efforts to maintain market integrity during the pandemic. Specifically, the Agency has noted that its

Enforcement Division is committing substantial resources to ensuring that our Main Street investors are not victims of fraud or illegal practices in these unprecedented market and economic conditions.[8]

The SEC and U.S. Department of Justice (DOJ) already have begun investigating insider trading allegations lodged against Senators Richard Burr, Kelly Loeffler, and others, alleging that these public officials sold millions of dollars in stock just weeks after being privately briefed on the substantial impact the novel coronavirus would have on the economy and the stock market.[9] Accordingly, while the SEC has been sensitive to the needs of public companies during this crisis, offering a filing extension and enhanced disclosure guidance,[10] the risk of being the target of an SEC investigation or enforcement action appears to have increased. Moreover, depending on the

nature of the infraction, insider trading could also expose corporate insiders to a DOJ investigation and potential criminal liability.

It is worth noting, however, that the current quarantine environment may create issues of proof for the SEC and DOJ when investigating or seeking to enforce the securities laws. Many family members who normally live apart have now found themselves residing in the same space, as they ride out quarantine restrictions together. Conversations that otherwise would have occurred by telephone, or via text message, or by email are now taking place face-to-face. Accordingly, there is a heightened risk that material nonpublic corporate information is being disseminated, wittingly or unwittingly, without any data or paper trail. Although insider trading is almost always established through circumstantial evidence, the lack of paper trails associated with potential COVID-19 insider transactions may hinder government efforts to successfully file and prosecute these cases.

Insider Trading and Section 10(b) Securities Class Actions

Evidence of COVID-19 insider trading can fuel more than government investigations and enforcement actions. It also can help private class action plaintiffs support a case for corporate liability under Section 10(b) of the Securities Exchange Act of 1934. Given the volatility of the current market, we are likely to see an increase in shareholder litigation seeking to recover market losses. Accordingly, companies should be cognizant of the ways in which insider trading allegations may support private claims for Section 10(b) relief.

Parties already have begun to file COVID-19-related securities class actions under Section 10(b) and Rule 10b-5 promulgated thereunder, which prohibit fraud in connection with the purchase or sale of securities. Many of these suits are alleging that corporations violated Rule 10b-5 by making material misstatements or omissions regarding the effect COVID-19 would have on their businesses, thereby artificially inflating the price of the companies' securities and harming investors when the truth was finally revealed to the market, causing the companies' stocks to drop. For instance, in *Douglas v. Norwegian Cruise Lines Holdings Ltd.*[11] and *Atachbarian v. Norwegian Cruise Lines*,[12] two securities fraud class actions recently filed against defendant Norwegian Cruise Lines, plaintiffs allege that defendant issued false statements about the cruise line's ability to withstand COVID-19, despite being aware that the pandemic would have a detrimental effect on the company's business.[13]

To succeed on a 10b-5 claim, plaintiffs successfully must plead that the individual corporate defendants had scienter—that is, that these defendants knew or recklessly disregarded the risk that the alleged material corporate misstatements or omissions were likely to deceive a reasonable investor. As the U.S. Supreme Court has held, plaintiffs may strengthen an inference of scienter by showing that the individual defendants had motive, such as "personal financial gain," to commit securities fraud.[14] Plausible allegations of insider trading are one way of pleading motive.[15] Accordingly, given the likely rise in COVID-19-related private securities class actions, companies should be mindful of the ways in which COVID-19 insider transactions may support claims for Section 10(b) liability. Further, insider trading allegations are a common basis for shareholder derivative litigation,[16] which also is expected to increase as companies continue to suffer

pandemic-related losses.[17] It is clear that the risks associated with COVID-19 insider trading extend well beyond government investigations and SEC enforcement actions, and should be taken seriously by companies seeking to reduce pandemic-related litigation risk.

Best Practices for Limiting the Risk of COVID-19 Insider Trading

To protect themselves from the threat of an SEC insider trading investigation or enforcement action, companies should take this opportunity to evaluate their internal controls and insider trading policies, and ensure that these policies clearly prohibit trading on material nonpublic information, and adequately address the increased opportunities for such trading that have been created by the current pandemic. This may mean revising or supplementing corporate policies in light of the company's remote working practices.

Companies also must monitor their employees' compliance with these policies, making sure that all employees are both aware of and abiding by the company's insider trading guidelines. Companies should consider disseminating to their workforce clear advisory communications to remind employees of their obligation to refrain from sharing or trading on material nonpublic information that they learn through their employment. Given the ease with which information may be disseminated among family members in a quarantine environment, company directors, officers, and employees should all be reminded of the substantial risks associated with insider trading, and best practices for protecting confidential information during quarantine. This includes reminding these individuals to ensure that material nonpublic information is only discussed in a private setting, and that computer screens displaying such information are not made visible to non-insiders.

The COVID-19 pandemic inevitably will lead to economic losses, both personal and corporate. Individuals who have access to material information about their own or other companies may not, however, sell stock in these companies to make up for losses without first disclosing this material information to the investing public. To avoid some of the risk associated with nonpublic material information, companies should consider disclosing some of this information in their Forms 8-K, to reduce the chance that the company's material nonpublic information is traded on prior to public disclosure. Further, when preparing their periodic disclosure documents, companies should review and follow the COVID-19 disclosure guidance recently issued by the SEC's Division of Corporation Finance.[18] This guidance asks firms to evaluate

the effects COVID-19 has had on [the] company, what management expects its future impact to be, how management is responding to evolving events, and how [the company] is planning for COVID-19-related uncertainties . . . .[19]

Companies therefore should assess carefully the impact COVID-19 and related government restrictions will have on their businesses prior to making their required disclosures, and should remind directors, officers, and employees to refrain from trading on material information prior to these disclosures being made public.

Endnotes

[1] SEC, Release No. 34-88465, Order Under Section 36 of the Securities Exchange Act of 1934 Modifying Exemptions from the Reporting and Proxy Delivery Requirements for Public Companies (Mar. 25, 2020), *https://www.sec.gov/rules/exorders/2020/34-88465.pdf.*

[2] Sarah Mervosh, Denise Lu and Vanessa Swales, "See Which States and Cities Have Told Residents to Stay at Home," *N.Y. Times*, *https://www.nytimes.com/interactive/2020/us/coronavirus-stay-at-home-order.html (last updated Apr. 20, 2020).*

[3] Michael Hollan, "How Parents Can Handle Grown Children Who Returned Home for the Quarantine," *Fox News (Apr. 15, 2020), https://www.foxnews.com/lifestyle/parents-grown-up-kids-home-quarantine.*

[4] SEC, Litig. Release No. 24375, SEC Charges Husband of Investment Banker with Insider Trading (Dec. 17, 2018), *https://www.sec.gov/litigation/litreleases/2018/lr24375.htm.*

[5] *SEC v. Chen*, No. 5:14-cv-01467 (N.D. Cal. Apr. 7, 2014).

[6] Patricia Cohen and Tiffany Hsu, "'Sudden Black Hole' for the Economy with Millions More Unemployed," *N.Y. Times (Apr. 9, 2020), https://www.nytimes.com/2020/04/09/business/economy/unemployment-claim-numberscoronavirus.html.*

[7] Stephanie Avakian and Steven Peikin, Co-Directors, SEC Division of Enforcement, *Statement Regarding Market Integrity (Mar. 23, 2020), https://www.sec.gov/biography/steven-peikin.*

[8] *Id.*

[9] Jack Kelly, "Senators Accused of Insider Trading, Dumping Stocks After Coronavirus Briefing," *Forbes* (Mar. 20, 2020), *https://www.forbes.com/sites/jackkelly/2020/03/20/senators-accused-of-insider-trading-dumping-stocks-aftercoronavirus-briefings/#5aa8e6c4a45d; Paul Tuchmann, "Insight: Senator's Insider Trading Allegations Can Be Proved," Bloomberg (Apr. 16, 2020), https://news.bloomberglaw.com/white-collar-and-criminal-law/insight-senatorsinsider-trading-allegations-can-be-proved.*

[10] *See* SEC, Division of Corporation Finance, CR Disclosure Guidance: Topic No. 9 (Mar. 25, 2020), *https://www.sec.gov/corpfin/coronavirus-covid-19.*

[11] *Douglas v. Norwegian Cruise Lines Holdings Ltd.*, Case No. 1:20-cv-21107 (S.D. Fla. Mar. 2, 2020).

[12] *Atachbarian v. Norwegian Cruise Lines,* Case No. 1:20-cv-21386 (S.D. Fla. Mar. 31, 2020).

[13] As of this writing, Norwegian Cruise Lines is facing three separate putative 10b-5 class actions related to its COVID-19 disclosures, with a third suit filed on April 22, 2020. *See Banuelos v. Norwegian Cruise Lines*, No. 1:20-cv-21685-JEM (S.D. Fla. Apr. 22, 2020).

[14] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 325 (2007).

[15] *See, e.g.*, *In re Hertz Global Holdings, Inc.*, 905 F.3d 106, 119 (3d Cir. 2018) (noting that "[a]lleging insider trading is one way to plead motive").

[16] *See, e.g.*, In re Oracle Corp. Deriv. Litig., 824 A.2d 917 (Del. Ch. 2003).

[17] Shareholder plaintiffs already have begun filing pandemic-related derivative actions against public companies. *See Beheshti v. Inovio Pharma., Inc. et al.*, No. 2:20-cv-01962 (E.D. Pa. Apr. 20, 2020) (alleging that officers and directors of Inovio breached their fiduciary duties to the company by issuing false statements concerning the development of a COVID-19 vaccine). This action contains an insider trading allegation, alleging that the individual corporate defendants "breached their fiduciary duties by failing to correct and/or causing the Company to fail to correct these false and misleading statement and omissions of material fact to the investing public, while one of the Individual Defendants engaged in an improper insider sale, netting proceeds of approximately $63,000." Complaint at 4–5, *Beheshti v. Inovio Pharma., Inc. et al.*, No. 2:20-cv-01962 (E.D. Pa. Apr. 20, 2020).

[18] CR Disclosure Guidance: Topic No. 9, *supra* n.10.

[19] *Id.*

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Articles & Publications

Companies Must Keep Pace With Whistleblower Reporting

12.17.20

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This year marks the 10-year anniversary of the launch of the U.S. Securities and Exchange Commission's whistleblower incentives and protection program. By any measure, the program has been a wonderful success. To date, the SEC has awarded roughly $728 million to 118 whistleblowers; and enforcement actions brought with information from whistleblowers have resulted in orders for more than $2.7 billion in monetary sanctions.

The program is picking up steam. In fiscal year 2020, the SEC whistleblower program shattered records for the number of tips received, the number of whistleblowers awarded, and the amount of money awarded to whistleblowers in a single year.

Despite the program's success, there remains considerable room for public companies and SEC registrants to improve their internal reporting apparatus—to build cultures that encourage whistleblowers to report internally without fear of reprisal, and systems that evaluate (and appropriately leverage) whistleblower tips.

The SEC Whistleblower Program

The Dodd-Frank Wall Street Reform and Consumer Protection Act directed the SEC to create a whistleblower program that rewards individuals who provide the agency with information about possible securities laws violations. As the U.S. Supreme Court explained in *Digital Realty Trust, Inc. v. Somers*, the core objective of the whistleblower program is "to motivate people who know of securities laws violations to tell the SEC."

Under the SEC whistleblower program, an individual may be eligible for an award if he or she voluntarily provides the SEC with original information that leads to a successful enforcement action in which sanctions of more than $1 million are ordered. In such a case, the whistleblower may be entitled to receive 10-30% of the total amount collected.

Importantly, whistleblowers are *not* required to report possible misconduct to their employers to qualify for an SEC whistleblower award. Whistleblowers are, however, required to report *to the SEC* in order to qualify for anti-retaliation protections under Dodd-Frank.

For more on the mechanics of the SEC whistleblower program, tune in to Episode 6 of PLI's inSecurities podcast where we discuss "the World of Whistleblowers" with Matt Stock, Director of the Whistleblower Rewards Practice at Zuckerman Law. Available here: https://www.pli.edu/insecurities/episode-6.

Tracking the Program's Success

The SEC's Office of the Whistleblower released its 2020 Annual Report to Congress on November 16, 2020. The report reflects the program's tremendous growth and success. Among its most notable achievements, in fiscal year 2020 the SEC:

- approved $175 million in whistleblower awards (the highest dollar amount awarded in a single fiscal year);
- approved awards to 39 individuals (the highest number of individuals awarded in a single fiscal year, and triple the number awarded in the next-highest fiscal year);
- approved a $50 million award (then the largest-ever whistleblower award to an individual);
- triaged over 6,900 whistleblower tips (the highest number of tips received in a single fiscal year, and 31% more than the next-highest tip year); and
- processed and resolved more whistleblower award claims than in any other fiscal year.

Since the SEC's fiscal year ended on September 30th, the Office of the Whistleblower has continued its incredible run of form. On October 22nd, the SEC announced a $114 million award to an individual whistleblower—the largest amount ever awarded to an individual under the SEC's whistleblower program and "a testament to the Commission's commitment to award whistleblowers who provide the agency with high-quality information," according to SEC Chairman Jay Clayton.

We are only two months into fiscal year 2021, but the SEC has already awarded more than $166 million to 12 individuals; this brings the program's grand total to approximately $728 million paid out to 118 individuals since issuing its first award in 2012.

Corporate Insiders Provide Credible Information

To date, approximately 68% of the individuals who have received SEC whistleblower awards were corporate insiders. That is, of the whistleblowers who provided the highest quality tips about securities laws violations—whistleblowers who were helpful enough to earn an award—*more than two-thirds were current or former employees*.

According to the SEC's annual whistleblower report, those individuals often pointed to specific documents or information that substantiated their allegations, identified co-workers who were involved in the misconduct or identified specific financial transactions that evidenced fraud. As a matter of fact, in a recent whistleblower award, the SEC applauded two joint whistleblowers for providing probative documents and information, participating in interviews with the staff, and identifying key individuals involved in the misconduct.

The Office of the Whistleblower explains in its Annual Report that the staff may use information from corporate insiders in several ways. A whistleblower tip might prompt the staff to commence an examination of a regulated entity, or it may be used in connection with an ongoing exam. The staff may also use whistleblower information to open a new enforcement matter or to buttress an ongoing investigation.

Indeed, according to the Annual Report, the Office of the Whistleblower is currently tracking over 1,100 matters in which a whistleblower's tip caused the staff to commence a new enforcement matter, or has been forwarded to the staff for consideration in connection with an ongoing investigation.

Internal Reporting Is an Underutilized Source of Information

While it is important to understand that *most* SEC whistleblowers are corporate insiders, it is equally important to understand that their complaints often strike at the heart of companies' operations and compliance or reporting obligations.

Year after year, the most common whistleblower tips relate to corporate disclosures or financial reporting issues—accounting for 25% of the tips in 2020—while insider trading and bribery (FCPA) also count among the most reported violations. (It is worth noting that issuer disclosure and reporting issues, insider trading and FCPA violations consistently rank among the top priorities for the SEC's Division of Enforcement.)

In that context, whistleblowers might be viewed as crucial *internal* sources of information about potential misconduct that companies would *want* to root out—literal "boots on the ground" who can help spot potential weaknesses in a company's compliance, reporting or other core regulatory obligations.

Yet internal reporting remains an underutilized source of information.

Of the corporate insiders who have received SEC whistleblower awards—again, *the most credible whistleblowers*—approximately 84% "raised their concerns internally to their supervisors, compliance personnel, or through internal reporting mechanisms, or understood that their supervisor or relevant compliance personnel knew of the violations, before reporting their information of wrongdoing to the Commission."

Stated differently, of the whistleblowers whose tips ultimately led to successful enforcement actions against their current or former employers, *roughly 1 in 5 did not report the misconduct internally*.

The percentage of corporate insiders who received whistleblower awards based on tips that they *did not report internally* has remained relatively constant over time: In 2014 (the first year the Office of the Whistleblower reported the figure) and again 2015 and 2016, the SEC reported that approximately 20% of corporate insiders who received whistleblower awards *did not report internally*. In 2017 and 2018, the SEC reported that 17% of the corporate insiders did not report internally; in 2019, the number fell to 15%.

Simply put, the surge in SEC tips is far outpacing the uptick in internal complaints. Companies must find ways to keep pace with whistleblower reporting.

To better understand why many whistleblowers are reluctant to report internally, tune in to Episode 26 of PLI's inSecurities podcast where we discuss "Whistleblowing's New Frontier" with Tom Mueller, the New York Times best-selling author of Crisis of Conscience: Whistleblowing in an Age of Fraud. Available here: https://www.pli.edu/insecurities/episode-26.

Credible internal reports present opportunities for public companies and SEC registrants to identify and potentially mitigate or remediate problems or weaknesses *before* the SEC (or another government agency) asks about them.

The key is to develop a reporting apparatus that encourages whistleblowers to report internally without fear of reprisal, and systems that evaluate (and appropriately leverage) whistleblower tips. Essentially, this involves two steps: (1) figuring out how to foster a culture that encourage internal reports; and (2) figuring out how to triage those tips.

There is no "one size fits all" solution. But given the potential benefits of assessing and triaging whistleblower complaints, companies simply cannot settle for systems that allow credible tips to become mired in automated hotline spreadsheets or otherwise fall through the cracks.

In the Office of the Whistleblower's 2014 Annual Report, Sean McKessy, the former chief of the whistleblower office, observed that "companies not only need to have internal reporting mechanisms in place, but they must act upon credible allegations of potential wrongdoing when voiced by their employees." Indeed.

The SEC whistleblower program will only continue to encourage reporting—and that's a good thing. Companies should make sure their reporting mechanisms are designed to seize the opportunities presented in this age of the whistleblower.

Authors

Kurt Wolfe

Related Practices and Industries

Government Claims and Investigations

Enforcement Actions and Investigations

Securities Investigations and Enforcement

White Collar and Government Investigations

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- **Kristin A. Snyder**, *Deputy Director, Co-National Associate Director and Associate Regional Director*, SEC Division of Examinations
- **Anil Abraham**, *Associate General Counsel, Managing Director – Legal*, Focus Financial Partners, LLC
- **Michelle L. Jacko**, CSCP, *Managing Partner and CEO*, Jacko Law Group, PC, and *Founder and CEO*, Core Compliance & Legal Services, Inc.
- **Mark Perlow**, *Partner*, Dechert LLP, Moderator

The Impact of COVID-19

- How the Division of Examinations has responded
  - Remote work
  - Approach to examinations
- Risk Alert on COVID-19 Compliance Risks
  - Supervision of personnel
  - Fees, expenses and financial transactions
  - Business continuity planning
  - Protection of sensitive information

Form CRS

- Risk Alert: Examinations that Focus on Compliance with Form CRS
- Focus areas include:
  - Filing and delivery mechanisms, policies and procedures
  - Content, for accuracy and completeness
  - Formatting, for following instructions
  - Updates, for timeliness
  - Recordkeeping

Additional Focus Areas

- Regulation Best Interest/Fiduciary Interpretation
- Multiple offices/supervisory risks
- ESG
- Marketing rule/advertising
  - Lee/Crenshaw Statement:
    - The decisions underlying the rule "will likely place advertisements on the list of examination and enforcement priorities for years to come."
    - Hypothetical performance, including "unjustifiable carve-outs" in response to unsolicited requests from retail investors, one-on-one communications with private fund investors.

Focus on Private Funds

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  - Compliance risks, including MNPI, conflicts of interest
- Risk Alert Regarding Recent Focus Areas in PF Adviser Examinations
  - Conflicts of interest
    - Multiple clients/allocations, adviser financial relationships with clients, adviser interests in client investments, co-investments
  - Fees and expenses
    - Allocation, operating partners, monitoring fees, valuation
  - MNPI and code of ethics
    - Public company insiders, expert networks, "value added" investors

LIBOR

- Risk Alert on Examination Initiative: LIBOR Transition Preparedness
- Exams will assess whether and how the registrant has evaluated the potential impact of the LIBOR transition along the following lines:
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  - Operational readiness for the LIBOR transition
  - Investor communications relating to the LIBOR transition
  - Potential conflicts of interest
  - Efforts to replace LIBOR

Dechert LLP

SEC EXAMINATIONS OF INVESTMENT ADVISERS

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February 15, 2021

[1] The authors would like to thank Richard Phillips, Elaine Lindenmayer, and Katie Hyer, for their contributions to this outline.

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I. Introduction

A. Regulatory Mission

Examinations are the SEC's front-line means for protecting investors and ensuring compliance with the federal securities laws by investment advisers and investment companies ("Regulated Firms"). The SEC's examination program is managed through the Division of Examinations (the "Division"). Prior to December 17, 2020, the Division was named the Office of Compliance Inspections and Examinations ("OCIE"). Peter Driscoll, Director of the Division,[2] has identified the Division's mission as having "four pillars":

(1) Improve Compliance;
(2) Prevent Fraud;
(3) Monitor Risk; and
(4) Inform Policy.[3]

Under the pillar "improving compliance," the Division views its efforts to communicate with registrants through its publications, risk alerts, outreach events, and speeches throughout the year as essential to its mission to help registrants improve and adopt compliance programs to fit evolving industry trends and risks. To achieve its mission of "preventing fraud," the Division staff relies on both informal remediation of compliance issues during examinations or in response to examination findings as well as formal referrals of issues to the SEC's Division of Enforcement for further proceedings. The Division's efforts to identify risks through data gathering, analysis, and technology are essential to fulfill its mission of "monitoring risk," and the Division "informs policy" by communicating its information and observations to the wider SEC to support rule-makings by the Commission and guidance issued by the staff.[4]

B. Statutory Authority

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2 Mr. Peter Driscoll has been Director of the Division since October 26, 2017.

3 *See* Peter Driscoll, Acting Director, OCIE, Speech at GIPS Standards Annual Conference (Sept 14, 2017), https://www.sec.gov/news/speech/speech-driscoll-2017-09-14; *See also* Marc Wyatt, Keynote Address: National Society of Compliance Professionals 2016 National Conference, Washington, D.C. (Oct 17, 2016), https://www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html.

4 National Exam Program: Offices and Program Areas, About Office of Compliance Inspections and Examinations, *available at*, https://www.sec.gov/ocie/Article/about.html.

The SEC's authority to conduct examinations is found in the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and the Investment Company Act of 1940, as amended (the "1940 Act"), to conduct inspections of investment advisers' and investment companies' books and records.[5] These statutes authorize the SEC to require that Regulated Firms make and maintain records relating to their business and to inspect such records. The SEC has adopted rules that implement this statutory authority by specifying the documents and records that each of the Regulated Firms must maintain for this purpose.[6]

While the SEC's express statutory examination authority is limited to books and records, as a practical matter the SEC staff also can and does use its inspection authority to gather information through requests for written submissions and informal interviews of officers and employees. Any insistence by a firm on strict observance of the statutory limitations is likely only to result in a prompt issuance of a subpoena for sworn testimony before the SEC's Enforcement Division – in most circumstances an undesirable escalation of a request for informal access to information.

C. Substance of Exams

The power to inspect enables the SEC to oversee not only compliance with applicable regulatory requirements of Regulated Firms but also the integrity of their representations to clients and investors. Importantly, it allows the Commission to evaluate each Regulated Firm's compliance controls and risk profiles with a view towards preventing future violations.[7] It thus gives the SEC an ability to oversee the activities of Regulated Firms to a far greater extent than oversight that is exercised merely through examination of reports and other filings.

The information gathered during examinations also supplements the data available to, and analysis conducted by, other SEC offices and divisions and broadly influences the SEC's wider regulatory agenda.

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5 *See* Section 204 of the Advisers Act, 15 USC 80b-4; and Section 31 of the 1940 Act. 15 USC 80a-32.

6 Rules 31a-1, 2, and 3 under the Investment Company Act, 17 C.F.R. §§ 270.31a-1, 2, 3 (2015). Rule 204-2 under the Advisers Act, 17 C.F.R. § 275.204-2 (2016).

7 For further discussion of the purposes of the SEC's inspection power, *see e.g.*, SEC 2006 Performance and Accountability Report at 11; Speeches of Lori Richards, Director, OCIE at 9th Annual IA Compliance Best Practices Summit 2007, IA Week and Investment Adviser Association (March 23, 2007), www.sec.gov/news/speech/2007/spch032307lar.htm, National Regulatory Services, 17th Annual Spring Conference, Miami Beach, Florida (April 2002), http://sec.gov/news/speech/spch548.htm and Mid-Atlantic Securities Forum, Philadelphia, Pennsylvania (March 21, 2002), http://sec.gov.news/speech/spch545/htm.

D. Frequency and Results of Examinations

All Regulated Firms should expect to experience SEC examinations from time to time. During 2020, the Division completed over 2,950 examinations and reviews of investment advisers, investment companies and broker-dealers, a decrease of 4% from 2019.[8] Director Peter Driscoll has indicated that the annual decrease in completed examinations is attributable to limitations related to the COVID-19 pandemic. The Division examined approximately 15% of registered investment advisers in 2020.[9] Accordingly, a thorough understanding of the examination process is critically important for those who represent or are associated with Regulated Firms. Not only can this knowledge assist in avoiding enforcement investigations and possible prosecution, it also can assist a Regulated Firm being classified as "low-risk" and obtain the benefit of less frequent, less intrusive and shorter examinations. Thus, effective preparation for and management of the examination process is an indispensable prerequisite to the ability of a Regulated Firm to remain in good standing with the SEC.

II. The Division and the Examination Program

A. History of the Division

The Division was created in 1995 to centralize the oversight of all SEC examination staff and coordinate examination activities in the Washington, D.C. office and the regional and district offices.[10] Many examination staff and management functions, which had historically been divided between the Division of Investment Management and the Division of Trading and Markets (formerly the Division of Market Regulation), were transferred to the Division, and the examination program was given independent management and legal staff to coordinate and support

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8 Peter Driscoll, "The Role of the CCO – Empowered, Senior and With Authority," Opening Remarks at National Investment Adviser/Investment Company Compliance Outreach 2020, Nov. 19, 2020; https://www.sec.gov/news/speech/driscoll-role-cco-2020-11-19.

9 *See* Testimony of Chairman Jay Clayton before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on Oversight of the U.S. Securities and Exchange Commission, Washington, D.C. (Nov. 17, 2020), https://www.sec.gov/news/testimony/clayton-sec-oversight-2020-11-17.

10 Historically, the SEC's inspection power was exercised through examination staffs attached to two of the SEC's Divisions: (i) the Division of Investment Management, which regulates investment advisers and investment companies, and (ii) the Division of Trading and Markets, which regulates broker-dealers, transfer agents, clearing agencies, non-bank government and municipal securities dealers and self-regulatory organizations. The examination staff were located in the SEC's Washington D.C. headquarters and in regional and district offices, and were overseen by these two Divisions. As noted above, prior to December 17, 2020, the Division was called the Office of Compliance Inspections and Examinations, or OCIE.

the program on a nationwide basis. The result of the Division's creation has been a better trained, coordinated and supervised examination staff than it had been historically.

B. The Division's Current Structure and Resources

Since 2010, the SEC has consolidated the examination personnel, policies and procedures across all 12 of its offices into the National Examination Program. The National Examination Program was intended to address the diversity in approaches, priorities, methods and document requests found across the various SEC offices. As a result, SEC examiners now operate under a single national examination manual and use common templates for document requests. While the National Examination Program has succeeded to a large degree in standardizing SEC examinations, there remains some diversity of approach and style among the SEC offices, often driven by the culture of the regional office and the nature of the local base of registrants requiring examination.

Most of the Division examiners are attached to the regional offices and report administratively to the heads of those offices. However, their activities are overseen, and to a significant extent directed, by Washington, D.C.-based Division officials through the National Examination Program.[11] The Washington, D.C.-based and regional office examination staff are grouped according to types of registrant: (i) investment adviser and investment companies; (ii) broker dealers; and (iii) transfer agent / clearance and settlement agencies.[12] For investment advisers and investment companies, the Division of Investment Management also maintains a Risk and Examination Office to provide expertise to examinations of Registered Firms within the responsibility of that Division.

In Washington, D.C., the Division is headed by the Office of the Director, who oversees several Associate Directors in charge of registrant-specific programs, the Division's Office of Chief Counsel, and an Office of Managing Executive.[13] In March 2016, the Division created a new office at the national level called the Office of Risk and Strategy ("RAS"), and appointed a Chief Risk and Strategy Officer, to consolidate the management and oversight of each of several the Division teams: the Risk Analysis Examination ("RAE") Group, the Strategy and Operational Risk team, and the Quantitative Analysis Unit ("QAU").[14]

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[11] *See* Speeches of Lori Richards, Director, OCIE, Speech at National Regulatory Services, IA Week and Investment Adviser Association, IA Compliance Best Practices Summit 2007, March 23, 2007. www.sec.gov/news/speech2007/spch032307.htm and 17th Annual Spring Compliance Conference, Miami Beach, Florida (April 8, 2002), http://sec.gov/news/speech/spch548.htm.

[12] *See* Office of Compliance Inspections and Examinations, Contact Information, https://www.sec.gov/about/offices/ocie/ocie_org.htm.

[13] *Id.*

The RAE Group and QAU are primarily responsible for developing and analyzing data to identify activity that may warrant an examination.[15] RAS is dedicated to evaluating the risk, particularly the financial risk, of large firms, a key priority of the SEC since the global financial crisis erupted in 2007-2008. The QAU uses quantitative analytics and modeling techniques to help the staff determine firms and areas that may require more attention.

In July 2020, the Division created the Event and Emerging Risks Examination Team ("EERT"), comprised of a multidisciplinary team of specialized examiners, industry experts, accountants and quantitative analysts.[16] The EERT engages with firms about emerging threats, responds to critical matters, and provides expertise and support to other divisions and offices during significant market events, such as exchange outages, liquidity events, and cyber-security or operational resiliency incidents.

The Division also has made a concerted effort recently to hire examiners at the national and regional level with industry experience, particularly practiced industry professionals with specialized experience in trading, quantitative management and coding, portfolio management, valuation, complex products, sales, compliance, and forensic accounting. In recent years, the SEC staff has also recruited staff with specialized expertise in the areas of derivatives, valuations, options and prime brokerage.

C. Resources Dedicated to Investment Advisers

The SEC has approximately 1000 examiners in 12 offices.[17] In 2016 the SEC made significant shifts in existing resources toward adviser and investment company examinations, increasing the number of examiners by 20% in 2016.[18] In the case of investment advisers, the

14 Testimony on Continued Oversight of the SEC's Offices and Divisions, Mark J. Flannery, Marc Wyatt, Thomas J. Butler, and Sean McKessy (April 21, 2016), *available at*, https://www.sec.gov/news/testimony/testimony-04-21-16.html.

15 *See* Testimony of Mark Flannery, Marc Wyatt, Thomas J. Butler, and Sean McKessy before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, Hearing on Continued Oversight of the SEC's Offices and Divisions, Washington, D.C. (April 21, 2016), https://www.sec.gov/news/testimony/testimony-04-21-16.html.

16 *See* Press Release, SEC Announces Creation of the Event and Emerging Risk Examination Team in the Office of Compliance Inspections and Examinations and the Appointment of Adam D. Storch as Associate Director (July 28, 2020).

17 Securities and Exchange Commission, Statement on the Renaming of the Office of Compliance Inspections and Examinations to the Division of Examinations (Dec. 17, 2020), https://www.sec.gov/news/public-statement/joint-statement-division-examinations.

18 *See* Marc Wyatt, Keynote Address: National Society of Compliance Professionals 2016 National Conference, Washington, D.C. (Oct 17, 2016) https://www.sec.gov/news/speech/inside-the-

Division of Investment Management's Risk and Examinations Office, which was formed in 2012 to provide sophisticated quantitative and qualitative risk analysis, works with the Division and utilizes relevant information obtained during examinations for use in its reports.

D. Types of Division Examinations

The Division currently relies on a risk-based approach, which was introduced in 2003, and which now drives the selection of inspection targets as a function of a firm's risk profile for most examinations.[19] A particular Regulated Firm may be selected for examination for any number of reasons including, but not limited to: (i) a firm's risk profile, (ii) a tip, complaint or referral about a firm (a "cause" examination), (iii) a general review of a particular compliance risk area (a "sweep" examination, sometimes called a "focused" examination), or (iv) to fulfill certain other administrative objectives, such as evaluating the effectiveness of the risk-based selection process, or following-up on the results of prior exams. Some firms may be selected at random over others. The reason a firm is selected is generally non-public information and is typically not shared with an entity under examination.[20]

(i) Risk-Based Examinations

A firm is often selected after an assessment of its "risk profile." The risk profile of a Regulated Firm is an assessment of the firm's compliance record, size, complexity, and nature of its operations, and the staff's perception of the compliance culture.

The SEC has had to regulate and examine, in an era of limited resources, a growing number of Regulated Firms, now encompassing over 13,800 advisers.[21] For example, the SEC

Conference, Washington, D.C. (Oct 17, 2016) https://www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html.

19 The selection of firms for SEC examinations has not always been risk-based. The SEC's earliest examinations focused on individual investment advisers, individual investment companies and broker-dealers. They examined each individual firm, one at a time, as a stand-alone entity. During the 1970s, in an attempt to adapt to a changing industry, the SEC took a "systems" approach and, for example, examined mutual funds together as part of a complex that generally shared the same investment adviser and compliance systems. In 1998, after the National Securities Markets Improvement Act redistributed regulatory responsibility for investment advisers between the state and federal regulators, "routine" SEC examinations of investment advisers and mutual fund complexes were based on cycles that the SEC anticipated would occur approximately every five years, with more frequent reviews as circumstances warranted and SEC resources allowed.

20 OCIE Exam Brochure, Examination Information for Entities Subject to Examination or Inspection by the Commission, https://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf.

examined only 15% of all registered investment advisers in each of 2019 and 2020.[22] The risk-based examination program is thus an attempt by the SEC to maximize the effectiveness of its limited resources by focusing on firms, sectors and areas of compliance that the SEC believes present a higher likelihood of more serious violations and thus where the SEC believes that it can have greater impact.

The SEC has been in the recent past sufficiently concerned about the limited resources that it has to conduct investment adviser examinations that it developed a rule proposal that would establish a program of third-party compliance reviews for registered investment advisers.[23] According to David Grim, the former Director of the Division of Investment Management, the reviews would not replace the Division examinations, but rather would supplement them "in order to improve compliance by registered investment advisers."[24] Former SEC Chair Mary Jo White indicated that she supported third party compliance reviews, but was not able to convince her fellow Commissioners to support such a program.[25]

In the Division's view, risk-based examinations facilitate the SEC's investor protection objectives through evaluations of both the investment advisory firms themselves and the conduct most likely to pose harm to investors. Carlo di Florio, former Director of the Division, has described the risk-based examination process for Regulated Firms as follows:

> [Focusing our examinations on risk management] involves understanding each registrant's business model, products and asset classes, and evaluating the risks and conflicts that are inherent in that business model. It also means seeking an understanding of what kind of risk management governance and compliance control frameworks registrants have put in place to mitigate and manage that risk profile. I want to emphasize that we are keenly aware of the lessons learned from

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21 *See* Testimony of Chairman Jay Clayton before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on Oversight of the U.S. Securities and Exchange Commission, Washington, D.C. (Nov. 17, 2020), https://www.sec.gov/news/testimony/clayton-sec-oversight-2020-11-17.

22 *Id.*

23 Oversight of the SEC's Division of Investment Management: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises, House Comm. on Fin. Services, Oct. 23, 2015 (Testimony of David Grim, Director, Division of Investment Management).

24 *Id.*

25 *See* Testimony of Chair Mary Jo White before the Subcommittee on Financial Services and General Government Committee on Appropriations United States Senate (April 12, 2016), https://www.sec.gov/news/testimony/testimony-white-budget-request-2017-senate.html#_ftnref5.

> the financial crisis, as well as from Madoff, where we were roundly criticized for losing the forest for the trees by honing in on some issues and missing broader, systemic and far more serious problems in the organization.[26]

As a result, SEC examinations generally are no longer all-encompassing as were the "routine" examinations of years past. The examiners now tend to focus on operational areas that are perceived at the time as posing the greatest compliance risk not only within the industry but also within the particular firm being examined. Many of the current industry-wide areas can be readily identified from the Division's annual examination priorities, speeches of Division officials and Division risk alerts, as well as from recent SEC enforcement actions.[27]

(ii) Cause Examinations

The Division also conducts so-called "cause" examinations, which are focused on potential specific violations. They are usually initiated on the basis of an investor complaint, employee or competitor tip, press report, review of the firm's Commission filings or other source which indicates a possibility of ongoing violations. Cause examinations tend to be highly focused on the particular problem or problems that led to the examination. Unlike typical examinations, which are scheduled in advance and are usually preceded by notice, cause examinations are generally unannounced. Cause examinations, in particular, require a careful response because of the potential for a referral to enforcement. They should not be dismissed as a "fishing expedition," but handled in close consultation with experienced enforcement counsel.

(iii) Sweep Examinations

A third type of examination are "sweep" examinations. Such examinations generally involve either requests for information, or visits to the firm preceded or supplemented by requests for information that seek to determine whether the manner in which a sample of the industry is handling a particular regulatory compliance issue is cause for regulatory concern and possible further investigation, guidance and/or rulemaking. Increasingly, the SEC staff is providing guidance to the industry based on the results of, and the knowledge the staff has gained of industry practice during, sweep examinations through Risk Alerts and Guidance Updates.[28]

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26 Carlo V. di Florio, Keynote address at the SIFMA Anti-Money Laundering Seminar (Mar. 3, 2011) *available at*, https://www.sec.gov/news/speech/2011/spch030311cvd.htm.

27 *See e.g.*, Lori Richards, Speeches before 9th Annual IA Compliance Best Practices Summit *supra*, at note 9 and National Society of Compliance Professionals (October 19, 2006) www.sec.gov/news/speech/2006/spch1019061.htm.

28 Securities and Exchange Commission, Division of Investment Management, January 2016 Guidance Update ("Many of the issues discussed in this guidance were brought into focus by a recent sweep examination of a number of mutual fund complexes, investment advisers, broker-dealers, and transfer agents.").

Sweep examinations vary in scope and intensity but commonly require the collection and analysis of relatively large quantities of information within relatively short time frames. Sweep examinations also require a careful response with a view towards precluding further inquiry, since violations discovered by the staff can lead to a deficiency letter or enforcement referral. The increased volume of sweep examinations in past years has subjected the SEC to industry criticism that the examination program is unnecessarily burdensome. However, the technique has been useful for the SEC, and while the Division has responded to this criticism by making more targeted use of the sweep examination mechanism in recent years, it is unlikely to abandon it.

Sweep examinations have focused on a variety of subjects of regulatory concern. For example, beginning in 2016, the Division conducted sweep examinations of recommendations made by advisers to their clients of mutual fund share classes that have substantial loads or distribution fees (the so called "share class initiative").[29] The Division also launched a sweep examination in 2014 on payments made by advisers and funds to distributors and other intermediaries (so called "distribution in guise"). Also in 2014, the Division conducted sweep examinations of bond mutual funds' preparedness for, and the adequacy of risk disclosures concerning, changes in market interest rates. The Division has also conducted three rounds of examinations of investment advisers' exposure to and preparedness for potential cybersecurity threats.[30] Beginning in 2018, the Division conducted sweep examinations on electronic communications, including text messages, personal email, and personal and private messaging services, used by investment advisers and their personal for business purposes.[31]

(iv) Other Examinations

The Division also has been recently conducting a series of specialized examination initiatives. It has conducted nearly 50 "Corrective Action Review" examinations, which are intended to determine whether registrants had implemented promised corrective actions to address deficiencies found by the staff in prior examinations. At various points in the past, it has conducted "Never Before Examined" initiatives, intended to conduct focused examinations of firms that have never been examined by the staff.

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29 OCIE National Exam Program Risk Alert, OCIE's 2016 Share Class Initiative (July 13, 2016), available at https://www.sec.gov/files/ocie-risk-alert-2016-share-class-initiative.pdf.

30 OCIE, National Exam Program Risk Alert, Observations from Cybersecurity Examinations (Aug. 7, 2017); OCIE, National Exam Program Risk Alert, OCIE's 2015 Cybersecurity Examination Initiative (Sept 15, 2015); OCIE, National Exam Program Risk Alert, OCIE Cybersecurity Initiative (Apr 15, 2014).

31 OCIE, National Exam Program Risk Alert, Observations from Investment Adviser Examinations Relating to Electronic Messaging (Dec. 14, 2018).

E. The Division's Exam Priorities

The Division annually publishes a summary of its examination priorities for the upcoming year. On January 7, 2020, the Division announced its examination priorities for 2020.[32] The notable priorities include the protection of retail investors, particularly seniors and those saving for retirement and the digital asset market (including crypto currencies). The Division also stated that it would conduct examinations that would continue and expand upon its focus on cybersecurity and would monitor market-wide risks, and money-laundering.[33]

F. The Division's Response to COVID-19

In 2020, in response to the COVID-19 pandemic, the Division shifted the national examination program to primarily off-site examinations through correspondence, supplemented with on-site activity on a case-by-case basis.[34]

In recognition that the COVID-19 pandemic fundamentally altered the way that Regulated Firms conduct business, including how investment advisory personnel serve their clients, the Division worked with Regulated Firms to provide flexibility with respect to the timing of document requests, personnel interviews, and other issues in response to the constraints faced by Regulated Firms during the pandemic.[35] The Division also contacted hundreds of firms in March and April 2020 to gauge the pandemic's impact, focusing on, among other matters, market and liquidity risks and exposure of Regulated Firms to affected industries and asset classes. In its reviews of Regulated Firms during the pandemic, the Division found that the majority of firms maintained business continuity plans ("BCPs"), had activated them in response to the disruptions, and had found them to be beneficial.[36] The Division found that Regulated Firms encountered

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32 SEC, OCIE National Examination Program, Examination Priorities for 2020. https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

33 *Id*.; *See also* Peter Driscoll Interview, *available at*, https://www.law360.com/cybersecurity-privacy/articles/1124963/sec-exams-chief-puts-focus-on-new-technology-new-firms.

34 *See* Testimony of Chairman Jay Clayton before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on Oversight of the U.S. Securities and Exchange Commission, Washington, D.C. (Nov. 17, 2020), https://www.sec.gov/news/testimony/clayton-sec-oversight-2020-11-17.

35 OCIE Statement on Operations and Exams – Health, Safety, Investor Protection and Continued Operations are our Priorities, https://www.sec.gov/ocie/announcement/ocie-statement-operations-health-safety-investor-protection-and-continued.

36 Peter Driscoll, "The Role of the CCO – Empowered, Senior and With Authority," Opening Remarks at National Investment Adviser/Investment Company Compliance Outreach 2020, Nov. 19, 2020; https://www.sec.gov/news/speech/driscoll-role-cco-2020-11-19.

initial challenges in responding to the pandemic, including issues with remote work and loss or impairment of personnel due to illness, travel bans, or lockdowns. But the Division also found that certain challenges for Regulated Firms that arose during the pandemic "will require more active revisiting and monitoring," including risks related to cybersecurity and data protection, market volatility, financial solvency, and addressing customers and clients facing financial hardships.[37]

III. The Examination Process

A. Identification of Risks by the SEC Staff

The Division approaches its risk-based methodology from several perspectives and using different processes. As noted above, the risk-based methodology is used for several purposes, including for setting general examination priorities and goals, determining examination targets, and during the course of the exam itself in prioritizing the examination staff's time and resources on particular areas.

(i) Survey of Regulatory Views and General Information

The Division asks examiners nationwide to identify what in their view are the most significant risks to investors, registrants and the markets.[38] The Division's senior management uses this information to assist in setting examination program goals and priorities for individual firms, as well as to determine whether to conduct sweep examinations on specific activities. The Division's identification of individual firms to examine also is based on the Division's analysis of a firm's disciplinary history, including the seriousness and number of "significant findings" from its prior examinations; the length of time the underlying deficiencies went unaddressed; and whether any deficiencies remain unaddressed.

The Division also considers information it gathers from other SEC offices, including the Divisions of Enforcement, Investment Management, Trading and Markets, Economic and Risk Analysis and Corporation Finance, and the Office of Investor Education and Assistance (which receives and analyzes investor complaints). It also consults with bank, insurance and state securities regulators to better understand the most significant risks to investors and thus to set examination priorities. After the global financial crisis, the Division staff also take into account the concerns of the Financial Stability Oversight Council ("FSOC") and of international organizations and standard setting bodies, such as the International Organization of Securities Commissions ("IOSCO").

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37 *Id.*

38 Mary Ann Gadziala, "Regulatory Examination Programs - Focus and Significant Findings," SIA Compliance and Legal Division Monthly Luncheon (June 22, 2006), http://sec.gov/news/speech/2006/spch062206mag.htm.

The Division staff may also access information and expertise of non-U.S. regulators, as well as non-U.S. securities exchanges and non-governmental institutions, and may coordinate with non-U.S. regulatory agencies regarding examinations of U.S. branches of non-U.S. firms.[39] In addition, it considers tips, complaints, and referrals (a more significant source of information after the Madoff scandal); analysis of outlier or aberrational information provided to investors; significant changes in registrants' business activities; and registrant disclosures regarding regulatory and other actions brought against them. The Division also monitors news, new products and activities of firms, recurrent problems, trends and academic studies in determining target firms and conduct to examine.

(ii) Quantitative Data Gathering

The staff gathers quantitative data and information using a variety of sources and methods. The staff analyzes data found in firms' Form ADV filings in order to consider factors such as an adviser's industry affiliations, compensation arrangements, number and type of clients, and conflicts of interest, such as those arising from the "side-by-side" management of performance fee and non-performance fee accounts. In August 2016, the SEC approved amendments to Form ADV to collect additional and more consistent data on separately managed accounts, including information on the use of borrowings and derivatives, and information on multiple private fund adviser entities (i.e., "relying advisers") operating a single advisory business and using a single registration.

The Division also uses data from Form PF in its examinations of private fund advisers. The Division staff generally reviews information contained in a private fund adviser's Form PF filing for inconsistencies with other information obtained from the adviser during an examination, such as due diligence reports, pitch books, offering documents, operating agreements, and books and records. The Division staff also typically looks for discrepancies between the adviser's Form PF filing and any publicly-available documents related to the adviser, including the adviser's Form ADV and brochure. In addition to reviewing Form PF filings for background and to identify inconsistencies with other documents, the Division staff also often reviews an adviser's Form PF filing in order to confirm that the investment strategies disclosed to investors match the information contained in the adviser's Form PF filing, particularly with respect to holdings, leverage, liquidity, derivatives, and counterparties.[40]

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[39] See Review and Analysis of OCIE Examinations of Bernard L. Madoff Investment Securities, LLC, Office of Inspector General, Office of Audits, U.S. Securities and Exchange Commission (Sept. 29, 2009) https://www.sec.gov/oig/reportspubs/468.pdf.

[40] Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports, U.S. Securities and Exchange Commission (Aug. 13, 2015), *available at*, https://www.sec.gov/investment/reportspubs/special-studies/im-private-fund-annual-report-081315.pdf.

(iii) Data Analysis and Investments in Technology

Quantitative risk analytic techniques are now a key part of the target selection process. RAE and QAU have developed tools, such as the National Exam Analytics Tool ("NEAT") and the Market Information Data Analytics System ("MIDAS"), that allow the staff to identify higher-risk Regulated Firms. The Office of Risk and Strategy centralizes the staff's resources and efforts to assess the riskiness of firms and practices.[41]

The Division formed the QAU to use quantitative analytics and modeling techniques to help the staff determine firms and areas that may require more attention and to enable examiners to conduct more targeted and efficient examinations.[42] The Division also has made a concerted effort to hire examiners with industry experience, particularly practiced industry professionals with specialized experience in trading, portfolio management, valuation, complex products, sales, compliance, and forensic accounting.[43]

Inputs to these models may include data indicating: anomalous characteristics; that a registrant does not meet certain thresholds for established financial metrics; high-risk sales practice patterns; and relationships among registrants exhibiting similar characteristics; larger fund sizes and AUM and greater adviser complexity; apparent overstatement of assets; consistently claiming high rates of return or aberrational performance; apparent smoothing of returns; and assets held/custodied by affiliates.

The Division has also invested heavily in technology, and recruited experts to enhance its data collection and analysis capabilities to identify risks. NEAT enables examiners to access and systematically analyze years' worth of registrants trading data at a much faster rate and with greater efficiency.[44] The RAE Group uses the data compiled by NEAT to, among other activities, compare trading data in light of significant corporate activity such as mergers to help identify potential insider trading and has also been used to review the securities a registrant has traded and

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41 SEC Names James Reese Chief Risk and Strategy Officer of the Office of Compliance Inspections and Examinations (May 15, 2018), *available at*, https://www.sec.gov/news/press-release/2018-86.

42 See Testimony of Mark Flannery, Marc Wyatt, Thomas J. Butler, and Sean McKessy before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, Hearing on Continued Oversight of the SEC's Offices and Divisions, Washington D.C. (April 21, 2016), *available at*, https://www.sec.gov/news/testimony/testimony-04-21-16.html.

43 See Testimony on Oversight of the SEC by Chair Mary Jo White before the U.S. House of Representatives Committee on Financial Services (May 16, 2013), https://www.sec.gov/News/Testimony/Detail/Testimony/1365171516050.

44 https://www.sec.gov/news/speech/2014-spch012714mjw

identify trading patterns by a registrant for suspicious activity. MIDAS, an SEC system that seeks to combine advanced technologies with empirical data to promote better understanding of markets, was developed in 2013, and is used to view and analyze the complete order books of individual equities as well as broader market events, such as flash crashes.[45] Technology experts at QAU have also developed additional data-driven tools to identify risks to reflect shifting regulatory concerns and industry developments, including technologies and methods to help examiners detect suspicious activity in areas such as money laundering and high frequency trading.[46]

In 2016 the Division consolidated the technological efforts and capabilities under the newly created Office of Risk and Strategy, and created the position of Chief Risk and Strategy Officer.[47] The office integrates the work of quantitative experts with staff members that have direct examination experience to develop tools that enhance productivity of examiners and to identify risks among registrants and the products and services they provide. Examiners are also able to leverage the knowledge of subject matter experts, including in the areas of derivatives, valuation, options, prime brokerage, and trading to enhance its data gathering, analysis, and technology-driven efforts. The Division also organizes working groups on new or potentially vulnerable areas of the market such as fixed income, microcap, and structured products.[48]

The Division also leverages information gained from data analysis and examinations to further the goal of improving compliance. In recent years, the Division staff members have published more frequent and detailed risk alerts that summarize common compliance issues observed by Division staff members during examinations. For example, in 2015 the Division published a risk alert that resulted from the examination of data from over 26,000 sales of

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45 Market Structure: MIDAS, *available at*, https://www.sec.gov/marketstructure/midas.html#.WnplK66nGHs.

46 See Testimony of Mark Flannery, Marc Wyatt, Thomas J. Butler, and Sean McKessy before the U.S. House of Representatives Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, Hearing on Continued Oversight of the SEC's Offices and Divisions, Washington D.C. (April 21, 2016), *available at*, https://www.sec.gov/news/testimony/testimony-04-21-16.html.

47 Sec Announces Creation of Office of Risk and Strategy for its National Exam Program: Peter B. Driscoll Named Chief Risk and Strategy Officer, SEC Press Release (March 8, 2016) https://www.sec.gov/news/pressrelease/2016-38.html.

48 See Marc Wyatt, Keynote Address: National Society of Compliance Professionals 2016 National Conference, Washington, D.C. (Oct 17, 2016) https://www.sec.gov/news/speech/inside-the-national-exam-program-in-2016.html.

structured securities products across a Regulated Firm's ten branch offices.[49] Recent Division risk alerts have addressed topics including electronic (email) messaging, the cash solicitation rule, advisory fee and expense compliance issues, and principal and agency cross transactions. The 2019 examination priorities noted that the Division plans to continue to add to and refine "the expertise, tools, and applications that help identify areas of risk, firms that may present heightened risk of non-compliance, and activities that may harm investors."[50] The 2020 examination priorities also noted that "[the Division] continues to make investments in human capital, technology and data analytics.…[The Division's] technology tools and data analytics work also continue to mature and help drive many of its risk identification efforts, initiatives and examination processes."

B. Conduct of the Examination

(i) Notice Exam vs. Surprise Exam

Once a Regulated Firm has been selected for an examinations, the SEC typically begins with a telephone call or communication from a regional office that specifies the date the examination is to begin and notifies the firm of documents that it must make available for inspection. There is generally no way of knowing when the SEC will notify a firm of the examination. The examiners generally choose the date at random or based on their own schedule.

Since the SEC is not obligated to provide prior notice to a firm, the examination can begin with a surprise visit by the examiners. Although in the past a surprise visit was not typical for examinations that were not "cause examinations," it is a technique that the staff has been using more frequently in recent years, particularly when responding to a tip, complaint or referral. The examination itself consists of several phases. It is conducted both at the firm's and the SEC's offices.

(ii) SEC Due Diligence and On-Site Visit

Before coming to the registrant's offices, the staff will research the firm and conduct initial due diligence, reviewing both publicly available news reports and documents and the firm's filings with the SEC on Form ADV and, for example, Forms D, 13D, 13G, 13F, 13H and PF. In recent years, the staff has expanded on this phase of the examination process and typically arrives at the adviser's officers with significant knowledge of the firm's operations and regulatory profile.

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[49] OCIE, National Examination Program Risk Alert, Broker-Dealer Controls Regarding Retail Sales of Structured Securities Products (Aug. 24, 2015).

[50] SEC, OCIE National Examination Program, Examination Priorities for 2019. https://www.sec.gov/files/ocie%202019%20Priorities.pdf.

The on-site portion of the examination, known as the "fieldwork," generally begins on the date specified in the notice of the examination. The Division staff will often request an "entrance interview" with the firm's personnel, typically the chief compliance officer and possibly other officers of the firm.[51] The staff also generally asks to interview members of senior management in order to assess the "tone at the top," and recently the staff has been asking to speak with members of the adviser's and/or fund boards. While on-site, the examiners review the requested records and interview firm personnel. These interviews may consist of questions about the documents produced, specific policies and procedures, and conduct at the firm generally. These interviews can play a critical role in the examiners' assessment of the firm's controls and risk environment.

(iii) SEC Off-Site Review

The examination continues off-site at the SEC's offices, where the examiners continue to review the documents and other information they have received from the firm. The examiners may make follow-up telephone calls to ask questions, request additional documents and request written responses to certain questions to support the firm's responses. These requests for additional records may occur many weeks (or months) after the examiners complete the on-site portion of the examination. The examiners may use technology to analyze large volumes of data that the firm has produced. They also may consult with supervisors, as well as Division and other SEC headquarters staff, such as the Division of Investment Management. Weeks or months can pass before the examiners complete their off-site review.

(iv) Exit Interview

When the SEC's off-site review is complete, the examiners typically request the firm to participate in an "exit interview," generally with senior management of the firm. These interviews can be conducted in person or by telephone, generally as determined by the SEC staff. In the exit interviews, the examiners discuss their preliminary findings. For this reason, the exit interview is critically important. The interview provides the firm an opportunity to react quickly to adverse findings either by attempting to correct the examiners' perception of the facts and/or applicable law or by taking prompt corrective action to remedy issues.

The SEC staff also may contact firms between on-site examinations to ask questions by phone and/or request additional documents or written responses to questions on an expedited basis on specific issues, such as for a sweep examination. This facilitates the SEC's management and prioritization of sweep examinations and enables it to better focus on-site examinations.

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[51] If an "entrance interview" is not specifically requested by Division staff, it can be an effective practice for a Regulated Firm to offer to give the Division staff an initial presentation before their on-site work begins.

C. Testing Compliance Policies and Procedures

The examination program has increasingly focused not just on substantive areas and business practices but also determining whether a Regulated Firm has implemented the key elements of a good compliance program. During examinations, the Division staff will test and seek to ascertain whether the firm has robust and compliance policies and procedures tailored to its own business and compliance risks; a systematic effort to assess the compliance risks presented by the firm's business, preferably rooted in an enterprise risk assessment and management program; how well the compliance program has been implemented and monitored, in particular whether the firm has dedicated an appropriate amount of resources to the program; the competence, knowledge and authority of the firm's chief compliance officer; the quality and seriousness of the required annual review of the adviser's compliance program; the adviser's culture of compliance and "tone at the top"; and whether the program is "evergreen," that is, in a state of constant improvement to identify and address new risks and enhance existing procedures. The SEC has brought a series of enforcement actions, arising from examinations, where the agency has charged investment advisers with violations derived from alleged failures to have an adequate compliance program.

To assess these considerations, the Division staff now often asks for the following: an interview with a member of senior management for an overview of the firm, its business, and compliance culture; a detailed discussion with the CCO or risk manager about the firm's system of controls, especially the compliance priority risk areas listed in the adopting release for Rule 206(4)-7, the Advisers Act compliance rule; a written narrative of the firm's controls in the priority risk areas; information and/or documents to assess the firm's risk management processes; a copy of the firm's written compliance policies and procedures; a copy of any inventory or matrix of compliance risks; information for each significant regulatory breach since the last audit; compliance documents, exception reports, and "forensic testing" of the firm's procedures; and the underlying records and documentation of processes and testing for the adviser's annual review of policies and procedures.

IV. Outcomes of Examinations

SEC examinations can result in several possible outcomes that range from no adverse findings to referrals to the SEC's Division of Enforcement for further action. In the vast majority of examinations, however, the outcome is the middle of the spectrum, in which the examined firm receives an "examination findings" document (also referred to as a "deficiency letter"). In recent years, about 72 per cent of Regulated Firms received examination findings, and about 20 percent receive examination findings with a "significant finding." Up to 7 per cent are typically referred to Division of Enforcement staff for further review and potential investigation.[52]

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[52] SEC Fiscal Year 2019 Congressional Budget Justification Annual Performance Plan (Feb 12, 2018), *available at*, https://www.sec.gov/files/secfy19congbudgjust.pdf.

The Dodd-Frank Act imposed on the Division a requirement that within "180 days after the date on which Commission staff completes the on-site portion of its compliance examination or inspection or receives all records requested from the entity being examined or inspected, whichever is later, Commission staff shall provide the entity being examined or inspected with written notification indicating either that the examination or inspection has concluded, has concluded without findings, or that the staff requests the entity undertake corrective action." Dodd-Frank allows the Division Director to extend this deadline for another 180-day period if s/he finds that an examination is sufficiently complex that a determination cannot be made within the initial 180 days, after providing notice the chair of the SEC. Although the staff can in effect delay the start of the 180-day period by requesting additional documents, the Division takes compliance with the spirit of the 180-day deadline seriously.

A. Deficiency Letters

Deficiency letters detail the examiners' findings regarding the firm's violations of laws and/or regulations, supervisory deficiencies and control weaknesses. These letters generally require the firm to respond to the SEC, typically within 30 days of the firm's receipt of the letter, with a detailed explanation of the steps that the firm intends to take to address the issues that are identified in the deficiency letter. In general, the firm's response should, as appropriate, discuss in detail the reasons why the firm believes that the examiner's findings are erroneous, the explanations for any acknowledged deficiencies, and most importantly, the steps the firm has taken or is taking to correct the deficiencies. The 30-day deadline is not inflexible, and firms should not hesitate to request an extension, if needed, since it is more important to respond adequately than quickly.

B. Letters Closing the Examination

Where the examiners make no findings regarding the firm's practices, policies and procedures or otherwise, the examiners send the firm a letter that concludes the examination and states that no findings were made. This is obviously an excellent, but less common, outcome. As noted earlier, it happens only in a small percentage of the examinations.

C. Enforcement Referral

When examiners make a determination that the conduct, lack of supervision, policies or procedures or any other aspect of the firm's business may warrant further action by the SEC's Division of Enforcement, the Division will make an "enforcement referral." This determination is subjective and is made on a case-by-case basis, generally in consultation with the Division of Enforcement staff and the appropriate operating division (Investment Management for investment advisers and investment companies). The decision may be reviewed by a committee of SEC staff from various divisions to determine whether a referral is appropriate given the facts and the

applicable law. Conduct most likely to result in an enforcement referral includes violations that involve fraud, customer abuse, intentional wrongdoing and significant investor losses.

An enforcement referral is likely to result in an investigation by the Division of Enforcement. Although in egregious cases an enforcement referral may occur promptly after, or even before, the close of a Division examination, in most cases it occurs only after review of the firm's response to the deficiency letter. To reduce the potential of such a referral, it is critically important to respond to any of the concerns expressed by the examiners during the exit interview if possible, and to respond thoroughly to the deficiency letter.

V. Handling an Examination

A. The Importance of an Effective Compliance Program

Preparation for an SEC examination must begin long before the commencement of the examination. Indeed, the preparation begins with the establishment of a strong compliance culture at the firm. An effective compliance program lies at the heart of a strong compliance culture. Such a program includes:

(i) Oversight by compliance personnel, business supervisors, management, and boards of directors;
(ii) Compliance standards, policies and procedures, and code of ethics;
(iii) Exercise of due diligence in delegating responsibilities;
(iv) Communication, education and training;
(v) Monitoring and auditing;
(vi) Response, prevention and evaluation; and
(vii) Enforcement and discipline.[53]

The firm's policies and procedures should address at a minimum portfolio management processes, trading practices for proprietary and employee personal trading, disclosures, safeguarding client assets, recordkeeping responsibilities, fee assessments, privacy and business continuity plans. Investment companies' compliance programs should also include pricing of portfolio securities and fund shares, processing of fund shares, identification of and policies with respect to affiliated persons, protection of nonpublic information, market timing and fund governance requirements.

Firms also should stay abreast of issues that the SEC considers "hot issues" and periodically review and update their compliance programs to the extent they have not addressed these issues. Compliance personnel should consider reviewing the "Risk Alerts" published by the

[53] *See e.g.*, Lori Richards, Speech before National Society of Compliance Professionals (October 19, 2006). www.sec.gov/news/speech/2006/spch1019061.htm.

Division, as well as the annual examination priorities. Firms should also consider responding to the Division's compliance outreach programs, which are in order to communicate its views of the compliance issues presented by common industry practices. The Division also publishes annually a summary of its examination priorities for the upcoming year.

B. Tone at the Top

A firm's culture emanates from the top. As such, senior management has a critically important role in establishing and maintaining a strong compliance culture by making compliance a priority for the firm. This can be accomplished in a variety of ways, including allocating appropriate resources for compliance operations and internal reviews and establishing and effectively communicating the consequences of violating policies and procedures. The staff will be testing to make sure that senior management does not just "talk the talk" but also "walks the walk" of compliance, and thus it is important that senior management set a strong personal example with their actions and messages on compliance.

C. A Qualified CCO

A qualified CCO is the core of a firm's compliance program. Qualifications to be considered include the individual's (i) level of experience, especially relevant to the risk, size and complexity of the firm and its investment products; and (ii) ability to establish, maintain and review the firm's compliance program, conduct mock examinations with the assistance of outside compliance consultants and law firms, and effectively manage relationships with regulators and firm management. As discussed in more detail below, the CCO should have the stature necessary to effectively coordinate firm personnel for the SEC examination, and to be the primary interface with the SEC examiners during the inspection.

D. Effective Recordkeeping and Documentation

Effective recordkeeping is essential to an effective compliance program. It is also critical to a positive outcome of a SEC examination. At a minimum, the firm must comply with applicable SEC and SRO recordkeeping requirements. In addition, the SEC examiners will expect the firm to promptly provide the records requested initially and throughout the examination. The firm's ability to meet the examiners' requests quickly and with ease will help establish a positive first impression with the examiners and help demonstrate that the firm maintains effective control of its operations. Conversely, disorganized recordkeeping, inability to respond promptly to examiners' requests for documents and/or recordkeeping violations, even if minor, can create a negative impression regarding the firm's overall compliance. A comprehensive recordkeeping matrix that identifies the regulatory records and other records that the firm otherwise maintains to support its business and the respective locations of the records will facilitate timely productions of the requested records.

E. Address Prior Deficiencies

The SEC will expect firms to address deficiencies that were raised in prior examinations. These issues may be the first areas to be examined, particularly if they are associated with potential harm to investors, the markets or the firm's business. The possibility of enforcement action is significantly enhanced if a firm fails to address prior criticism, particularly if the criticism has been raised in multiple examinations.

VI. Managing the Examination Process

Once the SEC examiners arrive at the firm, it is essential that the firm effectively manage the interactions with the examiners, production of records and responses to their questions. The examination will run more smoothly, and the firm will have better control over the process, if it designates a single contact for the examiners. In addition, setting the right tone and evidencing a strong compliance culture from the outset will serve the firm well throughout the examination and ultimately could affect the outcome. In this regard, the firm's senior management can help demonstrate the priority it places on compliance by being available to meet with the examiners at the initial inspection interview, even if the SEC has not requested that they be present.

A. Designate the Right Coordinator

The person responsible for coordinating the examination for the firm should be someone who understands the examination process, the firm's compliance program and potential consequences of a mishandled examination. The person's stature at the firm should be sufficiently senior so as to further evidence to the examiners the seriousness with which the firm considers the examination and compliance generally. This person frequently will be the firm's CCO or general counsel or a senior member of their staffs.

B. Exam Set-Up

At the outset of the examination, the firm's coordinator should introduce him or herself to the examiners and indicate to them that all requests for information, including requests to speak with the firm's personnel, should be made to the coordinator.

It also is important to designate a specific office or conference room where the examiners can perform their work. The workspace should be well-lit and have adequate space for the examiners to do their work. This will serve the dual purpose of making the examiners adequately comfortable to do their work and limiting their access to employees. All employees in the vicinity of the examiners' work room should be informed of the presence of the examination staff and that it is imperative that all conversations be conducted in offices and not in hallways.

C. Exam Type and Focus

At the beginning of the examination, it is important for the coordinator to ask the examination staff about the type of exam (regular risk-based, for cause or sweep exam) if this is not already known; the staff sometimes, but not always, will answer the question. Often, the initial notice and/or request for documents before the examination begins will provide this information, but if not, it is important at least to try to find out at its inception.

Similarly, the coordinator should inquire about the focus of the examination. Although this may be evident from the initial document request, fully understanding the areas that the examiners will cover can be helpful to handling responses to the examination staff. If the firm has any cause for concern about areas that the examination will cover, the coordinator should inform the CCO (if the CCO is not the coordinator) and possibly the firm's legal counsel. Consideration should be given to identifying any problem areas to the examiners before they find them on their own.

D. Prompt Responses to Requests

Cooperation with the examination staff is key to a successful examination. Responding promptly to examiners' requests is essential. The coordinator should be responsible for overseeing the gathering, review and copying of all documents that the examiners request. All documents should be reviewed before they are turned over to the examiners to ensure that privileged and irrelevant materials are not provided. The coordinator should confer with counsel before producing any documents if the coordinator or anyone else at the firm has any questions about the scope of the document request, as well as questions whether some of the documents may be privileged. Documents and other information to be furnished also should be thoroughly examined prior to production from the viewpoint of a regulator's perception and consideration given as to whether any information that may raise questions should be accompanied with appropriate explanations. Copies and/or records should be made of all documents that are produced, and careful notes should be taken of all interviews that are conducted. In other words, the firm should create an adequate record of the entire examination so as to be able to reconstruct the information that was provided to the examiners both in written form and orally.

Although a flat refusal to produce records to which the examination staff has a right to review is not wise, one should not hesitate to seek clarification of the scope of a request if the document request is unclear or will require production of an excessive number of documents. Often the examination staff has no idea of the extent of documents that will be responsive to its request and can be persuaded to narrow it after being informed of the number of documents involved. In any event, such a discussion can be invaluable in shedding light on the purpose of the staff's request.

E. Preparation of Interviewees

Thorough preparation of employees whom the examiners seek to interview is critical to successfully managing the examination. Well-prepared employees will be less nervous and better able to respond effectively to examiner questioning. The coordinator should also be the focal point for requests for interviews and preparing firm personnel who will be interviewed. Prior to any interview, the firm's CCO and/or legal counsel should meet with the employee to explain the interview process, offer guidance on what to expect and how to respond. The employee to be interviewed should be prepared for the interview: the employee should understand the importance of being honest, calm, polite and cooperative. It is essential that employees understand that although they should be responsive to the examiner's questions, employees should not volunteer information that is outside the reasonable scope of a request and never guess at an answer. All interviews of firm employees should be attended by counsel or someone from compliance to protect the employee's rights and to prevent the disclosure of irrelevant or privileged information. This will also assist the firm's understanding of the focus of the examination, enable it to assess potential issues or preliminary findings and to consider taking prompt remedial action during the pendency of the examination. Careful notes should be taken during the interview or immediately afterward to maintain a record of the substance of the interview, particularly if the staff later has a different recollection or record of what the employee stated.

F. Relating to the Examiners

As noted above, establishing a cooperative rapport with the examination staff is key to handling an examination successfully. So, too is facilitating an efficient process. Both the firm and the examination staff will benefit from an examination that runs efficiently. The sooner the examiners leave the firm's premises, the sooner the firm can resume business as usual. The examination staff has its own schedule to keep, and it is to the firm's benefit to enable the staff to keep to it. Moreover, the longer the examiners remain at the firm's premises, the greater the likelihood of their uncovering something that might not have been a focus of the examination and that could be the subject of examination findings or an enforcement referral. Accordingly, the firm should do whatever it can to enable the SEC staff to conclude the inspection as quickly as possible.

Responding promptly to the examiners' requests for information is a first step. In addition to moving the process quickly, prompt responses can leave the positive impression that the firm is well-organized, has recordkeeping under control and is otherwise well-managed. The firm should provide affected personnel and any outside counsel with notice of an upcoming examination and the likelihood that they will be requested to review documents or be available for interviews on short notice so that there is no time lost in waiting.

G. The Importance of Candor

The importance of truthfulness cannot be over-emphasized. False or misleading statements to an examiner not only undermine the firm's credibility, but they are also a federal

criminal offense if deliberately made.[54] Several steps will enable the firm to maintain its candor with the examination staff.

All personnel should be honest with the examiners at all times. Regulatory problems can only become more serious if personnel are not truthful about the firm's activities. Moreover, when faced with document requests that relate to a troublesome matter, it often is wise to call the examiners' attention to it before they find it themselves. In this regard, the examiners tend to be more understanding of conduct that constitutes a violation of the rules when firms inform the examiners that the firm has discovered such conduct and the steps the firm has taken to correct it. Such disclosures should only be made, however, after careful consideration with experienced enforcement counsel.

Second, records of all information provided to, as well as interviews with, the examination staff should be maintained. This includes records of the documents produced, personnel interviewed and comments made to the examiners in response to ongoing questions or otherwise.

Commitments made to the SEC, particularly those made in response to deficiency letters, should be fulfilled. Failure to correct conduct cited in a deficiency letter can leave the staff with a variety of negative impressions, including that the firm does not consider compliance a priority, that the firm does not deliver on its commitments generally, and/or that the firm is disorganized and does not remember commitments that it makes. Repeated failures to correct adequately a cited deficiency can lead to an enforcement action, even where the conduct did not lead to any identifiable harm to clients.[55]

H. Maintaining Confidentiality

Information that the firm produces in the context of an SEC inspection is likely to include confidential business information, such as client names, strategies, product information and compensation information. The information can be subject to disclosure to numerous sources, including competitors and the press, pursuant to Freedom of Information Act (FOIA) requests. It

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54 18 U.S.C. §1001.

55 Indeed a failure to correct prior deficiencies led to the first enforcement action under the new Compliance Rule, In the Matter of CapitalWorks Inv. Partners, LLC and Mark J. Correnti, Inv. Advisers Act Release 2520 (June 6, 2006). *See also*, for example, In the Matter of Gofen and Glossberg, Inc., Advisers Act Release No. 1400 (Jan. 11, 1994) (custody violations); In the Matter of Howard M. Borris & Co., Inc., et al., Advisers Act Release No. 1460 (Jan. 9, 1995) (books and records, custody and reporting violations); In the Matter of Louis E. Sharp, Exchange Act Release No. 35215 (Jan. 11, 1995) (books and records, reporting and cash solicitation rule violations); and

is therefore essential for the firm to take precautions to minimize the likelihood of any such disclosures.[56]

The firm can request confidential treatment under FOIA. The SEC has established procedures for requests for confidential treatment.[57] The procedure generally affords the party who produced the documents to object to their disclosure if they are requested pursuant to FOIA.

The firm also can request that produced documents be returned. Although the SEC retains some documents that are produced during an inspection, it frequently does not need to keep all of them. The firm's request for return of documents should be made in writing.

VII. The Limits of the SEC's Examination Powers

Although the SEC has broad powers to conduct examinations of Regulated Firms, its authority is not without limits. For the vast majority of firms, however, a detailed discussion of these limitations is more theoretical than real, because the primary objective in handling an SEC examination is not to win an argument. Rather, it is to do whatever is appropriate to demonstrate a

In the Matter of Stephen C. Schulmerich, et al., Advisers Act Release No. 1358 (Jan. 4, 1995) (books and records and reporting violations).

[56] There is a self-executing exception in Section 522(b)(8) of FOIA which generally provides that information "contained in or related to examination[s] . . . reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions," respectively, are considered to be non-public for purposes of FOIA. The SEC FOIA Regulations were recently amended to remove a parallel exemption for "information contained in reports, summaries, analyses, letters, or memoranda arising out of, in anticipation of or in connection with an examination or inspection of the books and records of any person or any other investigation". See Amendments to the Commission's Freedom of Information Act Regulations, Rel. No. FOIA-193 (June 28, 2018). The SEC explained in the adopting release for these amendments that the removal of the prior regulation's recitation of "the nine categories of records that are exempt from disclosure under [Section] 522(b) [of FOIA]" was intended to "eliminate[] certain provisions in the Commission's [now superseded] FOIA regulations that repeat information contained in the FOIA statute and [therefore] do not need to be in the Commission's regulations." Nonetheless, documents and information obtained by the SEC staff during an examination could become separated from official document production records at the agency and be disclosed inadvertently as a result or circumstances could arise where a person at the SEC is in custody of the examination records is unaware of the self-executing exemption. By marking all documents produced with a FOIA Confidential Treatment legend and making a formal confidential treatment request, the likelihood of inadvertent production of sensitive examination related materials in response to a FOIA request can be reduced. It is therefore a good practice always to mark documents submitted during the course of an examination and to request confidential treatment of those documents.

[57] Confidential Treatment Procedures under the Freedom of Information Act, Securities Act Release No. 6241 (Sept. 12, 1980), reprinted in [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶82,652.

"low risk" profile in order to limit the length of the current inspection and to enlarge as much as possible the period before the next inspection. This cannot be accomplished by stubbornly contesting the SEC's authority. Such a contest should be reserved for those few cases where it seems likely that the examination will end with a recommendation for an enforcement investigation, and it is necessary to assume a defensive posture during the examination process.

Nevertheless, a general awareness of the SEC's inspection authority is helpful to managing the process in a way that minimizes its burdens. Any discussion of the legal limitations on the SEC's power of inspection should start with the Fourth Amendment to the Constitution.[58] The SEC's statutory authority to conduct examinations of books and records of broker-dealers, investment advisers, investment companies and other Regulated Firms is a judicially created exception to the restrictions against unreasonable search and seizure imposed by the Fourth Amendment. To this point, the courts have held that power of an administrative agency to inspect books and records is consistent with the Fourth Amendment prohibitions as long as (1) the inspection pertains to a commercial business operating in a regulated industry; (2) the examination is relevant to the regulatory purposes; (3) its scope is clearly defined and limited and (4) is known to the Regulated Firms.[59] On this basis, the Court of Appeals for the Second Circuit has specifically upheld the SEC's power to inspect the records of a registered investment adviser against a Fourth Amendment challenge.[60] The court justified its decision on the basis of legislative history that indicated a Congressional finding that the availability of investment adviser records for inspection was necessary for effective regulation so that the records were deemed "characteristic of quasi-public documents and their disclosure may be compelled without violating the Fourth Amendment." [61]

At one time, the SEC's inspection powers were limited to books and records required to be kept under agency rules. In 1975, however, the relevant statutes were amended to authorize the SEC to examine all records maintained by Regulated Firms, and the SEC now takes the position that its examination authority is unconditional and unlimited except for the requirement that any

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58 The Fourth Amendment provides in pertinent part: "The right of the people to be secure in their persons, houses, papers and effects against unreasonable searches and seizures, shall not be violated."

59 Colonnade Catering Corp. v. United States, 410 F.2d 197, 202 (2d Cir. 1969) *aff'd* 397 U.S. 72 (1970). *See also*, United States v. Biswell, 406 U.S. 311 (1972), where the Supreme Court upheld statutory authority to conduct surprise inspections of firearms dealers. *But see*, Marshall v. Barlow's Inc., 436 U.S. 307 (1978), holding that Fourth Amendment prohibited an OSHA inspection without a search warrant.

60 SEC v. Olsen, 354 F. 2nd 166, 170 (2nd Cir. 1965).

61 *Id.* at 170.

such examination be "reasonable."[62] Armed with this broad grant of authority, the SEC has not hesitated to seek the assistance of the courts to prevent a Regulated Firm from interfering with its right of inspection[63] and later to take disciplinary action against the defendant for violation of its rules mandating availability of records for inspection.[64]

Moreover, the courts have made clear that various constitutional rights are unavailable during an SEC inspection. These include the privilege against self-incrimination by an individual or sole proprietorship registered with the SEC as an investment adviser and the right to representation by counsel, although as a practical matter, the SEC staff does not object to such representation. In addition, the self-evaluation privilege in all likelihood would not be recognized.

Notwithstanding the SEC's broad inspection powers and the concern over inciting an enforcement referral by contesting an the Division information request, firms should not hesitate to question a request in a professional and non-contentious manner if it appears excessively burdensome or otherwise appears to exceed the limits of the SEC's inspection authority. To this point, the Fourth Amendment requirement of "reasonableness" is the most important limitation on the SEC's authority, and one that the SEC itself readily concedes, at least in theory. In the context of an enforcement investigation, the courts have on rare occasion refused to enforce a subpoena that is unreasonably broad in scope.[65]

It is appropriate for a Regulated Firm faced with information requests that are exceedingly difficult or impossible to comply with to seek to negotiate more reasonable bounds to the request and if necessary, to escalate the matter within the examination staff. Such efforts, however, must recognize that the courts have been reluctant to curb the inspection powers of regulatory agencies. In any event, care should be exercised to raise questions concerning burdensome information requests in a manner that does not lead to a staff perception of bad faith in responding to their requests or that the firm is unable to do so.

In addition to staying within the bounds of reasonableness, the SEC and its staff cannot pursue a course of conduct designed to mislead a firm during an inspection. Thus, in one case, a court of appeals refused to enforce an SEC subpoena based on information obtained under

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62 Lori Richards and John Walsh, Compliance Inspections and Examinations by the Securities and Exchange Commission, 52 Bus. Lawyer 119 (1996).

63 *See*, SEC v. Barr Fin. Group, Inc., SEC Litig. Release 16159 (May 24, 1999); SEC v. Hammon Capital Management Corp., SEC Litig. Release 8580 (D. Colo. October 17, 1978).

64 In re to Hammon Capital Management Corp., 47 SEC 426, (January 8, 1981), (registrant suspended for 90 days for failure to make its records available for inspection).

65 *See e.g.*, SEC v. Sange, 513 F.2d 188 (7th Cir. 1975) subpoena enforcement denied because it required "mass removal of business records."

circumstances where SEC staff members pretended to be seeking general background on industry practices when in fact they were conducting an informal enforcement investigation.[66]

Court decisions also suggest that the SEC may not use its inspection power primarily for the purpose of gathering information for an enforcement inquiry. While the issues have never been adjudicated in the context of an SEC inspection, the District of Columbia Court of Appeals has held in the context of parallel Department of Justice and SEC inquiries that the SEC could not use its investigatory subpoena powers for the purpose of gathering evidence for criminal prosecution against a party that has been criminally indicted.[67] The court stated that such a "tactic" may undermine the party's Fifth Amendment privilege against self-incrimination, expand rights of criminal discovery beyond the limits of the Federal Rules of Criminal Procedure and otherwise prejudice the defendant by exposing the nature of the defense to the criminal prosecutors in advance of trial. In another case, a federal district court has found that the use of the SEC investigative process to conceal a pending criminal investigation constituted misconduct sufficient to either dismiss the indictment or suppress the evidence gathered in the SEC investigation. In that case, the court found a deliberate use of the SEC's investigative authority by criminal prosecutors to gather information for the criminal indictment and that the SEC staff made intentional misrepresentations amounting to "deceit" and "trickery."[68]

Finally, it should be noted that the Privacy Act of 1974 requires that SEC requests for information in connection with an investigation be preceded or accompanied by notification of (1) the authority and purpose of the request, (2) the routine uses to be made of the information requested, (3) the voluntary or mandatory nature of the request and (4) the consequences, if any, of a failure to produce the information. The Privacy Act requirements serve the important purpose of preventing the SEC from conducting undercover or sting operations under the guise of an inspection. It does so by requiring that the SEC staff disclose whether it is seeking information pursuant to its inspection or its law enforcement powers.

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66 SEC v. ESM Gov't Sec., Inc., 645 F.2d 310 (52 Cir. 1981).

67 *See e.g.*, SEC v. Dresser Industries, Inc., 628 F. 2nd 1368 (D.C. Cir. 1980) (en banc).

68 U.S. v. Stringer, 408 F. Supp. 2d 1083 (D. Ore 2006) appeal pending.

APPENDIX

Information Available on the SEC's Website

The SEC maintains on its website (sec.gov) a host of useful information about the National Examination Program. Links to some of this information are provided below.

Division IA Exams: Core Initial Request for Information

http://www.sec.gov/info/cco/requestlistcore1108.htm

Information for Newly-Registered IAs

http://www.sec.gov/divisions/investment/advoverview.htm

Exam Brochure

http://www.sec.gov/about/offices/ocie/ocie_exambrochure.pdf

Division Overview

https://www.sec.gov/exams/about

The Division's Public Alerts, Reports and Letters

http://www.sec.gov/about/offices/ocie/ocie_guidance.shtml

Commissioners' Speeches

http://www.sec.gov/News/Page/List/Page/1356125649549

Information About the SEC's Investor Advisory Committee

http://www.sec.gov/spotlight/investor-advisory-committee.shtml

Dechert LLP

August 24, 2020

ONPOINT / A legal update from Dechert's Financial Services Group

OCIE Publishes Risk Alert on COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers

The staff of the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (staff) issued a National Exam Program Risk Alert on August 12, 2020 (Risk Alert).[1] The Risk Alert is intended to share OCIE's observations on "a number of COVID-19-related issues, risks, and practices relevant to SEC-registered investment advisers and broker-dealers" (collectively, Firms) and on COVID-19-related market volatility that potentially "heightened the risks of misconduct in various areas." The Risk Alert groups the staff's observations into six broad categories: protection of investor assets; supervision of personnel; practices relating to fees, expenses and financial transactions; investment fraud; business continuity; and the protection of sensitive information. While risk alerts typically disseminate observations from registrant examinations, the Risk Alert reflects OCIE's outreach, consultation and coordination with Firms, SEC colleagues and other regulators as a result of the current pandemic.

The Risk Alert also highlights SEC resources to assist Firms during COVID-19 (particularly SEC resources related to fraudulent activities), as well as other guidance and speeches, and emphasizes that "OCIE has remained operational nationwide" throughout COVID-19.

Risk Alert

Protection of Investor Assets

Firms are required to assure the safety of investors' assets.[2] The staff observed a number of changes to existing practices by Firms during the pandemic, which were related to: the collection and processing of client checks; transfer requests; and disbursements. With regard to a Firm's receipt of checks and transfer requests, the Risk Alert encourages Firms to: review existing practices for any new processes and related risks; enhance policies and procedures to reflect such processes; and consider whether disclosure enhancements are necessary or appropriate in light of potentially delayed processing times. With respect to client disbursements, the Risk Alert encourages Firms to enhance existing policies and procedures to ensure the appropriateness of "unusual or unscheduled withdrawals from [client] accounts, particularly COVID-19 related distributions from [client] retirement accounts." The Risk Alert specifically states that Firms should:

- *Verify client-related matters* – consider additional steps to verify a client's identity and disbursement instructions (including the client's authorization to request a disbursement, as well as the accuracy of the bank account name and numbers used).
- *Recommend adding a trusted contact* – recommend that their clients have a "trusted contact" person.

Supervision of Personnel

Firms are required to supervise their personnel, including supervised persons' investment and trading activities.[3] The staff observed that Firms may be required to make "significant changes" to their operating models in light of the effects of COVID-19, including by: transitioning to a work-from-home posture; responding to issues raised by significant market volatility; and addressing technological and other operational issues. To the extent a Firm confronts one or more of these issues, the Risk Alert encourages Firms to modify existing policies and procedures to:

- *Conduct oversight of supervised persons' communications* – address the appropriate level of oversight of supervised persons (including the monitoring of Firm-related communications made by supervised persons) in a work-from-

home environment.

- *Conduct oversight of supervised persons' recommendations* – address any risks that may arise from supervised persons making securities recommendations in one or more market sectors that have experienced "greater volatility" or have "heightened risks" for fraud.

- *Consider the impact of limited on-site diligence* – address constraints imposed on a Firm's ability to conduct on-site due diligence of third-party investment managers, investments or portfolio holding companies.

- *Conduct oversight of trading* – address risks associated with trading (including consideration of "affiliated, cross, and aberrational trading, particularly in high volume investments").

- *Consider limitations on diligence of new personnel* – address risks associated with personnel onboarding (including risks associated with limitations on pre-onboarding background checks).

Fees, Expenses and Financial Transactions

Firms are required to consider and, to the extent material, inform investors about: the costs of services provided and investment products recommended; and the related compensation to the Firm and its supervised persons.[4] The staff observed that the impact of first quarter 2020 market volatility on Firms' revenue increases the incentive for Firms to engage in misconduct to mitigate the impact of lost revenue. The Risk Alert highlights the potential for misconduct related to: financial conflicts of interest (*e.g.*, resulting from retirement plan rollover recommendations, borrowing from investors and clients, making recommendations that result in higher investor costs and Firm compensation); and the fees and expenses charged to investors (*e.g.*, advisory fee calculation errors, inaccurate calculation of tiered fees, failure to refund prepaid fees for terminated accounts). In light of this potential for misconduct, the Risk Alert encourages Firms to review existing practices and policies and procedures related to fees and expenses, in order to:

- *Review practices for accuracy* – validate the continued accuracy of "disclosures, fee and expense calculations, and the investment valuations used."

- *Monitor higher-fee transactions* – identify transactions that result in investors bearing "high fees and expenses"; monitor for trends in such transactions; and evaluate whether those transactions are in the investors' best interest.

- *Assess conflicts related to investment recommendations and borrowings* – evaluate the risk posed to the impartiality of a Firm's investment recommendation and other conflicts of interest arising from borrowing from investors, clients or other parties.

Investment Fraud

The staff observed that COVID-19, like any crisis, presents an opportunity for fraudulent offerings. The staff encouraged Firms to be attentive to the risk of fraudulent investment offerings when conducting due diligence of these investments and determining whether an investment is in an investor's best interest.

Business Continuity

Certain Firms are required to maintain a business continuity plan.[5] The Risk Alert states that "many Firms have shifted to predominantly operating from remote sites" during COVID-19, which could raise compliance issues and other risks, including the need to modify or enhance:

- *Compliance policies and procedures* – to the extent that extended remote operations pose "unique risks and conflicts of interest" that differ from the ordinary course (*e.g.*, new or expanded roles for supervisory personnel), Firms may need to modify or enhance their compliance policies and procedures accordingly.

- *Security and support for facilities and remote sites* – to the extent not already addressed in a business continuity plan, Firms should consider whether it is necessary to modify or enhance the security of: servers and systems; "integrity of vacated facilities"; and remote data sites. Firms also should consider whether personnel operating from remote sites are properly relocated and supported. The staff recognized that Firms also could have "built-in redundancies for key operations and key person succession plans" to address services critical to investors.

OCIE encourages Firms to: review their business continuity plans; modify or enhance plans in light of unique risks; and communicate any material impact on their operations to investors.

Protection of Sensitive Information

Firms are obligated to protect an investor's personally identifiable information.[6] The Risk Alert observes that forms of electronic communication (*e.g.*, video-conferencing) that enable remote working can create risks, such as:

- *Vulnerabilities in recordkeeping*. The staff observed that risks could emerge due to: use of remote network access and web-based applications; increased use of personally owned devices; and "changes in controls over physical records" when personnel are not operating from the Firms' offices and printing records remotely.

- *Improper access to systems and accounts*. The staff observed that phishing schemes and other "impersonating [of a] Firms' personnel, websites, and/or investors" could rise as well.

OCIE encouraged Firms to assess "systems, investor data protection, and cybersecurity" to evaluate whether enhancements are needed to: protect investors' identity and information by promoting use of the phone to address investor security concerns; train and remind personnel of best practices to maintain security while working remotely; "heighten[] reviews of personnel access rights and controls" as supervisory personnel roles change; improve encryption technologies (including on personally owned devices); implement remote-access server security and patching; reinforce system access security (*e.g.*, through use of multifactor authentication); and address cyber-related issues pertaining to third-party service providers.

Implications for Firms

The Risk Alert previews a list of issues related to COVID-19 that the staff believes are impacting Firms. Accordingly, Firms may want to carefully review the Risk Alert, and consider whether corresponding changes to their existing practices, disclosures and/or supervisory and compliance policies and procedures are necessary or appropriate. While the SEC has brought actions related to fraudulent activities, the Risk Alert could signal that the SEC is considering future action if OCIE finds issues related to those identified in the Risk Alert.

COVID-19 has fundamentally altered the way that Firms conduct their business, including how their personnel work. While many of these changes to operations, supervision and system usage could be contemplated by a well-tailored business continuity plan, the Risk Alert reminds Firms to evaluate their practices, as well as the security and sustainability of extended remote working on the Firm's critical services as the pandemic continues.

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Footnotes

1) Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers, Risk Alert, Office of Compliance Inspections and Examinations (August 12, 2020). An OCIE examination could result in a no-comment letter, deficiency letter or a Firm being referred to the Division of Enforcement. An OCIE Risk Alert has "no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person."

2) Rule 206(4)-2 under the Investment Advisers Act of 1940 (requiring registered investment advisers (and those required to be registered) to comply with the custody rule if they are deemed to have custody over their clients' funds or securities, in order to safeguard those assets against theft, loss, misappropriation or financial reverses of an adviser); Rule 15c3-3 under the Securities Exchange Act of 1934 (requiring SEC-registered broker-dealers to obtain and maintain possession and control of all fully paid securities and excess margin securities).

3) Advisers Act Rule 206(4)-7 (requiring SEC-registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act); Exchange Act Sections 15(b)(4) and 15(b)(6) and FINRA Rule 3110 (requiring FINRA member broker-dealers to establish and maintain a system to supervise the activities of each associated person, reasonably designed to achieve compliance with the applicable securities laws and regulations, including FINRA rules).

4) Advisers Act Section 206 (imposing a fiduciary duty on investment advisers); Exchange Act Rule *15l*-1(a)(2)(ii) (Regulation Best Interest).

5) Advisers Act Rule 206(4)-7 (requiring advisers to implement written policies and procedures reasonably designed to prevent violation of the federal securities laws (including, as discussed in the rule's adopting release, that a compliance program should addresses business continuity plans)); FINRA Rule 4370 (broker-dealers must create business continuity plans, including those related to an emergency or significant business disruption).

6) Regulation S-P requires Firms to maintain policies and procedures to safeguard investor records and information. Certain Firms also are required to develop and implement identity theft prevention programs in accordance with Regulation S-ID.

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SEC Publishes OCIE Risk Alert on LIBOR Transition Preparedness Examination Initiative

U.S. Regulatory Relief Tracker for Registered Funds and Investment Advisers

Federal regulators and self-regulatory agencies have provided relief to registered funds and investment advisers whose operations may be affected by the COVID-19 coronavirus outbreak

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Dechert LLP

December 15, 2020

ONPOINT / A legal update from Dechert's Financial Services Group

OCIE Publishes Risk Alert on Notable Compliance Issues Found in Investment Adviser Examinations

The staff of the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (staff) issued a Risk Alert on November 19, 2020 (Risk Alert), related to OCIE's observations regarding deficiencies in investment adviser compliance programs.[1] The Risk Alert is intended to share OCIE's observations on "notable compliance issues" found in recent examinations of SEC-registered investment advisers (advisers) related to Rule 206(4)-7 (Compliance Rule) under the Investment Advisers Act of 1940, which issues are "among the most common cited by OCIE" according to the Risk Alert. The Risk Alert groups the staff's observations into six categories: inadequate compliance resources; insufficient authority of Chief Compliance Officers (CCOs); annual review deficiencies; implementing actions required by written policies and procedures; maintaining accurate and complete information in policies and procedures; and maintaining or establishing reasonably designed written policies and procedures. The Risk Alert emphasizes the staff's view that an "adviser's CCO should be competent and knowledgeable regarding the Advisers Act and should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the firm."

The Risk Alert should be considered in light of a companion speech delivered on the same day by Peter Driscoll, Director of OCIE.[2] In his remarks, Director Driscoll highlighted the importance of empowering CCOs, noting "[a]s the Commission stated, CCOs should be *empowered*, *senior* and have *authority*, but CCOs should not and cannot do it alone and should not and cannot be responsible for all compliance failures," and emphasizing that "[t]hese three words matter" but empowerment is the key. In the Director's view, a CCO "must be integral to an adviser's business and part of its senior leadership." Director Driscoll continued that CCOs "are on the front lines to help" registrants meet their obligations under the federal securities laws, and that OCIE sees its role similarly because compliance and examiners are "two-sides of the same coin," each critical to investor protection.

Compliance Rule

The Compliance Rule requires an adviser to: (i) adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules; (ii) review these policies and procedures at least annually for their adequacy and effectiveness; and (iii) designate a CCO to administer the compliance program. While the Compliance Rule imposes an annual review requirement, the Risk Alert recommends that advisers consider more frequent reviews in cases of: significant compliance events; changes to the business; or regulatory developments. Director Driscoll explained that "the Compliance Rule touches on all of the critical areas of being an adviser." In recognition of the "new normal" as a result of the pandemic, Director Driscoll acknowledged that many advisers have "adapt[ed] compliance with the existing policies and procedures and law to the new circumstances."

Inadequate Compliance Resources

The staff observed that some advisers did not dedicate adequate resources to their compliance programs. For example, certain CCOs had "numerous other professional responsibilities, either elsewhere with the adviser or with outside firms," such that the CCO could not devote adequate time to developing knowledge of the Advisers Act or overseeing the adviser's compliance program. The staff highlighted instances where the compliance function was under-resourced or inadequately trained and staffed, which hindered implementation of the adviser's compliance program. The staff also described advisers that "significantly" grew in size or complexity, but did not hire compliance staff or use adequate information technology to continue to implement and tailor their compliance programs.

Insufficient Authority of CCOs

The staff observed that some CCOs lacked authority to craft and implement compliance policies and procedures. For example, the staff noted instances where advisers prohibited their CCOs from viewing key compliance information, such as trading exception reports. The staff also described instances where CCOs had limited interaction with senior management, which restricted the CCO's knowledge of the firm's leadership, operations and strategies, and where senior management did not consult the CCO in matters with potential compliance implications.

Annual Review Deficiencies

The staff observed that some advisers could not provide proof that annual reviews had been performed or did not identify significant existing issues. In particular, the staff found that certain advisers' annual reviews did not properly identify or review key risk areas for the advisory business (*e.g.*, conflicts, custody), or did not review significant areas of their advisory business (*e.g.*, third-party managers, cybersecurity, fee calculation, allocation of expenses).

Implementing Actions Required by Written Policies and Procedures

The staff observed advisers that did not take actions required by their written policies and procedures. For example, even though particular activities were required as a matter of their firms' written policies, certain advisers did not: train employees; implement procedures; or perform specific tasks as set forth in their own compliance policies and procedures (*e.g.*, reviewing advertising materials, following compliance checklists, reviewing client accounts).

Maintaining Accurate and Complete Information in Policies and Procedures

The staff observed that some advisers had outdated policies and procedures, or had policies and procedures that did not accurately describe the adviser.

Maintaining or Establishing Reasonably Designed Written Policies and Procedures

The staff observed that some advisers had no written compliance policies and procedures, or had inadequate policies and procedures that were not reasonably tailored to the adviser (*e.g.*, relied on "cursory or informal processes" or used an affiliate's policies). For example, where advisers maintained written policies and procedures, the staff noted "deficiencies or weaknesses" in the following areas:

- *Portfolio management*: Shortcomings related to due diligence and oversight of third parties (outside managers and service providers) and investments, as well as with respect to investment restrictions imposed by clients or regulators and the need for additional oversight of branch offices and investment advisory representatives.
- *Marketing*: Deficiencies in oversight of solicitation arrangements and performance advertising, as well as in prevention of the use of misleading marketing materials (including on the firm's website).
- *Trading practices*: Deficiencies in the implementation of policies related to: soft dollar allocation; best execution; trade errors; and restricted securities.
- *Disclosures*: Inaccurate information in Form ADV disclosures and client communications.
- *Advisory fees and valuation*: Shortcomings in fee billing processes, expense reimbursement policies and asset valuation.

- *Safeguards for client privacy*: Deficiencies in physical and electronic security of client information, general cybersecurity (*e.g.*, limiting access rights, preventing data loss, undergoing system testing, employee training), as well as compliance with Regulations S-P and S-ID.[3]
- *Required books and records*: Weaknesses in written policies and procedures to create and maintain accurate books and records.
- *Safeguarding of client assets*: Deficiencies in written policies and procedures regarding custody of client assets.
- *Business continuity plans*: Lack of testing of business continuity plans, or improper designation of responsibility for those plans.

Implications for Advisers

In his speech, Director Driscoll emphasized that risk alerts are a "significant tool" that OCIE uses to communicate its priorities and to promote compliance. The November 19 Risk Alert highlights that compliance-related deficiencies are most common in adviser examinations and explains that "many of the advisers modified their written policies and procedures to address the issues identified by OCIE staff." Echoing Director Driscoll's remarks, the Risk Alert emphasizes the importance of empowering and integrating CCOs into senior management and key decision-making affecting the advisory business. The Risk Alert also underscores the necessity of providing adequate resources and staffing to perform the compliance function; advisers are reminded of the importance of supporting their CCOs by ensuring they can devote sufficient time to become knowledgeable about the Advisers Act and, as expressed by Director Driscoll, making them an "essential component of running an advisory or fund business." Accordingly, investment advisers may want to consider the items identified in the Risk Alert, as applicable to them, in reviewing the adequacy and implementation of their compliance policies and procedures.

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Footnotes

1) OCIE Observations: Investment Adviser Compliance Programs, Risk Alert, Office of Compliance Inspections and Examinations (Nov. 19, 2020). An OCIE Risk Alert has "no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person." This *OnPoint* provides a sampling of OCIE observations from the Risk Alert. All factual statements in this *OnPoint* are based on the Risk Alert.

2) The Role of the CCO – Empowered, Senior and With Authority, Remarks of Peter Driscoll, Director of OCIE, National Investment Adviser/Investment Company Compliance Outreach Program (Nov. 19, 2020).

3) Regulation S-P generally requires advisers and broker-dealers to provide notice of their privacy policies and practices to their customers. *See* 17 CFR Part 248, Subpart A. Regulation S-ID generally requires certain advisers to establish an identity theft "red flags" program to detect and prevent identity theft. *See* 17 CFR Part 248, Subpart C.

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In Case You Missed It

OCIE Publishes Risk Alert on COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers

Dechert LLP

July 13, 2020

ONPOINT / A legal update from Dechert's Financial Services Group

OCIE Publishes Risk Alert Regarding Recent Focus Areas in Private Fund Adviser Examinations

The staff of the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (staff) issued a National Exam Program Risk Alert on June 23, 2020 (Risk Alert).[1] The Risk Alert focuses on advisers that manage private equity funds or hedge funds (private funds), and highlights deficiencies observed by the staff that "may have caused investors in private funds ... to pay more in fees and expenses than they should have or resulted in investors not being informed of relevant conflicts of interest concerning the ... adviser and the fund."[2] Despite the SEC's focus under Chairman Clayton on retail investors, the Risk Alert exemplifies OCIE's continued efforts to regulate advisers to private funds, and is intended to assist private fund advisers in improving their compliance programs, as well as investors in their diligence of such advisers.

The Risk Alert identifies three "general areas of deficiencies": conflicts of interest; fees and expenses; and policies and procedures related to material nonpublic information (MNPI). For private fund advisers, these general areas of focus may sound more like a greatest hits album than a new tune. In the wake of the Dodd-Frank Act provisions requiring many advisers to private funds to register with the SEC, OCIE commenced an initial Presence Exam Initiative in October 2012 to assess the private fund industry. The Presence Exam Initiative focused on fees, allocation of expenses, marketing and valuation, and related disclosure. Since that time, high-profile speeches by senior SEC staff have re-emphasized many of those same areas, in particular conflicts of interest, fees, expenses, valuation and co-investment allocation.[3] More recently, in OCIE's 2020 examination priorities, the staff stated that examinations will "assess compliance risks, including controls to prevent the misuse of material, non-public information and conflicts of interest, such as undisclosed or inadequately disclosed fees and expenses, and the use of ... affiliates to provide services to clients."[4] These examination priorities also discuss side-by-side management of mutual funds and private funds.

Background

The staff's observations are tied to certain sections of the Investment Advisers Act of 1940 and rules thereunder. Advisers who are, or are required to be, registered (including advisers to private funds) are subject to the general anti-fraud provisions of Advisers Act Section 206, and Advisers Act Rule 206(4)-8 extends certain anti-fraud provisions to the advisers of pooled investment vehicles. Advisers to private funds also are subject to Advisers Act Section 204A, which requires an adviser to adopt, maintain and enforce policies reasonably designed to prevent the adviser (or its associated persons) from misusing MNPI. Advisers Act Rule 204A-1 (Code of Ethics Rule) requires advisers to adopt and maintain a written code of ethics that (among other elements) establishes a code of conduct and manages the conflicts related to advisory personnel's personal trading. In a footnote to the Risk Alert, the staff notes that the SEC "has brought [e]nforcement actions on a number of the issues discussed in this Risk Alert" and that "OCIE continues to observe some of these practices during examinations."

Risk Alert

The Risk Alert summarizes observations of the staff, including common deficiencies and compliance issues, based on examinations of "hundreds of private fund advisers each year," categorized into three broad groups.

Conflicts of Interest

The staff observed conflicts of interest that "appear to be inadequately disclosed and deficiencies under Section 206 and Rule 206(4)-8," including:

- *Conflicts related to allocations of investments.* The staff observed inadequate disclosure and practices "inconsistent with the allocation process disclosed to investors," which tended to cause certain investors to "pay more for investments" due to allocation in inequitable amounts or at different prices. In this regard, the staff highlighted "preferentially allocated limited investment opportunities to new clients, higher fee paying clients or proprietary accounts or proprietary-controlled clients."

- *Conflicts related to multiple clients investing in the same portfolio company.* The staff observed inadequate disclosure regarding clients investing in the same portfolio company but in different levels of the portfolio company's capital structure (*e.g.*, debt and equity).

- *Conflicts related to financial relationships between investors or clients and the adviser.* The staff observed inadequate disclosure regarding the "economic relationships" that advisers have with certain investors and/or clients, highlighting "seed investors" and investors who "provided a credit facility or other financing" to the adviser or to the adviser's funds or "had economic interests in the adviser."

- *Conflicts related to preferential liquidity rights.* The staff observed situations in which advisers either did not adequately disclose, or did not disclose at all: (i) the existence of side letters that created preferential liquidity terms for one or more investors; and (ii) the possibility of separate accounts or vehicles managed by the adviser investing alongside the adviser's primary fund but with preferential liquidity terms. The staff notes that such arrangements could be harmful to investors without such rights, especially in a financial or market downturn.

- *Conflicts related to private fund adviser interests in recommended investments.* The staff observed inadequate disclosure of the adviser's principals' and employees' ownership or financial interests (*e.g.*, referral fees, stock options) in the investments that were recommended to the adviser's clients.

- *Conflicts related to co-investments.* The staff observed inadequate disclosure, and processes disclosed but not followed, with respect to co-investment opportunities, as well as preferential arrangements that could mislead investors as to such opportunities, and the manner, process and "scale" of the co-investments.

- *Conflicts related to service providers.* The staff observed inadequate disclosure when a portfolio company entered into service agreements with an adviser's affiliates, or with a particular service provider where the adviser had a financial incentive (*e.g.*, an incentive payment from a discount program). The staff also highlighted instances where disclosure stated that an affiliated service provider would be engaged at "terms no less favorable" than a third-party, but the adviser lacked procedures or evidence to confirm such terms were in fact arms-length.

- *Conflicts related to fund restructurings.* The staff observed inadequate disclosure to investors of: (i) the value of their interests when selling at a discount; (ii) their rights and options during a restructuring; and (iii) the financial incentives of advisers in "stapled secondary transactions."

- *Conflicts related to cross-transactions.* The staff observed inadequate disclosure of cross-transactions executed to the detriment of certain clients (*e.g.,* at prices that disadvantaged either the buyer or seller).

The large majority of these apparent deficiencies reflect practices that have been subject to past enforcement actions and/or criticism in staff speeches. Some of these (*e.g.*, investment allocation, cross-transactions, adviser interests in recommended transactions) echo long-standing SEC concerns that predate the SEC's regulation of private fund advisers. However, a number of the deficiencies (*e.g.*, liquidity implications of side-by-side separate accounts, stapled secondary transactions and co-investment) indicate a sharpened focus on industry trends and conflicts particular to private fund management.

Fees and Expenses

The staff observed "issues that appear to be deficiencies under Section 206 and Rule 206(4)-8" including:

- *Allocation of fees and expenses.* Staff observations highlighted circumstances where clients overpaid fees and expenses, including situations where advisers: (i) allocated shared expenses, including those relating to broken deals and co-investments, between the adviser and its clients in a manner that was not in line with fund disclosures or procedures; (ii) charged funds for expenses that were not authorized by the fund's governing documents; (iii) exceeded agreed-upon expense caps; and (iv) charged travel and entertainment expenses inconsistent with their policies.

- *"Operating Partners."* The staff observed inadequate disclosure regarding "the role and compensation of individuals that may provide services to the private fund or portfolio companies, but are not adviser employees".

- *Valuation.* The staff observed that advisers valued assets in a manner inconsistent with their valuation method (in some cases leading to overvalued holdings), or provided inadequate disclosures to clients.

- *Monitoring/board/deal fees (portfolio company fees) and fee offsets.* The staff observed advisers that received fees from a fund's portfolio companies but: (i) "incorrectly allocated portfolio company fees across fund clients"; (ii) inadequately disclosed certain portfolio company fee arrangements (*e.g.*, the acceleration of long-term monitoring fees upon sale of the portfolio company); (iii) did not offset affiliated portfolio company fees against the management fee as required; or (iv) disclosed management fee offsets but (a) improperly calculated them; (b) did not apply them; or (c) lacked policies to keep records of portfolio company fees.

Virtually all of these apparent deficiencies have been the subject of SEC enforcement actions. The staff believes that those enforcement actions have improved industry practices regarding fee and expense transparency, and thus these types of fee and expense disclosures are likely remain the focus of SEC examinations for many years.[5]

MNPI and Code of Ethics

The staff observed "issues that appear to be deficiencies under Section 204A" and the Code of Ethics Rule, including:

- *Section 204A.* The staff observed advisers' policies and procedures related to MNPI that did not address or enforce the risks that result when employees: (i) interact with (a) public-company insiders, (b) outside consultants accessed through "expert network" firms or (c) "value added investors" (executives or financial professionals); (ii) could obtain MNPI through the adviser's or its affiliates' possession of MNPI through their ability to access office space and systems; and (iii) "periodically" view MNPI in connection with certain transactions (*e.g.*, private investment in a public issuer).

- *Code of Ethics Rule.* The staff observed advisers who did not properly: (i) enforce an adviser's "restricted list" to limit personal securities trading or explain how securities are added to or removed from the list; (ii) require access persons to submit personal transaction and holdings reports in a timely manner, or submit transactions for pre-clearance as required by the Code of Ethics Rule and their own code; (iii) identify all access persons; or (iv) enforce the adviser's gifts and entertainment policies with respect to third parties.

The SEC has shown very little tolerance for abuses of MNPI. As illustrated by the Risk Alert observations as well as OCIE enforcement actions, the SEC and its staff have grown increasingly willing to police the details of fund advisers' policies and procedures designed to prevent such abuse.

Implications for Advisers

The Risk Alert serves as an opportunity for advisers to review their internal practices, policies and procedures and to determine whether any issues identified herein require corrective action or enhancement of supervisory, compliance or risk management systems. In that spirit, advisers should carefully review the Risk Alert, and consider whether: (i) the adviser's material conflicts of interest have been identified, and whether they are sufficiently addressed (either through disclosure[6] or mitigating policies and procedures or other controls); (ii) fees and expenses as reflected in various agreements are properly disclosed[7] and the actual calculation of fees and expenses accurately reflects these disclosures; and (iii) MNPI policies and codes of ethics are properly implemented and, critically, understood by supervised persons, and that required reporting is completed and monitored. While the topics are familiar to advisers to private funds, the Risk Alert offers a glimpse of the current list of items related to private funds and their advisers that the staff believes are worthy of sustained attention. Although the SEC has not brought as many private fund enforcement actions in the most recent four years as in the preceding four years, the Risk Alert could be a warning that the SEC may be more willing to take action when OCIE finds these practices in future examinations.

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Footnotes

1) Observations from Examinations of Investment Advisers Managing Private Funds, Risk Alert, Office of Compliance Inspections and Examinations (June 23, 2020). An OCIE examination could result in a no-comment letter, deficiency letter or an adviser being referred to the Division of Enforcement. An OCIE Risk Alert has "no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person."

2) For further information regarding a prior OCIE publication that is applicable to all advisers, please refer to the *Dechert OnPoint*, US SEC Publishes Risk Alert on Top Five Investment Adviser Compliance Issues Found During Inspections.

3) Asset Management Unit (AMU) Co-Chief Julie Riewe, *Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View* (Feb. 26, 2015) (discussing the AMU's 2015 priorities, including "conflicts of interest, valuation, and compliance and controls" and anticipating cases related to "undisclosed fees; all types of undisclosed conflicts"); OCIE then-Acting Director Marc Wyatt, *Private Equity: A Look Back and a Glimpse Ahead* (May 13, 2015) (discussing OCIE's private equity examination priorities, including that "[m]any of the areas that could still be improved are ones that you are very familiar with – fees, expenses, valuation, and co-investment allocation – but some are new" such as "private equity eye[ing] the coveted and untapped retail space, [where] full transparency is essential").

4) 2020 Examination Priorities, Office of Compliance Inspections and Examinations (Jan. 7, 2020). For further information regarding the current OCIE Examination Priorities, please refer to *Dechert OnPoint*, OCIE Releases 2020 Examination Priorities.

5) Marc Wyatt, *supra* note 3.

6) It is important to note that in order for disclosure to be effective, it must be provided before investors commit capital to the applicable fund, and cannot be cured through subsequent disclosure, such as via routine investor reporting or Form ADV. TPG Capital Advisors, LLC, SEC Order, Admin. Proc. File No. 3-18317, SEC Rel. No. IA-4830 (Dec. 21, 2017).

7) *See id*.

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April 14, 2020

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OCIE Publishes Risk Alerts Providing Advance Information Regarding Inspections for Compliance with Regulation Best Interest and Form CRS

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations issued two Risk Alerts (Risk Alerts)[1] on April 7, 2020, identifying the scope and content of OCIE's initial examinations following the June 30, 2020 dates for compliance with Regulation Best Interest[2] (Reg. BI Risk Alert) and Form CRS[3] (CRS Risk Alert).

Reg. BI Risk Alert

Regulation Best Interest requires broker-dealers and their associated persons to act in the best interest of their retail customers at the time of making recommendations regarding any "securities transaction or investment strategy involving securities (including account recommendations)" and to place the interests of the retail customers ahead of the financial or other interests of the broker-dealer and its associated persons. Regulation Best Interest consists of four component obligations: the Disclosure Obligation; the Care Obligation; the Conflict of Interest Obligation; and the Compliance Obligation.

The Reg. BI Risk Alert indicates that: OCIE will examine broker-dealers to assess their compliance with Regulation Best Interest; and the emphasis of such examinations will be on whether broker-dealers have made a "good faith effort to implement policies and procedures reasonably designed to comply with Regulation Best Interest, including the operational effectiveness of broker-dealers' policies and procedures." Although the Reg. BI Risk Alert describes the four "primary focus areas for the initial Regulation Best Interest Exams," it also cautions that "the staff may select additional areas for review based on risks identified during the course of examinations." According to the Reg. BI Risk Alert, "initial examinations ... will likely occur during the first year after the [June 30, 2020,] compliance date."

Disclosure Obligation

Under Regulation Best Interest, broker-dealers must provide each retail customer with full and fair written disclosure of "all material facts relating to the scope and terms of the relationship," including: the capacity in which the broker-dealer or its associated persons are acting; all material fees and costs associated with a customer's transactions, holdings and accounts; the type and scope of services being provided, as well as any material limitations on the securities or investment strategies that may be recommended; and all material facts relating to conflicts of interest associated with the recommendation. The Disclosure Obligation requires that disclosure be provided at or prior to the time of the recommendation.

In reviewing compliance with the Disclosure Obligation, the Reg. BI Risk Alert states that OCIE may review the content of broker-dealers' disclosures and other records to determine whether all required disclosures have been made to retail customers covered by Regulation Best Interest. In addition, OCIE may review broker-dealers' timing in delivering their disclosures. Among the documents that OCIE may request in reviewing compliance with the Disclosure Obligation are:

- Fee schedules;
- Documents outlining compensation methods for registered personnel (*e.g.*, compensation tied to retail customer recommendations, sources and types of compensations, and related conflicts of interest);

- Disclosures related to the monitoring of customer accounts; disclosures of material limitations on accounts or services recommended to retail customers; and

- Lists of proprietary products offered to retail customers.

Care Obligation

Regulation Best Interest "requires a broker-dealer to exercise reasonable diligence care, and skill when making a recommendation to a retail customer." The broker-dealer must have a reasonable basis to believe that its recommendation with respect to a particular security or investment strategy could be in the best interest of "at least some" retail customers, taking into account the "potential risks, rewards, and costs associated with the recommendation." The broker-dealer also must have a reasonable basis to believe that a recommendation is in the best interest of the retail customer at the time the recommendation is made "based on that retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation and [which] does not place the financial or other interest of the [broker-dealer or the associated person of the broker-dealer] ahead of the interest of the retail customer." Further, in the case of a series of transactions, the broker-dealer must have a reasonable basis to believe that the series, viewed as a whole, is in the best interests of the retail customer and is not excessive, even if each transaction would be in the retail customer's best interest when viewed individually.

To assess compliance with the Care Obligation, the Reg. BI Risk Alert states that OCIE may review the information collected by a broker-dealer from its retail customers for purposes of developing retail customer investment profiles, as well as a broker-dealer's:

- Procedures for forming reasonable basis recommendations for retail customers, including the factors that the broker-dealer uses to evaluate the potential risks, rewards and costs of recommendations in view of a retail customer's investment profile;

- Processes for achieving a reasonable basis to believe that it has not placed its interests ahead of those of the retail customers;

- Processes for making recommendations related to "significant investment decisions," including rollovers of retirement accounts and account recommendations; and

- Methodology for determining that it has a reasonable basis to believe that more complex, risky or expensive products are in a retail customers' best interest, and its processes for recommending such products.

Conflict of Interest Obligation

Under Regulation Best Interest, a broker-dealer must have in place and enforce written policies and procedures that are reasonably designed to identify, and, at a minimum disclose, all conflicts of interest associated with recommendations to retail customers. In the case of conflicts of interest that create incentives for associated persons to place their or the broker-dealer's interest ahead of a retail customer when making recommendations, the broker-dealer also must mitigate such conflicts. However, in the case of any sales contests, sales quotas, bonuses or non-cash compensation that are based on the sales of specific securities or types of securities within a limited period of time, such practices must be eliminated.[4]

In reviewing for compliance with the Conflict of Interest Obligation, OCIE may review a broker-dealer's policies and procedures, including those with respect to:

- Conflicts associated with:

    - Incentives for associated persons to place their or the broker-dealer's interests ahead of the retail customer's interest;

    - Material limitations on the securities, or investment strategies involving securities (particularly, limited product menus, proprietary product-only offerings, or products with third-party arrangements), which may be recommended to a retail customer; and

    - The elimination of all sales contests, sales quotas, bonuses and non-cash compensation that are based on the sales of specific securities or types of securities within a limited period of time.

- Demonstrating its "structure for identifying the conflicts that the broker-dealer or its associated person[s] may face," which can include documentation identifying "all conflicts associated with the broker-dealer's recommendations."

- How the broker-dealer uses its policies and procedures to: identify and assess conflicts as its business changes over time; disclose conflicts; and, as appropriate, eliminate or mitigate conflicts (including "what conflicts are mitigated or eliminated").

OCIE's requests may include production of "all policies and procedures in place during the [examination] period," which could extend to points in time prior to the Regulation Best Interest compliance date of June 30, 2020.

Compliance Obligation

In addition to policies and procedures related to the Conflict of Interest Obligation, Regulation Best Interest requires that broker-dealers implement and enforce written policies and procedures reasonably designed to ensure compliance with Regulation Best Interest generally.

In order to assess a broker-dealer's compliance with the Compliance Obligation, the Reg. BI Risk Alert states that OCIE may review a broker-dealer's policies and procedures and evaluate "any controls, remediation of noncompliance, training, and periodic review and testing included as part of those policies and procedures."

Sample Information List

In the Reg. BI Risk Alert, OCIE included a three-page sample list of information that it may request from a broker-dealer when conducting a Regulation Best Interest examination (Sample Request). Although the Sample Request should not be considered to be all-inclusive, and the Reg. BI Risk Alert acknowledges that "[n]ot every document listed ... will be applicable to every firm," the Sample Request is a helpful tool for a broker-dealer to assess whether it has the core documents that OCIE might request in connection with a potential Regulation Best Interest examination. The Sample Request includes requests for information about the four component obligations outlined above, as well as information regarding the broker-dealer's: retail customers; brokerage and non-brokerage accounts; products offered (including proprietary products); retail marketing materials; selling arrangements with third parties; Regulation Best Interest disclosure document; processes for making oral disclosures; and Form CRS. The Sample Request also includes all policies, procedures and other materials related to Regulation Best Interest compliance, training materials on Regulation Best Interest and compliance monitoring reports.

CRS Risk Alert

The Form CRS relationship summary is intended to provide clarity and assist investors in comparing firms, by providing information about: "(i) the types of client and customer relationships and services the firm offers; (ii) the fees, costs, conflicts of interest, and required standard of conduct associated with those relationships and services; (iii) whether the firm and its financial professionals currently have reportable legal or disciplinary history; and (iv) how to obtain additional information about the firm." For investment advisers, the relationship summary is new Part 3 of Form ADV.

The CRS Risk Alert, as with the Reg. BI Risk Alert, states that, after June 30, 2020, OCIE will begin examinations focusing on Form CRS compliance by broker-dealers, SEC-registered investment advisers and investment advisers with registration applications pending before the SEC (collectively, covered firms), with a focus on whether the covered firm has "made a good faith effort to implement Form CRS."

Delivery and Filing

Covered firms must electronically file their initial relationship summaries on Form CRS with the SEC between May 1, 2020, and June 30, 2020. Broker-dealers that are required to deliver Forms CRS to investors will file the form electronically through FINRA's Central Registration Depository, and investment advisers that are required to deliver Part 3 of Form ADV to investors will file electronically through the Investment Adviser Registration Depository (IARD) system.

After June 30, 2020, newly registered broker-dealers will be required to file Form CRS before the effective date of their registration with the SEC, and investment advisers seeking SEC registration (and which expect to have clients to whom a

Part 3 must be delivered) will include their Part 3 with the initial application for registration on Form ADV. In addition, covered firms must deliver their relationship summaries to all existing retail investors on an initial, one-time, basis within 30 days after the date the covered firm is required to file its relationship summary with the SEC. For new retail investors, the Form CRS must be delivered before or at the time an account is opened.

The CRS Risk Alert explains that OCIE's examinations may include an assessment of: (1) whether the covered firm has filed the Form CRS and any amendments, and whether the Form CRS is posted publicly on the covered firm's website (if the firm maintains a public website); (2) the covered firm's mechanism for delivering the Form CRS to new and existing retail investors; and (3) the covered firm's Form CRS policies and procedures, to determine if they address the required delivery processes (including timing for deliveries). OCIE also may review a covered firm's records showing its delivery of *each* Form CRS, in order to determine if the delivery obligations with respect to new and existing investors were met with respect to: the opening of new accounts (or entering into new advisory agreements); placing of orders; recommendations of retirement account rollovers; and recommendations of new brokerage or investment advisory services or investments, even if no new account is opened or the investment is not held in an existing account.

Content

Form CRS provides information related to certain categories of data that the SEC believes to be important for retail investors to consider when choosing a firm or financial professional. Form CRS sets forth general content and presentation requirements for a relationship summary. It also requires specific disclosures within each category of information, to the extent applicable to the firm.

The CRS Risk Alert explains that OCIE may review the content of a covered firm's Form CRS to evaluate whether: all required information has been included; the information is true and accurate; and there are any omissions of material facts.[5] In this regard, OCIE may review the covered firm's descriptions of the services and relationships it offers to retail investors, including: account monitoring and investment authority; the compensation that it and its associated persons receive; and conflicts of interest.[6] OCIE also may review the disclosures related to fees and costs,[7] which may include an examination of the firm's fee schedules and other agreements to confirm that fee disclosures in the Form CRS are consistent.

Formatting

Form CRS includes specific formatting instructions, including page limits. The CRS Risk Alert explains that OCIE may review whether the covered firm followed these instructions, including whether the Form CRS contains "particular wording where required, it uses text features where required, and it is written in plain English."

Updates

Form CRS must be updated and filed within 30 days after the relationship summary becomes materially inaccurate, with such updates being communicated to retail investors within 60 days after the relationship summary becomes materially inaccurate. The CRS Risk Alert explains that OCIE may review a covered firm's policies and procedures related to updating Form CRS and communicating updates to retail investors. OCIE also may evaluate how such firms: notify retail investors of changes to Form CRS; and identify or summarize material changes with any filed updates.

Recordkeeping

Form CRS imposes certain recordkeeping requirements. Registered investment advisers must retain records in accordance with Rule 204-2 under the Investment Advisers Act of 1940, and broker-dealers must maintain Form CRS-related records for at least six years pursuant to Rule 17a-4 under the Securities Exchange Act of 1934. The CRS Risk Alert explains that OCIE may review a covered firm's records relating to its Form CRS delivery obligations, as well as its policies and procedures relating to record making and retention to evaluate whether a covered firm complies with the Form CRS delivery and recordkeeping requirements.

FINRA

Following the SEC's publication of the Risk Alerts, FINRA issued a press release stating that it would take the same approach as OCIE with respect to examinations of broker-dealers and their associated persons for compliance with Regulation Best Interest and Form CRS. In particular, FINRA stated that its "initial approach will focus primarily on assessing whether [broker-dealers] have made a good faith effort to establish and implement policies and procedures

reasonably designed to comply with Reg BI and Form CRS." FINRA noted, however, that it will take action if it sees indications of customer harm or conduct that would have violated Rule 2111 (Suitability Rule) or other FINRA conduct standards.

Conclusion

The SEC (and FINRA) have indicated that these regulators understand that the COVID-19 coronavirus has created challenges for covered firms. Accordingly, both regulators have indicated that their initial examinations will focus primarily on whether covered firms are making, and continuing, good faith and reasonable efforts to comply with Regulation Best Interest and Form CRS. The Risk Alerts provide useful tools to help firms evaluate their preparations, practices and procedures in advance of the June 30, 2020 compliance date for Regulation Best Interest and Form CRS.

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Footnotes

1) All statements in this *OnPoint* as to as to the intent or plans of OCIE are based on the text of the Risk Alerts.

2) Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318 (2019).

3) Form CRS Relationship Summary; Amendments to Form ADV, Release Nos. 84 Fed. Reg. 33492 (2019).

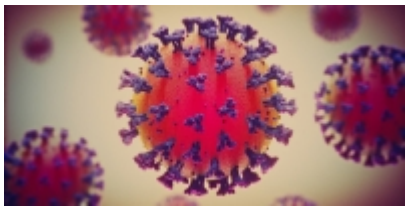
4) FINRA recently proposed to update to its non-cash compensation rules to also eliminate sales contests, sales quotas, bonuses or non-cash compensation, which are based on the sales of specific securities or types of securities within a limited period of time, in order to align with Regulation Best Interest. For further information regarding this proposal, please refer to *Dechert OnPoint*, FINRA Moves Forward with Proposed Amendments to its Suitability and Non-Cash Compensation Rules.

5) This includes assessing whether accurate information regarding the legal and disciplinary history of the covered firm and its registered persons has been provided in the Form CRS.

6) OCIE stated that this would include "incentives related to proprietary products, third-party payments, revenue sharing, and principal trading."

7) OCIE stated that this includes "the principal fees and costs that retail investors will incur, other fees and costs related to services and investments that retail investors will pay directly or indirectly, and examples of the categories of the most common fees and costs applicable to the covered firm's retail investors (*e.g.*, custodian fees, account maintenance fees, fees related to mutual funds and variable annuities, and other transactional fees and product level fees)."

More from Dechert



COVID-19 Coronavirus Business Impact

Helping businesses assess risks and find solutions during the COVID-19 pandemic.

See our guidance »

SEC Takes Targeted Action to Assist BDCs in Light of COVID-19 Coronavirus Pandemic

SEC Grants Requests to Automatically List Rule 6c-11 ETFs

SEC IM Staff Updates Custody Rule FAQs to Address Issues Arising in Connection with Surprise Examinations and Certain Certificated, Privately Offered Securities due to the COVID-19 Coronavirus

Dechert LLP

Dechert LLP

July 24, 2020

ONPOINT / A legal update from Dechert's Financial Services and Finance and Real Estate Groups

SEC Publishes OCIE Risk Alert on LIBOR Transition Preparedness Examination Initiative

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations issued a National Exam Program Risk Alert on June 18, 2020 (Risk Alert),[1] which introduces an examination initiative on the upcoming discontinuation of, and transition from, LIBOR[2] to alternative risk-free reference rates (widely referred to as RFRs) (LIBOR Transition). The Risk Alert states that the examination initiative (LIBOR Exams), which has commenced recently, is intended to allow OCIE to assess the preparedness of SEC-registered investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies (collectively, Registrants) that may be impacted by the LIBOR Transition. The Risk Alert includes a sample list of documents that may be requested in a LIBOR Exam and is intended to assist Registrants with their preparations.

This *Dechert OnPoint* provides general background regarding LIBOR and the LIBOR Transition, describes key points for Registrants impacted by the LIBOR Transition or who are the recipients of a related examination request, and offers next steps that Registrants can consider in their LIBOR Transition preparations. Dechert has tracked developments related to LIBOR and the LIBOR Transition – for further information, please refer to Preparing for the Replacement of LIBOR.

Background on LIBOR

On any given day, LIBOR is calculated across seven tenors for each of five currencies (USD, GBP, CHF, EUR and JPY). LIBOR is intended to be a measure, for each currency and tenor, of the average rate at which leading internationally active banks are willing to borrow wholesale, unsecured funds in the London interbank market.[3] LIBOR and other interbank offered rates (IBORs) are global, long-standing and extensively used benchmarks or reference rates (reference rates) for determining interest rates in contracts related to financial transactions, adjustable-rate financial products and derivatives.[4]

In July 2017, Andrew Bailey, then-Chief Executive of the UK Financial Conduct Authority (FCA), announced that the FCA would no longer persuade or compel LIBOR panel banks to continue to make LIBOR data submissions after 2021.[5] As a result, it is currently expected that around January 1, 2022, LIBOR will cease publication or will no longer be sufficiently robust or reliable to be representative of its underlying market.[6] It follows that LIBOR (and most other IBORs) then will cease to be effective reference rates for financial transactions and other contractual arrangements.

Following Mr. Bailey's 2017 announcement, working groups began to plan in earnest for the eventual unavailability of LIBOR and other IBORs throughout the world. Each of these working groups aimed to identify and recommend alternative RFRs denominated in the relevant local currency. Since reference rates serve a critical commercial function, any alternative to LIBOR will need to be commercially similar in a variety of respects in order to assure consistent adoption by the financial community.[7] It is expected that the majority of LIBOR (and other IBOR) replacements will be derived from RFRs developed by these working groups.

In the United States, the Federal Reserve Board and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC), a working group of private-sector representatives and financial regulators, to recommend an alternative reference rate to USD LIBOR. The ARRC recommended the Secured Overnight Financing Rate (SOFR)[8] as its preferred alternative reference rate. Launched in April 2018, SOFR is based on the cost of overnight loans, using repurchase agreements secured by U.S. government securities (which represents a larger section of transactions than is used to derive the Fed Funds rate). However, at this time, SOFR is not widely used as a reference rate. As LIBOR may become unavailable to be used in contracts in 2022, the timeline for the transition to using SOFR as the reference rate for USD LIBOR will be highly compressed. The ARRC and similar working groups are continuing their work on LIBOR replacement solutions.

Practically, transitioning to a new reference rate is not a flip-of-the-switch event, and the current timeline only emphasizes the need for a transition plan. Given the widespread use of LIBOR as a reference rate in common commercial arrangements, the LIBOR Transition no doubt will have a significant and broad-reaching impact on many Registrants (including their business activities, operations and service provider relationships). Based upon a Registrant's business model, the Registrant will need to implement LIBOR Transition solutions (such as those recommended by the ARRC or other similar working groups) in a manner appropriate to its businesses and operations.

In light of the commercial importance of LIBOR and other IBORs, coverage in the financial press has been widespread, and issues related to LIBOR and its expected discontinuation are high on regulatory agendas worldwide.[9] Financial services regulators – including the staffs of OCIE and various other SEC divisions and offices – have repeatedly emphasized the importance of Registrants' careful and considered preparation for the LIBOR Transition.[10] In addition, the LIBOR Transition is listed as one of OCIE's 2020 examination priority "risk themes" that would be used to "tailor its risk-based program" this year.[11] Consistent with those messages, the Risk Alert further emphasizes the importance of Registrants' preparations, and provides OCIE's views regarding the preparations required for a Registrant to effect an orderly transition away from LIBOR.

Risk Alert

The Risk Alert describes the "scope and content" for a series of risk-based examinations (often referred to as "sweep exams") that will focus on Registrants' preparedness for the LIBOR Transition.[12] The Risk Alert further emphasizes the theme of preparedness and provides some insight into what OCIE staff may view as steps Registrants could take in anticipation of the LIBOR Transition. The Risk Alert states OCIE's view that "[p]reparation for the transition away from LIBOR is essential for minimizing any potential adverse effects associated with LIBOR discontinuation" and that the "risks associated with this discontinuation and transition will be exacerbated if the work necessary to effect an orderly transition to an alternative reference rate is not completed in a timely manner." As such, OCIE staff stresses that the LIBOR Exams are intended to "help promote and facilitate an orderly discontinuation ... and transition."

Examinations

Consistent with the above themes, the Risk Alert states that LIBOR Exams will assess (among other matters) "whether and how the registrant has evaluated the potential impact of the LIBOR transition on the organization's: (i) business activities; (ii) operations; (iii) services; and (iv) customers, clients, and/or investors" (collectively, investors). By way of example, the Risk Alert states that OCIE will seek to review the Registrant's preparation, plans and actions related to the LIBOR Transition, which could include an evaluation of:

- *Exposure to LIBOR and mitigation efforts*. OCIE will seek to understand and evaluate, to the extent relevant, the exposure of the Registrant and its investors to contracts that use LIBOR as a reference rate beyond the expected LIBOR Transition date, "including any fallback language incorporated into these contracts";

- *Operational readiness for LIBOR Transition*. OCIE will review and evaluate enhancements or modifications the Registrant has made to its "systems, controls, processes, and risk or valuation models" in connection with the LIBOR Transition to a new reference rate;

- *Investor communications relating to the LIBOR Transition*. OCIE will examine the Registrant's "disclosures, representations, and/or reporting to investors regarding its efforts to address LIBOR discontinuation and the adoption of alternative reference rates";

- *Potential conflicts of interest*. OCIE will seek to understand and evaluate the Registrant's identification and mitigation of "any potential conflicts of interest" related to the LIBOR Transition; and

- *Efforts to replace LIBOR*. OCIE will examine the Registrant's actions taken to transition to an "appropriate alternative reference rate."

Sample Document Request List

The Risk Alert states that the sample document request list included in the Risk Alert is intended to "empower compliance professionals" to assess and assist with Registrants' preparedness for the LIBOR Transition. While this list is a "resource" for Registrants to consult, it is not "all-inclusive" or "specifically indicative of the validation and testing" OCIE could perform. Thus, an actual document request list received by a Registrant is likely to vary based on the facts and circumstances. The Risk Alert also references the OCIE staff's potential "review [of] certain information onsite."

The types of documents set forth in the document request list can be broadly categorized as pertaining to:

- *Organizational structure and management*. This consists of information identifying aspects of a Registrant that might be impacted by the LIBOR Transition, as well as the personnel responsible for assessing, overseeing and managing LIBOR Transition efforts, including any third parties, and documentary evidence of the same (*e.g.*, meeting minutes).

- *Assessment and management of LIBOR exposure*. This is documentation identifying: (i) potentially affected contracts or obligations of the Registrant or its investors, performance composites or advertisements, LIBOR-based models (*e.g.*, risk, valuation), and investors (*e.g.*, fee structures, performance reporting); (ii) the related underlying documents; and (iii) information regarding dependence on third-party service providers and the potential impact on their services. This also includes strategic plans or timelines for remediation, and any risk matrices "that reference" the LIBOR Transition.

- *Disclosures to stakeholders.* This includes information provided to governing bodies and filed with the SEC.[13]

- *Guidance provided by the Registrant to its employees or supervised persons regarding recommendations or advice to investors, issuers or clients*. This includes: recommendations to investors regarding "LIBOR-linked instruments or contracts that extend past the current expected discontinuation date, reviews of portfolios containing such instruments, or the underwriting of new instruments referencing LIBOR"; advice to issuers as to "new LIBOR-linked instruments"; and advice to clients regarding outstanding contracts or obligations that replace LIBOR with an appropriate reference rate.

- *Modifications to operations or compliance programs made or anticipated*. This includes planned or implemented changes to various systems (*e.g.*, "accounting, investor reporting, risk, valuation or trading") and "compliance procedures, controls, or surveillance systems."

Resources to Aid Registrants with the LIBOR Transition

The Risk Alert encourages continued engagement by: suggesting that Registrants' personnel keep up-to-date on developments related to the LIBOR Transition via the AARC website; and inviting "the public to share information about the potential impact" of the LIBOR Transition via LIBOR@sec.gov.

Implications for U.S. and Non-U.S. Registrants

While the Risk Alert is the statement of one office of one regulator regarding how to prepare for the LIBOR Transition, its message should resonate across all market participants and jurisdictions. The message is consistent with statements from other regulators internationally: the issue of LIBOR Transition is not going away, and it is now time for Registrants and other market participants to focus on preparations for the LIBOR Transition. The Risk Alert is a signal that Registrants and other market participants are expected to be preparing for the transition from LIBOR and other IBORs. As indicated by the document request list, Registrants can begin by evaluating the potential impact of the LIBOR Transition on their businesses and operations, with a view toward implementing solutions that are appropriate in light of their exposure to LIBOR or other IBORs.

Regardless of a Registrant's state of preparation, the Risk Alert can prove valuable in helping Registrants better understand OCIE's view as to the type of preparations that could best effectuate an orderly transition. Registrants at the beginning stages of preparedness can use the Risk Alert to assess the scale and scope of the Registrant's current exposure to LIBOR, as well as a road map for managing an orderly LIBOR Transition. Registrants that are further down the road might view the Risk Alert as a checklist to assess their own progress. The Risk Alert (in particular, the sample

document request list) also could be instructive to Registrants and other market participants in determining key documents that might be useful in identifying and managing any emerging risks across their businesses, and engaging and sharing information with various stakeholders about those risks and the Registrant's efforts to manage and/or mitigate them.

Dechert's Financial Services and Finance and Real Estate practice groups have significant experience and are available to assist firms on a collaborative basis to address concerns related to the LIBOR Transition, including guiding a Registrant through any SEC examinations.

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Footnotes

1) Examination Initiative: LIBOR Transition Preparedness, National Exam Program Risk Alert, U.S. SEC Office of Compliance Inspections and Examinations (June 18, 2020). The Risk Alert indicates that it "has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person."

2) LIBOR also is referred to as ICE LIBOR and formerly as the London Interbank Offered Rate.

3) The methodologies used to determine LIBOR for a particular currency and tenor are based on submissions made by panel banks to the LIBOR benchmark administrator, ICE Benchmark Administration Limited (IBA), each London business day. The methodologies and panel banks per currency and tenor used are listed on IBA's webpage. As a UK-based benchmark administrator, IBA is regulated by the UK's Financial Conduct Authority.

4) Libor: Entering the Endgame, Andrew Bailey, Governor of the Bank of England (July, 13, 2020) (including an indication that LIBOR rates directly impact the cash flows and values of an estimated $400 trillion of financial products globally).

5) The Future of LIBOR, Andrew Bailey, then-Chief Executive of the FCA (July, 27 2017).

6) Panel banks have agreed to continue submitting the relevant data through 2021. However, absent an active market for unsecured term lending to banks, the FCA has determined not to compel banks to provide this information after 2021. The limitations of LIBOR as a reference rate have been widely reported, and the July 2020 speech by Andrew Bailey (footnote 4 *supra*) includes a discussion of this topic.

More generally, and historically, regulatory investigations in Europe and the United States following the 2007-2008 financial crisis revealed that for some years, both preceding and during the financial crisis, the volume of transactions in the interbank markets of the relevant currencies had decreased significantly. It was determined that the panel banks that contribute to the production of LIBOR were relying on their expert judgment, rather than observable market rates, for some of their submissions, and in many cases were manipulating their submissions to the benchmark administrator and, thus, manipulating LIBOR for certain tenors and currencies.

7) RFRs generally measure market rates for secured overnight borrowing. RFRs do not purport to capture the sort of counterparty credit risk or term component that may be represented in unsecured term borrowing rates, like LIBOR or other IBORs; thus, a spread adjustment would be needed for an RFR to serve as a commercially practical replacement reference rate for LIBOR or other IBORs.

8) SOFR and the SOFR Averages are published by the Federal Reserve Bank of New York.

9) For example, regulatory investigations in Europe and the United States following the 2007-2008 global financial crisis revealed that for some years, both preceding and during the financial crisis, the volume of transactions in the interbank markets of the relevant currencies had decreased significantly. It was determined that the panel banks that contribute to the production of LIBOR were relying on their expert judgment, rather than observable market rates, for some of their submissions, and in some cases were seen as manipulating their submissions to the benchmark administrator (and, thus, manipulating LIBOR for certain tenors and currencies).

10) For example, *see* SEC Public Statement, Staff Statement on LIBOR Transition (July 12, 2019); for further information, please refer to *Dechert OnPoint,* SEC Staff Issues Statement on LIBOR Transition; Practical Considerations for Investment Companies, Investment Advisers and Other Financial Institutions in Proactively Addressing LIBOR Cessation and Transition.

11) 2020 Examination Priorities, U.S. Office of Compliance Inspections and Examinations (Jan. 7, 2020) ("The risk-based approach, both in selecting registrants as examination candidates and in scoping risk areas to examine, provides OCIE with greater flexibility to cover emerging and exigent risks to investors and the marketplace as they arise. For example, as our registrants and other market participants transition away from LIBOR as a widely used reference rate in a number of financial instruments to an alternative reference rate, OCIE will be reviewing firms' preparations and disclosures regarding their readiness, particularly in relation to the transition's effects on investors. Some registrants have already begun this effort and OCIE encourages each registrant to evaluate its organization's and clients' exposure to LIBOR, not just in the context of fallback language in contracts, but its use in benchmarks and indices; accounting systems; risk models; and client reporting, among other areas. Insufficient preparation could cause harm to retail investors and significant legal and compliance, economic and operational risks for registrants"). For further information, please refer to *Dechert OnPoint*, OCIE Releases 2020 Examination Priorities.

12) Typically, the federal securities laws subject Registrants (and those required to be registered) to examination by the SEC. The SEC views examinations as a front-line means to protect investors and ensure compliance with the federal securities laws. Sweep examinations are focused on identified risks, and these examinations tend not to be as broad as routine examinations of Registrants.

13) The sample document request list indicates that the relevant period for filings with the SEC is from January 2019 to present.

More from Dechert

Dechert LIBORcast

LIBOR Transition - The Rating Agency Perspective (July 16) »

A Discussion with the FCA (July 28) »

LIBOR Update Series

Lawyers from Dechert's Global Finance and Financial Services practices discuss LIBOR transition updates from the FCA/Bank of England, the Alternative Reference Rates Committee, the Federal Housing Finance Agency, and ISDA.

Watch Update from April 29 »
Watch Update from June 4 »

Dechert LLP

JACKO LAW GROUP, PC

Legal Risk Management Tip

How Risk Alerts Can Help You Prepare for Your Next Examination

Each year the SEC's Office of Compliance Inspections and Examinations ("OCIE") publishes *Risk Alerts* as part of its National Exam Program. The intent of the *Risk Alert* is to remind advisers of their regulatory responsibilities and to advance compliance efforts through education about what OCIE has observed during its examinations in terms or internal control systems, policies and procedures – both good and bad.

Since 2015, OCIE has issued twenty-one (21) *Risk Alerts*,[1] four (4) of which focused on cybersecurity issues,[2] two (2) of which focused on disclosures related to fees and expenses [3]and one (1) of which focused on senior investor issues coming off the heels of the OCIE-FINRA Report on National Senior Investor Initiative. [4] Each of these areas has consistently been in the SEC Examination Priorities Lists since 2015, and 2019 is no exception. [5] In comparing the *Risk Alerts*, to the ongoing SEC examination priorities, and the National Examination Program's routine initial document requests, a trend is apparent – in nearly all cases, each *Risk Alert* highlights issues that are areas of emphasis for the SEC staff. .

In this month's Legal Risk Management Tip, we will discuss how Risk Alerts can help you prepare for your next examination. We will explore recent SEC examination focus areas and include practical tips for mitigating risks, relating to three specific areas: advisory fees, senior client issues and cybersecurity.

1. The Advisory Fee Risk Alert

The April 12, 2018 *Risk Alert* entitled, *Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers* (the "Advisory Fee Risk Alert"), highlights some of the most common, repeated compliance issues related to fees and expenses observed by the SEC staff. Most investment advisers provide information related to their advisory service fees in a firm's advisory contracts, Form ADV Part 2A, marketing disclosures and/or during client meetings. But what has surfaced during recent OCIE examinations is that the disclosure of an adviser's fee is not always consistent or at an enterprise level, is not adhered to or is inconsistently applied. Moreover, OCIE found that the internal controls at advisory firms relating to reviewing billing methodologies were not effective, which resulted in incorrect calculations of advisory fees or assessing fees not reflecting associated discounts. [6]

The Advisory Fee Risk Alert emphasizes six (6) compliance issues for investment advisers to review, which include the following:

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[1] For a list of all *Risk Alerts*, see https://www.sec.gov/ocie.

[2] Cybersecurity *Risk Alerts* include Cybersecurity Examination Sweep Summary (Feb. 3, 2015), OCIE's 2015 Cybersecurity Examination Initiative (Sep. 15, 2015), Cybersecurity: Ransomware Alert (May 17, 2017) and Observations from Cybersecurity Examinations (Aug. 7, 2017) available at *Id*.

[3] *Risk Alerts* include OCIE's 2016 Share Class Initiative (Jul. 13, 2016) and Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 12, 2018) available at *Id*.

[4] *See* Risk Alert: Retire-Targeted Industry Reviews and Examinations Initiative (Jun. 22, 2015) and OCIE-FINRA Report on National Senior Investor Initiative (Apr. 15, 2015), both available at *Id*.

[5] For a full text of the 2019 SEC Examination Priorities, *see* https://www.sec.gov/files/OCIE%202019%20Priorities.pdf.

[6] *See, e.g., In the Matter of Barclays Capital Inc*., Advisers Act Rel. No. 4705 (May 10, 2017) and *In the Matter of Morgan Stanley Smith Barney, LLC*, Advisers Act Rel. No. 4607 (Jan. 13, 2017).

- Fee-Billing Based on Incorrect Account Valuations – Most investment advisers assess advisory fees based on a percentage of the value of the assets in client accounts. The SEC staff found that advisers were valuing assets based on original costs (rather than fair market value) or were using market values at the end of the billing cycle (instead of average daily balance of the account) or including assets that should have been excluded from the fee calculation (*e.g.*, cash or alternatives) as specified in the firm's advisory agreement.

- Billing Fees in Advance or with Improper Frequency – In some instances, the staff found that advisers were not billing in accordance with the time period stated in their advisory agreements and Forms ADV – such as billing monthly instead of quarterly, billing in advance instead of arrears or not pro-rating advisory fees for clients who opened or terminated an advisory account mid-billing cycle.

- Applying Incorrect Fee Rate – This was noted when an adviser applied a higher rate than what was agreed to in an advisory agreement or did not comply with Section 205(a)(1) of the Investment Advisers Act of 1940 ("Advisers Act"), which prohibits compensation to investment adviser based on a share of capital gains (with exception given to qualified clients). [7]

- Omitting Rebates and Applying Discounts Incorrectly – Perhaps one of the most commonly cited deficiencies observed is investment advisers who do not appropriately provide breakpoints to clients as specified in their disclosures to clients, resulting in overcharges, which are not detected or rebated. This occurs, for example, when an investment adviser fails to aggregate client account values for members of the same household (as the term "household" is defined by the firm) or does not apply the firm's tiered breakpoint schedule resulting in lower fee rates as a result of an increased value in the client's assets under management.

- Disclosure Issues Involving Advisory Fees – Generally, this compliance issue arises if the disclosures made within an adviser's contract or Form ADV are inconsistent with the adviser's actual fee practices (such as applying more than the stated maximum fee) or disclosures are omitted related to additional markups and fees to be assessed (*e.g.,* for third-party execution) or additional compensation earned by the adviser (such as for fee sharing arrangements with affiliates).
- Adviser Expense Misallocations – This was observed when an adviser to a private or registered fund, misallocated expenses to the fund, For example, such as an allocation for marketing expenses and regulatory filing fees, rather than to the adviser.

Advisers were put on notice during 2Q2018 to pay particular attention to these areas and to evaluate disclosures as well as policies, procedures and other controls used by the firm for its advisory fee billing practices. Now, in 1Q2019, JLG is observing OCIE's focus on these exact areas during SEC examinations of investment advisers. A sampling of the staff's initial document requests during recent investment adviser examinations include:

- Current standard client advisory contracts or agreements;
- The general ledger detail of the account(s) into which fees are being booked; provide the monthly reconciliation of fees received against feesbilled;

[7] *See* Advisers Act Sections 205(a)(1) and 205-3available at https://www.law.cornell.edu/uscode/text/15/80b-5 and https://www.law.cornell.edu/cfr/text/17/275.205-3.

- A list of revenue sharing and expense sharing agreements indicating the entity the agreement is with and the dollar amount involved for the **most recent fiscal year**;
- Current fee schedule for your advisory programs, if not otherwise stated in advisory contracts or in Form ADV, Part 2A; indicate if the standard fee schedule has changed within the past two years, and if so, please provide details regarding such changes. If fees are tiered, explain the tiered billing process and whether accounts are grouped or household for breakpoint purposes;
- Compliance and operational policies and procedures in effect for the Adviser and its affiliates **for the period of January 1, 2014 through the present.** These should include, but not be limited to, any written procedures (including operational or desktop procedures) for calculating and billing advisory fees. If Adviser does not maintain any of the aforementioned policies, provide a written statement to that effect;
- A description of the current fee billing process, including, but not limited to: identifying the person(s) who calculates advisory fees, sends the invoice to the custodian, and tests advisory fee calculations; identifying any software programs or systems that are used in calculating fees; description of any reconciliation processes that are completed. If this process has changed during the **period of January 1, 2014 through the present,** please describe the changes made;
- For the billing period ending **December 31, 2018,** provide a spreadsheet that includes advisory fee calculations for each advisory client. Include the billing rate, market value used to calculate the advisory fee, and total nominal fee billed. Please also identify which accounts, if any, are grouped together for fee billing purposes, and from which account the fee is paid;
- A copy of any on-going analysis or documentation during the most recent fiscal year of client accounts and fee billing practices to ensure clients are being billed the correct fees;
- Names of any securities in client portfolios for which a market value is not readily available and must be determined by you or a third party, if applicable. If so, please provide a list of those securities; and.
- Names of any security or account types that, as a matter of policy or practice, the Adviser does not charge a fee on.

From this list, it is apparent that the SEC staff is assessing those compliance issues identified in the Advisory Fee Risk Alert. If the adviser reviewed its compliance program practices considering this *Risk Alert*, the adviser will be better prepared to respond to these examination requests. Risk Management Tips for investment advisers to consider include:

- Review disclosures relating to advisory fees and whether there are omissions of material fact;
- Consider policies and procedures or protocols for calculating and reconciling advisory fees for accuracy; and
- Test to see if "householding" rules are consistently applied.

2. Senior Investors and the ReTire Risk Alert

The June 22, 2015 *Risk Alert* entitled, *Retirement-Targeted Industry Reviews and Examinations Initiative* (the "ReTire Risk Alert") highlights what the staff's examinations will focus on with advisers who service retiring retail clients, which includes seniors as the largest sub-set of that group. The ReTire Risk Alert provides insight into what the SEC staff will focus on during its examinations as it relates to retirement products and services, including sales to retirees and oversight processes related thereto.

The ReTire Risk Alert emphasizes four (4) compliance areas for investment advisers and broker- dealers to review, which include the following:

- Reasonable Basis for Recommendations – During examinations, OCIE staff will consider (a) the type of retirement account a client is recommended to hold retirement investments *(e.g.,* either remaining at the plan, through an IRA rollover, taking distributions or a combination of these); (b) the due diligence performed on investment options; (c) the firm's initial investment recommendations; and (d) ongoing account management provided.

- Conflicts of Interest – Generally, compensation arrangements can create conflicts. Therefore, during its exams, OCIE staff will analyze the sales and account selection practices of the adviser or broker-dealer. They will also take into account the fees and expenses assessed, services provided, conflict of interest disclosures made and strength of the compliance program to identify and mitigate such conflicts.

- Supervision and Compliance Controls – The compliance rules governing investment advisers and broker-dealers require registrants to have strong internal controls, including oversight and supervision of personnel. Consequently, OCIE staff will review the supervisory and compliance controls of registrants, with focus on multiple and branch office safeguards as well as outside business activities of associated persons.

- Marketing and Disclosure – The staff will be reviewing marketing and disclosure documents to assess the adequacy of disclosures to confirm that omissions of material fact are not occurring, that representations are true and correct, that credentials and endorsements are valid, and that fee disclosures are accurate.

Since the ReTire Risk Alert, the SEC has focused its attention on how advisers are servicing senior investors and the unique compliance challenges associated with this demographic. In recent examinations, the SEC staff's examination of advisers addresses not only the ReTire risks, but also the internal controls that investment advisers and broker-dealers should implement if they are serving senior investor clients. Recent initial documentation requests have consisted of the following:

- Indicate the approximate percentage of clients who are 62 or older[8] (including grantors to trusts). Provide a brief description as to how the approximate percentage was determined;
- Indicate the approximate percentage of Adviser's regulatory assets under management that are for advisory clients age 62 or older (including grantors to trusts). Provide a brief description as to how the approximate percentage was determined;
- Provide any policies and procedures designed to address issues associated with clients who are Senior Clients and perceived by the Adviser to have possible issues associated with diminished capacity or competence;
- Provide any policies and procedures concerning the handling of client requests for changes to beneficiaries, including all policies and procedures concerning monitoring and supervision relating to changes to beneficiaries;
- Provide any policies and procedures concerning powers of attorney, including all policies and procedures concerning monitoring and supervision relating to changes in power of attorney as

[8] Within several examination document requests, the staff defines "senior client" as any retail client who is age 62 or older, retired or transitioning to retirement, including accounts of deceased clients, and retail clients in joint accounts with at least one individual meeting this definition.

they relate to the adviser and/or third patties with power of attorney authority;
- Provide any policies and procedures concerning trustees, including all policies and procedures concerning monitoring and supervision relating to changes of a trustee as they relate to the adviser and/or third patties;
- Provide any policies and procedures that contemplate or consider establishing a trusted point of contact in the case the client(s) have diminished capacity or competence;
- Provide any policies and procedures designed to address what steps are taken with client account(s) upon death (e.g., establishing communication with beneficiary or trustee, repapering of account information, liquidation of account, or the transferring of assets to appropriate parties);
- Provide any policies and procedures designed to facilitate the transition of a Senior Client from actively employed to a retired status (e.g., communication with a client to setup an updated investment profile);
- Provide any policies and procedures that discuss how often the Adviser communicates with its clients (e.g., adviser speaks with its client on a quarterly basis to update the client's investment guidelines); and
- Provide a list of any training provided by the firm to its employees during the review period that related to Senior Clients and indicate the nature of the training method (e.g., in person, computer-based learning, or email alerts). Please identify the dates, topics, and groups of participating employees for these training events and provide a copy of any written guidance or training materials provided.

Similar to the Advisory Fee Risk Alert, the ReTire Risk Alert foreshadowed many of the examination "hot areas" that the staff is assessing during its examinations. Had a broker-dealer or investment adviser reviewed their compliance program practices in light of the ReTire Risk Alert, it would be better positioned to quickly respond to these types of examination requests. Risk Management Tips to consider include:

- Develop an escalation system for reporting elder abuse matters;
- Have a disclosure form for your senior and retirement investors explaining investment options available to them (e.g., they can stay in a 401(k), do an IRA rollover or take a lump sum distribution); and
- Add language to advisory contracts that addresses safeguards, such as trusted contacts, that the firm has established for retirees and senior clients.

3. The Cybersecurity Risk Alerts

As previously mentioned, there have been four (4) *Risk Alerts* focused on cybersecurity areas, each worthy of its own focus. For purposes of analysis, JLG believes that the latest of the *Risk Alerts* entitled, *Observations from Cybersecurity Examinations* (the "Cyber Risk Alert"), best highlights those areas JLG is seeing in recent document requests of SEC registrants.

During the Cybersecurity 1 Initiative, the SEC staff analyzed whether registrants were inventorying cyber risks and mapping them to cyber controls. For the Cybersecurity 2 Initiative, the SEC staff reviewed registrants' cybersecurity governance structure, access rights, data loss prevention, vendor management, training and incident response. Among other things, there were a number of issues found including:

- Policies and procedures were not reasonably tailored for employees, nor did they articulate necessary procedures to follow to implement the policy;

- Policies were not reflective of the firm's actual practices or were not adhered to or enforced;
- Systems were not maintained, patches were not done, and cyber risk assessments not conducted; and
- Cybersecurity vulnerabilities were not addressed.

Recent initial documentation requests include:

- Indicate whether the Adviser conducts periodic risk assessments to identify cyber security threats, vulnerabilities, and potential business consequences. If such assessments are conducted please also:
  - Identify who (individual(s), business group(s), and title(s)) conducts them, and the month and year in which the most recent assessment completed; and
  - Describe any findings from the most recent risk assessment that were deemed to be potentially moderate or high risk and have not yet been fully remediated.
- Indicate whether the Adviser provides clients with on-line account access. If so, please provide the following information:
  - The name of any third party or parties that manage the service;
  - The functionality for clients on the platform (e.g., balance inquiries address and contact information changes, beneficiary changes transfers among the clients' accounts, withdrawals or other external transfers of funds);
  - How clients are authenticated for on-line account access and transactions;
  - Any software or other practice employed for detecting anomalous transaction requests that may be the result of compromised client account access;
  - A description of any security measures used to protect client PINs stored on the sites; and
  - Any information given to clients about reducing cybersecurity risks in conducting transactions/business with the registrant.
- Describe the adviser's reaction to the following cyber issues.
  - Malware was detected on one or more Adviser devices. Please identify or describe the malware;
  - The availability of a critical Adviser web or network resource was impaired by a software or hardware malfunction. (Down time resulting from routine maintenance and equipment upgrades should not be included in this response.) Please identify the service affected, the nature and length of the impairment, and the cause;
  - The Adviser's network was breached by an unauthorized user. Please describe the nature, duration, and consequences of the breach, how the Adviser learned of it, and how it was remediated;
  - The compromise of a client's or vendor's computer used to remotely access the Adviser's network resulted in fraudulent activity, such as efforts to fraudulently transfer funds from a client account or the submission of fraudulent payment requests purportedly on behalf of a vendor;

The *Cyber Risk Alert* foreshadowed those areas of particular focus on recent SEC exams. To prepare, it important for firms to:

- Review incident response plans for thoroughness;
- Consider vendor management internal controls, such as cybersecurity risk provisions in servicing agreements; and

- Develop customized policies and procedures and training materials related to cyber risks identified for the firm (e.g., concentrate on higher risk areas, such as client portals).

Conclusion

In her 2004 speech, "The New Compliance Rule: An Opportunity for Change," Lori Richards Director of the SEC's Office of Compliance Inspections and Examinations, provided the following guidance.

> "Compliance staff should continually be asking: Are we detecting problematic conduct with this policy? Based on what we've detected, should we alter our policy? Is there a better way to detect problematic conduct? ..... Were the actions we took, once problematic conduct was detected, adequate to deter problematic conduct by this individual or others?"[9]

Being able to answer these questions articulately and competently is essential to today's examination process. Given the complexity of today's regulatory environment, the National Examination Program's *Risk Alerts* provide a valuable tool in alerting advisers about where to focus compliance program efforts. Consider conducting a mock regulatory examination which incorporates the topics outlined in recent *Risk Alerts*. This will allow senior management the opportunity to assess the strength and readiness of the firm's compliance program, and provide the firm an opportunity to improve policies, procedures and internal controls governing the business.

For more information on these and other considerations relating to SEC examinations, please contact us at info@jackolg.com or at (619) 298-2880.

Author: Michelle L. Jacko, Esq., Managing Partner, Jacko Law Group, PC ("JLG"). JLG works extensively with investment advisers, broker-dealers, investment companies, private equity and hedge funds, banks and corporate clients on securities and corporate counsel matters. For more information, please visit https://www.jackolg.com/.

[9] *See* https://www.sec.gov/news/speech/spch063004lar.htm.

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

ESG Investing and Implementation

Anthony Eames, *Director, Responsible Investment Strategy*, Calvert Research and Management
Sean Murphy, *Vice President*, EIG Global Energy Partners
Bob Toner, *Chief Legal Counsel – Investment Management*, William Blair Investment Management, LLC
Gwendolyn A. Williamson, *Partner*, Perkins Coie

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Agenda

- Overview
- Regulations
- Other Standards
- Case Study
- Key Takeaways and Questions

Overview

- Growth
- Movement from values to financial value
- Generational
- Client demand

Regulations

- Europe
- U.S.
- Examinations

Other Standards

- SASB
- TCFD
- PRI
- Others

Case Study on an ESG Strategy

- Defining it
- Describing it
- Implementing it
- Obtaining and managing data
- Reporting on it

Key Takeaways & Questions

INVESTMENT ADVISER ASSOCIATION

2021 INVESTMENT ADVISER COMPLIANCE CONFERENCE

ESG INVESTING & IMPLEMENTATION

GWENDOLYN A. WILLIAMSON, PERKINS COIE LLP

I. Environmental, Social, Governance (ESG) Investing

a. Overview

i. Belief that ESG factors can materially affect a company's performance

ii. Desire to make sustainable, "socially responsible" and other values-driven and/or impact-oriented investments

iii. Investment advisers pursuing ESG strategies might, without limitation:

A. offer ESG-oriented funds,[1] share classes, and/or separately managed accounts

B. use exclusionary (negative) or inclusionary (positive) "screens" across a broad spectrum of ESG criteria

C. vote proxies following ESG guidelines[2]

D. engage in activist investing

E. follow strict mandates or only refer to guidelines

F. be fully integrated on ESG principles in making investments and operating the firm or only apply ESG investing principles on clients' request

G. offer and/or rely on ESG indexes, rating/scoring systems, investment policies, and other tools

H. adopt the United Nations' Principles for Responsible Investing (UNPRI) and/or other ESG policies, codes, and standards

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[1] Offerings include ESG-focused private funds, hedge funds, mutual funds, ETFs, community and "green" bond funds, green money market funds, opportunity zone funds, and SPACs.

[2] Proxy proposals with ESG implications may relate to climate change and environmental stewardship, cybersecurity, diversity, human rights, politics, sexual harassment, and the reputational risks of products such as opioids and guns. *See J*ackie Cook, "How Fund Families Support ESG-Related Shareholder Proposals," (Feb. 13, 2020), https://www.morningstar.com/insights/2020/02/12/proxy-votes.

b. Continued Growth

i. ESG strategies are popular with investors

A. increasingly a focus of retail investors

B. pension funds and other institutional investors continue to be vocal and active ESG investors

- asking about ESG in RFPs and ongoing due diligence

C. recent performance has been strong

- studies have found that companies with strong ESG factors performed better during COVID-19[3]
- ESG strategies generally outperformed in 2020 in terms of flows and returns[4]
- fundamental theory of active ESG strategies that companies with strong ESG factors are likely to outperform
- impact on investment performance and risk remains in debate: critics argue that ESG-focused investing sacrifices returns and/or introduces new risk

ii. Movement from strictly values alignment toward financial materiality and improved risk management

iii. Advisers are seeking to meet investor demand

A. adoption of ESG policies, codes, and standards

- might adopt whether or not clients pursue ESG strategies
- can establish or reinforce a firm's brand with key investors/ target demographic(s)

B. advertising and other public statements about ESG

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[3] Esther Whieldon, Robert Clark, and Michael Copley, "ESG funds outperform S&P 500 amid COVID-19, helped by tech stock boom" (Aug. 13, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-outperform-s-p-500-amid-covid-19-helped-by-tech-stock-boom-59850808.

[4] John Hale, "Sustainable Equity Funds Outperform Traditional Peers" (Jan. 8, 2021), https://www.morningstar.com/articles/1017056/sustainable-equity-funds-outperform-traditional-peers-in-2020. *See also*, Jeffrey Ptak, "Did ESG Pay Off for Investors Last Year? Yes and No" (Jan. 5, 2021), https://www.morningstar.com/articles/1016714/did-esg-pay-off-for-fund-investors-last-year-yes-and-no.

- the problem of "greenwashing" to attract sustainability-focused clients
- need for alignment of ESG messaging and firm operations, investment activities, and proxy voting record

c. Lack of Regulatory and Business Standards in the U.S.

i. public/private company ESG reporting

ii. investment performance measurement

iii. social and environmental impact measurement

iv. ambiguity complicates and even hobbles comparison of public company ESG data and ESG funds managed by different advisers

v. efforts toward standardized public company ESG reporting

1. October 2018 petition to the SEC[5]

- advanced by academics with significant support from private and public institutional investors
- urged the SEC to adopt rules for standardized ESG reporting and disclosure by public companies that is "relevant, reliable, and decision-useful"
- pointed to "the existing rulemaking petitions, investor proposals, and stakeholder engagements on human capital management, climate, tax, human rights, gender pay ratios, and political spending, and highlight[ed] how these efforts suggest, in the aggregate, that it is time for the SEC to bring coherence in this area"

2. Commissioner Allison Herren Lee[6] has noted that "investors are overwhelmingly telling us…that they need consistent, reliable, and comparable disclosures of the risks and opportunities related to sustainability measures, particularly climate risk. Investors have been clear that this information is material to their decision-making process, and a growing body of research confirms that"[7]

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5 https://www.sec.gov/rules/petitions/2018/petn4-730.pdf.

6 Commissioner Herren Lee is the acting Chair of the SEC as of February 18, 2020.

7 SEC Commissioner Allison Herren Lee, Public Statement, "Modernizing" Regulation S-K: Ignoring the Elephant in the Living Room," (Jan. 30, 2020), https://www.sec.gov/news/public-statement/lee-mda-2020-01-30.

3. Sustainability Accounting Standards Board, Global Reporting Initiative, Climate Disclosure Standards Board, Carbon Disclosure Project and International Integrated Reporting Council announced in 2020 plans to collaborate on a framework for corporate disclosure on ESG factors

II. ESG Regulation in the U.S.

a. Federal Securities Laws

i. Investment Advisers Act of 1940 (Advisers Act)

A. Fiduciary Duties - ESG policies and practices:

1. cannot conflict with clients' best interests

2. must be consistent with obligation to seek best execution

B. Anti-fraud provisions,[8] with emphasis on truth in advertising

C. Advertising and marketing rules:[9]

1. must be truthful in advertising

2. recent amendments specifically prohibit:[10]

- making an untrue statement of a material fact, or omitting a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading

- making a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC

See also, Kimberly Chin and Dieter Holger, "Providing Timely ESG Information is Becoming More Crucial for CFOs," *Wall Street Journal* (Feb. 9, 2021).

[8] Section 206(4) of the Advisers Act: it is unlawful for an adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."

[9] The SEC amended Rule 206(4)-1 under the Advisers Act (the advertising rule) in December 2020, replacing the decades old rule with a modernized, principles-based "comprehensive framework for regulating advisers' marketing communications recognizes the increasing use of electronic media and mobile communications and will serve to improve the quality of information available to investors." Press Release, "SEC Adopts Modernized Marketing Rule for Investment Advisers" (Dec. 22, 2020), https://www.sec.gov/news/press-release/2020-334.

[10] SEC Rel. No. IA-5653, "Investment Adviser Marketing" (Dec. 22, 2020), https://www.sec.gov/rules/final/2020/ia-5653.pdf.

- including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser

D. Compliance program - advisers must adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws[11]

E. SEC Office of Compliance Inspections and Examinations (OCIE) Risk Alerts - enforcement actions will be pursued where advisers do not:

1. fully adhere to written policies

2. tailor compliance program to reflect particular business practices and investment strategies

3. have controls in place to prevent inaccurate or misleading statements in Form ADV and other public disclosures, including advertisements and claims of compliance with voluntary performance standards[12]

F. 2020 OCIE priorities included the accuracy and adequacy of disclosures provided by advisers offering clients ESG strategies

G. 2019- 2020 adviser exams sought information on ESG matters:

1. ESG investment strategies and the factors used in selecting ESG portfolio investments

2. policies and practices around ESG ratings/scores

3. ESG factors materially influencing proxy voting decisions

4. achievement of ESG goals

5. the firm's definition of "ESG" and ESG-related disclosure and marketing materials

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[11] Rule 206(4)-7(a) under the Advisers Act.

[12] "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers," OCIE National Exam Program Risk Alert, Volume VI, Issue 3 (Feb. 7, 2017), https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf; "OCIE Observations: Investment Adviser Compliance Programs," OCIE Risk Alert (Nov. 19, 2020), https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf.

6. adherence to the UNPRI and/or other ESG standards

7. the firm's most and least successful ESG investments and general ESG performance record

8. documentation of any ESG awards or similar recognition

9. results of any ESG audit

ii. Investment Company Act of 1940 (1940 Act)

A. fund "Names Rule" should be considered for registered funds with ESG strategies[13]

B. 2020 SEC request for comment on a number of questions:[14]

1. Should the Names Rule apply to terms such as "ESG" or "sustainable" that reflect certain qualitative characteristics of an investment?

2. Are investors relying on these terms as indications of the types of assets in which a fund invests or does not invest (for example, investing only in companies that are carbon neutral, or not investing in oil and gas companies or companies that provide substantial services to oil and gas companies)? Or are investors relying on these terms as indications of a strategy (for example, investing with the objective of bringing value-enhancing governance, asset allocation or other changes to the operations of the underlying companies)? Or are investors relying on these terms as indications that the funds' objectives include non-economic objectives? Or are investor perceptions mixed among these alternatives or otherwise indeterminate? If investor perceptions are mixed or indeterminate, should the Names Rule impose specific requirements on when a particular investment may be characterized as ESG or sustainable and, if so, what should those requirements be?

3. Should there be other limits on a fund's ability to characterize its investments as ESG or sustainable? For

[13] Rule 35d-1 under the 1940 Act requires, in sum, that mutual funds and business development companies with certain types of investments, industries, countries, or geographic regions in their names invest at least 80% of their assets in those investments, industries, countries, or geographic regions, and makes it fraudulent and misleading for a fund to do otherwise.

[14] SEC Rel. No. IC-33809, "Request for Comments on Fund Names," (Mar. 2, 2020), https://www.sec.gov/rules/other/2020/ic-33809.pdf.

example, ESG to three broad factors: must a fund select investments that satisfy all three factors to use the "ESG" term?

4. For funds that currently treat "ESG" as a type of investment subject to the Names Rule, how do such funds determine whether a particular investment satisfies one or more "ESG" factors? Are these determinations reasonably consistent across funds that use similar names? Instead of tying terms such as "ESG" in a fund's name to any particular investments or investment strategies, should we instead require funds using these terms to explain to investors what they mean by the use of these terms?

iii. Securities Exchange Act of 1934 (Exchange Act)

A. Anti-Fraud Provisions

1. illegal to use or employ any manipulative or deceptive device, in connection with the purchase or sale of any security[15]

2. in connection with the purchase or sale of any security, it is illegal to use interstate commerce, the mail or any national securities exchange to employ any device, scheme, or artifice to defraud, or to make materially untrue statements, omit material facts, or otherwise operate as a fraud[16]

B. Public Company Reporting

1. public companies must disclose material ESG topics in offering materials, 10-Ks and other reports[17]

[15] Section 10(b) of the Exchange Act.

[16] Rule 10b-5 under the Exchange Act.

[17] Rule 408 under the Securities Act of 1933 (Securities Act) and Rule 12b-10 under the Exchange Act.

2. January 2020 guidance on Reg. S-K disclosures:[18]

- all financially material metrics must be disclosed
- key performance indicators (KPIs) in the management discussion and analysis (MD&A) of a company's financial condition may (but are not required to) include non-material ESG metrics
- supplemental information must be included as necessary to make the ESG metrics not misleading, including at a minimum: a clear definition of the ESG metric, what it measures, and how it is calculated; an explanation of why the metric provides useful information to shareholders; and an indication of how management uses the metric in managing or monitoring the performance of the business

3. Modernizing S-K Amendments adopted Nov. 2020[19]

- maintained broad-based materiality, principles based, issuer specific disclosure framework
- the two Democratic commissioners rejected the final rule arguing that the SEC missed out an opportunity to require disclosure on climate risk and diversity metrics

iv. Proxy Matters

A. 2019 Guidance on Advisers' Use of Proxy Advisory Firms[20] and Proxy Advisory Firm "Solicitations"[21]

1. Commissioner Robert J. Jackson Jr. opposed the guidance, noting that it could raise costs for proxy advisory firms and

[18] SEC Rel. Nos. 33-10751 and 34-88904, "Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations," (Jan. 30, 2020), https://www.sec.gov/rules/interp/2020/33-10751.pdf.

[19] SEC Rel. Nos. 33-10890, 34-90459, and IC-34100, "Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information" (Nov. 19, 2020), https://www.sec.gov/rules/final/2020/33-10890.pdf.

[20] SEC Rel. No. IA-5325, "Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers" (Aug. 21, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf.

[21] SEC Rel. No 34-86721, "Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice" (Aug. 21, 2019), https://www.sec.gov/rules/interp/2019/34-86721.pdf.

thereby restrict or degrade the quality of proxy voting information available to investors[22]

2. UNPRI agreed, suggesting the guidance would "greatly undermine investors who rely on their advice to integrate…ESG considerations"

B. 2020 Supplemental Guidance on Advisers' Use of Proxy Advisory Firms[23] and New Exchange Act Rules for Proxy Advisory Firms[24]

1. Commissioner Allison Herren Lee argued that the new Exchange Act rules for proxy advisory firm would "harm the governance process and suppress the free and full exercise of shareholder voting rights," and characterized the rules as "unwarranted, unwanted and unworkable"[25]

C. 2020 Shareholder Proposal Rule Amendments[26]

1. raised the bar for investors eligible to submit shareholder proposals with increased holding period and investment amount thresholds

2. critics cite the potential chilling effect on shareholder proposals regarding carbon footprints, human rights, diversity and inclusion, gender and racial pay equality, etc.

c. Department of Labor (DOL) ESG Regulation

i. 2015 guidance in sum allowed ERISA fiduciaries to consider ESG factors where the ESG factors were directly related to economic considerations[27]

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[22] SEC Commissioner Robert J. Jackson Jr., "Statement on Proxy-Advisor Guidance," (Aug. 21, 2019), https://www.sec.gov/news/public-statement/statement-jackson-082119.

[23] SEC Rel. No. IA-5547, "Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers" (July 22, 2020), https://www.sec.gov/rules/policy/2020/ia-5547.pdf.

[24] SEC Rel. No 34-89372, "Exemptions from the Proxy Rules for Proxy Advice" (July 22, 2020), https://www.sec.gov/rules/final/2020/34-89372.pdf.

[25] SEC Commissioner Allison Herren Lee, Public Statement, "Paying More For Less: Higher Costs for Shareholders, Less Accountability for Management" (July 22, 2020), https://www.sec.gov/news/public-statement/lee-open-meeting-2020-07-22.

[26] SEC Rel. No 34-89962, "Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 141-8" (Sept. 23, 2020), https://www.sec.gov/news/press-release/2020-220.

[27] DOL Interpretive Bulletin 2015-01 (Oct. 26, 2015).

ii. 2016 guidance on shareholder engagement activities in sum allowed that engaging in shareholder activism on behalf of a retirement plan would not necessarily be inconsistent with an ERISA fiduciary's duties if there was a reasonable expectation of economic value for the plan being generated by the activism[28]

iii. 2018 guidance on ESG investment considerations asserts that, in sum, ERISA fiduciaries must place financial performance ahead of all other priorities, including when following ESG strategies[29]

iv. 2020 rules stand to hamper access of retirement plan investors to ESG strategies

A. uniformly criticized by the asset management industry, asked DOL to withdraw[30]

B. would prevent ERISA accounts from investing based on "non-pecuniary" factors in ESG strategies if doing so sacrifices returns or increase risks for participants[31]

C. would restrict retirement plan fiduciaries from voting on shareholder resolutions that wouldn't have a direct economic impact on their plan[32]

d. Congressional Review Act[33] (CRA)

i. January 20, 2021, President Biden announced a "regulatory freeze" on the rulemaking of federal agencies late in the Trump administration pending review by Congress[34]

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[28] DOL Interpretive Bulletin 2016-01 (Dec. 29, 2016).

[29] DOL Field Assistance Bulletin 2018-01 (Apr. 23, 2018).

[30] Joseph Lifsics, "The Department of Labor's ESG-less Final ESG Rule," Harvard Law School Forum on Corporate Governance (Nov. 24, 2020), https://corpgov.law.harvard.edu/2020/11/24/the-department-of-labors-esg-less-final-esg-rule/.

[31] DOL, "Financial Factors in Selecting Plan Investments" (Oct. 30, 2020), https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf.

[32] DOL, "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" (Nov. 13, 2020), https://www.govinfo.gov/content/pkg/FR-2020-12-16/pdf/2020-27465.pdf.

[33] 5 U.S.C. § 801 et seq. The CRA gives a new Congress has the authority to negate late-term rulemaking by federal agencies under the prior presidential administration with the majority vote of both the House and the Senate and the President's signature.

[34] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/regulatory-freeze-pending-review/.

ii. a separate executive order directed federal agencies to review and reconsider Trump administration regulations with climate, public health, and scientific implications[35]

- DOL ESG rules[36] included in the priorities identified by the White House

iii. for rules not published in the Federal Register, agencies directed to immediately withdraw them for review and approval

iv. for rules published in the Federal Register that have yet to take effect, agencies directed to reconsider the rules' factual, legal and policy issues and to consider opening a 30-day comment period to address such issues

- ESG-related rules that are not yet effective include amendments to the Advisers Act advertising rules[37]

v. ESG-related rules that the SEC may also reconsider include:

A. Reg. S-K amendments[38]

B. new Exchange Act Rules for proxy advisory firms[39]

C. new Exchange Act Rules 2020 on shareholder proposals[40]

e. Looking Forward

i. former SEC Chair Clayton expressed skepticism about ESG strategies generally and the SEC under his leadership maintained a cautious posture on ESG

ii. Biden administration expected to generally improve regulatory climate for sustainable investing: potential for even greater proliferation of ESG products and strategies

iii. new SEC position: Senior Policy Advisor on Climate change and ESG

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35 https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/executive-order-protecting-public-health-and-environment-and-restoring-science-to-tackle-climate-crisis/.

36 *See* n. 31-32, *supra*.

37 *See* n. 10, *supra*.

38 *See* n. 19, *supra*.

39 *See* n. 24, *supra.*

40 *See* n. 26, *supra.*

(Satyam Khanna)

iv. potentially enhanced ESG reporting, disclosures, and adviser regulation

A. on investment adviser regulation, Commissioner Herren Lee has said:[41]

1. the SEC might consider "rules that would require advisers to maintain and implement policies and procedures governing their approach to ESG investment"

2. policies and procedures related to climate or ESG investing "might include how an adviser will assess and implement a client's ESG preferences, including with respect to asset selection and in the exercise of shareholder voting rights"

B. on environmental risk, Commissioner Herren Lee has said:[42]

1. climate risk is a "a colossal and potentially irreversible risk of staggering complexity," a "green swan" that represents a "new type of systemic risk that involves interacting, nonlinear, fundamentally unpredictable, environmental, social, economic and geopolitical dynamics"

2. "to assess systemic risk, we need complete, accurate, and reliable information about those risks…that starts with public company disclosure and financial firm reporting and extends into our oversight of various fiduciaries and others"

3. "ESG risks and metrics now often underpin traditional investment analyses designed to maximize risk-adjusted returns on investments of all types…they represent a core risk management strategy for portfolio construction"

C. on diversity and inclusion, Commissioner Herren Lee has said:[43]

1. the SEC's recent adoption of amendments to Regulation S-K "took a step forward by adding human capital as a broad

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[41] SEC Commissioner Allison Herren Lee, Speech at PLI Annual Institute on Securities Regulation, "Playing the Long Game: the Intersection of Climate Change Risk and Financial Regulation" (Nov. 5, 2020), https://www.sec.gov/news/speech/lee-playing-long-game-110520.

[42] *Id.*

[43] SEC Commissioner Allison Herren Lee, Speech at the Council of Institutional Investors Fall 2000 Conference, "Diversity Works, Disclosure Matters, and the SEC Can Do More" (Sept. 22, 2020), https://www.sec.gov/news/speech/lee-cii-2020-conference-20200922.

topic for possible disclosure, but declined to require, among other things, disclosure of diversity data—even data that most companies are already required to keep under Equal Employment Opportunity Commission (EEOC) rules"

2. "disclosure can also drive corporate behavior… it's time to consider how to get investors the diversity information they need to allocate their capital wisely"

3. SEC should re-visit amendments to Regulation S-K to require disclosure of workforce diversity data at all levels of seniority and strengthen our 2018 guidance on disclosure of board candidate diversity characteristics

4. SEC should consider tasking the Division of Economic and Risk Analysis with assessing the extent to which SEC rules impact underrepresented communities

5. SEC should consider better integrating its Office of Minority and Women Inclusion into policymaking with respect to assessing diversity at SEC-regulated entities and understanding how SEC rulemaking may affect existing racial, gender, and other disparities, or otherwise affect diversity concerns

6. SEC could collaborate with the Consumer Financial Protection Bureau and the Small Business Administration to combat discrimination and support women and minority-owned small businesses

v. SEC Asset Management Advisory Committee (AMAC)

A. organized in 2019, with ESG and Diversity & Inclusion Sub-Committees

B. September 2020 Diversity & Inclusion Sub-Committee recommendations[44] - discussions centered on the SEC promoting diversity and inclusion in the asset management industry by:

1. providing minority-led firms greater access to investment opportunities

[44] SEC Chairman Jay Clayton, "Opening Remarks at the September 16, 2020 Meeting of the Asset Management Advisory Committee" (Sept. 16, 2020), https://www.sec.gov/news/public-statement/clayton-amac-09162020.

2. mandating diversity and inclusion reporting by asset management industry players

C. December 2020 ESG Sub-Committee preliminary recommendations for issuer disclosure of ESG risks[45] - SEC should:

- require the adoption of standards for corporate issuers to disclose material ESG risks
- utilize standard setters' frameworks
- require that material ESG risks be disclosed consistently with other financial disclosures

D. December 2020 ESG sub-committee preliminary recommendations for ESG investment product disclosure[46] - SEC should:

- suggest best practices to enhance disclosure, including alignment with the taxonomy developed by the ICI ESG Working Group and a clear description of strategy and investment priorities, including non-financial objectives such as environmental impact or adherence to religious requirements
- suggest best practices to describe planned approach to share ownership activities in the SAI, and any notable recent ownership activities outside proxy voting in shareholder reporting

III. ESG Regulation of Asset Managers in the European Union (EU)

a. European Commission (EC) 2018 Action Plan on Financing Sustainable Growth[47] - key points included:

i. taxonomy of environmental disclosures

ii. requirement that advisers consider ESG risks as part of their fiduciary duties

ii. standards for "green" financial products

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45 https://www.sec.gov/files/summary-draft-preliminary-recommendations-of-esg-subcommittee-for-the-amac-12012020.pdf.

46 *Id.*

47 https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en.

iii. sustainability benchmarks and standards

iv. EC Technical Expert Group on Sustainable Finance released a common voluntary sustainability taxonomy and "eco" labels and standards in late 2018[48]

b. EC Directive on Disclosure of Non-Financial Information[49]

i. requires listed companies, banks, insurers, and other large institutions to disclose information regarding environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, diversity on company boards (in terms of age, gender, educational and professional background)

c. EU Benchmark Regulation[50]

i. sustainability disclosures for EU benchmarks

ii. minimum technical requirements for EU climate benchmarks

d. EU Sustainable Finance Disclosure Regulation[51] (SFDR)

i. initial compliance date of March 2021

ii. regulatory technical standards (RTS) still forthcoming

iii. requires asset managers, insurers, and pension funds to disclose sustainability risks[52] in their investments (with 30/50 metrics mandatory)

A. additional disclosure required for ESG funds and other financial products, including pre-contractual disclosures

48 https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en.

49 https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en.

50 https://eur-lex.europa.eu/eli/reg/2019/2089/oj.

51 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN.

52 Sustainability risks include potentially adverse impacts (PAI) related to the natural environment as well those related to society, such as labor issues, human rights, corruption, etc.

B. two categories of products

- "sustainable investments" - those with environmental or social objectives[53]
- products that promote environmental and/or social characteristics but do not meet the requirements of "sustainable investments"[54]

iii. asset managers must integrate ESG factors into their investment decision-making processes

A. part of fiduciary duties to investors

B. must consider potentially adverse impacts (PAI) of investment decisions on ESG matters

iii. applies broadly to asset managers regardless of whether they are ESG-oriented

iv. designed to encourage ESG investing and discourage exaggerations of claims around the "greenness" of company practices

d. EU Taxonomy Regulation

i. initial compliance date of December 2021

ii. anti-greenwashing

iii. taxonomy for asset managers to use in determining whether an economic activity (and thus an investment) can be fairly described as "environmentally sustainable"

iv. ESG financial products marketed in the EU must make disclosures that conform with the EU Sustainable Taxonomy

f. MiFiD II - Suitability Delegated Regulation

i. proposed that beginning in 2021, advisers making suitability recommendations must consider and respect clients' ESG objectives and preferences and to disclose the firm's ESG objectives and preferences

[53] Such products are subject to the strict requirements of Article 2(17) of the SFDR and the pre-contractual disclosure requirements of Article 9 of the SFDR.

[54] Such products do not meet the strict requirements of Article 2(17) of the SFDR but are subject to the pre-contractual disclosure requirements of Article 8 of the SFDR.

IV. Key ESG Frameworks

a. Sustainability Accounting Standards Board[55] (SASB)

i. provides 77 industry-specific sustainability reporting standards intended to allow ESG comparisons of businesses within the same industry

ii. emphasizes "financial materiality" as the appropriate threshold for issuer reporting on ESG topics

b. Global Reporting Initiative[56] (GRI)

i. Dutch nonprofit organization aimed at helping "businesses and governments worldwide understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance and social well-being"

ii. GRI Sustainability Reporting Standards provide a general ESG disclosure framework for all companies, with industry-specific requirements

c. Task Force on Climate-Related Financial Disclosures[57] (TCFD)

i. created by the Financial Stability Board[58] to improve and increase reporting of climate-related financial information

ii. recommendations on climate-related financial disclosures are designed to solicit decision-useful, forward-looking information that can be included in financial filings

iii. recommendations structured around four thematic areas: governance, strategy, risk management, and metrics and targets

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55 https://www.sasb.org/standards/.

56 https://www.globalreporting.org/.

57 https://www.fsb-tcfd.org/.

58 https://www.fsb.org/.

d. United Nations Principles of Responsible Investing[59] (UNPRI)

i. six principles that are intended to set the standard for responsible ESG investing

ii. "greenwashing purge:" certain signatories notified in 2019 that they had been put on a watchlist for failure to demonstrate minimum investment responsibility and had two years to remediate or have their signatory status terminated

iii. in January 2020, in order to maintain their status as UNPRI signatories, asset management firms were required to respond to a questionnaire tied to the four pillars of the TCFD uniform reporting framework[60]

e. Carbon Disclosure Project[61]

i. international nonprofit organization

ii. manages a "global disclosure system for investors, companies, cities, states and regions to manage their environmental impacts"

f. Climate Disclosure Standards Board[62]

i. international consortium of business and environmental NGOs

ii. offers a framework for reporting environmental information in the same manner as financial information

iii. goals include providing investors with decision-useful environmental information

g. International Integrated Reporting Council[63]

i. global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs

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[59] UNPRI has approximately 3,000 signatories from across the globe with approximately $100 trillion in collective assets. https://www.unpri.org/.

[60] https://www.unpri.org/signatories/become-a-signatory.41 https://www.globalreporting.org/information/about-gri/Pages/default.aspx.

[61] https://www.cdp.net/en.

[62] https://www.cdsb.net/.

[63] https://integratedreporting.org/.

ii. promotes communication about value creation, preservation and erosion as the next step in the evolution of corporate reporting

V. Practical ESG Compliance and Risk Management Issues for Investment Advisers

a. Regulatory developments:

- Be alert for quick SEC action on ESG related issues under the leadership of acting Chair, Allison Herren Lee, and Gary Gensler, the yet-to-be-confirmed SEC chair named by President Biden
- EU regulations may apply to US asset manager's activities in Europe

b. Issues can arise in all areas ESG touches within a firm

c. Extent of controls needed depends on extent of the firm's ESG investing and its internal and external commitments to ESG

d. ESG principles can be hard to qualify and quantify, require complex due diligence generally

e. CCO in best position to develop a holistic control framework to test and document the firm's adherence to ESG commitments

f. Employees should be given clear and appropriately detailed guidance on adviser ESG policies, including in managing client accounts

g. ESG policies, codes and standards should:

i. be housed within the compliance program and annual compliance testing and risk assessment process[64]

ii. be appropriately tailored for the firm's ESG business

iii. as appropriate, cover firm investment activities and general operations

h. An independent ESG audit could be appropriate given extent and complexity of ESG commitment

i. Portfolio Management Issues

i. controls should be in place to ensure appropriate adherence to ESG-related:

A. commitments/directives in client management agreements and fund offering documents

[64] Rule 206(4)-7(b): at least annually the CCO must assess the adequacy of the adviser's compliance policies and procedures and the effectiveness of their implementation.

B. investment objectives, strategies, and policies

ii. for private fund portfolio companies, should consider how they do or do not align with ESG principles of the fund and/or its adviser

iii. ESG due diligence inquiries should be tailored by industry and other unique business characteristics

iv. methodologies should be developed to analyze and act on ESG-related investment risks

v. consistent with fiduciary duties, investment professionals with ESG expertise should be engaged on ESG strategies unless otherwise disclosed

vi. investment decisions should be tested over time to measure contributions to/exceptions from ESG policies and/or strategies

vii. care should be taken to fully document internal ESG scoring and ESG performance measurement methodologies in a manner that can be tested

j. Public Statements and Advertising

i. Controls should be in place to ensure the accuracy of ESG-related:

A. claims and commitments by the firm in all media

B. representations regarding ESG achievements (certificates and awards)

C. performance and financial reporting

D. verbal and written employee public statements (including on social media)

E. disclosures in Form ADV and other SEC filings

F. RFP responses (should not oversell ESG story)

ii. Appropriate documentation should be maintained:

A. to support ESG-related public statements and advertising

B. for ESG certifications and achievements, to evidence how:

1. environmental or other advertised certificates/awards were obtained

2. the firm continues to meet the certification/award standards

k. Third Party ESG Scores/Rankings

   i. third parties may assign advisers or funds ESG scores or rankings even if the firm does not consider itself an ESG shop

   ii. advisers should independently verify any third party ESG score or ranking before using it in any advertising or other communications

l. Proxy Voting

   i. advisers have long included ESG factors in their proxy voting guidelines

   ii. proxy voting must be consistent with client ESG investment strategies and firm ESG representations

m. Other areas of adviser operations can have ESG implications

   i. for example, executive compensation and human resource issues

   ii. enterprise risk management - as appropriate, advisers should:

      A. adopt procedures to identify, mitigate, and remediate ESG-related reputational and other risks

      B. adopt whistleblower procedures for ESG-related topics

      C. establish an ESG committee or other governing body responsible for overseeing the ESG policies and/or developing ESG initiatives

      D. develop an accountability framework for implementing stated ESG goals

Public Statement

Statement on the Review of Climate-Related Disclosure

Acting Chair Allison Herren Lee

Feb. 24, 2021

Today, I am directing the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings. The Commission in 2010 provided guidance to public companies regarding existing disclosure requirements as they apply to climate change matters. As part of its enhanced focus in this area, the staff will review the extent to which public companies address the topics identified in the 2010 guidance, assess compliance with disclosure obligations under the federal securities laws, engage with public companies on these issues, and absorb critical lessons on how the market is currently managing climate-related risks. The staff will use insights from this work to begin updating the 2010 guidance to take into account developments in the last decade.

The staff of the SEC plays a critically important role in ensuring compliance with disclosure obligations, including those that implicate climate risk, through its review of public company filings and its engagement with issuers. The perspective the staff brings to bear is invaluable in helping to ensure that issuers comply with their obligations and that investors receive the information they need to properly inform their investment decisions.

Now more than ever, investors are considering climate-related issues when making their investment decisions. It is our responsibility to ensure that they have access to material information when planning for their financial future. Ensuring compliance with the rules on the books and updating existing guidance are immediate steps the agency can take on the path to developing a more comprehensive framework that produces consistent, comparable, and reliable climate-related disclosures.

Investor.gov
U.S. SECURITIES AND EXCHANGE COMMISSION

Environmental, Social and Governance (ESG) Funds – Investor Bulletin

Feb. 26, 2021

Funds such as mutual funds and ETFs that focus on environmental, social, and governance principles (ESG Funds) have gained popularity with investors over time. Investors may hear about these funds from financial professionals, from investment-focused online sites, or even from popular media. The SEC's Office of Investor Education and Advocacy is issuing this bulletin to educate investors about ESG Funds, including important questions to ask if considering whether investing in them is right for you.

What is an ESG Fund?

Funds, like ETFs and mutual funds, may consider a wide range of factors that are consistent with their objectives and strategies when selecting investments. This can include ESG, which stands for environmental, social, and governance.

ESG investing has grown in popularity in recent years, and may be referred to in many different ways, such as sustainable investing, socially responsible investing, and impact investing. ESG practices can include, but are not limited to, strategies that select companies based on their stated commitment to one or more ESG factors —for example, companies with policies aimed at minimizing their negative impact on the environment or companies that focus on governance principles and transparency. ESG practices may also entail screening out companies in certain sectors or that, in the view of the fund manager, have shown poor performance with regard to management of ESG risks and opportunities. Furthermore, some fund managers may focus on companies that they view as having room for improvement on ESG matters, with a view to helping those companies improve through actively engaging with the companies.

Funds that elect to focus on companies' ESG practices may have broad discretion in how they apply ESG factors to their investment or governance processes. For example, some funds integrate ESG criteria alongside other factors, such as macroeconomic trends or company-specific factors like a price-to-earnings ratio, to seek to enhance performance and manage investment risks. Other funds focus on ESG practices because they believe investments with desired ESG profiles or attributes may achieve higher investment returns and/or encourage ESG-related outcomes. For example, some ESG funds select companies that have shown their commitment to a particular ESG factor, such as

companies with policies aimed at minimizing their negative impact on the environment. Some funds may implement shareholder voting rights in particular ways to achieve ESG goals, while others may only focus on selecting investments based on ESG criteria.

Fund managers focusing on ESG generally examine criteria within the environmental, social, and/or governance categories to analyze and select securities.

- The *environmental* component might focus on a company's impact on the environment—for example, its energy use or pollution output. It also might focus on the risks and opportunities associated with the impacts of climate change on the company, its business and its industry.
- The *social* component might focus on the company's relationship with people and society—for example, issues that impact diversity and inclusion, human rights, specific faith-based issues, the health and safety of employees, customers, and consumers locally and/or globally, or whether the company invests in its community, as well as how such issues are addressed by other companies in a supply chain.
- The *governance* component might focus on issues such as how the company is run —for example, transparency and reporting, ethics, compliance, shareholder rights, and the composition and role of the board of directors.

An ESG fund portfolio might include securities selected in each of the three categories—or in just one or two of the categories. A fund's portfolio might also include securities that don't fit any of the ESG categories, particularly if it is a fund that considers traditional fundamental analysis or other investment methodologies consistent with the fund's investment objectives.

ESG investing is not limited to ETFs and mutual funds. Other types of investment products, like exchange-traded products that are not registered under the Investment Company Act of 1940, might also consider ESG factors in selecting an investment portfolio.

Be sure you understand what you are investing in.

If you are considering investing in an ESG Fund, you should know that all ESG Funds are not the same. It is always important to understand what you are investing in, and to be sure a fund, or any other investment, will help you achieve your investment goals. In addition, you will likely want to consider whether a fund's stated approach to ESG matches your investment goals, objectives, risk tolerance, and preferences.

Here are some things to consider:

- Some factors are not defined in federal securities laws, may be subjective, and may be defined in different ways by different funds or sponsors. There is no SEC

"rating" or "score" of E, S, and G that can be applied across a broad range of companies, and while many different private ratings based on different ESG factors exist, they often differ significantly from each other.

- Some funds may focus on ESG investing, while others consider ESG factors alongside other more traditional factors.
- Different funds may weight environmental, social, and governance factors differently. For example, some ESG Funds may invest in companies that have strong governance policies, but may not have the environmental or social impact you may want to encourage through your investment in the fund.
- Different funds may focus on different specific criteria within a factor. For example, one fund may focus on shareholder rights for "governance," while another focuses on board of directors' diversity.
- Some ESG fund managers may consider data from third party providers. This data could include "scoring" and "rating" data compiled to help managers compare companies. Some of the data used to compile third party ESG scores and ratings may be subjective. Other data may be objective in principle, but are not verified or reliable. Third party scores also may consider or weight ESG criteria differently, meaning that companies can receive widely different scores from different third party providers.
- You can find more information about how a fund incorporates ESG and how it weighs ESG factors in the fund's disclosure documents. The fund's prospectus contains important information about its investment objective and strategies, and its shareholder report contains both a list of its top holdings and a graphical representation of its holdings by category. These documents, and in some cases supplemental information, are available on funds' websites.
- Some funds that don't have "ESG" in the name may still incorporate elements of ESG investing into their portfolios. Consider comparing an ESG Fund's portfolio to other fund portfolios to be sure you are investing in a fund that is consistent with your investment goals.
- Funds' websites may also have policy statements that more fully explain their ESG practices, and other information such as customized statistics about the relevant ESG attributes or approaches used by the fund.

Understand What an ESG Investment Strategy Could Mean for You

As with any investment, you could lose money investing in an ESG Fund.

- A portfolio manager's ESG practices may significantly influence performance. Because securities may be included or excluded based on ESG factors rather than

traditional fundamental analysis or () other investment methodologies, the fund's performance may differ (either higher or lower) from the overall market or comparable funds that do not employ similar ESG practices.

What this may mean for you: ESG funds may perform differently than other funds without the ESG parameters.

- Certain industries may be excluded from some ESG Fund portfolios. However, some ESG Funds may still invest in "best in class" companies within commonly excluded industries. For example, an ESG Fund could invest in a certain company within an industry where companies commonly have a large carbon footprint because that company demonstrated a commitment to improving its policies and practices on environmental issues. Moreover, companies which may score poorly on one ESG factor (such as carbon footprint) could be selected because they score well on another ESG factor (strong governance) or because the fund manager has plans to engage with the companies to improve their performance on ESG issues.

  What this may mean for you: One of the most important ways to reduce the overall risk of investing is to diversify your investments. You should read the fund's disclosure documents closely to be sure you understand what the fund is—and is not—invested in, and how its ESG orientation may affect its risk.

- Some funds that consider ESG may have different expense ratios than other funds that do not consider ESG factors.

  What this may mean for you: You should always evaluate a fund's expenses. Paying more in expenses will reduce the value of your investment over time.

Be sure to consider all of your goals when weighing any potential benefits and risks to making a particular investment.

Before you invest in an ESG fund

✓ Carefully read all of the fund's available information (https://www.investor.gov/introduction-investing/investing-basics/glossary/information-available-investment-company) , including its prospectus and most recent shareholder report. You can get this information by looking at the fund's filings on the SEC's EDGAR database (https://www.investor.gov/additional-resources/general-resources/glossary/edgar) , from your investment professional, or directly from the fund.

✓ Understand the fees and expenses you will pay for the fund, and compare them to other investment options.

✓ Be sure that the fund's investment strategy is consistent with your goals.

✓ Ask Questions:

- Is ESG a core component of the investment selection process, or is it one of many factors that are considered to select investments?
- To what extent does the fund focus on ESG factors versus more traditional factors?
- How does the fund weight each of the three ESG factors within its ESG portfolio holdings?
- What specific criteria within a factor does the fund use when determining its portfolio holdings?
- How do the fund's fees and expenses compare to other investment options?
- What types of investments do you expect or desire the fund to be invested in, and what types of investments do you expect or desire the fund NOT to be invested in? Compare those expectations with published fund holdings to better understand whether the fund's investment strategy is consistent with your preferences.
- How does the fund explain and discuss its ESG practices, and how do those practices affect the performance and risk of the fund?
- Is the fund employing an ESG practice that is of importance to you, such as voting proxies in a certain manner or engaging with issuers to influence their ESG practices?

Additional Resources

Mutual Funds and ETFs - A Guide for Investors (https://www.investor.gov/additional-resources/general-resources/publications-research/publications/mutual-funds-etfs-%E2%80%93-guide)

Five Questions to Ask Before You Invest (https://www.investor.gov/introduction-investing/getting-started/five-questions-ask-you-invest)

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IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

Adapting Technology to Improve Compliance Efficiency and Results

Alexander C. Gavis, Fidelity Investments

Jennifer B. McHugh, SEC Division of Investment Management Disclosure Review and Accounting Office, and Division of Investment Management Delegate to FinHub

Keith Marks, Compliance Solutions Strategies

Michael S. Didiuk, Perkins Coie LLP **MODERATOR**

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Speakers

Alexander C. Gavis

Jennifer B. McHugh

Keith Marks

Michael S. Didiuk

Adapting Technology to Compliance in Remote Working Environments

Adapting Technology to Compliance in Remote Working Environments

- **Remote working means expanded use of technology:**
  - Meetings conducted using virtual platforms like Zoom, WebEx and Teams
  - Secure document exchange (*e.g.*, DocuSign)
  - Cloud-based storage and shared drives
- **But it also presents compliance risks:**
  - Home office settings are less secure and create heightened risks for employees *(e.g.*, MNPI and cyber threats)
  - Firms must consider whether newly-implemented intra-firm messaging platforms (*e.g.*, Slack, Teams, WebEx) are adequate or sufficient to comply with books and records rules. Also, must consider "offline" communications such as person-to-person text messaging
  - A good opportunity for firms to review access rights and logs:
    - Applies to personnel access to data stored on remote servers, as well as physical documents stored on-site.
    - Are both onsite and offsite storage secure?

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021 — EFFECTIVE STRATEGIES & BEST PRACTICES

Adapting Technology to Compliance in Remote Working Environments

- **SEC Division of Examinations August 2020 Risk Alert highlighted risks relevant to RIAs and broker-dealers:**
  - ***Protection of Investor Assets.*** Firms must be wary of how they have modified normal operating practices, especially regarding the safeguarding of investor assets.
  - ***Supervision of Personnel.*** A firm's supervisory and compliance program should include policies and procedures that are tailored to its specific business activities and operations and should be amended as necessary to reflect the firm's current business activities and operations.
  - ***Protection of Sensitive Information.*** Remote access to networks and the increase usage of personal devices increases the risk of exposure to personally identifiable information.

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Adapting Technology to Compliance in Remote Working Environments

Even in this challenging environment, the <u>burden is on firms</u> to adapt:

"As firms continue to develop new ways to cope with the situation, new challenges may arise from the solutions. The burden on firms to adapt to processes such as remote due diligence on service providers and sub-advisers will require considerable attention by advisory firms. New technology adopted to address business or compliance needs during the pandemic may bring with it risks that will need to be evaluated by skilled and knowledgeable compliance departments."

\- Peter Driscoll, Director,
Division of Examinations (November 2020)


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SEC's New Strategic Hub for Innovation and Financial Technology ("FinHUB")
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& BEST PRACTICES
Strategic Hub for Innovation and Financial Technology
• Established in October 2018 within Division of Corporation Finance to facilitate the SEC's fintech-related issues and initiatives by:
• Providing a portal for industry and the public to engage directly with the SEC staff on innovative ideas and technological developments
• Publicizing information regarding the SEC's activities and initiatives involving FinTech
• Engaging with the public through publications and events, such as its FinTech forum in 2019 that focused on distributed ledger technology and digital assets
• Acting as a platform and clearinghouse for SEC staff to acquire and disseminate information and FinTech-related knowledge within the agency; and
• Serving as a liaison to other domestic and international regulators regarding emerging technologies in financial, regulatory and supervisory systems
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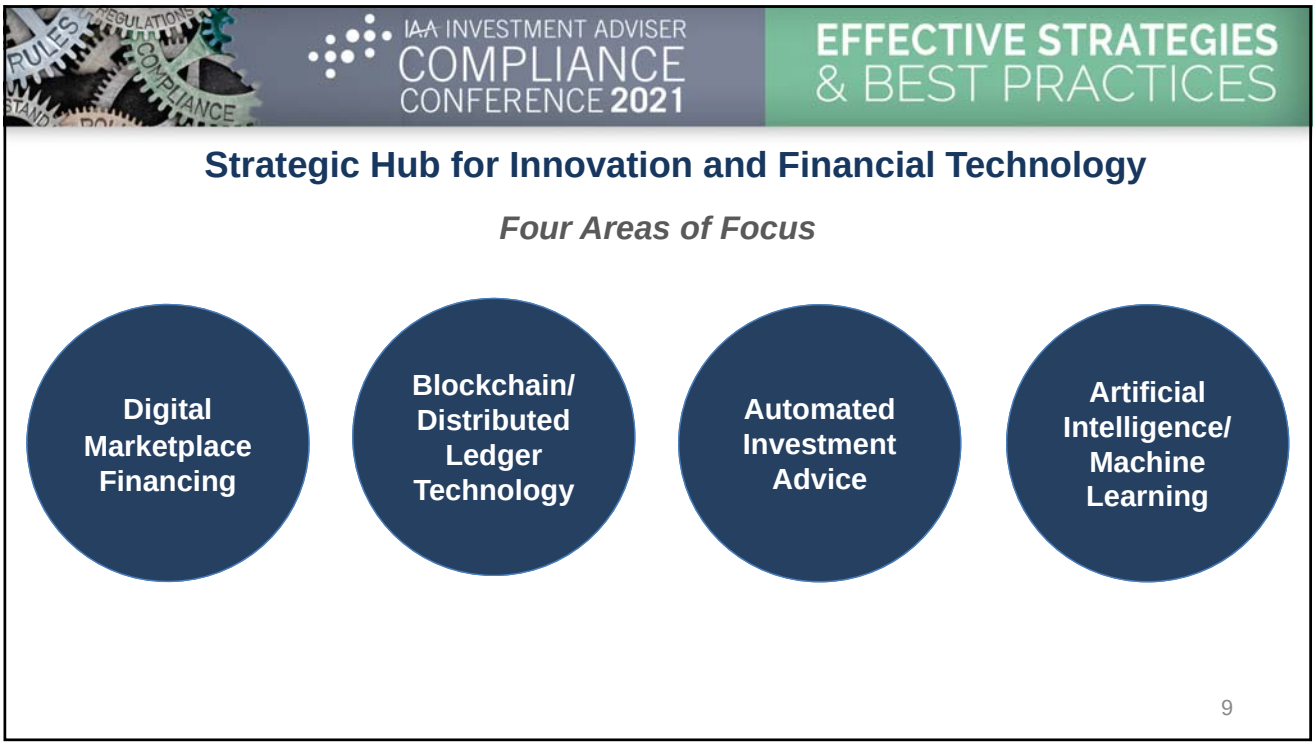
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Strategic Hub for Innovation and Financial Technology
Four Areas of Focus
Digital Marketplace Financing
Blockchain/ Distributed Ledger Technology
Automated Investment Advice
Artificial Intelligence/ Machine Learning
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Strategic Hub for Innovation and Financial Technology
• In December 2020, the FinHub become a stand-alone office.
• Valerie Szczepanik will continue to be the office's director.
"This organizational shift will facilitate the agency's agility and flexibility to work with market participants and regulators worldwide, and to encourage leading-edge innovation that will shape the intersection between the federal securities laws and technology."
- Valerie Szczepanik, Director, FinHub
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Using CompliTech and
RegTech for Compliance
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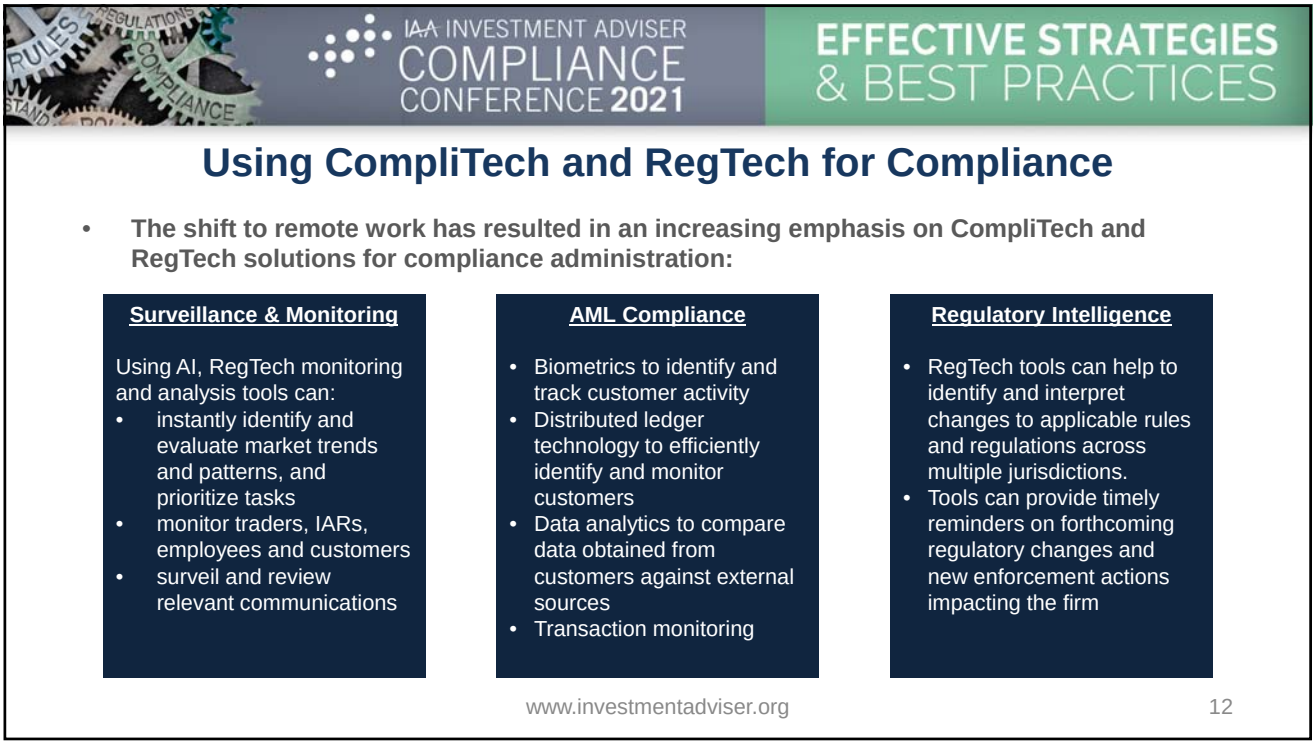
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& BEST PRACTICES
Using CompliTech and RegTech for Compliance
The shift to remote work has resulted in an increasing emphasis on CompliTech and RegTech solutions for compliance administration:
Surveillance & Monitoring
Using AI, RegTech monitoring and analysis tools can:
instantly identify and evaluate market trends and patterns, and prioritize tasks
monitor traders, IARs, employees and customers
surveil and review relevant communications
AML Compliance
Biometrics to identify and track customer activity
Distributed ledger technology to efficiently identify and monitor customers
Data analytics to compare data obtained from customers against external sources
Transaction monitoring
Regulatory Intelligence
RegTech tools can help to identify and interpret changes to applicable rules and regulations across multiple jurisdictions.
Tools can provide timely reminders on forthcoming regulatory changes and new enforcement actions impacting the firm
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Using CompliTech and RegTech for Compliance

- **The shift to remote work has resulted in an increasing emphasis on CompliTech and RegTech solutions for compliance administration (*continued*):**

Reporting & Risk Management

- Solutions include tools that facilitate or automate processes involved in: risk data aggregation, risk metrics and creation and; regulatory reporting
- ***Example*:** RegTech tools can gather and analyze data on capital and liquidity for internal models or regulatory reporting

Investor Risk Management

- Data aggregation and machine learning can help to determine an investor's risk appetite and tolerance more precisely. How?
  - Using tools designed to provide insights into the investor's reactions to changes in market conditions.
  - Monitor investor portfolios in changing market conditions to align it with investor's risk profile.

RegTech Compliance Challenges

- Financial services firms increasingly turn to RegTech companies to meet their regulatory obligations, but also to think more strategically about compliance
- The costs and risks of regulation are driving a reassessment of operating models, with the top compliance challenges identified as:
  - Regulatory change
  - Data management
  - Total cost of ownership
  - Risk
  - Scalability

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RegTech Problem-Solving

Shortage of resources and lack of adequately trained compliance teams remain an industry issue that RegTech is helping to solve.

- Transforming data into regulatory filings and surveillance solutions
- Developing new solutions quickly to meet new requirements:
  - Brexit starts a separate track for UCITS, AIFMD, MMFR & PRIIPS, parallel
  - EU Sustainable Finance Disclosure Regulation Level 1 (ESG)/ U.S DOL ESG prohibition & disclosure requirements
  - ESMA (2021-22): UCITS VI, AIFMD II, PRIIPS II, EMIR 2.2
  - U.S. (2021-22): New derivatives rule for funds; modernization of shareholder disclosure (proposed); marketing & advertising rule
- Upgrading core platforms: consistency, scalability and performance

RegTech companies now offer solutions across the complete RegTech value chain

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Global Themes of RegTech Solutions

- Digitalization/Automation
- Data management & deriving more value from data
- Operational & business resilience
- Cybersecurity
- Vendor oversight/chain of diligence
- Transparency of markets
- Investor disclosure
- Risk mitigation
- Oversight of marketing communications

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RegTech & Innovation

- Not only will RegTech companies continue to innovate, but there is increased interest from financial institutions
- Firms have gradually digitalized their operations, but the pandemic has accelerated this. To lower TCO, mitigate risk, scale and increase automation, "buy vs. build" has pushed RegTech into the spotlight
- Artificial Intelligence has been a focus of the SEC – from speeches to the upcoming theme of FinHub's virtual meetings

Current Application of AI in RegTech:

- Automated prospectus creation, summary documents and risk calculating engine

The Future of AI & RegTech:

- Form CRS compliance analytics
- Part 2A Brochure benchmarking
- New SEC RIC and BDCs Proposal for Streamlined Shareholder Report:
  - "*Creating fund disclosures that use modern communication techniques to emphasize clearly and concisely the information investors find most useful*"

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Thank You

How the Characteristics of Digital Assets Affect Compliance with the Custody Rule

Investment Adviser Association
Compliance Conference 2021

Virtual Conference
March 3-5, 2021

By Michael S. Didiuk, Joshua L. Boehm and Michael S. Selig
Perkins Coie LLP*

I. Background

When a mysterious individual, or group, under the moniker of Satoshi Nakamoto published a white paper describing an "electronic peer-to-peer cash system" called Bitcoin to an obscure cryptography mailing list in 2008, the last thing on his, her, or their mind was likely the U.S. federal securities laws, much less a rule under the Investment Advisers Act of 1940 ("Advisers Act"), known as the "Custody Rule." But with the popularity of Bitcoin and other digital assets, registered investment advisers must now consider application of the Custody Rule, among other federal securities laws and regulations, to investments in these new assets on behalf of clients.

Today, there are thousands of different types of digital assets, from cryptocurrencies like Bitcoin to non-fungible tokens like CryptoKitties. These digital assets are a form of virtual property that exists as data in a ledger safeguarded by a peer-to-peer virtual network of connected computers, known as a blockchain. Subject to local laws, anyone can establish a "digital wallet" address on a public blockchain and hold a variety of digital assets. Each digital wallet is associated with an alphanumeric code, known as a private key, that the wallet holder must keep secret like a password. Possession of this private key enables one to access and transfer the digital assets maintained in the digital wallet.

Custody of digital assets, both fungible and non-fungible, is a function of possession of the private key associated with the digital wallet that the digital assets are assigned to on the relevant blockchain. If a third party can obtain the private key associated with a digital wallet, the third party will be able to take possession of the digital assets in that account because the private key, like a password, grants access to the contents of the digital wallet. In the traditional securities context, by comparison, custody is generally a function of possessing a physical certificate or notation in a centralized computer database.

Registered investment advisers that provide advice to clients about digital assets therefore face novel questions in determining how to custody such digital assets. In particular, they must consider whether these assets are subject to the Custody Rule and, if so, how to maintain custody of this new type of asset in compliance with the Custody Rule. In March 2019, the SEC's Division of Investment Management circulated a request for public input on, among other things, "whether and how characteristics particular to digital assets affect compliance with the Custody Rule." In November 2020, the Division of Investment Management issued a statement on the "WY Division of Banking's NAL on Custody of Digital Assets and Qualified Custodian Status," requesting input on matters pertaining to custody of digital assets by state-chartered trust companies. The Division issued the statement in response to a Wyoming Division of Banking no-action letter, which analyzed the applicability of the Custody Rule to Wyoming state-chartered trust companies. In the statement, the Division requested more focused input on the characteristics of state-chartered trust companies to better enable it to consider whether such entities possess characteristics similar to those of the types of financial institutions the SEC has identified as qualified custodians, such as broker-dealers.

This article discusses how the characteristics of digital assets present important considerations for investment advisers when complying with the Custody Rule, particularly with the requirement that specified assets be maintained with a "qualified custodian." As this becomes

more mainstream, the SEC will need to work through policy and practical considerations to address these issues.

II. Custody Considerations

Compliance with the Custody Rule presents several important considerations for investment advisers, including:

A. Classification of Digital Assets

The Custody Rule requires registered investment advisers to maintain client "funds" and "securities" with a "qualified custodian," such as a broker-dealer, futures commission merchant, or bank, which includes a trust company meeting certain standards with proper regulatory oversight. This requirement minimizes the risk of an investment adviser misappropriating "investable assets."

While the term "security" is defined in the Advisers Act and has been interpreted by federal courts in numerous decisions, the term "funds" is not defined in the Advisers Act or the Custody Rule. To date, neither the SEC nor federal courts have addressed whether, or to what extent, virtual currencies may be "funds" under the Custody Rule. The SEC has historically regarded cash and bank deposits as funds, but left the door open for classification of other assets as such. Some digital assets, in particular dollar-backed "stablecoins," are akin to cash or bank deposits because they similarly function as a liquid medium of exchange, store of value and unit of account. Until the SEC provides clarity, investment advisers might find that the prudent and cautious course is to prophylactically treat, at a minimum, dollar-backed stablecoins, and, potentially, other virtual currencies as funds for purposes of the Custody Rule.

The SEC's Strategic Hub for Innovation and Financial Technology has indicated that the Supreme Court's test for whether an instrument is an "investment contract," as set forth in the 1946 case *SEC v. Howey*, will generally control when evaluating the status of a given digital asset as a "security." The "*Howey* test" calls for an assessment of the facts and circumstances unique to each digital asset, making it difficult to determine whether a given digital asset is a security absent a judicial opinion or an SEC staff no-action letter. Other parts of the definition of security, such as "notes" or "transferable shares," can also apply to digital assets that are not investment contracts. To date, there are very few digital assets that have been intentionally issued as securities.

If assets are neither funds nor securities, the technical provisions of the Custody Rule do not apply to them, but the adviser still owes a fiduciary duty to its clients to take reasonable steps to safeguard such client assets. Nevertheless, investment advisers typically maintain their digital assets with a qualified custodian as a prudent means of safekeeping, or because sophisticated investors have come to expect this as a best practice, or as a prophylactic matter in case the assets are deemed securities.

B. Storage and Security of Digital Assets

A cyberattack could result in the theft of private keys, and thereby customers' digital assets. Investment advisers must consider new technological and practical considerations relating to the storage and security of digital assets to mitigate against this risk. Many traditional custodians, including banks and broker-dealers, are not familiar with digital assets and the best practices for their safekeeping. The Office of the Comptroller of the Currency clarified in July 2020 that national banks are permitted to custody digital assets, and it has granted conditional approval for two national trust companies specifically chartered to provide digital asset custody services. It merits noting, however, that the fiduciary powers available to nationally-chartered trust companies, which are necessary to provide custody services as a qualified custodian, may be limited. Currently, the most popular digital asset custodians are newly-chartered state trust companies. Many of these trust companies are chartered in New York and South Dakota, where regulators have established frameworks for chartering and supervising digital asset trust companies, beginning with New York in 2015. These digital asset custodians offer security features such as cold storage and multi-signature digital wallets that are not part of a typical broker-dealer's existing custodial processes.

There are relative benefits for using either state or nationally chartered trust companies. State regulators have gained valuable experience through chartering and overseeing these entities; and there is a level of technical skill that these regulators have developed that might benefit state-chartered trust companies, both in the organizing stage and as operating entities. An issue with state-chartered trust companies is that not all states recognize and permit out-of-state entities to provide services for digital assets without obtaining a license or complying with other state-specific requirements. Nationally-chartered trust companies, on the other hand, have a greater likelihood of being exempt from these requirements, as states have specific carve outs for nationally-chartered banks and trust companies. Additionally, national banking laws, in many cases, preempt the licensing requirements of the states.

1. Hot vs. Cold Storage

As a technological matter, digital asset custody can be evaluated along a spectrum, with so-called "cold" storage at one end and "hot" storage at the other. Cold storage means that the private key information associated with a digital wallet is kept offline. This can be the most secure way to maintain digital assets because the private key information is much less susceptible to remote theft or misappropriation since it is not on a computer connected to the Internet. However, digital assets held in cold storage remain susceptible to internal risks (*e.g.*, theft by custodial employees; physical destruction of the holding place) especially if the custodian has an insufficient control framework. Cold storage can also require lengthy waiting periods for withdrawals (*e.g.*, 24 hours' notice) since digital asset custodians typically need to retrieve private keys through a secure, manual process. Accordingly, cold storage is typically most appropriate for digital assets that are not transacted frequently.

Hot storage means that the private key information associated with a given digital wallet is maintained on a computer that is connected to the Internet. Maintaining private key information online, even in an encrypted form, can be the least secure way to custody digital assets because cyber criminals may be able to find a way to gain access to this data via the Internet. In many cases where a digital asset exchange or custodian suffered a loss of customer assets, the digital assets were held in a hot storage arrangement that was hacked by an external attacker. Nonetheless, for

some investors (*e.g.*, those with active trading strategies), the ability to transact digital assets instantaneously can justify the increased operational risks of hot storage.

As a practical and prudential matter, investment advisers might determine to store the greatest possible amount of their assets in cold storage, while keeping the minimum needed amount of such assets in hot storage to facilitate timely withdrawals (based on typical withdrawal volume and frequency).

2. Multi-Signature Digital Wallets

Just like a nuclear missile silo that requires multiple keys to be turned simultaneously by more than one person, it is possible to establish a digital wallet that requires multiple private keys to initiate a transaction. Multi-signature technology effectively breaks up a private key into multiple private keys so that all or a quorum of keyholders must agree to initiate a transaction. Multi-signature digital wallets offer enhanced security against cyberattacks and rogue keyholders. Multi-signature arrangements exist in a variety of forms, and can be programmed with certain criteria (transaction threshold limits for example). Leading custodians often use some form of multi-signature technology in hot and cold storage custodial arrangements, as discussed above.

Advances are also being made with secure multi-party computation ("MPC"), which is a form of technology that achieves a similar result to multi-signature technology (the signing of a transaction by multiple parties) but does not require a custodian to maintain individual private keys. If successfully implemented, MPC-based custodial arrangements could enhance customer digital asset security by removing private key misappropriation as a potential risk vector.

3. Segregation and Settlement Mechanics

Digital asset custodians employ varying operational practices in their segregation and settlement of digital assets.

Some custodians hold customer assets in digital wallets that contain only the assets of a particular customer, which legally and operationally segregates such assets from the digital assets of other customers. This practice typically occurs only in cold storage arrangements. Other custodians combine the digital assets of multiple customers within an omnibus digital wallet, but legally segregate them by keeping track of customer ownership in a separate ledger. This practice is especially common in hot storage arrangements, but is increasingly used for cold storage arrangements as well. Historically, full operational segregation has been viewed as a best practice from an asset security perspective, since the compromise of one customer's digital wallet would not necessarily affect the assets of another customer. However, with robust internal controls, omnibus storage of digital assets (in both cold and hot environments) can be provided in a manner that mitigates risk of loss to a commensurate degree.

Whether customer digital assets are held in an operationally segregated or omnibus manner also has implications for reporting and auditing. Although digital asset custodians currently follow traditional account statement practices under the Custody Rule, blockchain technology could theoretically enable custodians to provide more frequent (potentially even real-time) visibility to

customer digital assets under custody where assets are stored in individual digital asset wallets. By contrast, omnibus storage arrangements likely would not permit customers to independently verify their storage of digital assets with the custodian using blockchain technology, given that their assets would be pooled with other customers' assets in a single digital wallet. While robust auditing is essential to all custodial arrangements, it is especially important to omnibus digital asset arrangements since a customer's ownership of digital assets is not independently verifiable at a single blockchain address. The Custody Rule's provisions on maintaining separate accounts for client funds and securities would also be relevant.

C. Capitalization, Insurance and Audit

Regulators of digital asset custodians typically impose capitalization standards that, among other purposes, require custodians to have enough capital to absorb unexpected losses, including losses of customer assets. Custodian capitalization requirements have been viewed as an important protection against customer digital asset losses, in part, because traditional forms of depositor and investor insurance (*i.e.*, FDIC and SIPC coverage) are generally not available to cover such losses.

In determining appropriate capitalization requirements for digital asset custodians, regulators have taken differing approaches. Some have applied a fixed net worth requirement. Others require the greater of (a) a floor net worth amount or (b) an amount that, according to a formula, increases with the custodian's assets under custody (and increases more rapidly if assets are held in hot rather than cold storage). Many digital asset custodians are non-depository institutions, and generally treat customer assets under custody as remaining the property of the customer. As is typical of traditional non-depository custodians, even well-capitalized digital asset custodians have capital levels that are a fraction of total customer assets under custody. For that reason, while a digital asset custodian's capitalization is an important signal of its financial wherewithal, it is not full protection against the possibility of customer asset loss.

Custodian and customer demand for additional protection against risk of digital asset loss has led to private insurance options, as well. A number of the leading digital asset custodians offer third-party insurance coverage as an element of their service to customers. The costs of insurance coverage vary considerably between digital assets stored in hot and cold storage for the reasons mentioned above. Costs may also vary based on other factors, such as the jurisdiction, operational processes and security protections of the custodian, as well as the third-party insurance provider. There are also other forms of insurance coverage of relevance to custodians' security procedures that are applicable to the risks of holding a digital wallet's private key, such as kidnap and ransom insurance.

With the increasing visibility in digital assets including among institutional customers, some digital asset custodians have obtained SOC ("System and Organization Controls") reports from independent auditors to demonstrate that their controls meet the standards and requirements expected by institutional customers. As most digital asset custodians provide trust services, the categories and criteria applicable to trust services contained within a SOC 2 report (such as security, availability, processing integrity, confidentiality and privacy) may be reassuring to prospective customers.

III. Policy Recommendations

While some of the new digital asset custodians that have emerged to serve the needs of investors in the asset class are "qualified custodians" for purposes of the Custody Rule, these custodians vary in their approaches to maintaining custody of digital assets on behalf of their customers. Many of the risks inherent in maintaining custody of digital assets may be mitigated by requiring investment advisers to use only qualified custodians that comply with certain principles-based standards for safekeeping digital assets. Because blockchain technology is constantly developing and improving, the best-in-class security features of today may be obsolete tomorrow. The Division of Investment Management might therefore consider certain technology-agnostic guidelines for digital asset safekeeping that will keep up with the pace of innovation.

The Division might wish to develop a set of general principles that define acceptable cold storage, hot storage and hybrid practices, including with respect to the maintenance of private keys, that all qualified custodians must satisfy. This would provide investment advisers with more confidence that their clients' digital assets are safe while not giving a roadmap for wrongdoers to attack specific required methods of safekeeping. Alternatively, the SEC's Office of Compliance Inspections and Examinations might consider incorporating this guidance into its Cybersecurity and Resiliency Operations report.

Similarly, the Division might consider voluntary audit and cybersecurity standards for digital asset custodians. Finally, the SEC might consider establishing minimum standards for the use of blockchains and distributed ledger technology more broadly for purposes of evidencing ownership of securities. This technology can be used to establish an immutable record of ownership of securities in a transparent, tamper-resistant and privacy-preserving way.

* * * * *

As blockchains become more mainstream and new use cases for blockchain technology continue to emerge, the digital asset market is likely to become more relevant. The unique characteristics of digital assets present important practical and technological issues for investment advisers, who are likely to look to the SEC for guidance and clarity on the application of the Custody Rule and related securities laws to this novel technology. The considerations and recommendations in this article may assist investment advisers, custodians and other industry participants regarding any guidance or proposed rules regarding digital asset custody.

* *Michael Didiuk is a partner, Joshua Boehm is a partner, and Michael Selig is an associate at Perkins Coie LLP.* *The authors thank their colleagues Jesse Kanach, Dana Syracuse, Andrew Cross and Conor O'Hanlon for their contributions.*

Technology Based Innovations for Regulatory Compliance ("RegTech") in the Securities Industry[1]

SEPTEMBER 2018

Contents

A REPORT FROM **THE FINANCIAL INDUSTRY REGULATORY AUTHORITY**

Executive Summary

Regulation is a fundamental pillar supporting the success of the financial services industry, ensuring protection of investors and integrity of markets. Over the past century, regulatory requirements have evolved, both in the U.S. and globally, to keep pace with the growing complexity, speed and sophistication of the financial markets.

As financial services firms seek to keep pace with regulatory compliance requirements, they are turning to new and innovative regulatory technology (RegTech) tools to assist them in meeting their obligations in an effective and efficient manner.[2] These RegTech tools may facilitate the ability of firms to strengthen their compliance programs, which in turn has the potential to create safer markets and benefit investors. However, these tools may also raise new challenges and regulatory implications for firms to consider.

RegTech tools may facilitate the ability of firms to strengthen their compliance programs, which in turn has the potential to create safer markets and benefit investors. However, these tools may also raise new challenges and regulatory implications for firms to consider.

To better understand the implications of RegTech for the securities industry, FINRA undertook a focused review to learn more about the emergence and adoption of related tools within the securities industry.[3] As part of these efforts, FINRA staff held discussions with over forty participants in the RegTech space, including broker-dealer firms, vendors, RegTech associations, academics and various other key players.[4]

This paper summarizes key findings from our review. Specifically, Section II of this paper provides a summary of how RegTech tools are being applied in the following five areas: (i) surveillance and monitoring, (ii) customer identification and anti-money laundering (AML) compliance, (iii) regulatory intelligence, (iv) reporting and risk management, and (v) investor risk assessment. Subsequently, Section III highlights key benefits and potential regulatory and implementation implications for broker-dealer firms to consider as they explore and adopt RegTech tools.

The discussion below is intended to be an initial contribution to an ongoing dialogue with market participants about the use of RegTech in the securities industry. Accordingly, FINRA is requesting comments on the areas covered by this paper.[5] FINRA also requests comments on any related matters for which it would be appropriate to consider additional guidance, consistent with the principles of investor protection and market integrity, based on RegTech applications and their implications for FINRA rules.

I. Introduction

Role of RegTech

While the term RegTech does not have a commonly agreed upon definition, it is generally used to refer to new and innovative technologies designed to facilitate market participants' ability to meet their regulatory compliance obligations. The Institute of International Finance defines RegTech as "the use of new technologies to solve regulatory and compliance burdens more effectively and efficiently."[6]

Market participants are increasingly looking to use RegTech tools to help them develop more effective, efficient, and risk-based compliance programs. These RegTech tools have the potential to fundamentally transform how securities industry participants perform their compliance obligations. However, these tools may also raise new challenges and regulatory implications such as those associated with supervision, vendor management, data privacy and security.

Similarly, regulators are looking to enhance their regulatory efforts by using RegTech tools that leverage innovative technologies. For example, FINRA has deployed cloud storage and computing, big data analytics, machine learning and natural language processing to enhance its market surveillance and other regulatory functions.[7]

Rise of RegTech

A growing number of technology startups are leveraging a variety of innovative technologies to assist financial services firms with their regulatory compliance efforts. Additionally, many incumbent financial services firms have begun to develop a variety of RegTech tools in-house. According to a Thomson Reuters survey of over 500 compliance and risk professionals, "[r]egtech has begun to shape compliance. More than half (52 percent) of respondents considered that regtech solutions were affecting how they managed compliance in their firms with almost a fifth (17 percent) reporting they have already implemented one or more regtech solutions."[8] A recent CB Insights study also notes that RegTech startups globally have raised nearly $5 billion in funding across 585 deals between 2013 and 2017, with the bulk of startups in this space focused on compliance in the financial services sector.[9] These past investment figures, however, only represent a small portion of the anticipated RegTech related expenditures in the coming years. One research report predicts that: "[t]he global demand for regulatory, compliance and governance software is expected to reach USD 118.7 billion by 2020."[10]

A growing number of technology startups are leveraging a variety of innovative technologies to assist financial services firms with their regulatory compliance efforts.

The recent rise of the RegTech industry has been shaped by both regulatory developments and technological innovations. While the use of technology to help meet regulatory requirements is not a new phenomenon, the confluence of significant regulatory and technological changes over the past few years has created incentives for firms to rethink how compliance functions operate.

The 2008 financial crisis resulted in the adoption of a number of new regulatory requirements on market participants both domestically and internationally, in an effort to strengthen the financial system and mitigate the potential for future crisis. In response, firms have been working to keep pace with the rapidly changing regulatory landscape as well as seeking better ways to comply with both new and existing mandates. As a result, many financial institutions have a greater need and desire to optimize the use of their limited resources by leveraging technology to develop compliance programs that are more effective, efficient, and risk-based.

The emergence and mainstream adoption of innovative technologies in recent years has also played a role in the rise of RegTech. Compliance functions now have the potential to be streamlined using a variety of technologies, such as artificial intelligence (AI)[11], natural language processing[12], big data and advanced analytics[13], cloud-based computing[14], robotics process automation[15], distributed ledger technology[16], application program interfaces (APIs)[17] and biometrics[18]. These technologies present great opportunities for firms to develop and use applications that may enhance existing compliance at reduced costs. Moreover, the utilization of these technologies may also offer unique opportunities to enhance the integration of risk-management and compliance within the operations of an enterprise.[19]

II. RegTech Applications in the Securities Industry

Securities market participants are exploring and using a variety of RegTech tools to enhance their regulatory compliance efforts. This section examines the utilization of RegTech tools in five main areas: surveillance and monitoring, customer identification and AML compliance, regulatory intelligence, reporting and risk management, and investor risk assessment. As RegTech tools are used to bolster the effectiveness and efficiency of compliance programs in these areas, it is likely that market participants may encounter new operational challenges and regulatory considerations. In addressing these challenges, broker-dealers may wish to consider both the benefits and risks associated with any specific tool and consider steps to mitigate risks where applicable.

Surveillance and Monitoring

Based on discussions held by FINRA staff with various broker-dealers and other participants in RegTech, surveillance and monitoring is an area where RegTech is gaining substantial traction. For purposes of this paper, the area of surveillance and monitoring applies broadly to market surveillance and conduct monitoring, such as monitoring traders, registered representatives, employees, and customers for regulatory purposes.

Market participants have indicated that they are investing significant resources in this area, primarily in RegTech tools that seek to utilize cloud computing, big data analytics or AI/machine learning to obtain more accurate alerts and enhance compliance and supervisory staff efficiencies. Several market participants have noted significant reductions in false alerts generated by surveillance systems after utilizing RegTech tools.

Market participants have indicated that they are investing significant resources in this area, primarily in RegTech tools that seek to utilize cloud computing, big data analytics or AI/machine learning to obtain more accurate alerts and enhance compliance and supervisory staff efficiencies.

RegTech tools generally aim to move beyond traditional rule-based systems to a predictive risk-based surveillance model that identifies and exploits patterns in data to inform decision-making. For example, computer programs trained with historical data may be used to look for suspicious patterns and trends in current data, or identify future patterns and trends. These programs also generally learn from periodically or continuously incorporating new data through a feedback process that seeks to refine future alerts.

Certain RegTech tools also potentially allow a greater volume and variety of information to be readily reviewed and thereby may help to enhance the operation of a firm's regulatory compliance program. Specifically, vendors have started offering tools to record, monitor and analyze various forms of communications (*e.g.*, audio, video and digital). These tools offer firms the ability to move from sample-based reviews of communications to potentially surveil and review all relevant communications. In addition, market participants have indicated that RegTech tools afford them the opportunity to potentially move beyond a traditional lexicon-based review focused on specific terms and instead move towards a more risk-based review utilizing processes such as natural language processing and machine learning to help identify patterns or anomalies. Some tools also claim the ability to understand multiple languages and decipher slang, tone, code language, and "emotional words" denoting a strong reaction. As these tools are still in early stages of development and adoption, many firms are running newer RegTech surveillance tools in parallel with their traditional tools and supplementing these automations with human reviews to validate their effectiveness.

Some RegTech tools that seek to employ a more predictive risk-based surveillance model also focus on linking data streams previously viewed largely in isolation. For instance, the relationship between certain structured data (such as trade orders and cancels, market data, and customer portfolio) and unstructured data (such as emails, voice recordings, social media profiles and others communications) have historically been difficult to link together. However, RegTech tools are being developed that would help to integrate these disparate data forms and then identify and track related anomalies that merit attention.

Customer Identification and AML Compliance

Another compliance program area where there has been greater interest in the adoption of RegTech tools involves customer identification (also known as "know-your-customer" or KYC) and AML programs.[20]

Customer identification and AML related rules and regulations are critical to legitimate and orderly conduct of financial markets. They allow market participants and regulators to identify and detect potential money laundering and terrorist financing activities, and other offences such as securities fraud and market manipulation. However, customer identification and AML compliance also come with associated costs.

Moreover, anecdotal statements by market participants suggest that traditional solutions and methods for customer identification and AML monitoring may, at times, have not been as effective as desired. The financial industry is exploring the use of RegTech tools as it looks for more effective solutions.

RegTech startups and various incumbent firms have started introducing solutions for customer identification and AML that are designed to employ technology to develop more effective, efficient, and risk-based systems. For example, some vendors are offering RegTech tools that incorporate the use of biometrics to more effectively identify and track customer activity. Other vendors are exploring the use of distributed ledger technology to reduce the burdens associated with individual financial institutions each separately identifying or monitoring the same customers.[21] Some market participants are also seeking to combine data obtained directly from customers with data from external sources, and then processing this data using sophisticated data analytics to create a more holistic view of the customer. Some RegTech tools also offer the potential to conduct real-time transaction monitoring.

Beyond firm-specific approaches and tools, some vendors and financial institutions are also exploring the creation of central industry utilities as shared solutions for customer identification and AML compliance. Using certain RegTech tools (such as those employing distributed ledger technology), these types of utilities may have the potential to reduce the overall compliance burden on the industry. Shared solutions in this space (operating in compliance with any data privacy requirements) also may facilitate the pooling of data from various industry participants, thereby potentially enhancing the ability to trace the relationship of transactions across firms as well as the related movement of funds.

Regulatory Intelligence

Regulatory intelligence programs refer to areas of compliance that focus on the identification and interpretation of changes to applicable rules and regulations, frequently across multiple jurisdictions, in order to update a firm's compliance operations. Given the significant resources devoted to this area, market participants have been exploring the use of RegTech tools to help streamline this process.

In their basic form, RegTech tools assisting with regulatory intelligence typically provide a catalog of regulatory requirements in a user-friendly manner, that are updated on a real-time basis with timely reminders on forthcoming changes and new enforcement actions that may alert firms to review applicable supervision and compliance operations. Vendors operating in this space have also started to use natural language processing and machine learning to read and interpret new and existing regulatory requirements and then offer a gap analysis to their clients to help identify potential deficiencies within an organization's compliance program. These RegTech tools seek to help automate at least portions of what is otherwise an extremely manual and time-consuming process under which firms track relevant regulatory changes and then determine and implement appropriate changes to their compliance programs.[22]

Some regulators are also exploring and adopting RegTech to facilitate dissemination of regulatory intelligence. For example, the UK Financial Conduct Authority (FCA) and the Bank of England (BoE) have launched an initiative to make their rulebooks "machine-readable," such that they can be easily processed and interpreted by machines and incorporated into firms' regulatory intelligence systems.[23]

In addition, some RegTech tools seek to embed compliance functions into the normal operations of a firm by providing a platform whereby it is necessary to review for compliance with applicable regulations before an action is even taken. For example, in the context of derivatives trading, RegTech solutions are being offered to enable firms and their traders to ensure that their trades are compliant with applicable rules and regulations (such as those related to clearing and reporting) before they are executed.

Reporting and Risk Management

Reporting and risk management programs represent another compliance area where firms are seeking to utilize RegTech tools. Solutions in this space leverage technology to develop tools to facilitate or automate processes involved in risk-data aggregation, risk metrics creation and monitoring (for enterprise risk management as well as operational risk management), and regulatory reporting. For example, to assist with risk-data aggregation or regulatory reporting, a RegTech tool may be deployed to gather and analyze information on capital and liquidity for use in internal models or to report to regulators.

Investor Risk Assessment

In order to provide appropriate investment advice to clients, firms must seek information from their clients and apply reasonable policies and procedures to determine the investor's risk appetite and tolerance, subject to any periodic updates or refinements. The development of RegTech tools to assist with investor risk assessment is a relatively small but growing space within RegTech.

These types of RegTech tools seek to leverage technological innovations (such as data aggregation and machine learning) in combination with behavioral sciences to determine an investor's risk appetite and tolerance in a more scientific manner than existing tools. For example, some tools assess an investor's risk appetite and tolerance based on an investor's performance on "games" designed to provide insights into the investor's reactions to changes in market conditions and portfolio performance. This information could be used in conjunction with an investor's stated preferences to help develop a more holistic picture of an investor. In addition, some RegTech tools monitor investor portfolios in changing market conditions and produce recommendations to better align the portfolio with the investor's risk profile.

III. Implications of RegTech for the Securities Industry

The use of RegTech offers several potential benefits while also posing potential new challenges. This section provides a brief overview of the potential benefits RegTech innovations may offer, followed by a discussion of some of the potential issues and key regulatory implications for market participants to consider when adopting emerging technologies for their compliance programs.

Potential Impact on the Securities Industry

RegTech tools and services have the potential to provide several benefits to firms, such as enhanced risk management, increased effectiveness and efficiency, and opportunities for enhanced industry collaboration. This in turn may support firms' ability to further promote compliance, resulting in potential benefits to investors and the broader securities market. Accordingly, this section summarizes below some potential benefits associated with RegTech tools.[24]

RegTech tools and services have the potential to provide several benefits to firms, such as enhanced risk management, increased effectiveness and efficiency, and opportunities for enhanced industry collaboration.

Risk Management

RegTech tools may strengthen a firm's ability to adopt a proactive risk-based approach to regulatory compliance. For example, instead of identifying violations after they occur, RegTech tools (based on AI and big-data analytics) are being used to proactively identify potential risks by creating alerts that facilitate the development of more forward-looking compliance programs. RegTech tools are also being used to facilitate the ability of firms to look at data across the organization to conduct enterprise-level reviews, thereby helping to break down silos and limiting potential compliance gaps.

Automation, Effectiveness and Efficiency

Increased automation of compliance processes is one of the most widely used forms of RegTech and offers many potential benefits. For example, use of robotics process automation (RPA) may allow firms to minimize the need to perform repetitive tasks (such as collecting data and analyzing information across systems), thereby reducing errors and speeding up processes, freeing up resources to perform higher level functions such as reviewing alerts and developing responses.

Moreover, certain RegTech tools can be embedded within a firm's operational and supervisory processes, thereby making rule compliance part of the business process (*e.g.*, tools that review for compliance with certain specific rules before trades are submitted for execution). This offers the ability to potentially prevent non-compliant activities before they occur, as opposed to identifying them during a post-event compliance review.

The use of certain RegTech tools could also assist in reducing the number of false alerts, thereby freeing up staff time to focus on alerts that warrant escalation. For example, during our research, one firm noted that false alerts of its employee surveillance system were reduced by 80% after the adoption of a RegTech tool and that the escalation rate of its alerts went up significantly. Such tools have the potential to result in cost efficiencies, increase productivity and focus resources on heightened areas of risk. In addition, shared RegTech solutions such as industry utilities and shared use of cloud computing platforms offer opportunities for cost reductions.

Moreover, many emerging RegTech tools offer intuitive, user-friendly interfaces with advanced graphics and interactive tools, which empower end users with non-technology backgrounds (*e.g.*, compliance and supervisory personnel) to tap into the benefits of these advanced technologies. The end-user interface of many RegTech tools offer synthesized visualizations of complex analytics and intuitive tools for end users to extrapolate different scenarios. These attributes make it easy to train personnel in the use of these tools as well as simplify the analysis for compliance functions.

Regulatory and Implementation Considerations

As broker-dealers explore RegTech tools and services to assist with their regulatory compliance efforts, they should be cognizant of potential challenges that the adoption of these tools may pose and their regulatory implications. This section discusses some of the key implications for broker-dealers to consider. While we highlight certain key thematic areas, this section is not meant to be an exhaustive list of all potential issues. Broker-dealers should conduct their own assessments of the implications of RegTech tools and services, based on their business models and compliance needs.

We invite market participants to engage in a dialogue with FINRA as they explore various RegTech tools and services and seek to understand and address any new regulatory implications that may arise during the process. We also invite market participants to provide feedback on areas where additional guidance, resources or modifications to FINRA rules may be desired to support adoption of these tools, while maintaining investor protection and market integrity.

Supervisory Control Systems

FINRA rules require firms to maintain reasonable supervisory policies and procedures related to supervisory control systems in accordance with applicable rules (*See, e.g.*, *FINRA Rules 3110* and *3120*). This includes having reasonable procedures and control systems in place for supervision and governance of RegTech tools, including supervision of AI-based tools and systems.

Some of the RegTech applications discussed earlier in this report may use highly complex and sophisticated AI algorithms, which are designed to learn and evolve based on data patterns. Compliance and business professionals may not have the technical skills to understand in detail how these algorithms function. Auditing the methodology or logic used by an AI-algorithm to generate a specific output or decision can be challenging. Previously, FINRA has stated with respect to the use of technology-based trading tools: "[T]he use of algorithmic strategies has increased, the potential of such strategies to adversely impact market and firm stability has likewise grown. When assessing the risk the use of algorithmic strategies creates, firms should undertake a holistic review of their trading activity and consider implementing a cross-disciplinary committee to assess and react to the evolving risks associated with algorithmic strategies."[25] A similar analysis may be helpful in the context of AI-algorithms used for compliance tools. A firm's written supervisory

procedures (WSPs) may benefit from being appropriately updated and tested to reflect any required changes in supervisory procedures due to the integration or adoption of new RegTech tools, particularly with respect to those that employ emerging, complex technologies.

Some potential supervisory and governance areas that broker-dealers may want to consider when adopting RegTech tools are listed below.[26]

- **Establishing a cross-functional technology governance structure.** It may be beneficial for a cross-disciplinary group to be involved in the development, testing and implementation of RegTech tools. Testing of various scenarios and outputs generated by the tools with input from a cross-functional group may also help limit potential issues.
- **Simplified summary of the RegTech tools.** Maintaining a simplified summary describing the underlying algorithms and related strategies may enable non-technical staff to understand the intended functions of the tools and algorithms so that they are better able to assess results that do not align with expectations.
- **Data quality risk-management.** Data integrity and control is of paramount importance for many RegTech tools, particularly those that employ AI to deliver desired results. Developing an appropriate data quality risk-management program is vital to helping ensure accuracy, completeness, and consistency of the data that is used to support the RegTech systems.
- **Process to identify and address errors or malfunctions.** Firms may benefit from having appropriate policies and procedures in place to identify, respond to, and mitigate material risks that may manifest in the event errors or malfunctions arise in association with the use of a RegTech tool. This may include establishing alternative processes that can be readily employed in the event the RegTech tool fails.
- **Training of personnel.** Firms may benefit from developing appropriate training for compliance, supervisory and operational staff on the use of RegTech tools adopted by the firm.

Outsourcing Structure and Vendor Management

Given the rapid development of RegTech tools and services, many broker-dealers are choosing to outsource discrete compliance and reporting functions (*e.g.*, customer identification, AML transaction monitoring, fraud surveillance, etc.) to RegTech vendors. The use of third party vendors enables firms, especially smaller ones, to leverage the use of advanced technologies and related efficiencies, without a significant capital investment.

Firms are reminded that outsourcing an activity or function to a third-party does not relieve them of their ultimate responsibility for compliance with all applicable securities laws and regulations and FINRA rules associated with the outsourced activity or function. As such, firms may desire to adjust or update their written supervisory procedures to ensure that they appropriately address outsourcing arrangements (*see, e.g.,* *Notice to Members 05-48* (Outsourcing)).

The following are some potential areas for broker-dealers to consider when outsourcing to RegTech vendors:

- Whether an appropriate due-diligence analysis of the vendor was conducted including, where applicable, consideration of its technical, operational and financial soundness;
- Whether the vendor understands the regulatory requirements that it offers RegTech solutions for, and has a system in place to monitor for and incorporate any changes to such regulatory requirements;

- Whether the vendor's cybersecurity policies and procedures are appropriate, particularly when the outsourcing arrangement involves sharing of sensitive firm and customer data;
- Whether there is a need for a continuity and transition plan, in the event the vendor is unable to fulfill its obligations and the required functions need to be abruptly moved back in-house;
- To the extent the use of outsourced RegTech services leads to the creation of new records, firms may wish to consider working with vendors to develop appropriate processes to meet the firm's recordkeeping obligations such as those associated with Exchange Act Rules 17a-3 and 17a-4 and *FINRA Rule 4511* (Books and Records: General Requirements).

Customer Data Privacy

Some emerging RegTech tools and services involve the collection, analysis, and sharing of customer-related information, such as in the areas of surveillance and monitoring (*e.g.*, recording of customers' communications with registered representatives), customer identification and AML compliance (*e.g.*, sharing customer onboarding data with a vendor), or investor risk assessment tools. While these tools and data-collection methods may strengthen a firm's ability to leverage technology and conduct compliance functions in an efficient manner, they may also pose potential risks associated with customer data privacy, particularly where customer data is shared with a third-party vendor. Broker-dealers should consider the application of customer data privacy rules when exploring such RegTech applications.

Protection of financial and personal customer information is a key responsibility and obligation of FINRA member firms. As required by *SEC Regulation S-P* (Privacy of Consumer Financial Information and Safeguarding of Personal Information)[27], broker-dealers must have written policies and procedures in place to address the protection of customer information and records. In addition, as detailed in NASD *Notice to Members 05-49* (Safeguarding Confidential Customer Information), the policies and procedures should be reasonably designed to:

- Ensure the security and confidentiality of customer records and information;
- Protect against any anticipated threats or hazards to the security or integrity of customer records and information; and
- Protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

Firms also have obligations to provide initial and annual privacy notices to customers describing information sharing policies and informing customers of their rights. In addition, SEC *Regulation S-ID* (the Red Flags Rule) requires broker-dealer firms that offer or maintain covered accounts to develop and implement written "Identity Theft Prevention Programs." Moreover, there are numerous international, federal and state regulations and statutes that set forth specific rules and requirements related to customer data privacy. Many of these laws are specific to the collection and use of personal information and firms should assess the applicability of these laws to both their business and their potential use of RegTech tools.

As firms adopt RegTech tools that involve changes in how they collect, store, analyze and share sensitive customer data, they may need to update their policies and procedures related to customer data privacy to reflect such changes. Accordingly, below are some issues that firms may want to consider:

- Whether appropriate consent from customers, as needed, has been obtained with respect to the collection of new or additional information (*e.g.*, recording of audio or video communications), use of such information for internal analysis and monitoring, and sharing of any customer data with third party vendors;

- Whether appropriate policies and procedures exist with respect to sharing such data with vendors, including how and what level of access is provided to vendors; any parameters for storing the data; any restrictions on vendors sharing data with other third parties, and any restrictions on aggregating customer information with data from other vendor clients;
- Whether related training is appropriate for relevant individuals and departments who collect or have access to customer data, including registered representatives, employees of the firm, and employees of vendors.

Security Risks

Cybersecurity and data-related risks continue to remain a top area of concern in the financial services industry. Some RegTech tools are being developed specifically to address security-related risks by leveraging advanced technologies, such as blockchain, biometrics and sophisticated cryptography.[28] However, the increased use and integration of RegTech into compliance and regulatory systems also has the potential to introduce new vulnerabilities related to security where segmented off-line processes are moved into a more automated computer-based system.

For instance, RegTech tools may involve linking to and pulling in data from multiple internal and external sources on an ongoing basis, which could potentially lead to new sources of security risks. Similarly, working with multiple new vendors and providing them with access to a firm's systems could also potentially create new sources of risk.

Security risk management should be an integral part of the evaluation and implementation of RegTech tools by firms. Specifically, firms should pay close attention to technology governance, system change management, risk assessments, technical controls, incident response, vendor management, data loss prevention, and staff training. For additional resources on this topic, including applicable rules, guidance and FINRA's report on Cybersecurity Practices, refer to *FINRA's webpage on cybersecurity*.

Other Regulatory and Implementation Considerations

Interoperability

Firms may wish to consider whether new RegTech tools, particularly vendor tools, are compatible with other operational and compliance systems within the firm in order to limit the potential for system errors.

Communications with the Public

To the extent RegTech solutions generate or monitor communications with the public (*e.g.*, investor risk assessment tools that may generate reports to be shared with the end client, or surveillance tools that may purport to capture and analyze social media conversations), firms should pay attention to applicable FINRA rules and guidance, such as FINRA Rule 2210 (Communications with the Public), *FINRA Regulatory Notice 17-18* on Social Media and Digital Communications, and *FINRA Regulatory Notice 10-06* on Blogs and Social Networking Websites.

Talent and Training

Firms should consider whether they have the appropriate staff, functions, and training for processes that may change with the adoption of RegTech tools. According to a Thomson Reuters[29] survey, financial institutions are focused on revising skill sets "with more than half (56 percent) having widened the skill set within the risk and compliance functions to accommodate developments in fintech and regtech innovation and associated digital disruption, while 15 percent of respondents reported investing specifically in specialist skills."

IV. Request for Comments

FINRA continues its efforts to foster a dialogue with the industry, including with broker-dealers, other regulators and key stakeholders, to proactively identify any potential benefits or risks that new financial technologies may present to investors, broker-dealers and the securities market. Through this process, FINRA seeks to support innovation that contributes to investor protection and market integrity.

As the securities industry continues to expend time and resources in exploring and adopting RegTech solutions, we encourage stakeholders to actively engage with FINRA on areas where additional guidance or resources may be desired to support adoption of these solutions, consistent with the principles of investor protection and market integrity.

FINRA encourages comments on this paper, including areas where guidance or modifications to FINRA rules may be desired to support adoption of RegTech tools while maintaining investor protection and market integrity.

Comments are requested by November 30, 2018. Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to: Marcia E. Asquith Office of the Corporate Secretary FINRA 1735 K Street, NW Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this paper will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.

Direct inquiries regarding this paper to Haimera Workie, Senior Director, Office of Emerging Regulatory Issues, at (202) 728-8097; or Kavita Jain, Director, Office of Emerging Regulatory Issues, at (202) 728-8128.

Endnotes

1. This paper is not intended to express any legal position, and does not create any new requirements or suggest any change in any existing regulatory obligations, nor does it provide relief from any regulatory obligations. While this paper summarizes key findings from FINRA's outreach and research on RegTech tools developed and adopted by the securities industry, it does not endorse or validate the use or effectiveness of any of these tools in fulfilling compliance obligations. Further, while the paper highlights certain regulatory and implementation areas that broker-dealers may wish to consider as they explore RegTech tools, the paper does not cover all applicable regulatory requirements or considerations. FINRA encourages firms to conduct a comprehensive review of all applicable securities laws, rules and regulations to determine potential implications of implementing RegTech tools.

2. This paper considers the use of RegTech to support compliance within the securities industry. In this context, RegTech can be thought of as a subset of financial technology (FinTech), given the focus is on the development of technology tools in the financial industry linked to promoting regulatory compliance.

3. In June 2017, FINRA launched the Innovation Outreach Initiative to foster an ongoing dialogue with the securities industry to help FINRA better understand FinTech innovations and to provide relevant information to our members, investors, and market participants. http://www.finra.org/newsroom/2017/finra-launches-innovation-outreach-initiative. The development of this paper was undertaken as part of the Innovation Outreach Initiative, and is designed to more broadly share insight gained from this outreach. More information on FINRA's FinTech efforts at http://www.finra.org/industry/fintech.

4. In addition, FINRA staff held roundtable discussions on the application of RegTech in the securities industry, at three separate FINRA FinTech Roundtables held in San Francisco, Dallas and New York City.

5. *See* Request for Comments section on page 11 of this paper.

6. RegTech, Institute of International Finance, https://www.iif.com/topics/regtech.

7. *See* FINRA Handles Record Volume of Market Activity through First Six Months of 2018, FINRA (July 12, 2018), http://www.finra.org/newsroom/2018/finra-handles-record-volume-market-activity-through-first-six-months-2018.

8. Susannah Hammond, FinTech, RegTech, and the Role of Compliance, Thomson Reuters (December 5, 2016), https://blogs.thomsonreuters.com/answerson/fintech-regtech-compliance.

9. The State of RegTech, CB Insights (Sept. 2017), https://www.cbinsights.com/research/briefing/state-of-regulatory-technology-regtech/.

10. Strategic Analysis of RegTech: A Hundred Billion-Dollar Opportunity, Medici (April 1, 2016), https://medici.letstalkpayments.com/research-categories/strategic-analysis-of-regtech-a-billion-dollar-opportunity.

11. Artificial intelligence generally refers to the theory and development of computer systems able to perform tasks that normally require human intelligence, such as visual perception, speech recognition, pattern recognition, and decision-making.

12. Natural language processing generally refers to the processing of a sample of human language (spoken or written) by computer programs in order to categorize and classify its contents.

13. Big data analytics generally refers to a set of tools and processes required to work with large sets of diverse data that include different types such as structured/unstructured and streaming/batch. Because of the very large volume of data, big data analytics often require new tools and processes that are different from traditional data management and processing systems.

14. Cloud computing generally refers to the offering of computing capacity as a set of services that can be rapidly provisioned and scaled up or down based on need. Hosting of Cloud services can either be self-managed (Private Cloud) or by an external vendor via the Internet (Public Cloud).

15. Robotics process automation (RPA) generally refers to software that can be easily programmed to do basic tasks across applications just as human workers do. Robotics Process Automation, Investopedia, https://www.investopedia.com/terms/r/robotic-process-automation-rpa.asp.

16. "Distributed ledger technology involves a distributed database maintained over a network of computers connected on a peer-to-peer basis, such that network participants can share and retain identical, cryptographically secured records in a decentralized manner." FINRA, Distributed Ledger Technology: Implications of Blockchain for the Securities Industry (Jan. 2017), http://www.finra.org/industry/blockchain-report.

17. An application programming interface (API) is a technology protocol that allows entities to access and retrieve information from another entity's operating system services, software libraries, or other systems, in a pre-determined manner.

18. Biometrics generally refers to "[T]he measurement and analysis of unique physical or behavioral characteristics (such as fingerprint or voice patterns) especially as a means of verifying personal identity." Biometrics, Merriam-Webster Dictionary, https://www.merriam-webster.com/dictionary/biometrics.

19. These innovative technologies also have the potential to facilitate the development of compliance checks and reviews conducted concurrent to when the business activity is undertaken, which is sometimes referred to as "in-built compliance" or "compliance by design."

20. The Bank Secrecy Act of 1970 (BSA) requires all broker-dealers to, among other things, implement compliance programs to detect and prevent money laundering. In addition, FINRA Rule 3310 (Anti-Money Laundering Compliance Program) requires all broker-dealers to develop and maintain a written AML program to comply with the requirements of the BSA. FINRA Rule 2090 (Know Your Customer (KYC)) requires broker-dealers to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."

21. "A report from Quinlan & Associates estimates that blockchain technology could deliver the industry $4.6 billion in annual AML cost savings – representing 32% of current annual costs – in the form of reduced compliance headcount, lower technology spend and fewer regulatory penalties." Building RegTech into your FinTech Strategy: Innovating to Stay Competitive in the Digital Age, FinExtra and Pegasystems (March 2017), *https://www.finextra.com/finextra-downloads/surveys/documents/c015120b-5e94-4f77-b523-be59591ad72d/pega_researchpaper_v4.pdf*.

22. In most cases any automation is also supplemented with human review by small teams of subject matter and technical experts.

23. UK Financial Conduct Authority, Model Driven Machine Executable Regulatory Reporting (Nov. 1, 2017), *https://www.fca.org.uk/firms/our-work-programme/model-driven-machine-executable-regulatory-reporting*.

24. Please note that FINRA does not endorse or validate the use or effectiveness of any specific tools in fulfilling compliance obligations. FINRA encourages broker-dealers to conduct a comprehensive assessment of any RegTech tools they wish to adopt to determine their benefits, implications and ability to meet their compliance needs.

25. Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies, FINRA Regulatory Notice 15-09 (March 2015). FINRA also requires registration of associated persons involved in the design, development, or significant modification of algorithmic trading strategies. *See Regulatory Notice 16-21* (June 2016).

26. These are some of many possible areas that broker-dealers may wish to consider as they explore adjusting their supervisory processes. This does not express any legal position, and does not create any new requirements or suggest any change in any existing regulatory obligations, nor does it provide relief from any regulatory obligations. It is not intended to cover all applicable regulatory requirements or considerations. FINRA encourages firms to conduct a comprehensive review of all applicable securities laws, rules and regulations to determine potential implications of implementing RegTech tools.

27. *17 C.F.R. Part 248*

28. Cryptography refers to the security process of converting data from its ordinary form into unintelligible text such that it can be read and processed by only those it is intended for.

29. Susannah Hammond, FinTech, RegTech, and the Role of Compliance, Thomson Reuters (December 5, 2016), *https://blogs.thomsonreuters.com/answerson/fintech-regtech-compliance*.

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-90788; File No. S7-25-20]

Custody of Digital Asset Securities by Special Purpose Broker-Dealers

AGENCY: Securities and Exchange Commission ("Commission").

ACTION: Commission statement; request for comment.

SUMMARY: The Commission is issuing a statement and requesting comment regarding the custody of digital asset securities by broker-dealers.

DATES: Effective date: April 27, 2021.

Comments due: You may submit comments at any time throughout the five-year term of this Commission Statement.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's internet comment form (https://www.sec.gov/rules/submitcomments.htm); or
- Send an email to *rule-comments@sec.gov*. Please include File No. S7-25-20 on the subject line.

Paper comments:

- Send paper comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-25-20. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method of submission. The Commission will post all comments on the Commission's website (*http://www.sec.gov*). Comments are also available for

website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Michael A. Macchiaroli, Associate Director, at (202) 551-5525; Thomas K. McGowan, Associate Director, at (202) 551-5521; Randall W. Roy, Deputy Associate Director, at (202) 551-5522; Raymond A. Lombardo, Assistant Director, at 202-551-5755; Timothy C. Fox, Branch Chief, at (202) 551-5687; or A.J. Jacob, Special Counsel, at (202) 551-5583, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, D.C. 20549-7010.

SUPPLEMENTARY INFORMATION:

I. INTRODUCTION

The Commission is issuing this statement and request for comment to encourage innovation around the application of the Customer Protection Rule to digital asset securities.[1] The Commission envisions broker-dealers performing the full set of broker-dealer functions with respect to digital asset securities – including maintaining custody of these assets – in a manner that addresses the unique attributes of digital asset securities and minimizes risk to investors and other market participants.[2] Consequently, as discussed below, the Commission's position in this

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[1] For purposes of this statement, the term "digital asset" refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology ("distributed ledger technology"), including, but not limited to, so-called "virtual currencies," "coins," and "tokens." The focus of this statement is digital assets that rely on cryptographic protocols. A digital asset may or may not meet the definition of a "security" under the federal securities laws. *See, e.g.*, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Release No. 81207 (July 25, 2017). As used in this statement, a "digital asset security" means a digital asset that meets the definition of a "security" under the federal securities laws. A digital asset that is not a security is referred to herein as a "non-security digital asset."

[2] *See* 17 CFR 240.15c3-3. The Commission staff has issued a joint statement with the Financial Industry Regulatory Authority on broker-dealer custody of digital asset securities ("Joint Statement"), as well as a no-action letter regarding the Joint Statement to broker-dealers operating alternative trading systems ("ATSs"). *See Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, dated July 8,

statement is premised on a broker-dealer limiting its business to digital asset securities to isolate risk and having policies and procedures to, among other things, assess a given digital asset security's distributed ledger technology and protect the private keys necessary to transfer the digital asset security. In this way, the Commission is cognizant of both investor protection and potential capital formation innovations that could result from digital asset securities.

Rule 15c3-3 under the Securities Exchange Act of 1934 (hereinafter the "Customer Protection Rule" or "Rule 15c3-3")[3] requires a broker-dealer to promptly obtain and thereafter maintain physical possession or control of all fully-paid and excess margin securities it carries for the account of customers.[4] Market participants have raised questions concerning the application of the Customer Protection Rule to the potential custody of digital asset securities for customers by broker-dealers. The Commission is requesting comment in this area to provide the Commission and its staff with an opportunity to gain additional insight into the evolving standards and best practices with respect to custody of digital asset securities. The Commission intends to consider the public's comments in connection with any future rulemaking or other Commission action in this area.

As an interim step, in addition to the request for comment, the Commission is issuing this statement. The Commission recognizes that the market for digital asset securities is still new and rapidly evolving. The technical requirements for transacting and custodying digital asset securities are different from those involving traditional securities. And traditional securities transactions often involve a variety of intermediaries, infrastructure providers, and counterparties

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2019, *available at* https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities. *See also* Letter to Ms. Kris Dailey, Financial Industry Regulatory Authority, ATS Role in the Settlement of Digital Asset Security Trades, dated September 25, 2020 (discussing a three-step process broker-dealers use when operating an alternative trading system for the purpose of trading digital asset securities), available at https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf. Staff statements represent the views of the staff. They are not rules, regulations, or statements of the Commission. The Commission has neither approved nor disapproved their content. These staff statements, like all staff guidance, have no legal force or effect: they do not alter or amend applicable law, and they create no new or additional obligations for any person.

3 *See* 17 CFR 240.15c3-3.

4 *See* 17 CFR 240.15c3-3(b).

for which there may be no analog in the digital asset securities market. The Commission supports innovation in the digital asset securities market to develop its infrastructure.

In particular, the Commission's position, which will expire after a period of five years from the publication date of this statement, is that a broker-dealer operating under the circumstances set forth in Section IV will not be subject to a Commission enforcement action on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities for the purposes of paragraph (b)(1) of Rule 15c3-3.[5] These broker-dealers will be subject to examination by the Financial Industry Regulatory Authority ("FINRA") and Commission staff to review whether the firm is operating in a manner consistent with the circumstances described in Section IV below.

The five-year period in which the statement is in effect is designed to provide market participants with an opportunity to develop practices and processes that will enhance their ability to demonstrate possession or control over digital asset securities. It also will provide the Commission with experience in overseeing broker-dealer custody of digital asset securities to inform further action in this area.

II. BACKGROUND

Customers who use broker-dealers registered with the Commission to custody their securities (and related cash) benefit from the protections provided by the federal securities laws, including the Customer Protection Rule and, in most cases, the Securities Investor Protection Act of 1970 ("SIPA").[6] Generally, the Commission's Customer Protection Rule requires a broker-dealer to segregate customer securities and related cash from the firm's proprietary business

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[5] Pursuant to the Congressional Review Act, the Office of Information and Regulatory Affairs has designated this statement as a "major rule" as defined by 5 U.S.C. 804(2). *See* 5 U.S.C. 801 et seq.

[6] 15 U.S.C. 78aaa, *et seq*. Under SIPA, customers' securities held by a broker-dealer that is a member of the Securities Investor Protection Corporation and customers' cash on deposit at such a broker-dealer for the purpose of purchasing securities would be isolated and readily identifiable as "customer property" and, consequently, available to be distributed to customers ahead of other creditors in the event of the broker-dealer's liquidation. *Id*.

activities, other than those that facilitate customer transactions.[7] The rule requires the broker-dealer to maintain physical possession or control over customers' fully paid and excess margin securities.[8]

Broker-dealer custody of securities is an integral service provided to the securities markets. However, broker-dealer custody of digital asset securities raises certain compliance questions with respect to the Customer Protection Rule. More specifically, while paragraph (b)(1) of Rule 15c3-3 requires that a broker-dealer "control" customer fully paid and excess margin securities, it may not be possible for a broker-dealer to establish control over a digital asset security with the same control mechanisms used in connection with traditional securities. Moreover, there have been instances of fraud, theft, and loss with respect to the custodianship of digital assets, including digital asset securities.[9]

The risks associated with digital assets, including digital asset securities, are due in part to differences in the clearance and settlement of traditional securities and digital assets. Traditional securities transactions generally are processed and settled through clearing agencies, depositories, clearing banks, transfer agents, and issuers. A broker-dealer's employees, regulators, and outside auditors can contact these third parties to confirm that the broker-dealer is in fact holding the traditional securities reflected on its books and records and financial statements, thereby providing objective processes for examining the broker-dealer's compliance with the Customer Protection Rule. Also, the traditional securities infrastructure has established processes to reverse or cancel mistaken or unauthorized transactions. Thus, the traditional securities infrastructure contains checks and controls that can be used to verify proprietary and

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7 *See Net Capital Requirements for Brokers and Dealers*, Exchange Act Rel. No. 21651 (Jan. 11, 1985), 50 FR 2690, 2690 (Jan. 18, 1985) (Rule 15c3-3 is designed "to give more specific protection to customer funds and securities, in effect forbidding brokers and dealers from using customer assets to finance any part of their businesses unrelated to servicing securities customers; *e.g.*, a firm is virtually precluded from using customer funds to buy securities for its own account").

8 *See* 17 CFR 240.15c3-3(b)(1).

9 *See generally*, Report of the Attorney General's Cyber Digital Task Force: Cryptocurrency Enforcement Framework (October 2020), at 15-16, available at https://www.justice.gov/ag/page/file/1326061/download.

customer holdings of traditional securities by broker-dealers, as well as processes designed to ensure that both parties to a transfer of traditional securities agree to the terms of the transfer.

Digital assets that are issued or transferred using distributed ledger technology may not be subject to the same established clearance and settlement process familiar to traditional securities market participants.[10] The manner in which digital assets, including digital asset securities, are issued, held, or transferred may create greater risk that a broker-dealer maintaining custody of this type of asset, as well as the broker-dealer's customers, counterparties, and other creditors, could suffer financial harm. For example, the broker-dealer could be victimized by fraud or theft, could lose a "private key" necessary to transfer a client's digital assets, or could transfer a client's digital assets to an unintended address without the ability to reverse a fraudulent or mistaken transaction. In addition, malicious activity attributed to actors taking advantage of potential vulnerabilities that may be associated with distributed ledger technology and its associated networks could render the broker-dealer unable to transfer a customer's digital assets.

The express language of the Customer Protection Rule includes cash and securities held at the broker-dealer. Therefore, customers holding digital assets that are not securities through a broker-dealer could receive less protection for those assets than customers holding securities. The potential liabilities caused by the theft or loss of non-securities property from a broker-dealer, including digital assets that are not securities, could cause the broker-dealer to incur substantial losses or even fail, impacting customers and other creditors. As a consequence, the broker-dealer may need to be liquidated in a proceeding under SIPA. SIPA protection does not extend to all assets that may be held at a broker-dealer. Consequently, in a SIPA liquidation of a broker-dealer that held non-security assets, including non-security digital assets, investors may

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[10] The clearance and settlement of securities that are not digital assets are characterized by infrastructure whereby intermediaries such as clearing agencies and securities depositories serve as key participants in the process. The clearance and settlement of digital asset securities, on the other hand, generally rely on few, if any, intermediaries and remain evolving areas of practices and procedures.

be treated as general creditors, to the extent their claims involve assets that are not within SIPA's definition of "security."[11]

III. DISCUSSION

A broker-dealer that maintains custody of a fully paid or excess margin digital asset security for a customer must hold it in a manner that complies with Rule 15c3-3, including that the digital asset security must be in the exclusive physical possession or control of the broker-dealer.[12] A digital asset security that is not in the exclusive physical possession or control of the broker-dealer because, for example, an unauthorized person knows or has access to the associated private key (and therefore has the ability to transfer it without the authorization of the broker-dealer) would not be held in a manner that complies with the possession or control requirement of Rule 15c3-3 and thus would be vulnerable to the risks the rule seeks to mitigate.

As noted above, the loss or theft of digital asset securities may cause the firm and its digital asset customers to incur substantial financial losses. This, in turn, could cause the firm to fail, imperiling its traditional securities customers as well as the broker-dealer's counterparties and other market participants. However, there are measures a broker-dealer can employ to comply with Rule 15c3-3 and mitigate these risks.

One step that a broker-dealer could take to shield traditional securities customers, counterparties, and market participants from the risks and consequences of digital asset security fraud, theft, or loss would be to limit its business exclusively to dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system for digital asset

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[11] Generally, SIPA defines the term "security" to include, among other things, any note, stock, treasury stock bond, debenture, evidence of indebtedness, any investment contract or certificate of interest or participation in any profit-sharing agreement, provided that such investment contract or interest is the subject of a registration statement with the Commission pursuant to the Securities Exchange Act of 1933 (15 U.S.C. 77a et seq.), and any put, call, straddle, option, or privilege on any security, or group or index of securities. *See* 15 U.S.C. 78lll(14). Generally, in a SIPA liquidation, customers' claims receive priority to the estate of customer property (generally cash and securities received acquired or held by the broker-dealer for the securities accounts of customers) over other creditors. *See* 15 U.S.C. 78fff & 78fff-2(c). In addition, to the extent that the estate of customer property is insufficient to satisfy the net equity claims of customers, the trustee can advance up to $500,000 for each customer, of which up to $250,000 can be used for cash claims. *See* 15 U.S.C. 78fff-3(a) & (d).

[12] *See* 17 CFR 240.15c3-3(b).

securities. Thus, to operate in a manner consistent with the Commission's position, the broker-dealer could not deal in, effect transactions in, maintain custody of, or operate an alternative trading system for traditional securities. In addition, by limiting its activities exclusively to digital asset *securities*, the broker-dealer would shield its customers from the risks that could arise if the firm engaged in activities involving non-security digital assets, which are not expressly governed by the Customer Protection Rule. For example, to the extent that the requirements of the Customer Protection Rule do not apply to non-security digital assets, such assets could receive less protection than securities, which would increase the risk of theft or loss and could ultimately cause the broker-dealer to fail, impacting customers and other creditors.

A second step the broker-dealer could take is to establish, maintain, and enforce reasonably designed written policies and procedures to conduct and document an analysis of whether a digital asset is a security offered and sold pursuant to an effective registration statement or an available exemption from registration, and whether the broker-dealer has fulfilled its requirements to comply with the federal securities laws with respect to effecting transactions in that digital asset security, before undertaking to effect transactions in and maintain custody of such asset. Such policies and procedures should provide a reasonable level of assurance that any digital assets transacted in or held in custody by the broker-dealer are in fact digital asset securities. Utilizing such policies and procedures should help ensure that the broker-dealer is confining its business to digital asset securities and that such digital asset securities are being offered, sold, or otherwise transacted in compliance with the federal securities laws.

A third step the broker-dealer could take is to establish, maintain, and enforce reasonably designed written policies and procedures to conduct and document an assessment of the characteristics of a digital asset security's distributed ledger technology and associated network[13]

[13] For the purposes of this statement, a digital asset security's distributed ledger technology and associated network includes the protocols and any smart contracts or applications integral to the operation of the digital asset security.

prior to undertaking to maintain custody of the digital asset security and at reasonable intervals thereafter. The assessment could examine at least the following aspects of the distributed ledger technology and its associated network, among others: (1) performance (*i.e.*, does it work and will it continue to work as intended); (2) transaction speed and throughput (*i.e.*, can it process transactions quickly enough for the intended application(s)); (3) scalability (*i.e.*, can it handle a potential increase in network activity); (4) resiliency (*i.e.*, can it absorb the impact of a problem in one or more parts of its system and continue processing transactions without data loss or corruption); (5) security and the relevant consensus mechanism (*i.e.*, can it detect and defend against malicious attacks, such as 51% attacks[14] or Denial-of-Service attacks, without data loss or corruption); (6) complexity (*i.e.*, can it be understood, maintained, and improved); (7) extensibility (*i.e.*, can it have new functionality added, and continue processing transactions without data loss or corruption); and (8) visibility (*i.e.*, are its associated code, standards, applications, and data publicly available and well documented). The assessment also could examine the governance of the distributed ledger technology and associated network and how protocol updates and changes are agreed to and implemented. This would include an assessment of impacts to the digital asset security of events such as protocol upgrades, hard forks, airdrops, exchanges of one digital asset for another, or staking.[15] Such assessments would allow a broker-dealer to be able to identify significant weaknesses or other operational issues with the distributed ledger technology and associated network utilized by the digital asset security, or other risks posed to the broker-dealer's business by the digital asset security, which would allow a broker-dealer to take appropriate action to identify and reduce its exposure to such risks. Accordingly, if there are significant weaknesses or other operational issues with the distributed

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[14] For the purposes of this statement, a "51% attack" is an attack on a blockchain or distributed ledger in which an attacker or group of attackers controls a majority of the network's hash rate, mining or computing power, allowing the attacker or group of attackers to prevent new transactions from being confirmed.

[15] For purposes of this statement, "hard forks" refer to backward-incompatible protocol changes to a distributed ledger that create additional versions of the distributed ledger, potentially creating new digital assets. "Airdrops" refer to the distribution of digital assets to numerous addresses, usually at no monetary cost to the recipient or in exchange for certain promotional services. "Staking" refers to the use of a digital asset in a consensus mechanism.

ledger technology and associated network, the broker-dealer would be able to determine whether it could or could not maintain custody of the digital asset security.

A fourth step the broker-dealer could take is to establish, maintain, and enforce reasonably designed written policies, procedures, and controls for safekeeping and demonstrating the broker-dealer has exclusive possession or control over digital asset securities that are consistent with industry best practices to protect against the theft, loss, and unauthorized and accidental use of the private keys necessary to access and transfer the digital asset securities the broker-dealer holds in custody. These policies, procedures, and controls could address, among other matters: (1) the on-boarding of a digital asset security such that the broker-dealer can associate the digital asset security to a private key over which it can reasonably demonstrate exclusive physical possession or control; (2) the processes, software and hardware systems, and any other formats or systems utilized to create, store, or use private keys and any security or operational vulnerabilities of those systems and formats; (3) the establishment of private key generation processes that are secure and produce a cryptographically strong private key that is compatible with the distributed ledger technology and associated network and that is not susceptible to being discovered by unauthorized persons during the generation process or thereafter; (4) measures to protect private keys from being used to make an unauthorized or accidental transfer of a digital asset security held in custody by the broker-dealer; and (5) measures that protect private keys from being corrupted, lost or destroyed, that back-up the private key in a manner that does not compromise the security of the private key, and that otherwise preserve the ability of the firm to access and transfer a digital asset security it holds in the event a facility, software, or hardware system, or other format or system on which the private keys are stored and/or used is disrupted or destroyed. These policies, procedures, and controls for safekeeping and demonstrating the broker-dealer has exclusive possession or control over digital asset securities should serve to protect against the theft, loss, and unauthorized and accidental use of the private keys and therefore the customers' digital asset securities.

A fifth step the broker-dealer could take is to establish, maintain, and enforce reasonably designed written policies, procedures, and arrangements to: (1) specifically identify, in advance, the steps it intends to take in the wake of certain events that could affect the firm's custody of the digital asset securities, including blockchain malfunctions, 51% attacks, hard forks, or airdrops; (2) allow the broker-dealer to comply with a court-ordered freeze or seizure; and (3) allow the transfer of the digital asset securities held by the broker-dealer to another special purpose broker-dealer, a trustee, receiver, liquidator, a person performing a similar function, or another appropriate person, in the event the broker-dealer can no longer continue as a going concern and self-liquidates or is subject to a formal bankruptcy, receivership, liquidation, or similar proceeding. These policies and procedures should include measures for ensuring continued safekeeping and accessibility of the digital asset securities, even if the broker-dealer is wound down or liquidated, and thus would provide a reasonable level of assurance that a broker-dealer has developed plans to address unexpected disruptions to the broker-dealer's control over digital asset securities.

A sixth step the broker-dealer could take is to provide written disclosures to prospective customers about the risks of investing in or holding digital asset securities. The disclosures could include, among other matters: (1) prominent disclosure explaining that digital asset securities may not be "securities" as defined in SIPA[16]—and in particular, digital asset securities that are "investment contracts" under the *Howey* test[17] but are not registered with the Commission are excluded from SIPA's definition of "securities"—and thus the protections afforded to securities customers under SIPA may not apply with respect to those securities; (2) a description of the risks of fraud, manipulation, theft, and loss associated with digital asset securities; (3) a description of the risks relating to valuation, price volatility, and liquidity associated with digital asset securities; and (4) a description of the processes, software and

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16 15 U.S.C. 78*lll*(14).

17 *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

hardware systems, and any other formats or systems utilized by the broker-dealer to create, store, or use the broker-dealer's private keys and protect them from loss, theft, or unauthorized or accidental use (including, but not limited to, cold storage, key sharding, multiple factor identification, and biometric authentication). The purpose of such disclosures is to provide the prospective customers with sufficient and easily understandable information about the risks to enable them to make informed decisions about whether to invest in or hold digital asset securities through the broker-dealer.

A seventh step the broker-dealer could take is to enter into a written agreement with each customer that sets forth the terms and conditions with respect to receiving, purchasing, holding, safekeeping, selling, transferring, exchanging, custodying, liquidating, and otherwise transacting in digital asset securities on behalf of the customer.[18] This step would ensure documentation of the terms of agreement between the customer and the broker-dealer providing custody of the customer's digital asset security, which would provide greater clarity and certainty to customers regarding their rights and responsibilities under the agreement with the broker-dealer.

IV. COMMISSION POSITION

The Commission's position[19] is expressly limited to paragraph (b) of Rule 15c3-3 under the Securities Exchange Act of 1934 ("Exchange Act"). Furthermore, the Commission's position does not modify or change any obligations of a broker-dealer, or other party, to otherwise comply with the federal securities laws, including the broker-dealer financial responsibility rules, obligations regarding proxy voting and beneficial ownership communications, as well as the broker-dealer's obligation to become a member of FINRA and to comply with applicable anti-money laundering and countering the financing of terrorism

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[18] The agreement should contain such provisions and disclosures as are required by applicable laws, rules, and regulations.

[19] The Commission's position is an agency statement of general applicability with future effect designed to implement, interpret, or prescribe law or policy.

obligations under the Bank Secrecy Act.[20] All terms used in this Commission position will have the definitions set forth in Rule 15c3-3. Finally, the Commission's position, which will expire after a period of five years from the publication date of this statement, applies only to the exercise of its enforcement discretion with respect to compliance with paragraph (b)(1) of Rule 15c3-3 under the circumstances set forth below. During this period, the Commission will continue to evaluate its position, and the circumstances set forth below, on an ongoing basis as it considers responses to the request for comments as well as further action in this area, including any future rulemaking.

After considering the minimum steps that can be taken to mitigate the risks posed by broker-dealer custody of digital asset securities, for a period of five years, the Commission's position is that a broker-dealer in the following circumstances would not be subject to a Commission enforcement action on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities:

1. The broker-dealer has access to the digital asset securities and the capability to transfer them on the associated distributed ledger technology;

2. The broker-dealer limits its business to dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system for digital asset securities; provided a broker-dealer may hold proprietary positions in traditional securities solely for the

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[20] *See* Heath Tarbert, Chairman, U.S. Commodity Futures Trading Commission, Kenneth A. Blanco, Director, Financial Crimes Enforcement Network, and Jay Clayton, Chairman, Commission, Leaders of CFTC, FinCEN, and SEC Issue Joint Statement on Activities Involving Digital Assets, dated Oct. 11, 2019 (reminding persons engaged in activities involving digital assets of their anti-money laundering ("AML") and countering the financing of terrorism ("CFT") obligations under the Bank Secrecy Act, and stating that broker-dealers are required to implement reasonably-designed AML programs and report suspicious activity, and that such requirements are not limited in their application to activities involving digital assets that are "securities" under the federal securities laws), *available at* https://www.sec.gov/news/public-statement/cftc-fincen-secjointstatementdigitalassets.

purposes of meeting the firm's minimum net capital requirements under Rule 15c3-1,[21] or hedging the risks of its proprietary positions in traditional securities and digital asset securities.

3. The broker-dealer establishes, maintains, and enforces reasonably designed written policies and procedures to conduct and document an analysis of whether a particular digital asset is a security offered and sold pursuant to an effective registration statement or an available exemption from registration, and whether the broker-dealer meets its requirements to comply with the federal securities laws with respect to effecting transactions in the digital asset security, before undertaking to effect transactions in and maintain custody of the digital asset security;

4. The broker-dealer establishes, maintains, and enforces reasonably designed written policies and procedures to conduct and document an assessment of the characteristics of a digital asset security's distributed ledger technology and associated network prior to undertaking to maintain custody of the digital asset security and at reasonable intervals thereafter;

5. The broker-dealer does not undertake to maintain 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, or is aware of other material risks posed to the broker-dealer's business by the digital asset security;

6. The broker-dealer establishes, maintains, and enforces reasonably designed written policies, procedures, and controls that are consistent with industry best practices to demonstrate the broker-dealer has exclusive control over the digital asset securities it holds in custody and to protect against the theft, loss, and unauthorized and accidental use of the private

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[21] 17 CFR. 240.15c3-1.

keys necessary to access and transfer the digital asset securities the broker-dealer holds in custody;

7. The broker-dealer establishes, maintains, and enforces reasonably designed written policies, procedures, and arrangements to: (i) specifically identify, in advance, the steps it will take in the wake of certain events that could affect the firm's custody of the digital asset securities, including, without limitation, blockchain malfunctions, 51% attacks, hard forks, or airdrops; (ii) allow for the broker-dealer to comply with a court-ordered freeze or seizure; and (iii) allow for the transfer of the digital asset securities held by the broker-dealer to another special purpose broker-dealer, a trustee, receiver, liquidator, or person performing a similar function, or to another appropriate person, in the event the broker-dealer can no longer continue as a going concern and self-liquidates or is subject to a formal bankruptcy, receivership, liquidation, or similar proceeding;

8. The broker-dealer provides written disclosures to prospective customers: (i) that the firm is deeming itself to be in possession or control of digital asset securities held for the customer for the purposes of paragraph (b)(1) of Rule 15c3-3 based on its compliance with this Commission position; and (ii) about the risks of investing in or holding digital asset securities that, at a minimum: (a) prominently disclose that digital asset securities may not be "securities" as defined in SIPA—and in particular, digital asset securities that are "investment contracts" under the *Howey* test but are not registered with the Commission are excluded from SIPA's definition of "securities"—and thus the protections afforded to securities customers under SIPA may not apply; (b) describe the risks of fraud, manipulation, theft, and loss associated with digital asset securities; (c) describe the risks relating to valuation, price volatility, and liquidity associated with digital asset securities; and (d) describe, at a high level that would not compromise any security protocols, the processes, software and hardware systems, and any other

formats or systems utilized by the broker-dealer to create, store, or use the broker-dealer's private keys and protect them from loss, theft, or unauthorized or accidental use;[22] and

9. The broker-dealer enters into a written agreement with each customer that sets forth the terms and conditions with respect to receiving, purchasing, holding, safekeeping, selling, transferring, exchanging, custodying, liquidating and otherwise transacting in digital asset securities on behalf of the customer.[23]

V. REQUEST FOR COMMENT

The Commission is seeking comment on the specific questions below. When responding to the request for comment, please explain your reasoning.

1. What are industry best practices with respect to protecting against theft, loss, and unauthorized or accidental use of private keys necessary for accessing and transferring digital asset securities? What are industry best practices for generating, safekeeping, and using private keys? Please identify the sources of such best practices.
2. What are industry best practices to address events that could affect a broker-dealer's custody of digital asset securities such as a hard fork, airdrop, or 51% attack? Please identify the sources of such best practices.
3. What are the processes, software and hardware systems, or other formats or systems that are currently available to broker-dealers to create, store, or use private keys and protect them from loss, theft, or unauthorized or accidental use?
4. What are accepted practices (or model language) with respect to disclosing the risks of digital asset securities and the use of private keys? Have these practices or the model language been utilized with customers?

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[22] The broker-dealer will need to retain these written disclosures in accordance with the broker-dealer record retention rule. *See* 17 CFR 240.17a-4(b)(4).

[23] The broker-dealer will need to retain these written agreements in accordance with the broker-dealer record retention rule. *See* 17 CFR 240.17a-4(b)(7).

5. Should the Commission expand this position in the future to include other businesses such as traditional securities and/or non-security digital assets? Should this position be expanded to include the use of non-security digital assets as a means of payment for digital asset securities, such as by incorporating a *de minimis* threshold for non-security digital assets?
6. What differences are there in the clearance and settlement of traditional securities and digital assets that could lead to higher or lower clearance and settlement risks for digital assets as compared to traditional securities?
7. What specific benefits and/or risks are implicated in a broker-dealer operating a digital asset alternative trading system that the Commission should consider for any future measures it may take?

By the Commission.

Dated: December 23, 2020

Vanessa A. Countryman
Secretary

February 26, 2021

The Division of Examinations' Continued Focus on Digital Asset Securities*

I. Introduction

In the experience of the Division of Examinations (the "Division"), a number of activities related to the offer, sale, and trading of digital assets[1] that are securities ("Digital Asset Securities") present unique risks to investors. Moreover, distributed ledger technology has many distinct features that the Division encourages firms to consider when designing their regulatory compliance program. To address these risks and adapt as distributed ledger technologies change and mature, many market participants involved with Digital Asset Securities have been updating and enhancing their compliance practices.

This Risk Alert provides observations made by Division staff during examinations of investment advisers, broker-dealers, and transfer agents regarding Digital Asset Securities that may assist firms in developing and enhancing their compliance practices. In addition, as more securities industry participants seek to engage in digital asset-related activities, this Risk Alert provides transparency about areas of focus for the Division's future examinations.

II. Investment Advisers

The staff has identified risks from recent examinations of investment advisers managing Digital Asset Securities, as well as other digital assets and derivative products, for their clients either directly or indirectly through pooled vehicles (e.g., private funds). Based on these observations, examinations will focus on regulatory compliance associated with, among other things:

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* This statement represents the views of the staff of the Division of Examinations (formerly known as the Office of Compliance Inspections and Examinations). It is not a rule, regulation, or statement of the U.S. Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content. This statement, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

1 The term "digital asset," as used herein, refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology ("distributed ledger technology"), including, but not limited to, so-called "virtual currencies," "coins," and "tokens." A particular digital asset may or may not meet the definition of "security" under the federal securities laws.

- *Portfolio management*. A review of policies, procedures, and practices of investment advisers investing client assets in Digital Asset Securities and other digital assets will focus in particular on the following areas:
    - Classification of digital assets managed on behalf of their clients, including whether they are classified as securities;[2]
    - Due diligence on digital assets (e.g., that the adviser understands the digital asset, wallets, or any other devices or software used to interact with the relevant digital asset network or application, and the relevant liquidity and volatility of the digital asset);
    - Evaluation and mitigation of risks related to trading venues and trade execution or settlement facilities (e.g., with respect to security breaches, fraud, insolvency, market manipulation, the quality of market surveillance, KYC/AML procedures, and compliance with applicable rules and regulations);
    - Management of risks and complexities associated with "forked" and "airdropped" digital assets (e.g., allocations thereof across client accounts, conflicts of interest, or other issues that may result from the fork or airdrop event);[3] and
    - Fulfillment of their fiduciary duty with respect to investment advice – across all client types.[4]
- *Books and records*. Examinations will include a review of whether advisers are making and keeping accurate books and records, including recording trading activity in

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[2] *See* Section 2(a)(1) of the Securities Act of 1933 ("Securities Act") and Section 3(a)(10) of the Securities Exchange Act of 1934 ("Exchange Act"), Section 2(a)(36) of the Investment Company Act of 1940 ("Investment Company Act"), and Section 202(a)(18) of the Investment Advisers Act of 1940 ("Advisers Act"). *See also* Staff publication, Framework for "Investment Contract" Analysis of Digital Assets (Apr. 3, 2019), available at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets; *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf.

[3] Digital assets essentially operate on software running across networks of peers that create and maintain shared ledger accounting for holdings of these assets. For purposes of this statement, "forked" refers to backward-incompatible protocol changes to a distributed ledger that create additional versions of the distributed ledger, creating new digital assets. For the purpose of this statement, "airdropped" refers to the distribution of digital assets to numerous addresses, usually at no monetary cost to the recipient or in exchange for certain promotional or other services.

[4] Advisers Act Section 206. *See also* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, IA Rel. No. 5248 at 12 (June 5, 2019) 84 FR 33669 (July 12, 2019) at 33672 (explaining that Section 206 imposes "a [fiduciary] duty to provide investment advice that is in the best interest of the client, including a duty to provide advice that is suitable for the client").

accordance with the recordkeeping requirements, if applicable.[5] Digital asset trading platforms vary in reliability and consistency with regard to order execution, settlement methods, and post-trade recordation and notification, which an adviser should consider when designing its recordkeeping practices.

- *Custody.* Examinations will review the risks and practices related to the custody of digital assets by investment advisers and examine for compliance with the custody rule (Rule 206(4)-2 under the Adviser's Act), where applicable.[6] Regardless of how digital assets are stored, the staff will review:

    - Occurrences of unauthorized transactions, including theft of digital assets;
    - Controls around safekeeping of digital assets (e.g., employee access to private keys and trading platform accounts);
    - Business continuity plans where key personnel have exclusive access to private keys;
    - How the adviser evaluates harm due to the loss of private keys;
    - Reliability of software used to interact with relevant digital asset networks;
    - Storage of digital assets on trading platform accounts and with third party custodians; and
    - Security procedures related to software and hardware wallets.

- *Disclosures.* Examinations will include a review of disclosures to investors in a variety of media (e.g., solicitations, marketing materials, regulatory brochures and supplements, and fund documents) regarding the unique risks associated with digital assets, including any risks that are heightened as a result of the digital nature of such assets.[7] In particular,

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[5] *See* Advisers Act Rule 204-2 ("Books and Records Rule"), which requires advisers to make and keep certain books and records relating to their investment advisory business, including typical accounting and other business records as required by the Commission.

[6] Advisers Act Rule 206(4)-2 (the "Custody Rule"). *See also* Staff Letter: Engaging on Non-DVP Custodial Practices and Digital Assets (Mar.12, 2019), available at https://www.sec.gov/investment/engaging-non-dvp-custodial-practices-and-digital-assets; and Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020), available at https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

[7] Registered investment advisers are required to provide their advisory clients and prospective clients with a written disclosure document (these requirements, and a few exceptions, are set forth in Rule 204-3 under the Advisers Act).

and among other things, the staff will assess disclosures regarding specific risks, including the complexities of the products and technology underlying such assets, technical, legal, market, and operational risks (including custody and cybersecurity), price volatility, illiquidity, valuation methodology, related-party transactions, and conflicts of interest.

- *Pricing client portfolios*. Investment advisers apply a variety of valuation methods to determine the value of digital assets managed on behalf of clients. Investment advisers may face valuation challenges for digital assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation. Examinations will include a review of, among other things, the valuation methodologies utilized, including those used to determine principal markets, fair value, valuation after significant events, and recognition of forked and airdropped digital assets.[8] The staff will also review disclosures related to valuation methodologies, and advisory fee calculations and the impact valuation practices have on these fees.

- *Registration issues*. For investment advisers, examinations will include a review of compliance matters related to appropriate registration. This includes, among other things, understanding how the investment adviser calculates its regulatory assets under management,[9] and characterizes the digital assets in the pooled vehicles it manages[10] and the status of clients.[11] For private funds managed by investment advisers, this also includes understanding how the funds determine applicable exemptions from registration as investment companies.[12]

III. Broker-Dealers

The staff has identified risks through regulatory coordination and through observations from recent examinations of broker-dealers. Due to the risks the staff has observed, future examinations of broker-dealers will focus on regulatory compliance associated with, among

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[8] *See, e.g.,* Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), available at https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm.

[9] Advisers Act Section 203A sets forth the requirements for investment adviser registration, including assets under management thresholds.

[10] *See* The definition of "investment company," contained in Section 3(a) of the Investment Company Act.

[11] *See* General Instructions to Form ADV, available at https://www.sec.gov/about/forms/formadv-instructions.pdf and definition of "client" in Item 7 of the Glossary of Terms.

[12] A private fund or other pooled investment vehicle that meets the definition of an "investment company" in Section 3(a) of the Investment Company Act must register with the SEC as an investment company, unless it satisfies an exclusion or exemption from that definition. *See, e.g.,* Crypto Asset Management, LP and Timothy Enneking, Securities Act Rel. No. 10544 (Sept. 11, 2018) (settled order), available at https://www.sec.gov/litigation/admin/2018/33-10544.pdf.

other things:

- *Safekeeping of funds and operations.* The staff will examine broker-dealers to understand operational activities, including operations that are unique to the safety and custody of Digital Asset Securities.[13]

- *Registration requirements.* Examinations will include broker-dealers' and any affiliated entities' compliance with registration requirements. For example, if an affiliate of a registered broker-dealer engages in the business of effecting transactions in Digital Asset Securities for the accounts of others, that affiliate may be required to register as a broker-dealer.[14]

- *Anti-Money Laundering (AML).* Certain pseudonymous aspects of distributed ledger technology present unique challenges to the robust implementation of an AML program. The staff has observed broker-dealer AML programs that have not consistently addressed or implemented routine searches or, to the extent they implemented routine searches, have not updated those searches to check against the Specially Designated Nationals list maintained by the Office of Foreign Assets Control ("OFAC") at the U.S. Department of the Treasury. The staff also has observed inadequate AML procedures, controls, and documentation regarding Digital Asset Securities. The staff will continue to examine broker-dealer compliance with AML obligations (e.g., filing suspicious activity reports and performing customer due diligence).[15]

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[13] *See* Exchange Act Rules 15c3-1, 15c3-3, 17a-3, and 17a-4. *See also* Commission Statement and Request for Comment, *Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, dated December 23, 2020, available at https://www.sec.gov/rules/policy/2020/34-90788.pdf (setting forth time-limited circumstances for broker-dealer custody of digital asset securities and requesting comment); Letter to Ms. Kris Dailey, Financial Industry Regulatory Authority (FINRA), ATS Role in the Settlement of Digital Asset Security Trades, dated September 25, 2020, available at https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf (setting forth the Commission's Division of Trading and Markets staff position describing circumstances under which staff will not recommend enforcement action against a broker-dealer operating an ATS that trades digital asset securities using a specified 3-step process); *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities*, dated July 8, 2019, available at https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities (statement of the Commission's Division of Trading and Markets and FINRA Office of General Counsel concerning application of federal securities laws and FINRA rules to the potential intermediation of digital asset securities and transactions).

[14] Securities exchanges and broker-dealers are required to be registered under the Exchange Act Sections 6 and 15(a), respectively. See generally the Division of Trading and Markets Investor Publication: Guide to Broker-Dealer Registration (April 2008), available at https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html#II.

[15] *See, e.g.*, Bank Secrecy Act implementing rules at 31 CFR 1023.320 (suspicious activity rule), 31 CFR 1023.210 (AML program rule including customer due diligence requirement), and 31 CFR 1010.320 (beneficial ownership rule). *See also* FINRA 3310 (AML compliance program rule for FINRA member firms); SEC's AML Source Tool for Broker-Dealers, available at

- *Offerings*. Broker-dealers may be involved in underwriting and private placement activity with respect to Digital Asset Securities, which can raise unique disclosure and due diligence obligations.[16] Examinations will include a review of the due diligence performed by broker-dealers, and the disclosures made by broker-dealers to customers related to the offering of Digital Asset Securities.[17]

- *Disclosure of conflicts of interest*. As the staff has observed, broker-dealers may operate in multiple capacities, including as trading platforms or proprietary traders of Digital Asset Securities on their own and other platforms.[18] Examinations will include a review of the existence and disclosures of conflicts of interest and the compliance policies and procedures to address them.

- *Outside Business Activities*. The staff has observed instances of registered representatives of broker-dealers offering services related to digital assets apart from their employer. FINRA-member broker-dealers must evaluate the activities of their registered persons to determine whether such activity constitutes outside business activities or an outside securities activity and therefore should be subjected to the approval, supervision, and recordation of the broker-dealer.[19] The staff will continue to review FINRA-member broker-dealer compliance processes in connection with the evaluation, approval, and monitoring of outside business activities.

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https://www.sec.gov/about/offices/ocie/amlsourcetool.htm. In addition, for FINRA member firms, the staff will assess firms' compliance with FINRA Rule 2090 ("Know Your Customer" rule).

[16] Securities Act Section 17(a), Exchange Act Section 10(b), and FINRA Regulatory Notice 10-22 Regulation D Offerings – Obligation of Broker-Dealers to Conduct Reasonable Diligence Investigations in Regulation D Offerings.

[17] To the extent a broker-dealer engages in trading on behalf of clients or in their own accounts, the staff will examine for compliance with relevant rules.

[18] *See also* Exchange Act Section 15(c) and FINRA Rules 2010 and 2020.

[19] FINRA Rule 3270. *See also* FINRA Rule 3280.

IV. National Securities Exchanges

- *Exchange Registration*. Advances in distributed ledger technology have introduced innovative methods for facilitating electronic trading in Digital Asset Securities. A platform that operates as an "exchange" as defined under Section 3(a)(1) of the Exchange Act and Rule 3b-16(a) thereunder must register as a national securities exchange or operate pursuant to an exemption.[20] The staff will examine platforms that facilitate trading in Digital Asset Securities and review whether they meet the definition of an exchange.

- *Compliance with Regulation ATS*. One exemption from national securities exchange registration that is available to an entity that meets the definition of an exchange is the exemption for alternative trading systems ("ATSs").[21] Examinations will include a review of whether an ATS that trades Digital Asset Securities is operating in compliance with Regulation ATS, including, among other things, whether the ATS has accurately and timely disclosed information on Form ATS and Form ATS-R, and has adequate safeguards and procedures to protect confidential subscriber trading information.

V. Transfer Agents

- *Compliance with Transfer Agent Rules*. Distributed ledger technology is increasingly being used by issuers of securities to perform, directly or indirectly, various shareholder administrative functions, including recordation of ownership.[22] The Commission has

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[20] Exchange Act Rule 3b-16 provides a functional test to assess whether an entity meets the definition of an exchange under Section 3(a)(1) of the Exchange Act. Exchange Act Rule 3b-16(a) provides that an entity shall be considered to constitute, maintain, or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by an exchange" if such organization, association, or group of persons: (1) brings together the orders for securities of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade. *See, e.g.*, Zachary Coburn, Exchange Act Rel. No. 84553 (Nov. 8, 2018) (settled order), available at https://www.sec.gov/litigation/admin/2018/34-84553.pdf.

[21] Exchange Act Rule 3a1-1(a)(2) exempts from the Exchange Act Section 3(a)(1) definition of "exchange" an organization, association, or group of persons that complies with Regulation ATS. A person or entity that meets the definition of an exchange and complies with Regulation ATS is not required to register as a national securities exchange. An entity that meets the exchange definition that fails to comply with the requirements of Regulation ATS would no longer qualify for the exemption provided under Rule 3a1-1(a)(2), and thus, could be deemed to be operating as an unregistered exchange in violation of Section 5 of the Exchange Act. *See* Exchange Act Release No. 83663 (July 18, 2018) 83 FR 38768 (August 7, 2018) at 38772.

[22] Section 3(a)(25) of the Exchange Act defines "transfer agent."

promulgated rules for registered transfer agents[23] that are intended to facilitate prompt and accurate clearance and settlement of securities transactions. Examinations will include a review of whether registered transfer agents servicing Digital Asset Securities are operating in compliance with such rules.

VI. Conclusion

In sharing the focus areas for the digital asset initiatives, the Division encourages market participants to reflect upon their own practices, policies and procedures, as applicable, and to promote improvements in their supervisory, oversight, and compliance programs. The Division understands that, as financial innovation continues, market participants may have questions as to their regulatory obligations. Should such questions arise regarding Digital Asset Securities, market participants are encouraged to engage with the Commission's staff through the agency's Strategic Hub for Innovation Technology ("FinHub"). To contact Commission staff for assistance, please visit the Commission's FinHub webpage.[24]

This Risk Alert is intended to highlight for firms risks and issues that Division staff has identified. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance, and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

[23] Section 17A(c) of the Exchange Act requires transfer agents to register with the Commission. *See* Exchange Act Rules 17Ad-1 to 17Ad-7.

[24] https://www.sec.gov/finhub.

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

Trading, Best Execution, and the Future of Soft Dollars

Ari Burstein, ***President***, Capital Markets Strategies
Lori Renzulli, ***Chief Compliance Officer and Counsel***, Harding Loevner LP
Steven W. Stone, ***Partner***, Morgan, Lewis & Bockius LLP
Monique Botkin, ***Associate General Counsel***, Investment Adviser Association (Moderator)

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Speakers


Ari Burstein


Lori Renzulli


Steven W. Stone


Monique Botkin

Agenda

- Market Structure Developments
- Duty to Seek Best Execution – SEC Guidance, Factors, Selected Issues, Fixed Income
- Soft Dollars, Research and MiFID II
- SEC Exam and Enforcement Focus

Market Structure Developments

- Increased transparency of market information and conflicts in order routing
  - Regulatory driven - new and amended Exchange Act Rule 606 for order routing and order execution reports on NMS stocks
  - Market driven – increased availability of information from counterparties
  - Challenges for advisers – how to interpret and use the data available and ask the right questions of trading counterparties
- Continuing proliferation of trading technology
  - Advancements in trading tools and services available
  - Challenges for advisers – allocation of resources to take advantage of new technology, understanding how to best utilize tools, decisions of whether to outsource trading functions

Market Structure Developments

- Market Data – Content, Dissemination and Governance
  - Market Data Infrastructure
  - Governance
  - Global Focus on Market Data
- Fixed Income Market Structure Reform / FIMSAC
  - SEC Concept Release on Electronic Corporate Bond and Municipal Securities Market
  - Proposed Amendments to Regulation ATS for Government Securities ATSs

Market Structure Developments

- Consolidated Audit Trail
  - Concerns around data security and cybersecurity: limiting the scope of sensitive information required to be collected by the CAT
- Disclosure of Order Handling Information by Broker-Dealers - Rule 606 under Reg NMS
  - How routing orders may impact execution quality, including managing potential for information leakage, conflicts of interest, and how following order handling instructions

Duty to Seek Best Execution – SEC Guidance

- SEC & staff Guidance
  - 1986 Release
  - 2008 Proposed Interpretive Guidance for Fund Boards
  - 2018 OCIE Risk Alert
  - 2019 Fiduciary Interpretation
- Core Concepts
  - Fiduciary duty to seek best execution
  - Advisers must execute securities transactions so that client's total cost or proceeds "is the most favorable under the circumstances"
  - Consideration or "full range and quality" of broker's services
  - Assessment does not turn on the lowest possible commission cost
  - Advisers should "periodically and systematically" evaluate the performance of brokers

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Duty to Seek Best Execution – Factors

- Net price, including commission, mark-up & down or spreads
- Execution quality – accurate and timely execution, clearance and error/dispute resolution
- Soft dollar research/services
- Reputation, financial strength and stability
- Block trading and block positioning capabilities
- Willingness and ability to execute hard trades
- Willingness and ability to commit capital
- Access to underwritten offerings and secondary markets
- Ongoing reliability
- Market intelligence
- Confidentiality

Duty to Seek Best Execution – Selected Issues

- Asset classes, emerging markets and digital assets
- Counterparty credit and settlement risk
- Zero commissions
- Payment for order flow
- Incorporating new technology offered by market participants
- Trends in outsourced trading
- Policies and procedures, committee/governance, monitoring and testing
- Disclosure practices and trends
- Cross trading – valuation release interpretation

Duty to Seek Best Execution – Fixed Income

- OCIE Examination Priorities (February 2018) - Best execution policies and procedures for municipal bond and corporate bond transactions
- Challenges with best price and execution
  - Opacity of issuer and market information
    - Many illiquid investments
    - Fungibility of investments complicates analysis
    - Limited information on best ex across trading venues and participants
  - Shallow nature of dealer "books"
- Challenges with interest rate environment (*e.g.,* high yield)

Soft Dollars, Research and MiFID II

- Effective January 2018 - banned the receipt of inducements, including research, by EU domiciled investment advisers, with two exceptions:
  - "Minor non-monetary benefits" capable of enhancing the quality of service provided to a client if disclosed and of a scale and nature that does not impair acting in best interest of client
  - Research paid for out of the firm's own resources or from a research payment account (RPA)
- MiFID II Unbundling Requirements
  - A firm providing execution services shall identify separate charges for these services that only reflect the cost of executing the transaction
  - The supply of, and charges for, those other benefits or services shall not be influenced or conditioned by levels of payment for execution services

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Soft Dollars, Research and MiFID II

- SEC No-Action Relief and Request for Comment – October 26, 2017
  - SIFMA Letter: Relief from Brokers Being Deemed Advisers When Accepting Cash for Research (Advisers Act Section 202(a)(11))
  - ICI Letter: Relief Allowing Investment Managers to Aggregate Orders with Differing Research Funding (Advisers Act Section 206 and 1940 Act Rule 17d-1)
  - SIFMA AMG Letter: Relief Allowing Investment Managers to Use Client-Funded RPAs to Obtain Research (Exchange Act Section 28(e))
- Impact on advisers subject MiFID II and those not subject to MiFID II (*e.g.*, investment process, best interests of clients, research on smaller companies, value and price of research)

12

Soft Dollars, Research and MiFID II

- EU Capital Markets Recovery Package permits commission bundling for research for small and medium-sized enterprises (SMEs) (December 15, 2020)
  - https://www.consilium.europa.eu/media/47469/st13798-ad01-en20.pdf
- ESMA paper concludes MiFID II research unbundling rules had no effect on SME research (February 17, 2021)
  - https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1269_research_unbundling.pdf
  - "In light of this consultation, the research unbundling rules may further evolve in the future."
  - EC will review rules on investment research by July 31, 2021
- SEC No-Action Relief expires on July 3, 2023

SEC Exam and Enforcement Focus

- Exam requests and data analysis ("NEAT")
  - Trade blotter (including trade errors, cancellations, rebills and reallocations) for client, proprietary & access person accounts
  - Wrap fee programs and trade-aways
  - Client-directed brokerage
  - Trade errors
  - Allocation exception reports
  - IPOs and allocations
  - Affiliated brokers
  - Principal and cross trades
  - Best execution reports and committee materials
  - List of brokers and brokerage agreements
- Enforcement trends
  - Best execution, including share class selection
  - Soft dollars
  - Trade allocation
  - Principal and agency trades
  - Wrap fee programs and trade-away practices
  - Cross trading
  - Algorithmic trading/models
  - Disclosures on trading team

SEC Exam Risk Alerts

- For advisers managing Digital Asset Securities (and other digital assets and derivative products) for their clients either directly or indirectly through pooled vehicles (*e.g.,* private funds)
- Areas of Exam Focus (February 26, 2021)
  - https://www.sec.gov/files/digital-assets-risk-alert.pdf
  - Portfolio Management: Risks of using trading venues and trade execution or settlement facilities (e.g., data, fraud, insolvency, AML)
  - Recordkeeping: Digital asset trading platforms' order execution, settlement methods, and post-trade recordation and notification
  - Custody: Controls around safekeeping of digital assets (*e.g.*, employee access to trading platform accounts) and storage of digital assets on trading platform accounts and with third party custodians

SEC Exam Risk Alerts

- Large Trader (December 16, 2020)
  - https://www.sec.gov/files/Risk%20Alert%20-%20Large%20Trader%2013h.pdf
  - Monitor when applicable, file Form 13H (including list of brokers), notify brokers of status
- Investment Adviser Compliance Programs Observations (November 19, 2020)
  - https://www.sec.gov/files/Risk%20Alert%20IA%20Compliance%20Programs_0.pdf
  - Trading practices: allocation of soft dollars, trade errors, best execution, restricted securities
- Compliance Issues Related to Best Execution (July 11, 2018)
  - https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

IAA 2021 Investment Adviser Compliance Conference March 4, 2021

Trading, Best Execution, and the Future of Soft Dollars

Trading, Best Execution, and the Future of Soft Dollars

Steven W. Stone*

I. BEST EXECUTION – RECENT AREAS OF FOCUS

A. Move to zero commissions in the retail marketplace and payment for order flow (and different types of payment for order flow)

B. Institutional marketplace and regulatory changes

C. Outsourced trading desks and joint trading desks

D. Addressing volatile markets, settlement risks, etc.

E. Digital assets

F. Cents-per-share vs. BPS commissions?

II. BEST EXECUTION – CORE PRINCIPLES

A. The Fiduciary Duty to Seek Best Execution. As the landscape for trading has changed in recent years, the trading practices of investment advisers also have changed to adapt. Trading and best execution decisions for advisers pose complex issues, including the choice of broker-dealers to execute trades, venues for execution, information leakage, efforts to gauge transaction costs and conflicts issues that cloud the analysis of best execution and related judgments. The SEC further interpreted this fiduciary duty in its 2019 guidance.[1]

B. Investment Advisers as Fiduciaries. By way of background, neither the Investment Company Act of 1940, as amended (the "Investment Company Act"), nor the Investment Advisers Act of 1940, as amended (the "Advisers Act"), expressly delineates the fiduciary duties of registered investment advisers.[2] However, the US Supreme Court has held that investment advisers are fiduciaries who have an affirmative duty to act in utmost good faith and provide full and fair disclosure of all material facts.[3] The SEC's 2019 IA Interpretation clarified the duty by providing that, under the Advisers Act, an

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 Prior versions of this outline were prepared with the help of my colleagues.

1 *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) ("2019 IA Interpretation").

2 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (citations omitted) ("*Capital Gains*"). As a general rule, the nature of an investment adviser's fiduciary duties is determined by reference to principles of common law applicable to fiduciaries. Tamar Frankel, *The Regulation of Advisers – Mutual Funds and Investment Advisers* § 14.01 (2002 Supp.) ("Frankel"). *See also* Investment Advisers Act Release No. 40 (Jan. 5, 1945) ("It is clear, however, that investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship."). The extent of an investment adviser's duties, like the duties of other fiduciaries, depends on the expertise they represent themselves to have, their control over clients' assets and investment decisions, and the degree of clients' reliance on the advisers. *See* Frankel § 13.01[A].

3 *Capital Gains*; *Transamerica Mortg. Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

investment adviser is a fiduciary that "must, at all times, serve the best interest of its client and not subordinate its client's interest to its own."[4]

C. The Duty to Seek Best Execution. Under common law, two of the primary duties owed by a fiduciary are the duty of care and the duty of loyalty. As a fiduciary, an investment adviser has the duty to perform its activities in a competent manner.[5] According to the 2019 IA Interpretation, the duties of loyalty and care also require that an investment adviser act in the best interest of its client at all times.[6] Principles of agency law provide that, unless otherwise agreed, an investment adviser must act solely for the benefit of the client in all matters connected with the relationship.[7] A specific duty flowing from an adviser's duties of care and loyalty is the duty to seek best execution of client transactions.[8] An investment adviser must seek to execute securities transactions for its clients in such a manner that the client's total cost or proceeds in each transaction – to the extent ascertainable – are the most favorable under the circumstances. In seeking to achieve best execution, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the account under the circumstances. Accordingly, an investment adviser may take into account the full range and quality of a broker's services in selecting broker-dealers including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser, as well as other factors.[9] The 2019 IA Interpretation reinforced this obligation and methodology for seeking best execution, and added that an investment adviser should periodically and systematically evaluate the execution it is receiving for its clients.[10]

D. The Duty of Loyalty – Conflicts of Interest and Disclosure. Inextricably related to the duty of loyalty is that, unless the client otherwise agrees, an investment adviser may not act for persons whose interests conflict with those of the adviser's client or deal with the client as an adverse party in a transaction connected with the adviser's relationship with the client.[11] However, under common law agency principles, an investment adviser is permitted to modify its duty of loyalty through clear disclosure and informed consent. In other words, an adviser can engage in a transaction even when the adviser is faced with a potential or actual conflict of interest, provided that the adviser informs its client in advance and obtains the client's consent.[12] The 2019 IA Interpretation further provides that "an investment

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4 *See supra* note 1.

5 The duty of care requires a fiduciary to make decisions "only after paying attention, getting the relevant information, and deliberating. This is the basis for the fiduciary duty of care." Frankel § 13.07.

6 *See supra* note 1.

7 *See* Restatement of Agency (Second) § 387 (1958) (the "Restatement").

8 *See, e.g.*, Disclosure by Investment Advisers Regarding Soft Dollar Practices, Advisers Act Release No. 1469 (Feb. 14, 1995) (an investment adviser has a "fundamental obligation under the Advisers Act (and state law) to act in the best interest of its clients. This duty requires the adviser to obtain best execution of client transactions."); *see also* Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Investment Company Act Release No. IC-28345 (July 30, 2008) (the "Proposed 2008 Guidance").

9 Exchange Act Release No. 23170 (Apr. 23, 1986) ("1986 Release").

10 *See supra* note 1.

11 *See* Restatement §§ 389, 394.

12 *See, e.g.*, Restatement §§ 390, 394. "One employed as agent violates no fiduciary duty to the principal by acting for another party to the transaction if he makes full disclosure of all relevant facts which he knows or should know, or if the principal otherwise knows of them and acquiesces in the agent's conduct. . . . The agent's disclosure must include not only the fact that he is acting on behalf of another party, but also all facts which are relevant in enabling the principal to make an intelligent determination." Comment b to Restatement § 392, cmt. b; *see also* Restatement § 390, cmt. a. *See also* Frankel § 13.01[B][1] ("[T]he rules of the common law are mostly default rules, which [clients] can waive upon disclosure.").

adviser must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser . . . to render advice which is not disinterested such that a client can provide informed consent to the conflict."[13] Registered investment advisers, of course, are subject to certain provisions governing specific conflicts of interest that disclosure and consent do not completely resolve, e.g., Section 10(f) and Section 17(a) of the Investment Company Act.

E. Best Execution – Brokers and Advisers. All broker-dealers and investment advisers have a legal duty to seek the best execution of their customers' and clients' securities transactions. The general duty to seek best execution for both broker-dealers and investment advisers derives from common law agency principles and fiduciary obligations.[14] Over the years, the best execution obligations for both broker-dealers and investment advisers have developed into multi-element analyses, but some of the elements differ between the two types of entities. For example, a broker-dealer's best execution obligation largely focuses on the price at which the client's order is executed in the marketplace, without considering the amount of commission that the broker-dealer charges.[15] On the other hand, an investment adviser's best execution obligation focuses on the client's total transaction cost, including the commission that the client pays the broker-dealer executing the transaction.

1. Broker-Dealers. In addition to the common law and fiduciary principles, the duty of best execution for broker-dealers has been addressed in SEC releases,[16] judicial opinions,[17] and self-regulatory organization ("SRO") rules.[18] As noted above, commissions are generally not included in the determination of whether a broker-dealer is achieving best execution. However, broker-dealers are subject to separate legal restrictions on the amount of commission that they may charge.

2. Broker-Dealers' Duty of Best Execution.

a. As a general matter, the duty of best execution requires a broker-dealer to seek the most advantageous terms for its customers' orders reasonably available under the circumstances. However, the SEC has recognized that obtaining best execution does not simply mean obtaining the best price or the fastest execution. The SEC has stated that factors other than price and speed may be relevant to best execution, including (1) the size of the order; (2) the trading characteristics of the security involved; (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information; and (4) the cost and difficulty associated with achieving an execution in a particular market center.[19]

b. The determination of whether a broker-dealer is satisfying its best execution obligation does not necessarily require an order-by-order evaluation. In fact, the SEC has recognized that it could be impractical for a broker-dealer that handles a large volume of orders to make

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13 *See supra* note 1.

14 *See, e.g.*, *Hall v. Paine*, 224 Mass. 62 (1916); *see also* Restatement § 424.

15 The reasonability of commissions or other charges imposed by broker-dealers is governed primarily under self-regulatory organization rules relating to fair prices for services and, in some circumstances, suitability.

16 *See, e.g.*, Securities Exchange Act Release Nos. 49,325 (Feb. 26, 2004) ("Regulation NMS Proposing Release"), 43,590 (Nov. 17, 2000) ("Execution Quality Release"), and 37,619A (Sept. 6, 1996) ("Order Handling Rules Release").

17 *See, e.g.*, *Newton v. Merrill Lynch*, 135 F.3d 266 (3rd Cir. 1998).

18 *See, e.g.*, FINRA Rule 5310 (providing that broker-dealers must use reasonable diligence to ascertain the best market for a security, and buy or sell the security in such market so that the resulting price to the customer is as favorable as possible under prevailing market conditions).

19 *See* Regulation NMS Proposing Release; Execution Quality Release.

execution decisions on each individual order.[20] Accordingly, the SEC has stated that automated routing or execution of customer orders is not necessarily inconsistent with best execution.[21] However, when a broker-dealer does not make execution decisions on an order-by-order basis, the broker-dealer must carry out a regular and rigorous review of the quality of market centers to evaluate its best execution practices, including the determination of the markets to which it routes customer order flow.[22] In conducting that review, the broker-dealer must consider whether different markets may be more suitable for different types of orders or particular securities.[23] In addition, broker-dealers must periodically examine their best execution practices in light of market and technology changes and modify those practices if necessary to enable their clients to obtain the best reasonably available prices.[24]

3. Investment Advisers.

a. An investment adviser's duty to seek best execution involves seeking the best total transaction cost for its clients, including commissions under the circumstances. More specifically, the SEC stated in a 1986 interpretive release, and more recently in the 2019 IA Interpretation, that an investment adviser "must execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."[25] However, the SEC has also stated that the amount of the transaction cost is not the sole determinative factor and that an investment adviser should consider the full range and quality of a broker-dealer's services, including, among other things, execution capability, the value of research provided, commission rates, and responsiveness to the investment adviser.[26]

b. As part of its duty of best execution, an investment adviser must periodically and systematically evaluate the execution performance of all broker-dealers executing the adviser's transactions.[27] The SEC has held that an investment adviser must periodically review the quality of execution of its clients' transactions even when the client has an existing relationship with the executing broker-dealer that predates the customer's relationship with the investment adviser.[28] Moreover, while the SEC expressly permits broker-dealers to determine their satisfaction of best execution obligations based on an overall review of execution quality, the SEC staff has implicitly

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20 *See* Exchange Act Release No. 36130 (Sept. 29, 1995); *see also* Order Handling Rules Release.

21 Order Handling Rules Release.

22 *Id.*

23 *Id.; see also* NASD Notice to Members 01-22 (Apr. 2001) ("The focus of the [regular and rigorous review] analysis is to determine whether any 'material' differences in execution quality exist and, if so, to modify the firm's routing arrangements or justify why it is not modifying its routing arrangements. This analysis must compare the quality of the executions the firm is obtaining via current order routing and execution arrangements (including the internalization of order flow) to the quality of the executions that the firm could obtain from competing markets and market centers. Accordingly, a broker/dealer must evaluate whether opportunities exist for obtaining improved executions of customer orders.").

24 *Newton*, 135 F.3d at 271; *see also* Order Handling Rules Release.

25 1986 Release & Proposed 2008 Guidance; 2019 IA Interpretation; *see In the Matter of Jamison, Eaton & Wood*, Advisers Act Release No. 2129 (May 15, 2003) ("*Jamison*"); *In the Matter of Renberg Cap. Mgmt., Inc.*, Advisers Act Release No. 2064 (Oct. 1, 2002); *In the Matter of Portfolio Advisory Servs., LLC*, Advisers Act Release No. 2038 (June 20, 2002); *see also In the Matter of Kidder, Peabody & Co.*, Advisers Act Release No. 232 (Oct. 16, 1968); Rule 206(3)-2(c) under the Advisers Act (recognizing an investment adviser's duty to seek best execution of its customers' transactions).

26 1986 Release; 2019 IA Interpretation; *Jamison*.

27 1986 Release; 2019 IA Interpretation; *Jamison; In the Matter of Portfolio Advisory Services*.

28 *Jamison*.

endorsed the notion that both the Investment Company Act and the Advisers Act may require an investment adviser to analyze its execution quality on individual transactions under certain circumstances.[29]

c. An adviser's specific duty to seek best execution varies with individual client trading arrangements because the concept of best execution is, as noted above, circumstantial. Some clients limit their adviser's choice of broker-dealers or the trading arrangements for their accounts. For example, in directed brokerage or commission recapture arrangements, a client directs an investment adviser to use a specific broker-dealer to execute some or all transactions for an advised account. Under these arrangements, known as "directed brokerage arrangements," an investment adviser's duty of best execution is substantially reduced, if not completely obviated, because the adviser's discretion to choose the executing broker-dealer is greatly curtailed, if not eliminated.[30]

F. Proposed Guidance to Fund Boards. In August 2008, the SEC proposed guidance to mutual fund boards for fulfilling their oversight and monitoring responsibilities for advisers' best execution obligations and the conflicts that arise with the use of soft dollar arrangements in particular under Securities Exchange Act (the "Exchange Act") Section 28(e) (discussed below).[31] The Proposed 2008 Guidance, which was never adopted, claimed it would not impose any new requirements on fund directors, but rather sought to provide directors with a flexible framework to evaluate the adviser's best execution obligations. However, the Proposed 2008 Guidance was controversial in the level of detailed scrutiny proposed to be expected of directors. Specifically, the Proposed 2008 Guidance suggested that fund directors ascertain how a fund adviser:

1. Makes trading decisions;

2. Selects broker-dealers;

3. Determines best execution and evaluates execution quality (including how best execution may be affected by the use of alternative trading systems);

4. Negotiates and evaluates commission rates and how transaction costs are measured generally;

5. Evaluates and compares the execution of "execution only" trades;

6. Evaluates the performance of traders and broker-dealers;

7. Oversees and monitors sub-adviser activities;

8. Conducts portfolio transactions with affiliates;

9. Trades fixed income securities;

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[29] *See* SMC Capital Inc., SEC No-Action Letter (pub. avail. Sept. 5, 1995) ("SMC Capital") (granting no-action relief under Section 206, Section 17(d) and Rule 17d-1 to an investment adviser's order aggregation arrangement where the adviser agreed not to aggregate transactions unless it believed that the aggregation was consistent with its duty to seek best execution).

[30] *Jamison* (finding that an investment adviser owed a duty of best execution to a client who executed through a broker-dealer with which it had a previously established relationship, where the client had not executed a separate writing specifically directing the use of that broker-dealer)

[31] Proposed 2008 Guidance).

10. Evaluates trade execution quality for fixed income and other instruments traded on a principal basis; and

11. Conducts and monitors international trades.

III. TRADE AGGREGATION AND ALLOCATION

A. Overview. An adviser whose clients include registered and unregistered funds, retail and institutional accounts, or some combination thereof can face challenging trading issues. The funds generally are "free to trade" accounts, while some institutional accounts may direct brokerage, and wrap-fee account trades tend to be placed with the program sponsor. The existence of accounts that direct may effectively force an adviser to break up orders it might otherwise aggregate and send to a single broker.

B. Concerns Associated with Disaggregation. Disaggregating trades may raise concerns. For example:

1. The first accounts to trade may receive a better price than accounts trading down the line, especially with large orders or thinly traded securities. This is because the first and following trades may tend to "push" the market (that is, create market impact).

2. If the sell-side community understands that the adviser disaggregates orders, the adviser effectively may be "signaling" or "tipping" its executing broker-dealers that larger volume may be forthcoming, and some broker-dealers might use this information to the detriment of the adviser's clients.[32]

3. The adviser's similarly managed accounts may experience performance dispersion as a result of paying different prices for a security, incurring different transaction costs, or failing to purchase the security due to market impact concerns or limited availability. Disaggregation may also lead to performance dispersion among the adviser's similarly managed funds, institutional accounts and other accounts.

C. Failure to Aggregate Does Not Result in a Breach of Fiduciary Duty. An adviser does not breach its fiduciary duty to its clients merely by failing to aggregate orders for client accounts. The adviser could, depending on the circumstance, have to disclose to its clients that it will not aggregate and any material consequences of the failure to aggregate, such as potentially higher commissions.[33]

D. Other Procedures for Placing Client Orders Permitted. Using multiple broker-dealers to execute transactions in the same security for fund and non-fund accounts is the reverse of aggregation. In approving procedures that called for pro rata allocation among client accounts, the SEC staff observed that there may be other allocation methods that advisers can use without violating Section 206 of the

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[32] *See* Wagner & Glass, *The Dynamics of Trading and Directed Brokerage*, 2 J. Pension Plan Inv. at 53, 63 n.21 (1998) ("Wagner") ("Although not necessarily common, 'worst case' scenarios of broker conduct that managers worry about include a dealer who gets a call from a manager asking for a price quote instead colludes with other dealers to inflate prices; a dealer who gets a manager's call immediately buys up all available stock so that the manager has to buy from the dealer regardless of price; a dealer who gets a manager's call surreptitiously tips off a good client of the dealer who in turn buys up all of the available stock with the intent of selling it back to the manager; and a dealer who gets a manager's call may know of a willing seller but represents to both sides that the other one wants a higher price so as to widen the spread (and the broker's profit).").

[33] Pretzel & Stouffer, SEC No-Action Letter (pub. avail. Dec. 1, 1995).

Advisers Act.[34] Advisers should be able to satisfy their fiduciary duties by employing methodologies or procedures other than aggregating transactions and sending them to a single broker, provided that these procedures are disclosed to clients and designed to ensure that clients are treated equitably and fairly over time and that no client account is systematically disadvantaged.

E. Other Types of Procedures. Rather than broadcast orders across multiple brokers simultaneously, an adviser may place orders with one broker and, once those orders have been executed, place orders with the next broker (and so on). Sequential allocation is done to avoid multiple orders from one adviser competing with one another for execution. It also can lessen the "data leakage" problem – the excessive market impact that could result if the market thought that multiple brokers were working orders, although some market impact may occur.[35] These procedures include the following:

1. *Random Rotation*. Many advisers seek to deal with these sequencing issues by implementing a rotational process in which funds and other free-to-trade accounts and directed accounts take turns going first.[36] Random rotation seeks to ensure that clients are treated fairly and equitably over time, but it can place fund and institutional orders at the mercy of directed orders, especially when the broker-dealer handling the directed accounts takes time to execute a large order. The rotation schedule can be determined on a trade-by-trade basis, preferably through random selection (i.e., each trade produces a new rotation) or it can be set in advance, again through random selection (i.e., the rotation is fixed for a set period or a set number of trades). In the latter case, the adviser will have to determine how to accommodate new client accounts.

2. *Last to Trade*. Where a client explicitly directs that all trades be executed through a particular broker, the adviser may decide to place that client's trades behind those of its clients who have non-directed accounts (i.e., at the "back of the bus").[37] However, accounts that consistently trade last may trade on less favorable terms than clients who trade ahead of them. In any situation in which client accounts are traded last because of the directions, circumstances or arrangements surrounding the clients' accounts, an adviser should disclose the practice to the affected clients together with the possible effects on trade execution.

3. *Percentage of Assets-Based Rotation*. A less widely used methodology is rotation based on percentage of assets. The adviser creates a rotation determined by the percentage of assets, by client type. For example, if fund assets represent 73% of the adviser's assets under management, and institutional accounts and retail accounts represent 20% and 7%, respectively, then the fund would trade first 73% of the time, institutional accounts 20% of the time and retail accounts 7% of the time. This approach is sometimes used when an adviser first starts managing non-fund assets, to avoid putting large accounts at the mercy of small ones.

4. *Simultaneous Release*. Advisers often avoid the simultaneous placement of orders for different clients through multiple broker-dealers because those orders may compete with each other for execution, and may present the potential for excessive market impact. However, simultaneous

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34 SMC Capital.

35 *See, e.g., Boards Fight Front-Running of Funds*, BoardIQ (Mar. 6, 2007).

36 In a survey of wrap-fee arrangement trading practices, 57% of respondents noted that their firms employ a trading rotation to determine where wrap accounts trade in relation to traditional accounts. *2005 Survey of Wrap Trading Practices*, conducted by TraderForum.

37 Thomas Lemke and Gerald Lins, Investment Advisers: Law & Compliance § 2:105. *See also* Wagner at 63 ("Since managers have an obligation to seek the best possible price for the greatest number of clients, they tend to place (sequence) the blocks of aggregated orders in front of directed trades (which would have been part of the block order but for the [client's] direction). In practice, what this means is that the manager will wait until the block order is completed before even beginning to try to execute the directed order.").

release of all orders may not affect clients if, for example, the order is small or for a liquid security, because the market may absorb multiple orders without significant price movement.

5. *Step-Outs*. A step-out generally involves the adviser's direction that an executing broker-dealer allocate – or "step out" – all or part of a trade to another broker-dealer for clearance and settlement. Step-outs can be attractive to advisers because they may allow the adviser to accommodate client-directed trading (e.g., commission recapture) arrangements and to obtain soft dollar credits under Section 28(e) of the Exchange Act. The use of step-outs may alleviate problems associated with rotational or back-of-the-bus procedures. Brokers may be willing to take on step-out transactions because they will earn the commission on the other side of the trade, or to attract more commission business from the adviser, even though settlement may be more complicated. Step-outs can raise potential thorny "cross-subsidization" or "free riding" issues, because step-out orders are, in essence, executed for free while the adviser's other clients pay their negotiated commissions.[38]

6. *Hybrid Approaches*. Some advisers may use two or more of the procedures described above, including aggregation, in combination.

F. Disclosure. Advisers should have the appropriate Form ADV or other disclosure informing clients of their trading practices and any related conflicts. In particular, an adviser should as appropriate disclose the trading process it employs, the circumstances under which it deviates from that process, and the consequences to the clients of employing that process.[39]

IV. SOFT DOLLAR ISSUES

A. Overview.

1. Commission arrangements between money managers and broker-dealers have been the subject of debate ever since the end of fixed commissions. When Congress abolished fixed commission rates in 1975, it enacted Section 28(e) of the Exchange Act, which provides a safe harbor to protect arrangements in which a money manager might pay more than the lowest available commission rate based on the particular products and services it receives from the broker-dealer. These arrangements, known as "soft dollar" arrangements, allow a money manager to take into account all of the brokerage and research products and services that it receives from a broker-dealer in directing its clients' securities transactions, rather than simply considering the broker-dealer's commission rates. Similar types of arrangements have developed in other jurisdictions, including the United Kingdom.

2. Twenty years after issuing its last substantive guidance, the SEC updated its views in 2006 to reflect current industry practices. On July 18, 2006, the SEC issued a revised

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[38] *See* Wagner at 64 ("Unfortunately, while step-outs permit a manager to send an entire block trade to one broker (and thereby avoid sequencing delays), they too have some troublesome drawbacks. In particular: [s]tep-outs cannot be used with principal brokers[;] [i]f a significant portion of an order (more than 20 to 25 percent) has to be stepped out, the executing broker, when busy, may prioritize other orders (where it gets to keep all of the commissions) first[;] [i]f a manager is 'working' an order over several days, it needs to be concerned that the recipient of the first day's step out doesn't use that information to front run, or compete, with the manager's subsequent trades.").

[39] *See generally In re Mark Bailey & Co. and Mark Bailey*, Advisers Act Release No. 1105 (Feb. 24, 1988) (SEC outlined a series of disclosures that should have been made by an investment adviser who did not negotiate commissions for certain client-directed transactions.).

interpretation of Section 28(e),[40] which followed a proposed interpretation of Section 28(e) that the SEC issued for public comment in October 2005.[41]

3. As expected, the SEC largely adopted the guidance that it proposed for determining what constitutes "research" and "brokerage" under Section 28(e). However, the SEC substantially revised its prior guidance regarding arrangements involving money managers and broker-dealers, indicating an intention to provide market participants with greater flexibility in structuring arrangements under Section 28(e). The SEC's illustrative guidance on the types of products and services that constitute research and brokerage appears to be final, for now at least. However, the SEC requested additional comment on its interpretation of eligible arrangements involving money managers and broker-dealers, leaving open at least the possibility that the SEC's guidance in that area may be further modified or refined.

4. The SEC's revised interpretation follows a comprehensive effort by the SEC and its Staff to evaluate the application of Section 28(e) from a practical standpoint. In 2004, then–SEC Chairman William Donaldson set up an internal task force to consider revisions to the SEC's interpretation of Section 28(e). Before the SEC issued its proposed interpretation, that task force met with a large number of industry representatives and worked hard to gather a substantial amount of information and gain a thorough understanding of industry practices in this area. The SEC's release clearly reflects that the task force was successful in this regard, and that it understands the challenges the securities industry faces in harmonizing global requirements governing commission arrangements. The SEC's release includes a detailed analysis of the complicated issues that arise in connection with soft dollars, and the revised guidance reflects the dynamic nature of client commission practices and the changes that have occurred in this area since the SEC last considered these issues 20 years ago.[42]

B. Overview of Section 28(e).

1. Section 28(e) of the Exchange Act provides a safe harbor for persons exercising investment discretion over an account, under which a person will not be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of having caused the account to pay a broker-dealer a higher commission for effecting a trade than another broker-dealer would have charged. However, to receive the benefit of the safe harbor, the person must make a good faith determination that the commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

2. Unlike many other provisions of the Exchange Act, Section 28(e) does not provide the SEC with rulemaking authority to set requirements under the safe harbor.[43] As a result, the SEC has issued guidance on the parameters of the safe harbor over the years through interpretive

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40 Exchange Act Release No. 54,165, 71 Fed. Reg. 41,978 (July 24, 2006).

41 Exchange Act Release No. 52,635 (Oct. 19, 2005), 70 Fed. Reg. 61,700 (Oct. 25, 2005). The SEC's proposal followed recommendations from the NASD's Mutual Fund Task Force in 2004 as well as a rulemaking initiative adopted in 2005 by the United Kingdom's Financial Services Authority.

42 The SEC last considered the substantive issues regarding the scope of products, services, and arrangements that qualify under Section 28(e) in a 1986 interpretive release. Exchange Act Release No. 23,170 (Aug. 23, 1986), 51 Fed. Reg. 16,004 (Aug. 30, 1986). However, in 2001, the SEC issued an interpretation of Section 28(e) to extend the safe harbor to certain riskless principal transactions on the Nasdaq Stock Market. Exchange Act Release No. 45,194 (Dec. 27, 2001), 67 Fed. Reg. 6 (Jan. 2, 2002).

43 Section 28(e) does provide the SEC with limited authority to adopt recordkeeping requirements. However, the SEC has not adopted rules directly pursuant to that authority.

releases. Historically, the SEC's interpretations have focused on the particular products and services that qualify as "research" or "brokerage" under the safe harbor.

3. The SEC's 2006 release was somewhat broader than its previous interpretations, and provided guidance on a number of general areas relating to Section 28(e) and soft dollar arrangements. However, the release focused most significantly on two particular areas under the safe harbor: (1) eligible research and brokerage products and services; and (2) eligible arrangements involving money managers and broker-dealers.

C. Eligible Research and Brokerage Under the SEC's Revised Interpretation.

1. The SEC's revised interpretation largely adopted the standards it proposed in 2006 for determining the applicability of the safe harbor. Under the revised interpretation, a money manager must carry out a three-step analysis to determine whether a particular product or service falls within the safe harbor:

(1) The money manager must determine whether the product or service constitutes brokerage or research services under Section 28(e);

(2) The money manager must determine whether the product or service actually provides lawful and appropriate assistance in the performance of the money manager's investment decision-making responsibilities; and

(3) The money manager must make a good-faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer.

Ultimately, the Section 28(e) analysis hinges on whether a particular product or service constitutes "research" or "brokerage." The SEC's revised interpretation included new standards for determining whether particular products and services constitute research or brokerage. Those standards are substantially the same as the standards the SEC proposed in 2006.

2. Eligible Research. To be eligible as research under the revised interpretation of Section 28(e), a product or service must satisfy several requirements:

a. First, the product or service must constitute "advice," "analyses," or "reports."

b. Second, the product or service must satisfy the "subject matter" requirements of Section 28(e) (which the SEC stated should be construed broadly to subsume other topics related to securities and the financial markets) by furnishing:

> *Advice*, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; or *Analyses and reports* concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts.

c. Third, the product or service must reflect "the expression of reasoning or knowledge."[44]

3. Eligible Brokerage. Consistent with its 2006 proposal, the revised interpretation adopted what the SEC calls a "temporal standard" for determining eligible brokerage. Specifically, the temporal standard provides that brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent. The SEC noted further that brokerage services can include connectivity services and trading software (e.g., T1 lines) where they are used to transmit orders to the broker-dealer.[45]

4. Eligible Products and Services Under the Revised Interpretation. The SEC's release included extensive illustrative guidance on products and services that are eligible and ineligible under the safe harbor. In many ways, the SEC's illustrative guidance on specific products and services came as little surprise. For example, the SEC reaffirmed that traditional research reports are eligible under the safe harbor, but computer hardware and accessories that deliver research are not eligible. In addition, the SEC took commenters' suggestions into account in its final interpretation of the products and services that constitute research and brokerage under the safe harbor. As a result, the SEC's guidance shifted during the public comment process in several respects. Exhibit A to this article summarizes the SEC's illustrative guidance, but some of the more notable aspects of the SEC's interpretation of eligible products and services include the following:

a. *Order Management Systems*: In the 2006 proposal, the SEC stated that order management systems would not be eligible under the safe harbor as brokerage (the SEC did not address their eligibility as research). However, the SEC's revised interpretation wisely takes a functional approach to these services, and provides that a money manager may use soft dollars to pay for those aspects of its order management system that otherwise qualify as either brokerage or research (e.g., pre-trade and post-trade analytics, order routing services, algorithmic trading services, or direct market access systems).

b. *Mass-Marketed Publications*: In a departure from its 1986 interpretation, the SEC's revised interpretation provides that mass-marketed publications do not constitute research under Section 28(e). Nevertheless, the SEC states that the safe harbor does apply to publications that are not mass-marketed, including publications that, among other things, are marketed to a narrow audience; are directed to readers with specialized interests in particular industries, products, or issuers; and have high cost.

c. *"Market" Research*: The SEC's revised interpretation provides that certain types of "market research" are eligible for the safe harbor. For example, eligible market research under Section 28(e) can include pre-trade and post-trade analytics, software, and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies. In addition, the safe harbor applies to advice from broker-dealers on order execution, including advice on execution strategies, market color, and the availability of buyers and sellers (and software that provides these types of market research).

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[44] As described below, however, the SEC was somewhat flexible in this respect. For example, the SEC indicated that market data constitutes research under Section 28(e) even though data, literally speaking, might not reflect "the expression of reasoning or knowledge."

[45] However, as described below, the SEC indicated that connectivity services do not constitute research under the revised interpretation.

d. *Proxy Services*: The revised interpretation provides that certain proxy products and services that contain reports and analyses on issuers, securities, and the advisability of investing in securities may be eligible research under Section 28(e), subject to a mixed-use allocation. However, the SEC stated that the safe harbor does not extend to proxy services that assist a money manager in deciding how to vote proxy ballots, or services that handle the mechanical aspects of voting, such as casting, counting, recording, and reporting votes. Many money managers had paid for these services with soft dollars based on the notion that a manager's proxy voting obligations are related to the investment decision-making process.[46]

5. SEC's Functional Approach.

a. On the whole, the SEC adopted a functional approach to determining the products and services that are eligible under Section 28(e). In many cases, this approach has been helpful to market participants by extending the safe harbor to discrete aspects of a product or service that previously might have been evaluated only in the context of the overall product or service. For example, the SEC's guidance on order management systems recognizes the utility of specific aspects of those products, even where the overlying system might not qualify under the safe harbor. Similarly, the SEC recognized the value of market data and electronic research services, even while excluding the computer equipment and accessories used to deliver them.

b. In other cases this functional approach has required that market participants make finer distinctions among products and services than was previously necessary. For example, the SEC stated that "analytical software that relates to the subject matter of the statute before an order is transmitted may fall within the research portion of the safe harbor, but not the brokerage portion of the safe harbor." However, the SEC also stated that quantitative analytical software used to test "what if" scenarios related to adjusting portfolios, asset allocation, or portfolio modeling does not qualify as "brokerage" under the safe harbor because it falls outside the temporal standard. Nevertheless, the SEC also stated that, if money managers use analytical software to test "what if" scenarios related to adjusting portfolios, asset allocations, or portfolio modeling both for research and non-research purposes, the manager may make a mixed-use allocation for the product under Section 28(e). In any event, given the increasingly complex nature of analytical products, money managers often have to consider both the function and use of a particular product in determining whether, or to what extent, the product qualifies under Section 28(e).

c. Similarly, the SEC stated that a money manager's legal expenses generally would be considered overhead and therefore would not constitute research under Section 28(e). However, it is not clear that the SEC completely precluded legal expenses from qualifying as research (nor should they). Presumably, money managers might be able to distinguish legal expenses related to how an adviser conducts its business (e.g., corporate legal services), which would be treated as overhead, from legal expenses related to specific investment decisions (e.g., legal advice on antitrust issues affecting a proposed merger or patent advice on a company's technology), which should be treated as research.

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[46] *See, e.g.*, Rule 206(4)-6 under the Advisers Act (requiring investment advisers to establish written policies and procedures that are reasonably designed to ensure that advisers vote client securities in the best interest of clients); Rule 30b1-4 under the Investment Company Act (requiring registered investment companies to file annual reports containing their proxy voting records).

D. Arrangements Involving Money Managers and Broker-Dealers.

1. Overview.

a. The SEC's revised interpretation departs significantly from its proposal, and from the SEC's 1986 interpretation, in the area of arrangements between money managers and broker-dealers. Both the SEC and its Staff have indicated that the modifications are designed to provide market participants with greater flexibility in structuring arrangements, but many of the details of the modifications remain subject to interpretation. Perhaps anticipating the need for further guidance, the SEC requested additional public comment on this aspect of the interpretation, and indicated that it may supplement the revised interpretation based on any comments it receives.

b. The SEC's guidance in this area arises from the fact that Section 28(e) expressly provides that the safe harbor is available for commissions paid to a broker-dealer for "effecting" securities transactions based on their relation to the value of the brokerage and research services "provided by" the broker-dealer. This aspect of the safe harbor requires that the broker-dealer providing brokerage and research must also be effecting transactions for the money manager. Additionally, the SEC had previously interpreted Section 28(e) such that a broker-dealer was "providing" research only if it produced a product or service or was legally obligated to pay for a product or service. The SEC's revised interpretation increases flexibility in structuring arrangements by modifying previous guidance on the application of the terms "effecting" and "provided by."

c. In the revised interpretation, the SEC expressly took into account so-called "commission-sharing arrangements." Under a commission-sharing arrangement, the executing broker agrees that part of the commission it earns will be redirected to one or more third parties, as directed by the money manager, as payment for research services provided to the money manager. These arrangements allow money managers to direct broker-dealers to collect and pool client commissions that may have been generated from orders executed at that broker-dealer, and periodically direct the broker-dealer to pay for research that the money manager has determined is valuable.

2. The "Effecting" Requirement.

a. Historically, soft dollar arrangements involving multiple broker-dealers have been structured as introducing/clearing relationships. For example, a broker-dealer that produces research would "introduce" trades to a "clearing" broker for execution and clearing. In this regard, the SEC had taken the view generally that the safe harbor does not apply to arrangements in which the broker-dealer providing research receives a portion of the client's brokerage commissions without performing any role in the trade. Until 2006, however, the most definitive statement on the level of activity necessary for a broker-dealer to be deemed to be performing a role in a trade came in a 1983 no-action letter in which the SEC staff stated that the use of the safe harbor was not precluded where a broker-dealer provided research and performed four types of functions.[47]

b. In its proposal in 2006, the SEC had considered formally adopting the Staff's 1983 no-action position by interpreting the term "effecting" to require a broker-dealer's performance of all four functions. However, the revised interpretation provides that a broker-dealer may be considered to be effecting transactions under Section 28(e) if it performs at least one of the following four functions:

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[47] *SEI Financial Services Company*, Letter from SEC's Division of Market Regulation to Morgan, Lewis & Bockius LLP (Dec. 15, 1983).

(i) Taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities);

(ii) Making or maintaining records relating to customer trades required by SEC and SRO rules, including blotters and memoranda of orders;

(iii) Monitoring and responding to customer comments concerning the trading process; or

(iv) Generally monitoring trades and settlements.

The broker-dealer must nevertheless take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement, and in a manner that is fully consistent with their obligations under SEC and SRO rules.

3. The "Provided By" Requirement.

a. Historically, the SEC has required that a broker-dealer be legally obligated to pay for research in order to satisfy the "provided by" requirement, and the SEC reaffirmed this concept in the 2006 proposal. In practice, this interpretation has required that broker-dealers in soft dollar arrangements either provide research directly (e.g., by producing research reports) or be contractually obligated to pay for research prepared by a third party (e.g., market data services).

b. The SEC's revised interpretation retains this means of satisfying the "provided by" requirement, but also extends the safe harbor to certain arrangements where a broker-dealer is not legally obligated to pay for research. Under the revised interpretation, the "provided by" requirement generally may also be satisfied if a broker-dealer does the following:

(i) Pays the research vendor directly;

(ii) Reviews the description of the research to be provided for "red flags" that indicate the services are not within Section 28(e), and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor; and

(iii) Develops and maintains procedures so that research payments are documented and paid for promptly.

The SEC did not provide specific guidance on complying with the new interpretation of the "provided by" requirement. For example, the SEC did not explain what types of "red flags" broker-dealers should look for in reviewing a research description. In addition, the SEC did not provide specific examples of the types of prompt payment procedures broker-dealers would have to develop and maintain.

4. Structuring Arrangements Under the Revised Interpretation. Based on public statements by the SEC and its staff, the SEC's revised interpretation appears to be designed to permit arrangements similar to commission-sharing arrangements within the limits of Section 28(e). To that end, the SEC stated specifically in the release that an arrangement involving multiple broker-dealers will satisfy Section 28(e) if at least one of the broker-dealers satisfies the requirements for "effecting"

transactions and "providing" research.[48] This aspect of the revised interpretation should permit arrangements that would not have been permitted under the SEC's prior interpretations, including:

a. An executing broker may pay for brokerage or research services at the money manager's direction without being legally obligated to pay for the services. In those cases, the executing broker will have to satisfy the new "provided by" requirement by reviewing research descriptions and establishing policies and procedures for prompt payment of the services.

b. An executing broker may share commissions with a broker-dealer that produces research but does not play an active role in the trading process. In those cases, the second broker-dealer will have to perform one of the four functions that make up the revised "effecting" requirement and allocate the remaining three to the executing broker.

5. While the SEC noted that multi-broker arrangements under Section 28(e) have historically been structured as introducing/clearing arrangements, early indications from the SEC staff are that the revised interpretation does not, in and of itself, require that broker-dealers use a clearing agreement to allocate performance of the four functions. Similarly, the SEC staff has indicated that the functions do not necessarily have to be allocated to the executing broker-dealer, and could be allocated to a third broker-dealer.

E. EU's Regime on Payments for Research, Use of Dealing Commissions.

1. On January 3, 2018, the European Union's Markets in Financial Instruments Directive II ("MiFID II") regime took effect – with ramifications for buy-side global asset managers and sell-side research providers relating to use of dealing commissions and cost allocation for research expenditures. By far the most controversial area of the MiFID II reforms has been that relating to the methods of payment by portfolio managers for research produced by investment banks, brokers, and independent research providers. This reform had long been foreshadowed in the United Kingdom by the Financial Conduct Authority ("FCA"), which in November 2012 highlighted the conflicts of interest faced by the UK asset management industry following the regulator's thematic review from June 2011 to February 2012 on the arrangements UK portfolio managers had in place for managing conflicts of interest—including with specific reference to the use of customer commissions.

2. MiFID II significantly builds on the existing MiFID I inducements standards. For portfolio managers (and providers of independent investment advice), it bans the receipt and retention of fees, commissions, or any monetary or non-monetary benefits from third parties other than qualifying "minor non-monetary benefits" ("MNMBs"). That prohibition is elaborated by implementing provisions that seek to identify acceptable MNMBs and a bespoke regime to allow portfolio managers to receive research without it constituting an inducement. MNMBs are allowed provided that they are clearly disclosed and capable of enhancing the quality of service provided to the client, and cannot be judged to be of a scale and nature to impair compliance with a firm's duty to act in its clients' best interests. Under MiFID I, the provision of research was never treated as an inducement.

3. The MiFID II delegated directive states that research received from third parties shall not be regarded as an inducement for a portfolio manager if, in essence, the receipt of research does not create a pecuniary benefit to the portfolio manager because the research is received in return for either:

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[48] Specifically, footnote 182 states that "[i]n Section 28(e) arrangements involving multiple broker-dealers, at least one of the broker-dealers (but not necessarily all) must satisfy the requirements for 'effecting' transactions and 'providing' research."

a. direct payments by the portfolio manager out of its own resources; or

b. payments from a separate research payment account ("RPA") controlled by the manager, provided that a range of conditions relating to that account are met.

4. Crucially, article 13(3) of the delegated directive suggests that it remains possible under MiFID II to collect the research charge alongside a transaction commission: "[T]he specific research charge shall . . . not be linked to the volume and/or value of transactions on behalf of the clients . . . . Every operational arrangement for the collection of the client research charge, where it is not collected separately but alongside a transaction commission, shall indicate a separately identifiable research charge and fully comply with the conditions [relating to the operation of RPAs]." This language suggests what is now generally accepted—that portfolio managers will be able to pay for both research and execution in a single transaction in basis points—provided that the separate costs of the two are clearly distinguished and the payment is not linked to the value/volume of transactions.

5. In order to operate an acceptable RPA model, the portfolio manager must ensure the following:

a. The RPA can only be funded by a specific research charge to the client, which generally must not be linked to the volume/value of transactions executed on behalf of the client. It is clear that the charge may be paid for out of dealing commission, provided, with limited exceptions discussed below, that the research is priced separately ("unbundled").

b. A research budget must be set, regularly assessed, and agreed upon with clients. Increases to the research budget may only take place after the provision of "clear information" to clients about such intended increases. The position under the delegated directive is more flexible than that proposed in the European Securities and Markets Authority's ("ESMA's") Final Advice, which appeared to require a specific written agreement between the portfolio manager and its client for the initial budget and for any increase. If a surplus remains in the RPA at the end of a period, the portfolio manager is required to rebate that amount back to clients or offset it against future research costs.

c. The quality of research purchased is regularly assessed based on robust quality criteria and its ability to contribute to better investment decisions.

d. Clients and regulators are provided, upon request, with detailed information about the budgeted amount for research, research costs actually incurred, providers of research, amounts paid to such providers, benefits/services received from such providers, and any surplus.

e. A written policy in respect of investment research is in place and provided to clients. The policy must cover (i) the extent to which research purchased through the RPA may benefit clients' portfolios, including, where relevant, consideration of the investment strategies applicable to the various types of portfolios, and (ii) the "approach the firm will take to allocate such costs fairly to the various clients' portfolios."

6. The MNMB Exemption. Research which constitutes an MNMB is neither prohibited as an inducement nor subject to the bespoke research payment regime described above. The delegated directive gives some useful examples, including short-term commentary on the latest economic strategies or company results, or third-party written material that is commissioned and paid for by a corporate issuer to promote a new issuance. It is worth noting that the portfolio manager may only

receive MNMBs that are capable of enhancing the quality of service provided to the client in accordance with the standards governing that assessment under MiFID II.

7. SEC Tackles MiFID II Research Issues. On October 26, 2017, the staff of the SEC, following consultation with European authorities, issued three coordinated no-action letters to, in the words of one letter, "address concerns that have arisen in light of the adoption of [MiFID II] while preserving choice in maintaining the SEC's long-standing approach" for the use of client commissions to pay for research that prevails in the United States. According to the SEC's press release announcing these actions, the SEC staff relief "provides a path for market participants to comply with the research requirements of MiFID II in a manner that is consistent with the U.S. federal securities laws."[49] The SEC staff no-action letters provide relief in three key ways:

a. *SIFMA Letter: Relief from Broker-Dealers Being Deemed Advisers When Accepting Cash for Research*. The staff of the SEC's Division of Investment Management ("IM") provided temporary relief (for 30 months from MiFID II's implementation date, or July 3, 2020) stating that it would not recommend that the SEC take enforcement action under the Advisers Act against a broker-dealer that provides research services that constitute investment advice under Section 202(a)(11) of the Advisers Act to an investment manager that is required under MiFID II, either directly or by "contractual obligation," to pay for the research services from its own money, from an RPA funded with its clients' money, or from a combination of the two. This relief (the "SIFMA Letter") was provided in response to a request letter from Morgan Lewis on behalf of the Securities Industry and Financial Markets Association ("SIFMA").

(i) In the SIFMA Letter, the IM staff stated that it would not recommend that the SEC take enforcement action under the Advisers Act against a broker-dealer that provides research services that constitute investment advice under Section 202(a)(11) of the Advisers Act to an investment manager that is required under MiFID II, either directly or by "contractual obligation," to pay for the research services from its own money, from an RPA funded with its clients' money, or from a combination of the two. The letter specifically provides that the relief is available for a 30-month period following the January 3, 2018 MiFID II implementation date. While the temporary relief is available, the staff has stated that it "will not consider a Broker-Dealer to be an investment adviser."

(ii) This relief addressed concerns that the receipt of payments for research services directly or indirectly out of an investment manager's own money or from an RPA as a result of MiFID II, in the words of the SEC staff, "might subject a broker-dealer to the Advisers Act if deemed special compensation" by creating questions about the broker-dealer's ability to rely on the longstanding broker-dealer exclusion from the definition of "investment adviser" under Section 202(a)(11) of the Advisers Act.[50] The relief covers SEC-registered broker-dealers, as well as non-US broker-dealers (including affiliates of SEC-registered broker-dealers) that are not registered with the SEC in reliance on Exchange Act Rule 15a-6 and that meet the conditions of paragraph (a)(2) of the rule or the SEC's position on distribution of research in Exchange Act Release No. 25,801 and the adopting release for Rule 15a-6, as supplemented by subsequent guidance.[51]

(iii) A significant limitation on the relief is that it is only available in situations where a broker-dealer receives payments from an investment manager that is domiciled in the European Union, and thus directly subject to MiFID II, or that is domiciled elsewhere and contractually

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[49] SEC Press Release, SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions (Oct. 26, 2017).

[50] *See* also Letter from SEC Chairman Jay Clayton to US Senator Thom Tillis (R-NC) (Sept. 14, 2017).

[51] *See* Registration *Requirements* for Foreign Broker-Dealers, Securities Exchange Act Release No. 27,017 (July 11, 1989), 54 Fed. Reg. 30,013 (July 18, 1989) (adopting Rule 15a-6).

required to comply with MiFID II or equivalent protections. In this regard, a non-EU-domiciled investment manager ("Non-EU Manager") would be treated as subject to MiFID II by "contractual obligation" where an investment manager directly subject to MiFID II directly or indirectly delegates portfolio management to the Non-EU Manager and the Non-EU Manager is contractually required to comply with MiFID II or equivalent protections in managing accounts under the delegation.[52] This includes situations where an investment manager that is domiciled in the United States, but is indirectly subject to MiFID II by contractual obligation, makes payments for research services to a non-US broker that provides research to the US investment manager in reliance on Exchange Act Rule 15a-6. Notably, the SEC staff's relief does not extend to a broker-dealer that accepts separate payments for research from a manager not subject to MiFID II directly or via a contractual obligation. This may present practical obstacles to global investment managers seeking to conform their research practices across the entire enterprise even where MiFID II does not apply by law or contractual obligation.

(iv) The staff's assurances were temporary, and were originally set to expire 30 months from MiFID II's implementation date, or July 3, 2020. The SEC staff subsequently extended the SIFMA Letter to July 2, 2023 and confirmed that the SIFMA Letter also applies to an investment manager subject to compliance with provisions in UK law related to research that are substantially similar to MiFID II and its implementing rules and regulations.[53]

(v) On July 24, 2020, the European Commission ("EC") launched a consultation on a proposal that would allow investment firms to re-bundle payments for research on small- and mid-cap issuers and fixed income instruments to aid the recovery from the COVID-19 pandemic and, more generally, to arrest a decline in research coverage of both those sectors caused by unbundling, as observed prior to the onset of the pandemic.[54] If adopted, the proposal would provide a limited exception from the requirement under the MiFID II regime that investment firms pay for research separately from execution.[55] Under the proposed legislative text, investment firms could re-bundle (i.e., pay for research and execution jointly) if (1) the investment firm and research provider enter into an agreement on the amount of the bundled payment (i.e., full-service commission) to be paid for research, and (2) the investment firm "informs" clients about the bundled payment. Comments were due by September 4, 2020. Based on the consultation, the EC has decided to proceed with aspects of the proposal relating to small and medium enterprise ("SME") research. When that occurs, the SEC staff will need to address how best to modify the SIFMA Letter to minimize possible disruption in the global research marketplace for SMEs.

b. *ICI Letter: Relief Allowing Investment Managers to Aggregate Orders with Differing Research Funding*. The IM staff also issued a letter stating that it would not recommend enforcement action under Section 17(d) of the Investment Company Act , Rule 17d-1 thereunder, or Section 206 of the Advisers Act against an investment manager that aggregates orders for the sale or purchase of securities on behalf of its clients where some clients may pay different amounts for research

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52 *See* Letter from Stephen Hanks, Fin. Conduct Auth., to Jiri Krol, *Deputy* CEO, Alternative Inv. Mgmt. Ass'n (July 19, 2017). Notably, although the request letter sought relief for dealings with investment managers domiciled in the United Kingdom following Brexit, the SIFMA Letter did not address the issue. The FCA has announced its intention of transposing MiFID II into UK law, and is anticipated to impose the MiFID II unbundling requirements following Brexit.

53 *See* Secs. Indus. & Fin. Mkts. Ass'n, SEC Staff No-Action Letter (Nov. 4, 2019) [hereinafter Extension Letter]; Secs. Indus. & Fin. Mkts. Ass'n, SEC Staff No-Action Letter (Oct. 26, 2017).

54 For purposes of the proposal, small- and mid-cap issuers would include issuers that did not have a market capitalization greater than EUR 1 billion during the 12 months preceding the provision of research. *See* Capital markets – research on companies seeking alternative financing (updated rules in light of COVID-19).

55 *See* Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

because of MiFID II's requirements, but each client participating in the aggregated order pays the same (average) price for the security and the "same cost of execution (measured by rate)" (the "ICI Letter"). This relief was provided in response to a request letter from the Investment Company Institute.

8. In the ICI Letter, the IM staff stated that it would not recommend enforcement action under Section 17(d) of the Investment Company Act, Rule 17d-1 thereunder, or Section 206 of the Advisers Act if an investment manager aggregates client orders in reliance on the staff's earlier position taken in a 1995 letter to SMC Capital Inc. ("SMC Capital"). In that letter, which addressed similar legal concerns, the IM staff stated that it would not recommend enforcement action when orders for multiple clients were aggregated for execution where each client received the same price and paid the same commission. The latest letter contemplates that some clients may pay different amounts for research because of the MiFID II requirements, but each client participating in the aggregated order pays the same (average) price for the security and the "same cost of execution (measured by rate)." The relief is conditioned on representations made in the incoming letter to the staff, including three specific representations recited in the ICI Letter that investment managers will adopt policies and procedures reasonably designed to ensure the following:

(i) Each client in an aggregated order pays the average price for the security and the same cost of execution (measured by rate);

(ii) The payment for research in connection with the aggregated order will be consistent with each applicable jurisdiction's regulatory requirements and disclosures to the client; and

(iii) Subsequent allocation of such trade will conform to the adviser's allocation statement (as described in the request letter) and/or the adviser's allocation procedures.[56]

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[56] The relief is conditioned on other representations made in the incoming letter, including the following:

- The adviser will prepare, before entering an aggregated order, an Allocation Statement.
- Each account that participates in an aggregated order will participate at the average security price for all the adviser's transactions in that security in accordance with the adviser's Allocation Statement and/or trade allocation policy, with execution costs shared pro rata based on participation in the transaction.
- All trades will be subject to the adviser's duty of best execution, and total transaction costs for each client will continue to be subject to the adviser's good-faith determination that the transaction costs are reasonable in relation to the value of the execution and research services.
- The adviser will adopt and maintain policies and procedures to address how orders will be aggregated and allocated among participating accounts. Such policies and procedures will be designed to ensure that all orders are aggregated and allocated in a manner that is consistent with the adviser's fiduciary duty and its representations and disclosures to clients.
- If the aggregated order is filled in its entirety, it will be allocated among the accounts in accordance with the Allocation Statement and/or policies and procedures; if the order is partially filled, it will be allocated pro rata based on the Allocation Statement and/or policies and procedures. Notwithstanding the foregoing, the order may be allocated on a basis different from a pro rata allocation if all accounts of clients whose orders are allocated receive fair and equitable treatment and the reason for such different allocation is either specified by the policies and procedures or approved in writing by the adviser's compliance department no later than the next trading day.
- The adviser's trade aggregation policies and procedures will include periodic review by one or more oversight committees that include the adviser's chief compliance officer or designee (or similar control function, such as risk), designed to ensure that they are adequate to prevent any client from being systematically disadvantaged as a result of the aggregated orders and the subsequent allocation thereof. In the case of registered investment companies ("RICs"), compliance with these policies and procedures would be reviewed at least annually by the RIC's board of trustees as part of, or in addition to, the board's general oversight of the adviser's allocation of brokerage and its use and acquisition of research (*see* Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with

(iv) This relief addressed concerns that prior IM no-action positions on the aggregation of client trades might not be available when placing trades for multiple clients that have a combination of commission-sharing arrangements ("CSAs") (where research is purchased through bundled commission payments) and RPA arrangements.[57] These earlier letters included representations that transaction costs would be shared pro rata based on each client's participation in the trade. As a result of MiFID II's requirements, an investment manager might have, and seek to include in an aggregated order, clients with a combination of research arrangements, including clients funding research through commissions via CSAs, clients funding research by agreeing to fund investment manager RPAs (where payments are unbundled), and clients whose investment manager is paying for research out of its own resources. If the investment manager cannot aggregate those orders because those clients might not pay a pro rata share of *all costs*, including commissions, the investment manager might need to place competing trades for the same security, which could result in worse execution for clients overall and might even benefit one set of clients at the expense of others.

(v) The IM staff addressed these concerns by substituting the requirement in the SMC Capital letter that each client in an aggregated order pay a pro rata share of all costs with the requirement that each client in an aggregated order pays the same (average) price for the security and the "same cost of execution (measured by rate)." While logical in many ways, the requirement that all clients participating in an aggregated order pay the same execution rate (e.g., cents or bps per share) even where the clients are not similarly situated may prove problematic in practice. For example, an aggregated order might include clients that have special commission arrangements including those not set or negotiated by the investment manager, such as retail wrap-fee accounts and institutional client-directed brokerage arrangements—the execution rates for which may vary. Accordingly, the staff's position may nonetheless leave open the issue of whether trades for various accounts may be aggregated, even though a manager might reasonably determine that improved price through inclusion in the larger aggregated trade may have a greater influence on overall execution quality than differences in the nominal commission rates.

(vi) Importantly, in a footnote, the IM staff stated that "this position does not apply to an investment adviser that is not subject to MiFID II (either directly or contractually)." Although this reflects the IM staff's efforts to align this relief to the other staff no-action letters, it is not immediately clear why this limitation is necessary given the safeguards outlined in the ICI Letter. Moreover, for a global investment manager organization that centralizes trading activities across multiple investment managers, some of which are subject to MiFID and some that are not, we expect that this limitation should not be construed literally to preclude central order aggregation otherwise complying with the terms of the ICI Letter. A more narrow reading would seem contrary to the purpose of the IM staff relief, but that may be a matter for IM staff clarification.

b. *SIFMA AMG Letter: Relief Allowing Investment Managers to Use Client-Funded RPAs to Obtain Research*. The staff of the SEC's Division of Trading and Markets ("TM") issued a letter stating that it would not recommend enforcement action against an investment manager seeking to operate in reliance on Section 28(e) of the Exchange Act if it pays for research through the use of an RPA

Respect to Investment Manager Portfolio Trading Practices, Exchange Act Release No. 58,264 (July 30, 2008) (proposed but not adopted interpretation)).

- Policies for aggregation of transactions will be fully disclosed in the adviser's Form ADV and the RIC's statement of additional information.
- The adviser's books and records will separately reflect, for each account of a client whose orders are aggregated, the securities held by, and bought and sold for, each account.

[57] *See* SMC Capital; *see also* Mass. Mut. Life Ins. Co., SEC Staff No-Action Letter (pub. avail. June 7, 2000); Pretzel & Stouffer, SEC Staff No-Action Letter (Dec. 1, 1995).

and certain conditions are met. This relief was provided in response to a request letter from the Asset Management Group of SIFMA ("SIFMA AMG Letter").

(i) In the SIFMA AMG Letter, the TM staff stated that it would not recommend enforcement action against an investment manager seeking to operate in reliance on Section 28(e) of the Exchange Act if it pays for research through the use of an RPA if four conditions are met:

(ii) The investment manager makes payments to the executing broker-dealer out of client assets for research alongside payments to that executing broker-dealer for execution;

(iii) The research payments are for research services that are eligible for the safe harbor under Section 28(e);

(iv) The executing broker effects the securities transaction for purposes of Section 28(e)\; and

(v) The executing broker is legally obligated by contract with the investment manager to pay for research through the RPA in connection with a client commission arrangement.

(vi) This relief addressed concerns that investment managers using RPA mechanisms to pay for research would not qualify for Section 28(e) because research payments that are charged alongside execution payments might not be deemed "commissions" for purposes of Section 28(e) and the research services might not be viewed as "provided" by the executing broker. If Section 28(e) were not available for RPA funding arrangements, investment managers might face issues under the Investment Company Act or the Employee Retirement Income Security Act of 1974 such as using research purchased with one client's assets to benefit other clients (i.e., cross-subsidization), for which disclosure alone might not suffice and other exemptions might not be available.

V. SEC INVESTMENT ADVISER ENFORCEMENT ACTIONS

A. "Best Execution."

1. *In re Founders Financial Securities, LLC*, Advisers Act Release No. 5397, 2019 LEXIS 2862 (Sept. 30, 2019). The Commission accepted an offer of settlement from Founders Financial Securities, LLC (the "Firm"), a dually registered investment adviser and broker-dealer. The Commission alleged that the Firm invested advisory clients in mutual fund share classes with 12b-1 fees instead of share classes of the same funds without 12b-1 fees, and received more than $1.24 million in 12b-1 fees as a result, between January 1, 2014 and February 1, 2017. The Commission also alleged that the Firm's Form ADV disclosures regarding these practices were inadequate, as they failed to disclose the conflict of interest that resulted from the Firm's receipt of additional compensation for investing advisory clients in a fund's 12b-1 fee-paying share class when a lower-cost share class was available, and that the Firm would and did select 12b-1 fee-paying share classes in those circumstances. The Commission further alleged that the Firm breached its duty to seek best execution by investing clients in 12b-1 fee-paying share classes when cheaper share classes were available. According to the Commission, the Firm failed to adopt and implement written compliance policies and procedures governing mutual fund share class selection. In determining to accept the settlement offer, the Commission considered the Firm's remediation. The Commission censured the Firm and ordered it to cease and desist from committing or causing further violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and to pay disgorgement of $1,246,133.60 and prejudgment interest of $229,332.28. The Commission did not impose a civil monetary penalty and noted that the Firm was not eligible to self-

report pursuant to the Division of Enforcement's Share Class Selection Disclosure Initiative because the Division contacted the Firm before the Initiative was announced.

2. *In re Sigma Planning Corp.*, Advisers Act Release No. 5358, 2019 LEXIS 3520 (Sept. 19, 2019). The Commission accepted an offer of settlement from Sigma Planning Corp. (the "Firm"), a registered investment adviser. The Commission alleged that, from at least January 1, 2013 through March 1, 2017, the Firm failed to disclose the conflicts of interest that resulted from its receipt of a percentage of 12b-1 fees from its clearing broker and its selection of 12b-1 fee-paying share classes when clients were eligible for lower-cost share classes. The Commission also alleged that the Firm breached its duty to seek best execution by investing clients in 12b-1 fee-paying share classes when cheaper share classes were available. The Commission further alleged that, from at least January 1, 2013 through March 31, 2018, the Firm failed to disclose a conflict of interest related to the asset-based fee it was required to pay to its clearing broker for share classes that did not pay a 12b-1 fee and its avoidance of that fee by investing clients in 12b-1 fee-paying share classes, even when the clients were eligible for the lower-cost share classes. The Commission also alleged that the Firm failed to disclose that its affiliated broker-dealers received revenue-sharing payments pursuant to tiered sponsorship agreements with certain alternative investment sponsors. Further, according to the Commission, the Firm engaged in brokerage activities without registering as a broker-dealer. Finally, the Commission alleged that the Firm failed to adopt and implement written compliance policies and procedures governing its mutual fund share class selection and revenue-sharing arrangements. The Commission censured the Firm and ordered it to cease and desist from committing or causing further violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and Section 15(a) of the Exchange Act, and to pay disgorgement of $1,920,809, prejudgment interest of $225,909, and a civil penalty of $400,000. The Commission noted that the Firm was not eligible to self-report pursuant to the Division of Enforcement's Share Class Selection Disclosure Initiative because the Division contacted the Firm before the Initiative was announced.

3. *In re Lefavi Wealth Management, Inc.*, Advisers Act Release No. 5336, 2019 SEC LEXIS 2423 (Sept. 3, 2019). The Commission accepted an offer of settlement from Lefavi Wealth Management, Inc. (the "Firm"), a Utah-based registered investment adviser, in connection with recommending and investing client assets in alternative investments—namely, non-traded real estate investment trusts, business development companies, and private placements. The Commission alleged that from June 2014 through December 2016, the Firm recommended certain alternative investments to its advisory clients at a share price that included a sales commission paid to the Firm and its dual-registered investment adviser representatives ("IARs"). According to the Commission, the Firm failed to disclose that it could have invested client assets in the same alternative investments at a lower share price by purchasing the investments net of commission, or at a volume discount based on the aggregate purchases in each investment by the Firm's affiliated broker-dealer. The Commission further alleged that either method would have lowered or eliminated the amount of the sales commission received by the Firm and its IARs, creating a conflict of interest. According to the Commission, the Firm failed to adequately disclose this conflict in its Form ADV, and the alleged practices rendered certain statements in its Form ADV concerning these conflicts of interest to be misleading or untrue. The Commission also alleged that the Firm failed to adopt and implement reasonable and adequate written policies and procedures regarding how to identify or disclose conflicts of interest, when it should apply net-of-commission and volume discounts, and how to meet its duty to seek the best execution related to alternative investments. The Commission found that this conduct violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The Commission censured the Firm and ordered the Firm to cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, review and update its policies and procedures, and correct its disclosure documents concerning alternative investments. The Commission also ordered the Firm to pay disgorgement of $994,296.10, prejudgment interest of $144,439.12, and a civil penalty of $150,000, and to administer a fund to distribute the disgorgement to affected clients.

4. *In re Voya Financial Advisors, Inc.*, Advisers Act Release No. 5651, 2020 SEC LEXIS 5241 (Dec. 21, 2020). On December 21, 2020, the SEC filed settled charges against Voya Financial Advisors, Inc. ("Voya"), a dually registered investment adviser and broker-dealer, arising from various alleged fee-related issues including compensation in connection with cash sweep accounts, mutual fund share class practices, and the sale of illiquid alternative investment products. With regard to cash sweeps, the SEC alleged that the unaffiliated clearing broker that Voya used for its client accounts paid Voya a portion of the revenue that the clearing broker received from the cash sweep products selected for investment advisory clients by Voya. However, the Order asserted that Voya did not disclose to its clients the revenue-sharing arrangement or the conflict of interest such arrangement created. As to the share class selection issues, the Commission alleged that Voya received 12b-1 fees, and in some instances avoided paying transaction fees, when it recommended certain mutual funds while other lower-cost share classes were available and not disclosed. The Order further states that certain of Voya's disclosures misstated the availability of lower-cost shares, the monitoring of such purchases and the rebate of fees (which they did but not in all occasions). Finally, with regard to illiquid alternative investments, the SEC asserted that "Voya caused certain advisory clients to pay higher fees, in the form of upfront commissions, when purchasing Illiquid Alt products when those same investments were available with commissions waived for advisory clients. Voya did not disclose this practice or the related conflicts of interest." The Commission's Order found that Voya violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, ordering Voya to cease and desist from future violations, a censure, disgorgement of $11,547,820 plus prejudgment interest of $2,371,335, and a civil penalty of $9 million. Voya also agreed to comply with certain undertakings, including that it retain an independent compliance consultant.

5. *In re Pruco Securities, LLC,* Advisers Act Release No. 5657, 2020 SEC LEXIS 5274 (Dec. 23, 2020). On December 20, 2020, the SEC filed settled charges against Pruco Securities, LLC ("Pruco"), a dually registered investment adviser and broker-dealer, concerning various alleged fee-related issues including the suitability of wrap-fee programs, revenue sharing from both cash sweep vehicles and mutual funds, and the avoidance of transaction fees. With regard to the wrap-fee programs, the Commission alleged that Pruco breached its fiduciary duty by failing to conduct promised monitoring of accounts to determine whether wrap-fee accounts remained suitable for clients. While Pruco ultimately addressed this issue in 2017, the Commission found that from January 2014 through September 2017 the firm received an additional $1.7 million in fees. As to mutual fund share class selection, the Order alleges that Pruco received undisclosed 12b-1 fees totaling over $7.1 million. Further, the Order states that a clearing firm used by Pruco shared over $4.3 million in revenue with Pruco that the clearing firm received from mutual funds in return for the clearing firm offering the mutual funds' programs. This was accomplished in part through a "no transaction fee program" where the revenue sharing was used by the clearing firm to offset Pruco's transaction fees, creating what the SEC alleged was a conflict of interest. The SEC also alleged that when Pruco caused investment advisory clients to invest in mutual funds with higher expenses than other share classes of the same fund that were available to the clients, Pruco violated its fiduciary duty to seek best execution for those transactions. With regard to bank sweep vehicles, the SEC alleged that Pruco received revenue-sharing payments from its clearing firm, and those payments "created a conflict of interest because Pruco had an incentive to recommend that clients hold uninvested cash in the Bank Sweep Program versus other cash sweep vehicles that did not provide for revenue sharing payments." After the Commission's investigation began, Pruco reimbursed affected customers for some of the conduct ultimately identified in the Order. The Commission found that Pruco violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Pruco consented to a cease-and-desist order and a censure, and agreed to pay disgorgement of $12,690,585, prejudgment interest of $3,061,786 and a civil penalty of $2,500,000. In addition, Pruco agreed to an above-the-line undertaking to, among other things, correct all relevant disclosures and, within 30 days of the order, evaluate the firm's policies and procedures regarding share class selection and transaction fees in wrap accounts.

6. *sanagement, LLC*, Advisers Act Release No. 4983, 2018 SEC LEXIS 1978 (Aug. 10, 2018). The Commission accepted an offer of settlement from Hamlin Capital Management, LLC ("Respondent"), a registered investment adviser. The Commission alleged that Respondent breached its fiduciary duties by favoring certain advisory clients over others through its pricing methods when engaging in cross-trades. According to the Commission's Order, Respondent's cross-trades favored its purchasing client transactions over its selling client transactions by arranging for the buy-side transaction to be executed at a lower price than the valuation price, which was set predominantly by the bonds' underwriters ("Bid Price"). The Commission further alleged that Respondent would often challenge the underwriters' Bid Price with a substantially higher price than the secondary market trade, and would only use broker-dealers that executed cross-trades at Respondent's predetermined spreads. The Commission alleged that as a result of these practices, Respondent's buy-side clients saved more than $829,344; Respondent deprived its seller-side clients of approximately $414,672 in market savings; and clients buying securities at Respondent's predetermined pricing overpaid by approximately $194,500. The Commission also alleged that Respondent's Form ADV misrepresented that it would execute cross-trades at the current market price, and failed to disclose that cross-trades would be executed at a Bid Price, and that Respondent failed to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act in connection with cross-trading practices and disclosing conflicts of interest. In determining to accept the offer of settlement, the Commission considered the cooperation and prompt remedial acts of Respondent, including the enhancements Respondent made to its policies, procedures, controls, and disclosures regarding cross-trading and security valuation, as well as voluntary payment to affected clients. The Commission censured Respondent, and ordered it to cease and desist from further violations of Sections 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8(a)(2) thereunder. The Commission also ordered Respondent to pay a civil money penalty of $900,000.

7. *In re Cushing Asset Management*, Investment Company Act Release No. 33,226, 2018 SEC LEXIS 2312 (Sept. 14, 2018). The Commission accepted an offer of settlement from Cushing Asset Management, LP, a registered investment adviser ("Respondent"). The Commission alleged that Respondent caused its clients' violations of the affiliated transaction provisions of the Investment Company Act in connection with two undisclosed cross-trades of approximately $33,500,000. The Commission alleged that, on December 20, 2012, Respondent sold, on behalf of a hedge fund it managed, 1,565,786 units of a publicly traded master limited partnership to a closed-end fund and open-end fund it also managed (the "Registered Funds"), using two brokers to execute the trades, resulting in its clients incurring $125,000 in brokerage fees. The Commission further alleged that, although Respondent sought legal advice as to how to conduct the trades so that they would not be prohibited "cross-trades," Respondent's traders did not follow the oral instructions they received or seek guidance on how to implement these instructions, and, as a result, the trades constituted cross-trades between the affiliated hedge fund and Registered Funds, and Respondent caused the hedge fund client it advised to violate Section 17(a)(1) of the Investment Company Act by knowingly selling securities to affiliated registered investment companies in the absence of an order from the Commission exempting the transaction from the prohibition on doing so. The Commission ordered Respondent to cease and desist from committing or causing any violations and any future violations of Section 17(a)(1) of the Investment Company Act and to pay a civil money penalty of $100,000.

8. *In re Putnam Investment Management, LLC and Zachary Harrison*, Advisers Act Release No. 5050, 2018 SEC LEXIS 2645 (Sept. 27, 2018). The Commission accepted an offer of settlement from registered investment adviser Putnam Investment Management, LLC ("Putnam") and Zachary Harrison, a portfolio manager and residential mortgage-backed securities ("RMBS") trader at Putnam (together, "Respondents"). According to the Commission Order, from at least April 2011 through September 2015, Putnam served as investment adviser to numerous registered investment companies ("RICs") and other clients; Harrison was a portfolio manager in Putnam's Structured Credit Group. The Commission stated that, during the relevant period, certain Putnam advisory accounts for various reasons needed to sell positions in nonagency RMBS that Harrison viewed as desirable investments and wished to

transfer to other Putnam-advised accounts. Rather than attempting to sell the securities into the market, the Commission alleged that Harrison prearranged with broker-dealers to temporarily sell the securities and repurchase them at a small markup, usually the next business day. The Commission alleged that Harrison's conduct caused Putnam to engage in cross-trades for RIC and RIC-affiliated client accounts on dozens of occasions that were not in accordance with Investment Company Act Rule 17(a)-7, Putnam's policies and procedures, and its Form ADV disclosures. The Commission further alleged that the manner in which Harrison effected the trades on behalf of Putnam resulted in undisclosed favorable treatment of certain advisory clients over others. Specifically, the Commission alleged that Harrison executed the sell side of each cross-trade at either the highest or only bid he received for the securities, and proceeded to execute the repurchases at a small markup over the sale price. Finally, the Commission alleged that Putnam did not adopt and implement policies and procedures reasonably designed to prevent unlawful cross-trading, failed to reasonably supervise Harrison, and filed Forms ADV with the Commission that contained untrue statements of material fact and omitted to state material facts that it was required to disclose. The Commission ordered Putnam to cease and desist from further violations of Section 17(a)(1) and 17(a)(2) of the Investment Company Act and Sections 206(2), 206(4), and 207 of the Advisers Act and Rule 206(4)-7 promulgated thereunder, and to pay a civil money penalty of $1 million. Harrison was ordered to cease and desist from causing any violations of Section 206(2) of the Advisers Act and Section 17(a)(1) and 17(a)(2) of the Investment Company Act, and to pay a civil money penalty of $50,000. The Commission's order noted that it considered Putnam's remedial acts, including termination of Harrison, voluntary placement of funds in escrow to compensate affected clients, and retention of a compliance consultant.

B. Soft Dollars.

1. *In re Knowledge Leaders Capital, LLC*, Advisers Act Release No. 4980, 2018 SEC LEXIS 1971 (Aug. 9, 2018). The Commission accepted an offer of settlement from Knowledge Leaders Capital, LLC ("Respondent"), a registered investment adviser. The Commission alleged that Respondent used client commissions under Section 28(e) of the Exchange Act (soft dollars) to purchase approximately $1 million in research from a firm affiliated with Respondent's then-Managing Director and chief investment officer ("CIO"). The Commission alleged that Respondent's Management Committee approved the use of soft dollars to pay for research software to assist in investment decisions using an algorithm developed by the CIO-affiliated firm, totaling $994,000 of soft dollars in a matter of three years, without identifying (and, as a result, without disclosing to clients) the conflict of interest created by these payments. The Commission also alleged that Respondent failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by identifying and disclosing conflicts of interest. In determining to accept the settlement offer, the Commission considered the cooperation of and remedial actions taken by Respondent, including, among other things, self-reporting the conduct to Commission staff and returning the clients' money used to pay for use of the research, with interest. The Commission ordered Respondent to cease and desist from future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, to pay a civil money penalty in the amount of $50,000, and to comply with undertakings, including hiring an independent third-party consultant.

2. *In re J.S. Oliver Capital Management L.P., and Ian O. Mausner*, Advisers Act Release No. 5236, 2019 SEC LEXIS 1169 (May 16, 2019). The Commission accepted an offer of settlement from J.S. Oliver Capital Management, L.P. (the "Firm"), a registered investment adviser, and the Firm's founder, president, head portfolio manager, and sole control person, Ian O. Mausner (collectively, "Respondents"), in connection with allegedly fraudulent trade allocations and misuse of client commission credits (soft dollars). The Commission alleged that from June 2008 to November 2009, Respondents engaged in a "cherry-picking" scheme in which they disproportionately allocated profitable equity trades to six clients, including affiliated hedge funds in which Mausner and his family were personally invested, and allocated less-profitable trades to three other clients: a widowed client, a profit-sharing plan, and a charitable foundation. In addition, the Commission alleged that Mausner used the

inflated profits to boost the performance of an affiliated fund, then both falsely marketed the fund's profitability and growth and collected performance fees from the fund based on the inflated profits. According to the Commission, the total harm inflicted on the three clients was approximately $10.7 million. The Commission also alleged that Respondents engaged in a fraudulent soft dollar scheme by misusing over $1.1 million in soft dollar credits. According to the Commission, Respondents used soft dollars in ways not disclosed in the Firm's Form ADV or offering memorandum, including to pay Mausner's personal expenses. Finally, the Commission alleged that from May 2008 to June 2009, the Firm failed to maintain required books and records, including order tickets and original emails. The Commission found that this conduct violated Section 17(a) of the Securities Act of 1933 (the "Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-8 thereunder. The Commission also alleged that the Firm violated, and Mausner aided and abetted and caused the Firm's violations of, Sections 204 and 206(4) of the Advisers Act and Rules 204-1(a)(2), 204-2(a)(3), 204-2(a)(7), and 206(4)-7 thereunder. Respondents were ordered to cease and desist from committing or causing any violations and any future violations of the Securities Act, the Exchange Act, and the Advisers Act. Mausner was barred from association and prohibited from acting as an employee, officer, or director of an investment adviser with a conditional right to reapply, and was ordered to pay disgorgement of $669,965. The Commission revoked the Firm's investment adviser registration.

C. Trade Allocation.

1. *In re Valor Capital Asset Management, LLC and Robert Mark Magee*, Advisers Act Release No. 4864, 2018 SEC LEXIS 686 (Mar. 6, 2018). The Commission accepted an offer of settlement from Valor Capital Asset Management, LLC, a state-registered investment adviser, and its principal and sole employee, Robert Mark Magee (collectively, "Respondents"). The Commission alleged that from July 2012 to May 2015 Respondents defrauded clients by engaging in a cherry-picking scheme in which they disproportionately allocated profitable or less-unprofitable trades from Valor's omnibus trading account to Magee's personal account, while disproportionately allocating unprofitable or less-profitable trades to client accounts. The Commission alleged that as a result of this conduct, Respondents violated Sections 206(1) and 206(2) of the Advisers Act and Section 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder. Respondents were ordered to cease and desist from committing further violations of the Advisers Act. Magee was barred from association and prohibited from acting as an employee, officer, or director of an investment adviser with a conditional right to reapply. The Commission ordered Respondents to pay disgorgement of $505,663, prejudgment interest of $50,208.57, and a civil money penalty of $160,000.

2. *SEC v. Strong Investment Management,* Litigation Release No. 25,045, 2018 SEC LEXIS 542 (Feb. 21, 2018); *In re John B. Engebretson*, Advisers Act Release No. 4967, 2018 SEC LEXIS 1701 (July 12, 2018). The Commission filed a complaint against an investment adviser, Strong Investment Management ("Strong"); its president and sole owner, Joseph B. Bronson; and its chief compliance officer, John B. Engebretson (collectively, "Respondents"), in connection with a cherry-picking scheme. The Commission alleged that Bronson traded securities in Strong's account but delayed allocating those securities to client accounts until after he observed how the securities performed throughout the day, allocating the profitable trades to himself and unprofitable trades to Strong clients and thereby reaping substantial profits at the clients' expense. The Commission further alleged that Bronson and Strong misrepresented their practices in Strong's Form ADV by falsely stating that trades would be allocated in accordance with pretrade allocation statements and that no client or firm personnel account would be favored. Lastly, the Commission alleged that Engebretson aided and abetted the defrauding of investors by repeatedly disregarding red flags relating to Strong's trade allocation practices and by failing to ensure that Strong's trade allocation policies and procedures were implemented. The Commission charged Bronson and Strong with violating Section 10(b) of the Exchange Act, Sections 17(a)(1) and 17(a)(2) of the Securities Act, and Sections 206(1), 206(2), and 207 of the Advisers Act. The Commission additionally charged Strong with violating Section 206(4) of the Advisers Act and

Bronson and Engebretson with aiding and abetting those violations. On June 15, 2018, the court entered a judgment on consent from Engebretson, permanently enjoining him from future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. Thereafter, in a follow-on administrative proceeding, the Commission accepted an offer of settlement from Engebretson. The Commission's order bars Engebretson from association.

3. The Commission brought several cases in this area, focusing on trade allocation from an adviser's omnibus account, in 2018. *See, e.g.*, *In re BKS Advisors LLC*, Advisers Act Release No. 4987, 2018 SEC LEXIS 2018 (Aug. 17, 2018); *In re Roger T. Denha*, Advisers Act Release No. 4988, 2018 SEC LEXIS 2017 (Aug. 17, 2018); *SEC v. World Tree Financial, LLC, et al.*, Litigation Release No. 24278, 2018 SEC LEXIS 2486 (Sept. 20, 2018).

4. *In re Channing Capital Management, LLC*, Advisers Act Release No. 5412, 2019 SEC LEXIS 4771 (Nov. 22, 2019). The Commission accepted an offer of settlement from Channing Capital Management, LLC (the "Firm"), a registered investment adviser providing institutional investment management services to institutional investors and pension funds, in connection with the Firm's allocation of trading commission costs associated with aggregated (or block) securities trades. The Commission alleged that the Firm failed to follow its policies and procedures mandating that the terms negotiated for block trades apply equally to each participating client. Specifically, the Commission alleged that the Firm's policies and procedures separately required compliance with and observance of all policies and prohibitions mandated by a client. The Commission alleged that four of the Firm's approximately 35-45 institutional clients had included a contractual provision that placed limitations on the amount they were willing to pay in commission rates for execution of their brokerage transactions. The Commission alleged that between January 2014 and January 2018, other clients that did not specify or otherwise limit their commission rate paid commission rate per share in block trades higher than those clients that had placed restrictions on their execution commission rates. The Commission alleged that this resulted in the Firm's failure to comply with its written trade aggregation policies and procedures concerning pro rata allocation of trading costs in block trading transactions. The Commission found that this conduct violated Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder. The Commission censured the Firm and ordered it to cease and desist from committing or causing any present or future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7. The Commission also ordered the Firm to pay a civil penalty of $50,000.00. In reaching the settlement, the Commission credited the Firm's voluntary and promptly undertaken remedial acts, as well as its cooperation with the Commission staff.

D. Principal and Agency Transactions.

1. *In re Ophrys, LLC*, Advisers Act Release No. 5041, 2018 SEC LEXIS 2544 (Sept. 21, 2018). The Commission accepted an offer of settlement from registered investment adviser Ophrys, LLC ("Respondent"). The Commission alleged that Respondent failed to adequately disclose to clients the capacity in which it was acting with respect to, and obtain consent from its clients for, agency transactions for which it received compensation in addition to its advisory fee. The Commission also alleged that Respondent failed to disclose its conflicted role in a principal transaction. Specifically, the Commission stated that Respondent engaged in two agency transactions where it acted as broker within the meaning of Section 206(3) of the Advisers Act, without providing adequate prior written disclosure to the affected advisory clients that it was acting as agent in the sale of securities from one client account to another, or obtaining client consent. The Commission alleged that in a third transaction, Respondent, through its wholly owned subsidiary, purchased securities, which consisted of defaulted consumer debt, from a private fund of which it was the sole remaining investor. According to the Commission Order, Respondent then sold those same securities to another advisory client without disclosure as to the conflicted transaction, or obtaining client consent. As a result of this conduct, the Commission found that Respondent violated Section 206(3) of the Advisers Act. The Commission ordered Respondent to cease and desist from committing or causing further violations of Section 206(3) of the Advisers Act. Finally, the Commission ordered that Respondent pay a civil money penalty of $500,000.

E. Wrap-Fee Programs – Trading Away.

1. *In re Lockwood Advisors, Inc.,* Advisers Act Release No. 4984, 2018 SEC LEXIS 1989 (Aug. 14, 2018). The Commission accepted an offer of settlement from Lockwood Advisors, Inc. ("Respondent"), a registered investment adviser. The Commission alleged that Respondent's policies and procedures were not reasonably designed to prevent violations of the Advisers Act in connection with gathering and disclosing information about the trading-away practices of the third-party portfolio management firms in its wrap programs. According to the Commission's Order, Respondent was the sponsor of a separately managed account wrap program offered to third-party registered investment advisors ("RIAs") and their clients (wrap clients), for which the wrap clients' investment advisers had the responsibility of evaluating the suitability of the portfolio managers for its individual clients. The Commission alleged that Respondent failed to provide clients and RIAs with material information about trading away and the additional costs associated with choosing certain portfolio managers in Respondent's wrap programs.

In determining to accept the settlement offer, the Commission considered both Respondent's cooperation and the voluntary remedial acts undertaken by Respondent, including improving the specificity of its policies and procedures regarding the quarterly step-out trading reviews, and improving its Form ADV disclosures regarding trading away by disclosing to wrap clients that the portfolio managers are permitted to trade away; providing a history of the portfolio managers' record of trading away; and revising certain footnotes in its Form ADV to state that there may be fees associated with trading away, and giving the overall ranges of those fees. The Commission ordered Respondent to cease and desist from committing or causing any violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and ordered Respondent to pay a civil money penalty of $200,000.

F. Trading Resources and Disclosure.

1. *In re BlueCrest Capital Management Limited*, Advisers Act Release No. 5642, 2020 SEC LEXIS 5086 (Dec. 8, 2020). On December 8, 2020, the Commission filed settled charges against the UK-based investment adviser BlueCrest Capital Management Limited ("BlueCrest"), a former registered investment adviser, arising from alleged "inadequate disclosures, material misstatements, and misleading omissions concerning its transfer of top traders from its flagship client fund."[58] As set forth in the Order, BlueCrest transferred traders from BlueCrest Capital International ("BCI") to a proprietary fund, BSMA Limited, and replaced those traders with an underperforming algorithm. The Order alleges that "BlueCrest created BSMA to trade the personal capital of BlueCrest personnel using primary trading strategies that overlapped with BCI's."[59] The SEC further alleged that for more than four years BlueCrest made inadequate and misleading disclosures concerning the existence of the proprietary fund, the movement of traders and the use of an algorithm for BCI. The Order also found that BlueCrest transferred many of its highest performing traders to the proprietary fund and assigned the most promising new traders to the proprietary fund, and that the algorithm used in place of the transferees generated "significantly less profit with greater volatility than the live traders."[60] The SEC concluded that BlueCrest willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, and Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-8 and 206(4)-7 thereunder. BlueCrest agreed to a cease-and-desist order imposing a censure, disgorgement and prejudgment interest of $132,714,506 and a civil penalty of $37,285,494. The Order further created a fair fund to return the monetary relief to investors.

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58 Press Release, Securities and Exchange Commission, SEC Orders BlueCrest to Pay $170 Million to Harmed Fund Investors (Dec. 8, 2020), https://www.sec.gov/news/press-release/2020-308.

59 *Id.*

60 *Id.*

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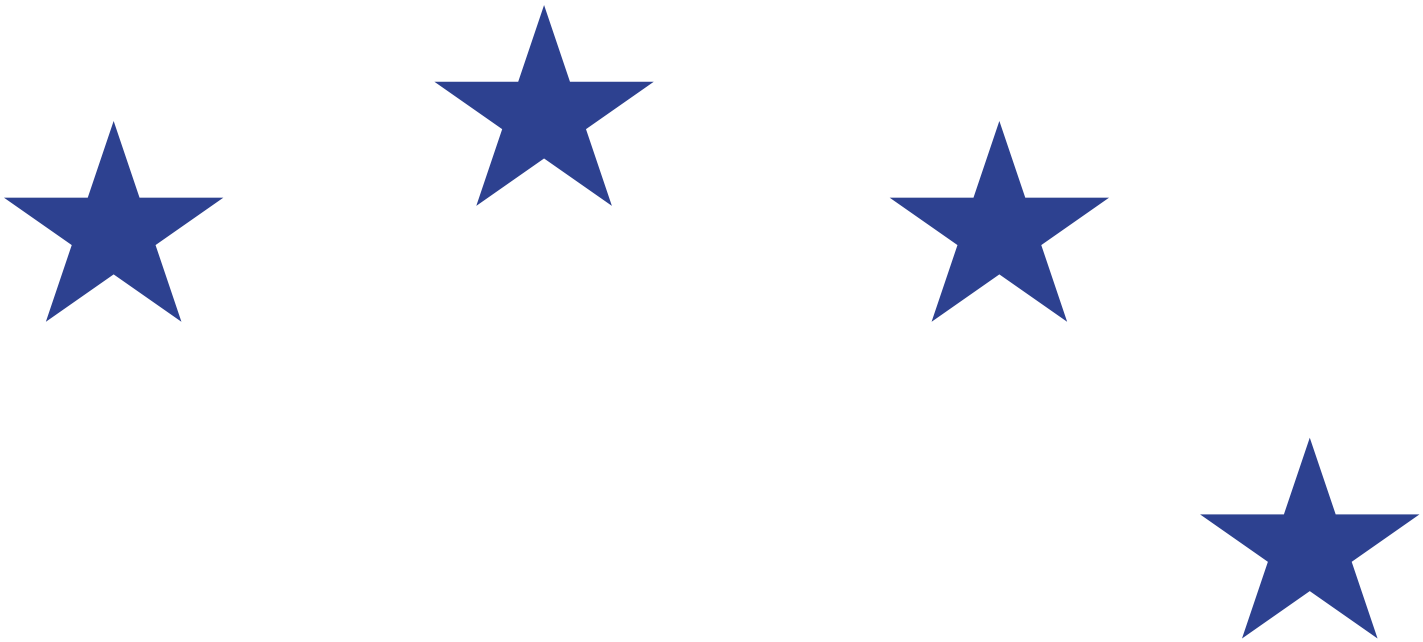
MiFID II research unbundling: assessing the impact on SMEs

Adrien Amzallag, Claudia Guagliano, Valentina Lo Passo



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MiFID II Research Unbundling – impact on EU equity markets

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Abstract

This article analyses the impact of the MiFID II research unbundling provisions on EU sell-side research, following their application on 3 January 2018. The MiFID II provisions require portfolio managers to pay for the research that they obtain, either by paying themselves or by passing on that charge to their clients. Concerns have been raised that the rules could have had detrimental effects, particularly on SMEs, on the availability and quality of research on EU companies, as well as on company financing conditions. We do not find material evidence of these effects: following the introduction of the MiFID II research unbundling provisions, 1) the quantity of research per SME has not declined relative to larger firms; 2) the probability of an SME completely losing coverage has not increased relative to a larger firm; 3) the quality of SME research has not worsened relative to larger firms; and 4) SME liquidity conditions have worsened, relative to larger firms, in terms of tightness (measured by bid-ask spreads), but not in terms of depth (measured by the Amihud illiquidity ratio and the turnover ratio). However, in absolute terms, SMEs continue to be characterised by lower amount of analyst research, higher probability of losing coverage, worse quality of research and limited market liquidity. This situation appears to have been neither improved nor worsened by the MiFID II research unbundling provisions.

JEL Classification: G14, G28, G29

Keywords: MiFID II, Equity markets, analyst coverage, sell-side research, market liquidity

[1] The views expressed are those of the authors and do not necessarily reflect the views of the European Securities and Markets Authority. Any error or omissions are the responsibility of the authors. The authors would like to thank Barbara Alemanni, Antoine Bouveret, Salvatore Gnoni, Steffen Kern, Giovanni Petrella, Casper Rutting, Christian Winkler, the ESMA Committee of Economic and Market Analysis, the ESMA Committee on Consumer Protection and Financial Innovation, and seminar participants in the ESMA MiFID II Research Unbundling workshop held on 7 October 2020, for useful discussions and comments.
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1. Introduction

As of 3 January 2018, and as part of the Markets in Financial Instruments Directive II (MiFID II)[2], firms that provide portfolio management or investment advice on an independent basis (denoted asset managers) must pay for the research that they obtain, either by paying themselves or by passing on that charge to their clients. As a result, entities that, until that date, provided both research and brokerage and other investment-related services (i.e. investment firms) to asset managers must now separately identify the cost of the research they provide. In other words, the cost of research is now 'unbundled' from the cost of other services provided to the asset manager (to allow that firm to either absorb the costs itself or to pass on those costs to its clients).

These 'research unbundling' provisions aim to reduce the potential conflict of interest for those investment firms offering both execution and research services. As per Article 27 of MiFID II, investment firms are obliged to execute orders on terms that are the most favourable to their clients ('best execution'). These same firms often offer their clients research in addition to (i.e. bundled with) the order execution services that are provided. As a result, it can be challenging for investment firms to honour their best execution requirement when research is being offered at the same time and without being charged separately. Theoretically, this could lead to asset managers paying more for order execution services than they would otherwise have been willing if the cost of research was clearly separated from the cost of order execution services. Alternatively, brokerage firms can bundle research in at no or little additional cost for clients, whereas independent research providers do not have the option of cross-subsidization—which may lead to competition issues in the overall market for research.

The 'research unbundling' provisions also aim to address a second and related topic in the market for financial and economic research: the risk of overproduction of research. The provision of research can generate more business for an investment firm than would otherwise be the case if only brokerage services are provided. As a result, investment firms are economically incentivized to not only bundle research with order execution services, but also to produce more research than would otherwise be needed on particular companies or industries. There are several ways in which this can be manifested, including excessive amounts of research (e.g. multiple research pieces all providing similar recommendations), as well as research that is of lower quality (e.g. poor forecasts). Consequently, the MiFID II research unbundling provisions enable asset managers (and, ultimately, their own clients) to have clarity on the 'cost' aspect of the 'cost vs. benefit' trade-off they face when assessing whether research is useful to them.

To summarize, the MiFID II research unbundling provisions affect three distinct economic actors: research producers (typically investment firms who employ analysts to produce research and who also provide execution/brokerage services), research subjects (companies), and research consumers (asset managers)[3]. As shown in the chart below, these impacts can be self-reinforcing: if a company is less well-researched, then fewer asset managers may consider that company as an investment. In turn, a reduction in investor interest in that company can theoretically lead to less favourable financing conditions, such as higher issuance costs and/or a lower probability of oversubscription. In turn, a higher cost of issuance may also lead to less capital market activity for companies, and a greater reliance on other non market-based sources of financing, such as bank loans, or potentially a reduction in business activity. In either case, a company with less capital market activity is likely to be of less interest for research analysts, thus reinforcing the above-mentioned sequence.

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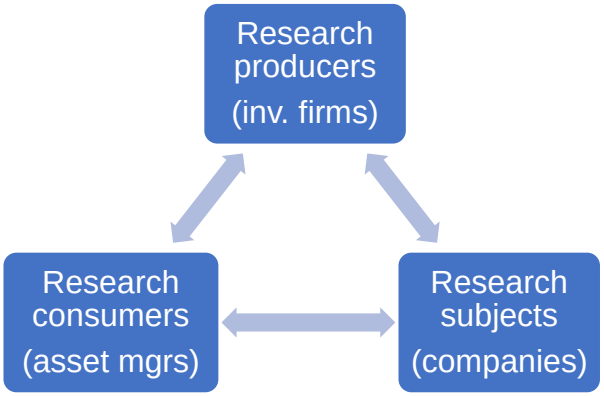
[2] See Article 24(7)-(9) of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 ('MiFID II') and Article 13 of Commission Delegated Directive (EU) 2017/593 of 7 April 2016 ('the MiFID II Delegated Directive').

[3] See also Pope et al. (2019) for a discussion of similar efforts in Sweden involving specific pension fund managers. In the case of MiFID II, the provisions apply primarily both to asset managers and collective investment management companies providing the services of portfolio management and independent investment advice in the EU, and also to third-country firms providing these services through the establishment of a branch in the EU.



Since their application, the research unbundling provisions have generated a substantial amount of commentary and discussion and, more recently, academic research based on available data. For example, market participants, frequently quoting survey data, claim that, since the introduction of these provisions, the total amount of research produced has fallen, there are fewer analysts producing research on companies, and the quality of research has worsened (CFA 2019, Hull 2019). Public authorities have also begun investigating the impact of these provisions, also using survey evidence. However, their findings are less clear-cut: FCA (2019) survey results suggest little overall effect, whereas AMF (2020) indicate a more extensive impact of the research unbundling provisions on the quantity and quality of research in their respective jurisdiction.

Market participants have also identified the possibility that the MiFID II research unbundling provisions may have disproportionately affected small and medium-sized enterprises (SMEs) (Société Générale 2019). In addition, on 18 January 2020, the Commission launched a MiFID II-related consultation, wherein it requested feedback on a number of proposals to foster research coverage on SMEs, including "*to increase its production, facilitate its dissemination and improve its quality*". Subsequently, the Commission, on 24 July 2020, issued a consultation on a proposal to introduce a "*narrowly defined exception*" from the research unbundling provisions for small and mid-cap issuers (defined as companies whose market capitalisation has not exceeded EUR 1 billion at any time during the previous twelve months) and for fixed income instruments.

In light of this consultation, the research unbundling rules may further evolve in the future. Indeed, on 15 December 2020, following an earlier legislative proposal from the European Commission on 24 July 2020, the European Council approved the so-called Capital Markets Recovery Package[4]. This includes, among other measures, an exemption to the unbundling provisions for investment research on issuers whose market capitalization did not exceed EUR 1 billion during the preceding 36 months, provided that certain conditions are met. Moreover, a review clause is created, according to which the Commission shall review, amongst others, the rules on investment research, by 31 July 2021 at the latest.

In parallel to survey-based reports, there is a growing body of academic literature that seeks to assess the provisions' impact on various outcomes (e.g. analyst coverage, market liquidity, etc.). The literature has mainly focused on the impact of MiFID II on the number of analysts that research listed companies and on the quality of research.

This research points to a general decline in the number of analysts covering EU firms, following the entry into application of unbundling provisions. For example, Anselmi and Petrella (2020), Fang et al. (2019), and Guo and Mota (2020) find that the MiFID II research unbundling provisions have, since their date of application, led to an overall reduction, in terms of analysts covering a company, of 0.55, 0.44 and 0.67 analysts per company respectively. According to Guo and Mota (2020), this fall is driven by the fact that large companies tend be covered by more analysts. Thus, investment firms seeking to reduce costs have a greater incentive to scale back research on these companies. Similarly, Anselmi and Petrella (2020) find that the impact of MiFID II depends on company size: larger EU companies (i.e. those with market capitalisation greater than 3.5 billion euros) have experienced a fall of about 1.55 analysts covering them, relative to a pre-MiFID II average of between 18 and 20 analysts. In contrast,

[4] See https://www.consilium.europa.eu/media/47469/st13798-ad01-en20.pdf for further details

the authors find that small companies (i.e. those whose market capitalisation is between 300 million and 1 billion euros) experienced a reduction of 0.22 analysts covering them, as a result of the application of MiFID II, from an average of 4 to 5 analysts per company in the several years preceding MiFID II. Lastly, Lang et al. (2019) analyse specific companies' characteristics and find a significant reduction in analyst coverage of about 0.057 analysts for the largest, oldest, and less volatile (in terms of forecast dispersion) companies.

Regarding the quality of research post-MiFID II, recent studies have concluded that the accuracy of analyst forecasts has tended to increase following the implementation of MiFID II (Fang et al. (2020), Guo and Mota (2019), and Lang et al. (2019)). In particular, Guo and Mota (2019) find that analysts employed both before and after MiFID II tend to produce better quality research, while analysts that produce less accurate research are more likely to cease their research activities entirely after MiFID II than analysts whose forecasts are more accurate. Fang et al. (2020) conclude that stock recommendations on EU companies post-MiFID II seem to be more profitable and stimulate greater market reactions.

Elsewhere, research on the impact of MiFID II on market liquidity conditions indicates a moderate negative impact. For example, Lang et al. (2019) find evidence that the MiFID II research unbundling provisions have led to a widening in the bid-ask spread for affected companies. Anselmi and Petrella (2020) find that there might be a positive association between the introduction of MiFID II and the bid-ask spread for both small and mid-cap companies.

This paper contributes to the emerging literature by extensively comparing the impact of the MiFID II research unbundling provisions on SMEs in relation to larger companies. In doing so, we introduce a definition of SMEs that is grounded less by market conventions (which, by definition, are subjective) and more in legal and supervisory frameworks. This is not an arbitrary distinction: whether a firm satisfies the regulatory definition of SMEs has material consequences for the capital requirements faced by any banks providing funds to the company and, therefore, the company's overall strategy for accessing funding from capital markets. In addition, SMEs have fewer disclosure requirements under the Prospectus Regulation and Accounting Directive, which may also (while reducing reporting burdens) imply less investor awareness of these companies at outset, all else being equal. Lastly, SMEs are also clearly identified in various statistical collection exercises (e.g. in Eurostat and in the European Central Bank), which also provides them with a distinct status that can be exploited using a difference-in-difference strategy.[5]

In addition, our paper extends recent efforts (e.g. Anselmi and Petrella 2020) to assess the impact of the MiFID II research unbundling provisions on companies' liquidity and financing conditions. It does so by recognizing that there are various and complementary ways in which market conditions can be measured, for example in terms of tightness, depth, and cost.

Elsewhere, the paper aims to take a longer-term perspective when assessing the impact of research unbundling provisions on sell-side research quantity and quality. In doing so, this paper sheds light on structural developments in the market that may also affect the supply of sell-side research, such as digitalization, industry consolidation and decreasing number of listings.

In this respect, we find that, after the application of the MiFID II research unbundling provisions on 3 January 2018, the quantity of research per SME has not declined relative to larger companies, the probability of an SME completely losing coverage has not increased relative to a larger firm, and the quality of SME research has not declined relative to larger firms. However, SME liquidity and financing conditions have worsened relative to larger firms, in terms of tightness (measured by bid-ask spreads) and cost of debt, but not in terms of depth (measured by the Amihud illiquidity ratio and the turnover ratio). Finally, in absolute terms, SMEs continue to be characterised by relatively less analyst research, higher probability of losing coverage, lower quality of research and limited market liquidity. This situation has not been affected by the MiFID II research unbundling provisions.

Taken together, these findings appear to be more in line with the existing academic literature than with industry surveys.

[5] Other papers (as Fang et al. 2020) group companies by economic measures, as size, liquidity or other features.

The remainder of this paper is organised as follows. Section 2 describes the data used for this analysis. Section 3 presents the data-based empirical evidence on research quantity and research quality in the EU. Section 4 describes the estimation strategy and Section 5 shows the results. Section 6 concludes.

2. Data

Our sample comprises sell-side research (i.e. research provided by either investment firms or independent research providers) data via I/B/E/S Datastream on 8,000 companies headquartered in the 27 European Union (EU) member states and the United Kingdom[6]. This sample represents companies that have been active at any time between January 2006 to December 2019[7]. Table A1 presents our sample by headquarter country and company classification (SME and large)[8].

We focus on the possible impact of MiFID II on sell-side research rather than on buy-side research (i.e. research produced in-house by investment funds) due to data availability considerations[9]: buy-side research is generally not published. In particular, we look at the quantity of research produced by sell-side analysts, the company's probability of losing coverage, the quality of the research produced, as well as companies' liquidity and financing conditions. Company-level data was collected according to all different specifications.

As discussed further in the estimation strategy section below, we focus on the possible differential effects of MiFID II research unbundling provision on SMEs, relative to the effect of the same provisions on large companies. We classify 2,605 firms as SME (3,122 large companies) using the criteria set out by the European Commission (2003)[10], which are:

- Number of employees < 250 and total assets ≤ EUR 43m.
- Number of employees < 250 and turnover ≤ EUR 50m.

All variables are defined in detail in Table A2 of Annex A1, while Table A3 in that same annex presents descriptive statistics and Table A4 displays a correlation matrix for the main variables of interest.

To approximate the *quantity of research* produced by sell-side analysts on a specific company, in line with similar papers, such as Anselmi and Petrella (2020) and Lee and So (2017), we collect and use the variable "*earnings per share total number of estimates*" from Refinitiv on a monthly frequency. Earnings per share (EPS) estimates are the most common research estimates produced by sell-side analysts covering a particular company and, therefore, represent a worthwhile measure for assessing the extent of analysts' coverage of individual companies[11].

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6 The United Kingdom's membership of the European Union ceased on 31 January 2020, and thus it remains as part of the EU during our sample period.

7 Active firms are defined as those listed on one or more European exchanges as at end-2019. In contrast, inactive firms are firms that, as at end-2019, were delisted (due to mergers, bankruptcy, etc.), but were active at some point between January 2006 and December 2019. To allow effective identification of a possible MiFID II impact, we restrict our econometric analysis to a shorter time window: from January 2015 to December 2019, which represents two years either side of the start of the MiFID II provisions of interest. Companies included in this sample must have been active in at least several months both before and after the entry into application of the MiFID II research unbundling provisions. Our sample during this time window comprises 5,727 companies and includes 60% of listed companies considered as 'active' by the end of December 2019 (as reported by the Federation of European Securities Exchanges (FESE)).

8 Similar table but, on the full original sample (2006-2019) is available in Amzallag et al. (2020) "The impact of research unbundling on equity markets" ESMA Report on Trends, Risks and Vulnerabilities, No 2, 2020.

9 See Fang et al. (2020) for an exploration of impacts on buy-side research. Further quantitative assessment of the provisions by research categories such as sponsored compared with unsponsored research, was considered but not further explored due to data availability limitations.

10 Underlying data description and additional information of firms' classification are available in Amzallag et al. (2020) "The impact of research unbundling on equity markets" ESMA Report on Trends, Risks and Vulnerabilities, No 2, 2020. Firms for which the above variables (number of employees, total assets, and turnover) are not available are excluded from the econometric analysis.

11 The variable "*number of analysts covering a firm*" available on Refinitiv Eikon (I/B/E/S Summary Estimates) was downloaded to perform some robustness checks. As shown in Table A3 below, the average number of EPS estimates produced by

Research quality is measured using the "*EPS annual surprise percentage difference*" which represents the difference between the latest outturn EPS and the most recent EPS estimate for the period. This variable is available on I/B/E/S Datastream at a yearly frequency[12] and reflects the extent to which analysts' estimates for a company's annual EPS were different from reality (the "surprise"). In other words, it represents the median surprise across all analysts in the sample. Thus, a zero "*EPS annual surprise percentage difference*" for a company in a given year implies that there has been no surprise and therefore analysts' median forecasts for that company in that year were identical to the result. This variable thus appears to be a reasonable way of measuring the accuracy of an analyst's forecasts and is of a similar nature as the *quantity of research* measure: both variables use the EPS estimate as a basis for their calculation.

We use several indicators to measure the secondary market liquidity conditions faced by the companies in our sample, in line with the existing academic literature in this area (see Diaz and Escribano, 2020). These include the average monthly bid-ask spread and Amihud illiquidity ratio (Amihud 2002) and the turnover ratio (the monthly trading volume divided by the outstanding market capitalisation of a company's shares at the end of the same month). It is possible that any impact of the MiFID II provisions could be felt via companies' financing conditions, in a manner independently of liquidity conditions. To this end, we retrieve, on a monthly frequency, the variable "*weighted cost of debt*"[13] representing the marginal cost to the company of issuing new debt.

Finally, we use (monthly) data on market capitalisation and turnover as company-level control variables throughout the econometric analysis.

3. Empirical evidence

3.1 Impact on research quantity

Figure 1 illustrates trends in the intensity of research, focusing on the yearly range in the number of analysts covering companies in our data sample. In order to ensure that we look at intensity of research, we only analyse companies that were both listed in an EU exchange in late 2019 and have been active at all times between 2006 and 2019.

First, it does not appear that the introduction of MiFID II (see the vertical red line) in January 2018 has led to a significant difference in the number of analysts producing EPS estimates per company. This is illustrated both by the median (black horizontal bar) in each box just before and after the vertical red line staying identical (3 analysts per company)[14].

Second, the number of analysts producing EPS estimates for the company at the 75th percentile (the top of the green vertical bars) has declined slightly but, interestingly, this appears to be the continuation of a long-term trend that began as far back as 2012.[15]

Third, as Figure 2 below illustrates, data on SMEs suggests that this sub-market has remained largely stable in terms of research intensity. Indeed, all indicators –the 90th percentile (not shown), 75th percentile, median (50th percentile), and 25th percentile number of analysts covering SME companies – have remained constant since 2010 (standing at 6, 3, 2, and 1 analysts, respectively). This appears to indicate that the long-term slight reduction in research intensity is affecting mainly large companies.

analysts is 5.162 for the entire sample. Similarly, the average number of analysts following a firm is 5.402. These two estimates, together (as shown in Table A4 below) with the high correlation (0.994) and a similar distribution, suggest an almost one-to-one correspondence between the two variables (i.e. one EPS estimate for a firm corresponds to one analyst covering a firm and vice versa).

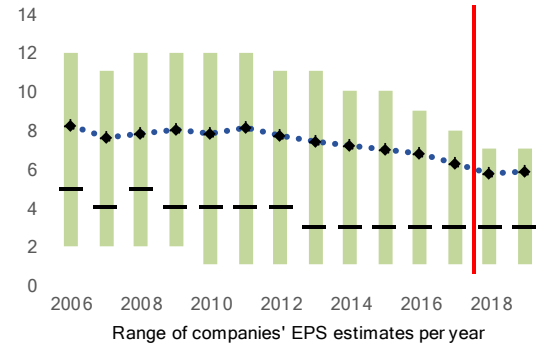
12 Because of the variable construction, the analysis on *research quality* has been conducted on annual data.

13 As defined in Table A2, the variable is calculated by adding weighted cost of short-term debt and weighted cost of long-term debt based on 1-year and 10-year point of an appropriate credit curve.

14 Similar results are found when examining the number of analysts covering a firm, in contrast to the number of analysts producing EPS estimates for a firm.

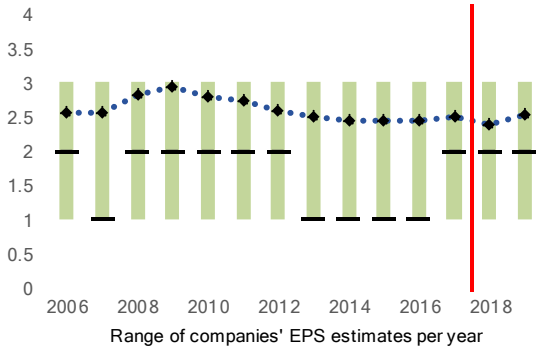
15 A similar picture can be seen when looking at the 90th percentile of the data sample (not shown): among companies with very high number of analyst estimates being produced, there has been a large and steady fall in the number of these estimates per firm after 2011.

Figure 1
Impact of MiFID II on intensity of research for large companies and SMEs
Stable number of analysts covering each company before and after MiFID II



Note: Sample of 4,870 EU firms that have been in operation at all times bet. 2006 and end-2019, and at all times researched (i.e. have EPS estimates produced) by analysts. Black diamonds (horizontal bars) in each box = average (median) across firms in the year. 25th and 75th percentiles = bottom and top edges in each box. MiFID II date of application = vertical red line.
Sources: Refinitiv, I/B/E/S, ESMA calculations

Figure 2
Impact of MiFID II on intensity of research for SMEs only
SMEs: Stable number of analysts covering each company before and after MiFID II



Note: Sample of 2,100 EU firms that have been in operation at all times bet. 2006 and end-2019, and at all times researched (i.e. have EPS estimates produced). Black diamonds (horizontal bars) in each box = average (median) across firms in the year. 25th and 75th percentiles = bottom and top edges in each box. MiFID II date of application = vertical red line. SMEs defined as per European Commission (2003).
Sources: Refinitiv, I/B/E/S, ESMA calculations.

Taken together, these findings suggest that the research industry has undergone a steady process of consolidation in terms of the amount of research coverage being provided on companies in the EU, and that this trend is concentrated on companies rather than SMEs. This is in line with pre-MiFID II market participant observations that there were excess amounts of research being provided on certain (presumably larger) companies (Marriage 2016). For example, one research study estimated that "*well over 40,000 research notes – from comprehensive reports to minor updates linked to corporate announcements – are sent out every week by the top 15 global investment banks, of which less than 5% are opened*" (Kwan and Quinlan 2017). Another potential driver is the steady growth in the past decade in index-tracking funds and passive management, both of which make less use of research than actively-managed investment vehicles (see also Anselmi and Petrella 2020).

The next step is to examine the possible impact of the MiFID II research unbundling provisions on the second measure of research quantity: research coverage, i.e., whether or not companies have EPS estimates produced by analysts in the analysed period.

3.2 Loss of coverage

Figure 3 presents the number of companies that were no longer researched (i.e. have EPS estimates produced by analysts), over the period 2006 to end-2019.[16] It appears that the number of companies losing coverage in this way has been increasing[17]. However, this increase began much earlier than the introduction of MiFID II: since 2012 there has been a steady rise in the number of companies that are no longer receiving EPS estimates from any analyst, which suggests a steady rise in the number of companies losing research coverage. It is likely that this trend is driven by reductions in the number of

[16] Information is presented on a quarterly basis for a total of about 6,800 companies, separated into SMEs (c. 3,200 companies), large companies (c. 2,800 companies), and companies that could not be classified (c. 760). Companies that drop out of the data sample due to bankruptcies, mergers, or delisting are excluded from the sample. Only companies that continue to be listed and are no longer covered on a permanent basis are included in the figure. For firms that lose coverage during 2019, it is challenging to assess whether that loss is temporary or permanent. This is because past data since 2006 indicates that some firms that are no longer covered by analysts in a given time period will subsequently resume to be covered by the same or other analysts in future years. The numbers presented in Figure 3 include a correction for the average number of firms losing coverage on a temporary basis in each year between 2011 and 2018. The total number of firms deemed to lose coverage in 2019 is reduced by this correction, which has been calculated separately for SMEs, non-SMEs, and not classifiable firms.

[17] Roughly 270 EU companies were no longer covered by sell-side research analysts during 2019, in comparison to 140 companies losing coverage in 2017. In both years, the proportion of SMEs losing coverage as a share of total companies losing research coverage was roughly constant (55% of companies losing coverage in a year were SMEs).

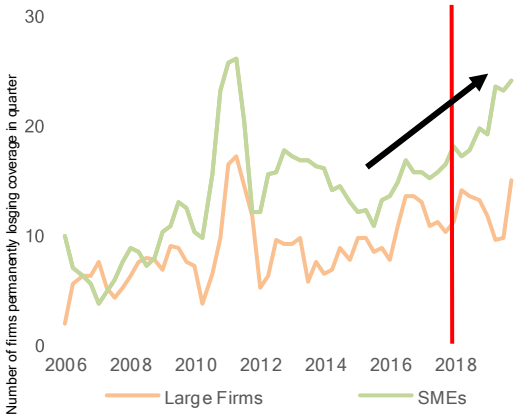
research analysts, for example due to a greater use of technology and 'big data', the steady rise in passive alternatives to active asset management, as well as a fall in equity commissions (Noonan 2016, Wigglesworth 2017a, Wigglesworth 2017b, Mayhew 2019).

The number of large companies losing coverage (orange line in Figure 3) actually declined for roughly 1.5 years after the introduction of MiFID II, before sharply increasing at the end of 2019[18]. The sharp increase in loss of coverage (both for large companies and SMEs) has only appeared in recent months and it is difficult to conclude that this is a trend that is driven by MiFID II, also since the research unbundling provisions were widely known in advance, as described in the introduction. Similarly, although there has been a sharp increase in the number of SMEs losing coverage since January 2019 (green line in Figure 3), other sharp jumps have been observed in the past, including from mid-2015 to mid-2016.

In addition, it is important to recall that there are also companies that gain coverage at any point in time, and that have not been covered in earlier years. This fact must also be considered when examining the overall impact of the MiFID II research unbundling provisions on the quantity of research produced on EU companies. Figure 4 below subtracts the number of companies losing research coverage from the number of companies gaining coverage in each quarter (starting from 2009).

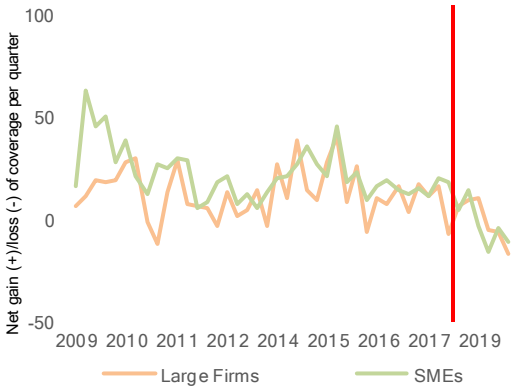
Figure 4 below suggests that both large and SME companies across the EU steadily *gained* analyst coverage until around the end of 2018[19]. However, in early 2019 – i.e. more than one year after the implementation of MiFID II, and for the first time in the sample period, the net growth in SMEs and large companies across the EU being researched began to turn negative. Further investigations are needed before concluding that the MiFID II research unbundling provisions are the reason for this change of situation, and whether this is a consistent trend. For example there is recent evidence that the Covid-19 pandemic and resulting economic uncertainty has led to a surge in research analyst coverage (Clarke 2020).

Figure 3
Impact of MiFID II on research coverage
Long-term increase in companies losing coverage



Note: Sample of 6,800 EU firms that have at any time from 2006 to end 2019 permanently ceased to be researched (i.e. have EPS estimates produced) by all analysts. SMEs classified as per European Commission (2003).
Sources: Refinitiv, I/B/E/S, ESMA calculations.

Figure 4
Impact of MiFID II on research coverage
Net loss across the EU of research coverage starting in 2019



Note: Sample of 6,120 EU firms that have at any time from 2006 to end 2019 either begun or permanently ceased to be researched (i.e. have EPS estimates produced) by at least one analyst. Firms that cannot be classified as either SMEs or Large are excluded.
Sources: Refinitiv, I/B/E/S, ESMA calculations.

[18] It is likely that the large jump in firms losing research coverage during 2010 and 2011 is at least in part driven by brokerages and other research providers reducing their number of research analysts, as part of widespread layoffs in the EU financial services sector during 2009, 2010, and 2011 (see for example Eurostat employment data: series code nama_10_a64_e and industry sector "*Financial service activities, except insurance and pension funding*").

[19] Additionally, further calculations suggest that, although the cumulative number of firms gaining coverage is overall higher than the one of firms losing coverage entirely, the growth rate of the two go in the opposite directions. In other words, it seems that in the data sample, firms are losing coverage faster than firms are gaining coverage.

3.3 Impact on research quality

Figure 5 below provides an initial visualisation of the possible impact of the MiFID II research unbundling on the *quality* of research produced on EU companies. The figure suggests a weak trend towards improved accuracy of EPS forecasts after the implementation of MiFID II. This is illustrated by the median (black dot), in the two bars after the vertical line, approaching zero (i.e. no surprise in terms of EPS forecasts and therefore better quality). At the same time, there appears to be a trend, from 2012 onwards, for the 90th and 10th percentiles in each year to be narrowing[20].

This trend suggests that research quality has been improving in the last years, rather than merely following the application of the MiFID II research unbundling provisions. One reason for this improvement could be that, despite the increase in the number of companies losing coverage, those analysts who continue to follow specific companies tend to be more accurate in terms of EPS estimates—which appears to be in line with the recent academic studies discussed above. At the same time, the low market volatility environment that has largely prevailed since 2012 (Goedhart and Mehta 2016, ECB 2012) also undoubtedly created favourable conditions for an improvement in forecast accuracy.

Figure 5
Impact of MiFID II on research quality
Research quality stable post vs. pre-MiFID II

Note: Sample of 5,200 EU firms that have at any time been in operation at all times bet. 2006 and end-2019, and at all times researched (i.e. have EPs estimates produced) by analysts. Black horizontal bars in each box = median across firms in the year. 25th and 75th percentiles = bottom and top edges in each box. Additional lines ('whiskers') = 10th and 90th percentiles. MiFID II date of application = vertical red line.
Sources: Refinitiv, I/B/E/S, ESMA calculations.

4. Estimation strategy

4.1 Overall strategy

Faced with additional constraints, sell-side research providers may decide to focus on companies that have greater ex ante interest for their clients, in terms of size, liquidity or other features. We focus our econometric analysis on SMEs classified using the criteria set out by the European Commission (2003), as explained in section 2. We follow the regulatory definition of SMEs. because, from a regulatory and supervisory perspective, it has material consequences in other regulatory areas, such as supervisory capital requirements for lenders (under the Capital Requirements Regulation for example). In addition, SMEs have fewer disclosure requirements under the Prospectus Regulation and Accounting Directive, which may also (while reducing reporting burdens) imply less investor awareness, all else being equal. Lastly, SMEs are also clearly identified in various statistical collection exercises (e.g. in Eurostat and in the European Central

[20] Research quality appears to improve slightly for large companies (not shown). Although the median forecast error approaches zero for both SMEs and large companies, dispersion for SMEs (90th and 10th percentiles) tends to expand after the application of MiFID II. However, there may be other confounding factors behind this as well, such as greater data availability for large companies combined with a trend toward using 'big data' techniques to conduct research.

Bank), which also provides them with a distinct status that can be exploited using a difference-in-difference strategy.[21]

We use a difference-in-difference strategy to assess several possible effects of MiFID II on SMEs, in comparison with large companies.

We begin by using equation (1) below when testing the impact of the MiFID II research unbundling provisions. In equation (1), β_1 captures the potential differential effect of the entry into application of the MiFID II research unbundling provisions on SMEs, relative to the effect of the same provisions on large companies. This is represented econometrically by the indicator variable $Post\ MiFID\ II_t$ taking the value of 1 for any month on or after January 2018. Elsewhere, SME is an indicator variable which takes the value of 1 for companies defined as SMEs, 0 as large. Lastly, we introduce various company-level controls, as described in the previous section, as well as month-year and company fixed effects.

$$y_{i,t} = \beta_1 * SME * Post\ MiFID\ II_t + \boldsymbol{\beta} * \boldsymbol{X_{i,t}} + \delta_t + \gamma_i + \varepsilon_{i,t} \quad (1)$$

In formulating this equation (as well as equation (2) further below), we seek to explore whether, since the date of application of the MiFID II unbundling provisions, EU SMEs have been treated differently than larger companies by the research community. This difference in treatment could arise in several ways, which are explored in turn.

4.2 Research quantity and loss of coverage

First, we begin by examining the possible effect of the MiFID II research unbundling provisions on the quantity of research produced by sell-side analysts on SMEs, relative to large companies. A possible mechanism for this effect is the following: the MiFID II research unbundling provisions imply that investment funds have greater clarity on the costs of the research that they consume from sell-side brokers and other research providers. By virtue of greater clarity, investment funds' sensitivity to research costs increases and, compared with the pre-MiFID II research unbundling era, may choose to consume less research. As a result, sell-side research providers may earn lower revenues and feel pressure to rationalize their own resources, whether through reducing the frequency and/or depth of research produced on individual companies (lower research intensity), or by ceasing to cover some companies overall (lower research coverage).

To test the research intensity effect, in equation (1), the dependent variable is the monthly *number of eps estimates* produced by sell-side analysts. Control variables are *market capitalisation* and *turnover* expressed in natural logarithms. In the main specifications we employ year-month and firm-level fixed effects. In addition, we perform several robustness checks, including allowing for a longer-term trend to affect our results (using a larger sample window starting from 2006), restricting our sample to companies that have never lost coverage between 2015 and 2019 (so as to better isolate the impact of the unbundling provisions purely on the intensity of covering certain firms), and lastly using a different—but related—dependent variable (number of analysts covering a company, rather than number of EPS estimates produced for a company).

Besides reducing the amount of research produced on individual companies, sell-side research providers may take the decision of ceasing to cover some companies overall (lower research coverage). Indeed, as soon as MiFID II has come into force, market participants have expressed their concern regarding SMEs losing coverage entirely. We employ equation (1) again to investigate whether MiFID II research unbundling provision has any effect on SMEs' probability of losing coverage completely (either temporary or permanently), relative to large companies.

For this research question the dependent variable in equation (1) is *loss of coverage*, an indicator which takes the value of 1 if a company loses all coverage at any month between January 2015 and December 2019, 0 otherwise. Companies that are no longer researched 'because they are no

[21] Other papers (as Fang_2020) group companies by economic measures, as size, liquidity or other features.

longer listed are excluded. Since *loss of coverage* is binary for construction, we employ the Probit model as estimation strategy. In the main specifications we use year-month fixed effects[22].

4.3 Research quality

We then examine another possible effect of the MiFID II research unbundling provisions, namely whether, following the introduction of these provisions, the quality of research has changed for SMEs in a different way compared to large companies. The question of the impact of these provisions on research quality across EU companies is a key topic that has been explored in numerous papers mentioned above. However, we choose here to focus on the differential impact on SMEs relative to large companies and, in doing so, seek to test the following mechanism: As mentioned above, the MiFID II research unbundling provisions are likely to increase investment funds' sensitivity to research costs. As a result, it is likely that funds will become more demanding in terms of the quality of research that they are willing to pay for, all else being equal. In this way, sell-side research providers may seek to improve their research quality offering, either by being more aggressive in retaining only the most accurate analysts, or by expending greater efforts to seek out hidden or lesser-known opportunities. By virtue of their smaller size, lower liquidity, and less frequent access to capital markets, SMEs are likely to generally be less well-known than larger companies.

We employ equation (1) as well to measure *research quality*, where the dependent variable is the median forecast accuracy defined as the absolute value of the difference between the latest interim EPS and the most recent prior estimate, for the same future horizon.[23] For this analysis we employ an annual dataset. Controls are the same as for research quantity and loss of coverage, and we perform similar robustness checks. In the main specifications we use year and firm-level fixed effects

4.4 Exploring whether research quantity or research quality impacts dominate

It is important to recall that the above-mentioned effects are unlikely to operate in isolation. In other words, changes in the quantity of sell-side research and the relative effort placed by sell-side analysts in producing higher-quality research can counterbalance each other. Indeed, sell-side research companies can cover fewer companies, but may at some point find it profitable to cover lesser-known companies that are therefore offering greater profit-making opportunities for clients and to ensure that they improve the quality of their research as well.

As explained in 4.1 above, SMEs are almost by definition less well-known than their larger peers. It is thus possible to explore which effect mentioned in the previous two sub-sections ultimately dominates (quantity vs. quality). This is because a reduction in research on companies may well lead to less investor interest (i.e. if investors are less aware of a company, all else being equal, they may invest less in that company). On the other hand, if there is a reduction in research, but this is counterbalanced by improved quality of the remaining research even on an industry as a whole, rather than on individual companies – this may instead build confidence in the company or its overall industry and attract investors to explore opportunities.

4.5 Companies' liquidity and financing conditions

Finally, we focus on the impact of research unbundling provisions on the market conditions experienced by the companies in our sample: their costs of financing (debt) and secondary market liquidity conditions.[24] Even if there is less research for companies, it is possible that their financing

[22] We do not introduce firm fixed effects as unconditional probit fixed effects model are known to be biased, in particular in short panels.

[23] Strictly-speaking, we thus measure the forecast *in*accuracy insofar as an increase in the absolute value of the difference between the latest interim EPS and the most recent prior estimate would imply less accuracy.

[24] It is challenging to isolate the effect of the MiFID II research unbundling provisions from the effect of the other simultaneous reforms adopted by MiFID II on companies' liquidity and financing conditions. We attempt to insert some measure of research intensity in our regressions by use of the number of eps estimates per firm. Nevertheless, this section can also be viewed as an assessment of the overall MiFID II package's possible differential impact on SME liquidity and financing conditions relative to large companies' similar conditions over the sample time window.

conditions may improve if the remaining research is of higher quality. Indeed, as shown by Fang et al. (2020), the reactivity of investors to analyst announcements appears to have increased following the introduction of the MiFID II research unbundling provisions.

First, we check whether SMEs, relative to larger companies, have witnessed significant changes in their secondary market liquidity conditions following the introduction of MiFID II. As well known, market liquidity is a complex concept and has several dimensions to be considered (Diaz and Escribano, 2020). In our econometric exercise we analyse market liquidity from the angle of market tightness and market breadth:

- Market tightness is proxied by bid-ask spreads. Tighter markets are those in which market participants face large transaction costs when buy or sell an asset.
- Market breadth is proxied by the Amihud illiquidity ratio and the Turnover ratio. A market is said to be broad when there are numerous buying and seller orders that at the same time present large volumes.

In addition, we analyse the impact on financing conditions of companies – measured by the weighted cost of debt — following the introduction of MiFID II.

The effect on companies' liquidity and financing conditions are assessed using a modified version of equation (1), presented below as equation (2), which introduces the notion of 'permanent loss of coverage'. In doing so, we test, first, whether losing coverage permanently has any effect on companies' liquidity conditions. Second, we test if this effect is stronger for SMEs or large companies. These separate effects are shown in equation (2), where β_2 captures the potential differential effect of losing coverage in a permanent way on SMEs' stocks liquidity or financing conditions, relative to large companies' (SME*permanent-loss is an indicator variable which takes the value of one when no EPS estimate is produced at any time between January 2015 and December 2019 for SMEs). Moreover, in equation (2) we test specifically if the quantity of research matters for companies' market liquidity and financing conditions. We do this by adding the number of EPS per company as a control variable. We believe that this control variable is particularly relevant as it addresses directly the question of the relevance of the amount of the research available per company (analysed with equation (1)) for the company's market liquidity and financing conditions, for example because more analyst eps estimates per company may increase attention on that company and, as a result of greater attention, lead to greater market activity on that firm[25]. As before, we introduce other various company-level controls, as described in the previous data section, as well as year-month and company-level fixed effects.

$$y_{i,t} = \beta_1 * SME * Post\ MiFID\ II_t + \beta_2 * SME * permanentloss_{it} + \boldsymbol{\beta} * \boldsymbol{X_{i,t}} + \delta_t + \gamma_i + \varepsilon_{i,t} \qquad (2)$$

As mentioned above, companies' liquidity conditions are assessed using three dependent variables: monthly average bid-ask spread, the Amihud illiquidity ratio and the turnover ratio.[26] We employ year-month and firm-level fixed effects in all specifications when possible. To investigate the relation between MiFID II research unbundling provisions and companies' liquidity we add the control variable # *eps estimates*, which is defined as the number of EPS estimates provided by analysts, as control variable[27].

For companies' cost of financing regressions, the dependent variable is *weighted cost of debt*. We use year-month and firm-level's fixed effects and control for market capitalisation and number of EPS estimates in different specifications to avoid problem of multicollinearity (see footnote 27).

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[25] We do not include the number of eps estimates per company as a control variable when using the turnover ratio as a dependent variable, as (see Table B2 in Annex B1) there is a high positive correlation between the number of eps estimates and the market capitalisation of a company (which is the denominator of the turnover ratio). Any effect of the number of eps estimates per company on that company's turnover of shares is likely to be confounded by the impact of the number of eps estimates on market capitalisation.

[26] Depending on the dependent variable we use different estimation models, OLS for bid-ask spread and turnover ratio, and Tobit for Amihud illiquidity ratio.

[27] Ideally, we would have controlled both for market capitalisation and for number of eps estimates per company but, as shown in Table B2 in Annex B1, these two variables are highly correlated among each other leading to risks of multicollinearity. We do not use trading volume as a control variable because this forms part of the Amihud Illiquidity ratio.

5. Results

5.1 Research quantity and loss of coverage

Table B1 in Annex B1assesses the correlation between the introduction of MiFID II research unbundling provision and the quantity of research produced by sell-side analysts for SMEs, relative to large companies, within Europe.[28] As shown in Table B1, the quantity of research produced by sell-side analysts has generally declined following the application of MiFID II, by around 1 analyst per company. This reduction may be interpreted as increased efficiency in the production of research, when considering, as shown in Fang et al. (2020) that, in conjunction with these per-company analyst reductions, recommendations issued by the remaining analysts on EU companies post-MiFID II appear to be more profitable and to stimulate greater market activity.

SMEs do not appear to have been disproportionately affected by the implementation of research unbundling provisions, in terms of the number of analysts following each company. The overall decline in analyst coverage per company across all companies (-1 analyst per company) is counterbalanced by the positive interaction term *sme x mifid_II* (+1 analyst per company). As a result, the overall amount of the analyst coverage for SMEs is unchanged—or at most only slightly reduced— following the entry into application of MiFID II. These results continue to hold under robustness checks performed on a larger time window (2015-2019), on a different dependent variable (number of analysts covering a company) and on a restricted sample based on companies that have never ceased being covered by sell-side analysts between January 2015 and December 2019. These robustness checks are shown in columns (5), (6) and (7), respectively. The results on the impact of research unbundling on the quantity of research are consistent with the evidence described in Section 3, with Amzallag et al. (2020) and with recent academic studies on the topic as Anselmi and Petrella (2020).

Table B2 in Annex B1examines the correlation between the introduction of MiFID II research unbundling provision and the probability of losing coverage (either temporarily or permanently) for SMEs, relative to large companies. The results suggest that all companies in the sample are more likely to cease being researched by analysts after the implementation of MiFID II, as indicated by the positive and significant coefficient of the *mifid_II* dummy variable.

Moreover, at first glance, the positive and significant coefficient of the *sme* dummy variable in columns 1 to 3 of Table B2 suggests that, compared with larger firms, SMEs have a greater likelihood of completely losing research coverage. Although this is worrisome for SMEs over all, it is important to note that the MiFID II research unbundling provisions do not appear to have contributed to this situation. This is shown by the interaction term *sme x mifid_II* in Table B2, which is negative and unstable with respect to its magnitude and significance (see columns 1 to 3 of Table B2).

Lastly, column (4) in Table B2 explores how quickly any impact of the research unbundling provisions on the probability of firms losing coverage takes effect. This is performed by restricting the time window of the sample to 2016 (inclusive) to 2018 (inclusive), compared with the 2015 to 2019 in the previous regressions for this table. Indeed, the *sme x mifid_II* interaction term is statistically insignificant, in contrast to columns (1) to (3) in the same table. This suggests that the MiFID II research unbundling provisions began to affect the probability of firms losing research coverage during 2019. This lagged effect may be due to outside factors not related to MiFID II, such as the duration of contracts signed between research providers and their clients. If contracts are renegotiated only once per year or, in any case, much later than 3 January 2018, it is likely that the impact of MiFID II may be delayed. These results also support the rise in firms losing coverage observed in late 2018 and 2019 in Figure 3 above.

5.2 Research Quality

[28] The table presents the Difference-in-Difference model introduced in Eq. (1) where the dependent variable is quantity of research, measured as the total number of estimates on EPS published by analysts for a given stock in any month over the timeframe considered. All variables are defined in Annex A1.

Table B3 in Annex B1assesses whether the introduction of MiFID II research unbundling provisions have affected the quality of research produced by sell-side analysts on EU companies. The results suggest that the quality of research, as measured by forecast accuracy, has remained broadly stable after MIFID II, as indicated by the insignificant coefficient of the *mifid_II* dummy variable. This result, which is not surprising in light of Figure 5 above, appears to hold also for SMEs as well relative to larger firms, as indicated by the statistically insignificant *sme x mifid_II* interaction term. In other words, the quality of research produced by sell-side analysts on SMEs does not appear to have significantly changed following the introduction of the MiFID II research unbundling provisions. In a similar manner to the quantity of research estimates discussed above, robustness checks performed on a larger time window (2006-2019) and on a restricted sample of companies are shown in columns (5) and (6) and confirm these results.

Perhaps interestingly, the general accuracy of research produced on SMEs appears to be lower relative to larger firms. This can be seen in models (1) and (2) of Table B3, which indicate that the range in EPS estimates is much wider across SMEs relative to large companies (positive coefficient). Understanding better why there appear to exist consistent divergences in research accuracy between SMEs and large companies (for example, due to less readily available information on which to base research) would be an interesting avenue for future research[29].

5.3 Market Liquidity and cost of capital

In this section we test the impact of MiFID II research unbundling provisions on secondary market liquidity and financing conditions.

As discussed further in section 4.5 above, we consider different measures of market liquidity. In columns (1) and (2) of Table B4 in Annex B1 a larger bid-ask spread suggests worsened secondary market liquidity conditions; in columns (3) and (4) higher Amihud illiquidity ratio indicates lower market liquidity; and, in columns (4) and (5) a larger turnover ratio points to higher market liquidity.

With reference to columns (1) and (2), the coefficient on *mifid_II* is positive and statistically significant, which indicates worse liquidity conditions for all EU companies in our sample after the entry into force of MiFID II[30]. At the same time, SMEs appear to have encountered particularly higher bid-ask spreads, relative to larger firms, following the introduction of MiFID II, as indicated by the positive and statistically significant coefficient on the *sme x mifid_II* interaction term. Despite this, SMEs that permanently cease being covered by sell-side research analysts, at any time in our sample window, do not appear to suffer particularly in terms of widening bid-ask spreads. Finally, the amount of research available per company appears relevant for market liquidity conditions. Indeed, more abundant research being available on a company appears to be associated with smaller bid-ask spreads as indicated by the negative and statistically significant coefficient of *# eps estimates* in columns (1) and (2).

However, the picture changes when liquidity is examined from the perspective of market breadth. Indeed, in columns (3) and (4) the coefficients on the *mifid_II* dummy variable and on the *sme x mifid II* interaction term are both not statistically significant. This suggests that MiFID II has not affected market liquidity conditions, as measured by the Amihud illiquidity ratio, either for all firms or for SMEs relative to large firms. Elsewhere, and not surprisingly, the positive and significant coefficient on the *permanent loss* dummy variable in columns (3) and (4) indicates that companies that permanently cease being covered by sell-side research analysts appear to subsequently suffer from worse liquidity conditions, as measured by the Amihud illiquidity ratio . Lastly, the negative and statistically significant coefficient of *# eps estimates* in columns (3) and (4) appears to indicate that more abundant research on a company is associated with improved liquidity conditions for that entity (i.e. a lower Amihud illiquidity ratio).

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[29] We also explored an additional time-series measure of research quality, using the standard deviation (i.e. range of disagreement) on EPS forecasts across analysts researching each company. This measure could also capture additional information on the diversity of opinions in the market, in a complementary manner to the accuracy of analysts' forecasts. Regression models using this variable were consistently not significant (i.e. F statistic below a 95% critical value) and thus this was not pursued further—results are available from the authors upon request.

[30] It is very important to stress that many other provisions related to MiFID II started to apply on 3 January 2018 and it is very difficult to isolate the impact of research unbundling from other measures introduced at the same time, as those related to transaction reporting, +tick size and high-frequency trading.

In columns (5) and (6), the introduction of MiFID II is associated with a general improvement in turnover in share trading (turnover ratio), as indicated by the positive and statistically significant coefficient of *mifid_II*. SMEs appear to have particularly benefited from this, relative to larger firms, as evidenced by the positive and significant coefficient on the *sme x mifid_II* interaction term.[31]

In summary, results are inconclusive: market liquidity conditions seem to have worsened in terms of tightness, measured by bid-ask spreads, but not in terms of depth, measured by Amihud illiquidity ratio and turnover ratio, following the introduction of MiFID research unbundling provisions.

Finally, Table B5 in Annex B1 examines the extent to which firms' cost of capital, here proxied by the weighted cost of debt, has been affected following MiFID II. The negative and statistically significant coefficient of *mifid_II* in indicates that financing conditions appear to have improved after the introduction of MiFID II. SMEs appear to have benefited from this reduction by less than larger firms however, as evidenced by the positive and statistically significant coefficient on the *sme x mifid II* interaction term. Nevertheless, in net terms, SMEs appear to have experienced a reduction in the marginal cost of debt issuance. Whether an SME permanently ceases to be covered by research analysts (columns 3 and 4 in Table B5) does not appear to significantly affect its cost of issuing debt.

6. Discussion and conclusions

This paper has assessed several ways in which EU sell-side research could have been impacted by the MiFID II Research Unbundling provisions. These provisions began to apply on 3 January 2018 and require portfolio managers to pay for the research that they obtain.

The econometric analysis presented in this paper suggests that, after the introduction of the MiFID II research unbundling provisions: 1) the quantity of research per SME is overall unchanged—or at most has only slightly declined—relative to larger firms; 2) the probability of an SME completely losing coverage has not increased relative to the probability faced by a larger firm; 3) the quality of SME research has not worsened relative to larger firms; and 4) SME liquidity conditions have worsened, relative to larger firms, in terms of tightness (measured by bid-ask spreads), but not in terms of depth (measured by the Amihud illiquidity ratio and the turnover ratio). However, in absolute terms, SMEs continue to be characterised by lower amount of analyst research, higher probability of losing coverage, worse quality of research and limited market liquidity. Although regrettable, this situation does not appear to have been worsened by the MiFID II research unbundling provisions.

As mentioned above, both academic data-based studies and industry surveys tend to agree that the introduction of the MiFID II research unbundling provisions has led to a general reduction in the number of analysts producing research per company. Data-based research studies have noted, however, that this reduction appears to be oriented towards larger companies, in contrast to smaller companies, and more precisely towards companies that are older and more 'predictable'.

On the other hand, perhaps the greatest contrast between the academic literature and feedback on the MiFID II research unbundling provisions obtained via industry surveys relates to divergences in research quality. For example, and in contrast to the literature cited above, according to CFA (2019), "*Buy-side professionals mostly believe that research quality is unchanged, but sell-side respondents are generally more pessimistic, with 44% believing that research quality has decreased overall... Less than 10% of both buy-side and sell-side respondents believe research quality has increased.*"

In this regard, the aggregate results presented in this paper appear to be closer to the academic literature than to survey-based studies.

The MiFID II research unbundling provisions may also have had differential impacts on subsets of the EU market for research, such as on buy-side analysts in contrast to sell-side analysts, as well

[31] The number of EPS estimates is not included as a regressor in columns (5) and (6) because of the strong positive association between this variable and the market capitalisation of firms (as shown in Table B1 in Annex B1), and the fact that the market capitalisation enters in the denominator of the turnover ratio.

as on different types of research like unsolicited research versus sponsored research, as well as independent research providers. These areas, in particular the possible impact on sponsored research and on independent research providers, were not considered in this article due to limitations in data availability. However, they are noted here as interesting avenues for further research. It is also important to note that studies to date have tended to focus on the impact of the MiFID II provisions on firms already listed on EU exchanges. However, it would be interesting to explore whether the provisions have had an impact on firms' decisions to list on exchanges in the first place. A final possible area for future research concerns an evaluation of the actual price of research, with a view to examine whether any 'dumping' of research prices is taking place. Data limitations make this a challenging area to investigate, but material on this perspective would also contribute another element to this rich area for future study.

The research unbundling rules are also likely to evolve in the coming months. On 15 December 2020, following an earlier legislative proposal from the European Commission on 24 July 2020, the European Council approved the so-called Capital Markets Recovery Package[32]. This includes, among other measures, an exemption to the unbundling provisions for investment research on issuers whose market capitalization did not exceed EUR 1 billion during the preceding 36 months, provided that certain conditions are met. Moreover, a review clause is created, according to which the Commission shall review, amongst others, the rules on investment research, by 31 July 2021 at the latest.

[32] https://www.consilium.europa.eu/media/47469/st13798-ad01-en20.pdf

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Annex A : Sample Description

Table A1.Breakdown of companies per EU country and size classification.

This table presents the sample composition by country and size classification. The sample is based on data of 5,727 companies, divided into SMEs (2,605) and large companies (3,122), headquartered in the 27 European Union (EU) and United Kingdom from 2015 to 2019.

Country	SMEs	Large Companies	Total
Austria	11	52	63
Belgium	52	62	114
Denmark	33	73	106
Finland	53	115	168
France	312	352	664
Germany	366	366	732
Greece	37	82	119
Ireland	21	33	54
Italy	121	222	343
Netherlands	33	108	141
Poland	145	177	322
Spain	60	348	408
Sweden	416	254	670
United Kingdom	890	664	1,554
Others*	55	214	269
Total	2,605	3,122	5,727

Notes: Countries with fewer than 50 companies in total have been grouped into 'Other', and include Bulgaria (27), Croatia (21), Cyprus (16), Czech Republic (10), Estonia (18), Hungary (19), Latvia (7), Lithuania (18), Luxembourg (20), Malta (7), Portugal (44), Romania (46), Slovak Republic (1), and Slovenia (1)
Sources: Refinitiv I/B/E/S, ESMA calculations.

Table A2.Variable Definitions

Variable	Description
amihud illiquidity ratio	Ratio of the absolute return to the trading volume in that month, as defined in Amihud (2002). Underlying variables of this ratio are sourced from Refinitiv Eikon and Datastream.
bid-ask spread	Average monthly bid-ask spread for stock i in month t in bps. Ask price and bid price available in Datastream.
loss of coverage	Indicator that takes the value of 1 if a company loses all coverage (i.e. no EPS estimate is produced) at any month between January 2015 and December 2019, 0 otherwise. Companies' loss of coverage can be either temporary or permanent. Loss of coverage due to delistings is excluded.
market cap	Natural logarithm of market capitalisation expressed in millions of euros. Market capitalisation, available in Datastream, is the share price multiplied by the number of ordinary shares in issue.
median forecast accuracy	Absolute value of the difference between the latest interim EPS and the last estimated estimate for the period. The earning-per-share surprise percentage difference is available in I/B/E/S Datastream at yearly frequency.
mifid II	Indicator variable that takes the value of 1 for reporting periods after the implementation of MiFID II, i.e. after January 1, 2018, 0 otherwise.
# analysts	Number of analysts covering a company available in Refinitiv Eikon (I/B/E/S Summary Estimates). This variable is at monthly frequency.
# eps estimates	Total number of earnings-per-share (EPS) estimates provided by sell-side analysts and available in I/B/E/S Datastream. The EPS1NET varies monthly. Estimates are updated by a contributing analyst sending a confirmation of their estimate. When an analyst has not updated their estimate in the last 105 days, such estimate is filtered and excluded from the overall number of estimates.
permanent loss	Indicator variable that takes the value of 1 when a company permanently ceases to be covered by research analysts (i.e. no EPS estimate produced) at any time between January 2015 and December 2019, 0 otherwise. This indicator is time-varying. Loss of coverage due to delistings are excluded.
sme	Indicator variable that takes value of 1 for companies defined as SMEs, 0 for companies defined as 'large companies'. Companies are classified as SMEs and large companies according to the criteria set out by the European Commission (2003).
turnover	Natural logarithm of the number of shares traded for a company on a particular month. Turnover by volume is available in Datastream and is expressed in thousands.
turnover ratio	Ratio of the monthly trading volume to the market capitalisation in the month, both of which are available in Refinitiv Eikon and Datastream.
weighted cost of debt	Cost of debt represents the marginal cost to the company of issuing new debt and it is available in Refinitiv Eikon. The variable is calculated by adding weighted cost of short-term debt and weighted cost of long-term debt based on 1-year and 10-year point of an appropriate credit curve. It varies monthly and it is expressed in percentage.

Table A3.Descriptive statistics for the full sample (2015-2019)

The sample is based on 297,095 monthly observations for 5,727 European companies from 2015 to 2019. Number of earnings-per-share estimates and number of analysts following a company are expressed in units. Median forecast accuracy is the earnings-per-share annual surprise percentage difference expressed in absolute value; the relatively low number of observations is driven by the fact that this variable is at yearly frequency. Bid-ask spread represents the average bid-ask spread quoted during that month in bps and, together with the amihud Illiquidity ratio, were multiplied by 100. Weighted cost of debt is expressed in percentage, and is available in Refinitiv Eikon starting from December 2015. Turnover and market capitalisation are in natural logarithms and, prior to being transformed, are expressed in thousands and millions of euros, respectively. All variables are defined in the Variable ***Definitions***.

	N	Mean	St. Dev	min	max
amihud illiquidity ratio	247,082	.02	.10	0	1.19
bid-ask spread (bps)	247,469	3.53	11.97	-147.04	200
loss of coverage	297,095	.30	.46	0	1
(ln) market cap	264,128	5.17	2.44	-4.61	12.25
median forecast accuracy	15,107	73.26	658.24	0	35,233.33
mifid II	434,580	.38	.49	0	1
# analysts	284,159	5.40	7.85	0	42
# eps estimates	297,095	5.16	7.71	0	43
permanent loss	313,569	.20	.40	0	1
sme	434,580	.46	.50	0	1
(ln) turnover	252,637	6.34	3.08	-2.30	17.18
turnover ratio	248,736	.11	.61	0	10.39
weighted cost of debt	222,094	1.90	2.45	-50.67	55.64

Table A4.Correlation for main variables (2015-2019)

The sample is based on 297,095 monthly observations for 5,727 European companies from 2015 to 2019. Number of earnings-per-share estimates and number of analysts following a company are expressed in units. Median forecast accuracy is the earnings-per-share annual surprise percentage difference taken in absolute value. Bid-ask spread represents the average bid-ask spread quoted during that month in bps and, together with the Amihud illiquidity ratio, were multiplied by 100. Weighted cost of debt is expressed in percentage. Turnover and market capitalisation are in natural logarithms and they expressed in thousands and millions of euros, respectively. All variables are defined in the Variable ***Definitions***. Sample size changes due to market data availability. See Table A2 for a description of each variable.

Variables	# eps estimates	# analysts	loss of coverage	median forecast accuracy	bid-ask spread	amihud illiquidity ratio	turnover ratio	weighted cost of debt	sme	mifid	(ln) turnover	(ln) market cap	permanent loss
# eps estimates	1.000												
# analysts	0.994	1.000											
loss of coverage	-0.158	-0.152	1.000										
median forecast accuracy	-0.053	-0.053	0.046	1.000									
bid-ask spread	-0.227	-0.228	0.112	0.046	1.000								
amihud illiquidity ratio	-0.046	-0.045	0.023	0.010	0.079	1.000							
turnover ratio	-0.008	-0.008	0.009	0.001	0.005	-0.001	1.000						
weighted cost of debt	0.007	0.004	0.033	0.033	0.083	-0.024	0.016	1.000					
sme	-0.410	-0.409	0.099	0.061	0.245	0.022	0.013	0.034	1.000				
mifid_II	-0.039	-0.040	0.002	-0.011	0.012	0.032	0.006	0.009	0.019	1.000			
(ln) turnover	0.434	0.435	-0.088	-0.012	-0.149	-0.219	0.017	0.208	-0.186	-0.027	1.000		
(ln) market cap	0.790	0.792	-0.192	-0.069	-0.376	-0.054	-0.036	-0.070	-0.548	0.003	0.414	1.000	
permanent loss	-0.108	-0.108	0.683	0.053	0.096	0.027	0.012	0.022	0.061	0.020	-0.075	-0.143	1.000

Annex B : Econometric results

Table B1: Impact of research unbundling on quantity of sell-side analyst research

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	All companies	*All companies*	*All companies*	*All companies*	*All companies*	*All companies*	*Only companies that never lose coverage*
VARIABLES	# eps est. (2015-2019)	# eps est. (2015-2019)	# eps est. (2015-2019)	# eps est. (2015-2019)	# eps est. (2006-2019)	# analysts (2015-2019)	# eps est. (2015-2019)
sme x mifid_II	**1.051*** **	**1.046*** **	**1.046*** **	**0.771*** **	**1.036*** **	**0.819*** **	**1.062*** **
	(0.0535)	**(0.0532)**	**(0.0532)**	**(0.0484)**	**(0.0668)**	**(0.0499)**	**(0.0780)**
mifid_II	-1.004***	-1.198***	-1.198***	-0.860***	-0.663***	-1.006***	-1.098***
	(0.0495)	(0.0669)	(0.0670)	(0.0611)	(0.105)	(0.0631)	(0.0863)
turnover				0.0570***	0.0939***	0.0568***	0.161***
				(0.0106)	(0.0151)	(0.0115)	(0.0261)
market_cap				0.321***	0.821***	0.380***	0.608***
				(0.0249)	(0.0386)	(0.0271)	(0.0529)
sme	-6.708***	-6.703***					
	(0.169)	(0.169)					
Constant	8.163***	8.433***	5.658***	3.156***	0.109	3.020***	3.468***
	(0.163)	(0.170)	(0.0300)	(0.144)	(0.220)	(0.160)	(0.390)
Observations	297,095	297,095	297,095	241,433	626,208	232,671	135,091
Fixed Effects	NO	Year-Month	Firm & Year-Month	Firm & Year-Month	Firm & Year-Month	Firm & Year-Month	Firm & Year-Month
Clustering of errors at company level	YES	YES	YES	YES	YES	YES	YES
R-squared	0.187	0.187	0.070	0.064	0.103	0.073	0.089
Estimation Model	OLS	OLS	OLS	OLS	OLS	OLS	OLS

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Note: The sample is based on a dataset of company-year-month observations for companies that have been researched by at least one analyst at any time in the considered time-window. Only Model 7 makes the exception to be built on a sample constituted by companies that never lose coverage between 2015 and 2019. More accurate details on the sample construction are available in Section 2. Standard errors are always clustered at the company level and fixed effects are as indicated in each model. Models 5, 6 and 7 report the results of some robustness checks performed on a larger sample time-window (2006-2019), on a different dependent variable (number of analysts following a company). All models are OLS estimations and report the Adjusted R-squared. Statistical significance is based on two-tailed tests and is indicated as follows: ***p-value < 0.01, **p-value < 0.05, *p-value < 0.1.

Table B2: Impact of research unbundling on companies' probability of losing coverage

	(1)	(2)	(3)	(4)
	All companies	*All companies*	*All companies*	*All companies*
VARIABLES	loss of coverage (2015-2019)	loss of coverage (2015-2019)	loss of coverage (2015-2019)	loss of coverage (2016-2018)
sme x mifid_II	**-0.393*** **	**-0.392*** **	**-0.163** **	**-0.123**
	(0.0717)	**(0.0719)**	**(0.0809)**	**(0.0828)**
mifid_II	0.556***	0.430***	0.144*	0.158*
	(0.0587)	(0.0735)	(0.0834)	(0.0849)
sme	2.273***	2.037***	1.096***	1.270***
	(0.149)	(0.126)	(0.173)	(0.240)
market_cap			-0.466***	-0.532***
			(0.0284)	(0.0377)
turnover			-0.0166	-0.0121
			(0.0112)	(0.0145)
Constant	-4.227***	-3.714***	-1.204***	-1.304***
	(0.151)	(0.121)	(0.245)	(0.325)
Observations	297,095	297,095	241,433	145,428
Fixed Effects	NO	Year-Month	Year-Month	Year-Month
Clustering of errors at company level	YES	YES	YES	YES
R-squared	0.025	0.025	0.050	0.041
Estimation Model	Probit	Probit	Probit	Probit

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Note: The sample is based on a dataset of company-year-month observations for companies that have been researched by at least one analyst at any time in the considered time-window. We do not introduce firm fixed effects as unconditional probit fixed effects model are known to be biased (Greene 2002), in particular in short panels. More accurate details on the sample construction are available in Section 2. Standard errors are always clustered at the company level and fixed effects are as indicated in each model. Model 4 reports the results of a robustness check performed on a shorter sample time-window (2016-2018). Since loss of coverage is a binary variable, all models are Probit estimations and report the Pseudo R-squared. Statistical significance is based on two-tailed tests and is indicated as follows: ***p-value < 0.01, **p-value < 0.05, *p-value < 0.1.

Table B3: Impact of research unbundling on quality of sell-side analyst research

	(1)	(2)	(3)	(4)	(5)	(6)
	All companies	*All companies*	*All companies*	*All companies*	*All companies*	*Only companies that never lose coverage*
VARIABLES	median forecast accuracy (2015-2019)	median forecast accuracy (2015-2019)	median forecast accuracy (2015-2019)	median forecast accuracy (2015-2019)	median forecast accuracy (2006-2019)	median forecast accuracy (2015-2019)
sme x mifid_II	**0.469**	**0.304**	**-5.636**	**17.09**	**26.09**	**-7.383**
	(33.75)	**(33.78)**	**(42.67)**	**(45.35)**	**(38.58)**	**(40.43)**
mifid_II	-10.78*	-4.111	2.097	23.98	11.39	27.00
	(6.038)	(14.03)	(14.98)	(18.78)	(20.31)	(18.70)
turnover				-35.44**	1.294	-30.28*
				(17.08)	(7.418)	(17.34)
market_cap				-22.13	-32.61**	-25.79
				(21.46)	(12.75)	(22.12)
sme	90.63***	90.45***				
	(23.45)	(23.47)				
Constant	49.31***	50.56***	77.82***	328.3**	275.6***	332.9**
	(4.482)	(11.24)	(13.34)	(128.7)	(86.70)	(137.2)
Observations	15,107	15,107	15,107	10,349	29,926	9,814
Fixed Effects	NO	Year	Firm & Year	Firm & Year	Firm & Year	Firm & Year
Clustering of errors at company level	YES	YES	YES	YES	YES	YES
R-squared	0.004	0.005	0.002	0.003	0.001	0.002
Estimation Model	OLS	OLS	OLS	OLS	OLS	OLS

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Note: Median forecast accuracy is defined as the absolute value of the difference between the latest interim EPS and the most recent prior estimate for that period—a positive coefficient on an explanatory term thus implies an association with forecast *in*accuracy. The sample is based on a dataset of company-year observations for companies that have been researched by at least one analyst at any time in the considered time-window. Only Model 6 makes the exception to be built on a sample constituted by companies that never lose coverage between 2015 and 2019. More accurate details on the sample construction are available in Section 2. Standard errors are always clustered at the company level and fixed effects are as indicated in each model. Models 5 reports the results of a robustness check performed on a larger sample time-window (2006-2019). All models are OLS estimations and report the Adjusted R-squared. Statistical significance is based on two-tailed tests and is indicated as follows: ***p-value < 0.01, **p-value < 0.05, *p-value < 0.1.

Table B4: Impact of research unbundling on companies' liquidity conditions

	(1)	(2)	(3)	(5)	(7)	(8)
	All companies	*All companies*	*All companies*	*All companies*	*All companies*	*All companies*
VARIABLES	bid-ask spread (2015-2019)	bid-ask spread (2015-2019)	amihud illiquidity ratio (2015-2019)	amihud illiquidity ratio (2015-2019)	turnover ratio (2015-2019)	turnover ratio (2015-2019)
sme x mifid_II	**0.590*** (0.220)**	**0.334* (0.187)**	**-0.000982 (0.000625)**	**-0.000986 (0.000636)**	**0.0485*** (0.0109)**	**0.0432*** (0.0107)**
sme x permanent_loss		1.223 (0.883)		-0.00366* (0.00206)		0.0440 (0.0602)
mifid_II	0.733*** (0.232)	0.445** (0.220)	0.000179 (0.00163)	0.000365 (0.00163)	0.0897*** (0.0115)	0.0734*** (0.0112)
permanent_loss		1.165* (0.610)		0.00774*** (0.00164)		0.0649 (0.0423)
n_eps_est	-0.0823*** (0.0146)	-0.0612*** (0.0124)	-0.000431*** (9.94e-05)	-0.000351*** (9.91e-05)		
sme			0.00709*** (0.00228)	0.00658*** (0.00227)		
Constant	3.403*** (0.165)	3.079*** (0.179)	0.0286*** (0.00202)	0.0262*** (0.00201)	0.0542*** (0.00757)	0.0412*** (0.00971)
Observations	236,859	234,746	236,652	234,566	248,736	235,661
Fixed Effects	Firm & Year-Month	Firm & Year-Month	Year-Month	Year-Month	Firm & Year-Month	Firm & Year-Month
Clustering of errors at company level	YES	YES	YES	YES	YES	YES
R-squared	0.004	0.004	0.016	0.015	0.005	0.006
Estimation Model	OLS	OLS	Tobit	Tobit	OLS	OLS

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Note: The sample is based on a dataset of company-year-month observations for companies that have been researched by at least one analyst at any time in the considered time-window. More accurate details on the sample construction are available in Section 2. Standard errors are always clustered at the company level and fixed effects are as indicated in each model. R-squared measures differ according to the underlying estimation model (Adj. R-squared for OLS and Pseudo R-squared for Tobit). Statistical significance is based on two-tailed tests and is indicated as follows: ***p-value < 0.01, **p-value < 0.05, *p-value < 0.1.

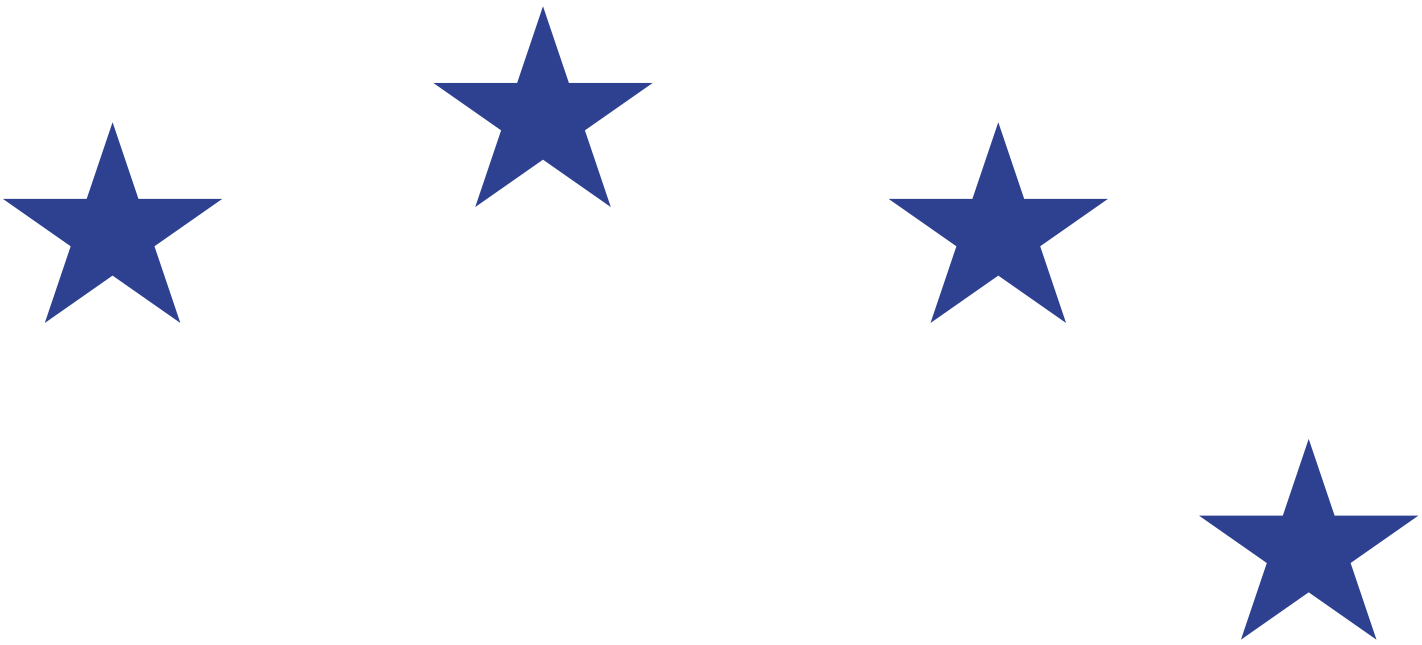
Table B5: Impact of research unbundling on companies' financing conditions

	(1)	(2)	(3)	(4)
	All companies	*All companies*	*All companies*	*All companies*
VARIABLES	weighted cost of debt (2015-2019)	weighted cost of debt (2015-2019)	weighted cost of debt (2015-2019)	weighted cost of debt (2015-2019)
sme x mifid_II	**0.170*** **	**0.208*** **	**0.149*** **	**0.179*** **
	(0.0552)	**(0.0590)**	**(0.0552)**	**(0.0599)**
sme x permanent_loss			0.421*	0.357
			(0.215)	(0.218)
mifid_II	-0.661***	-0.611***	-0.662***	-0.599***
	(0.0433)	(0.0466)	(0.0430)	(0.0465)
permanent_loss			-0.116	-0.138
			(0.149)	(0.145)
n_eps_est	0.00793		0.0103	
	(0.00918)		(0.00910)	
market_cap		-0.363***		-0.390***
		(0.0445)		(0.0478)
Constant	2.417***	4.389***	2.372***	4.518***
	(0.0633)	(0.236)	(0.0662)	(0.257)
Observations	215,660	196,341	214,055	189,633
Fixed Effects	Firm & Year-Month	Firm & Year-Month	Firm & Year-Month	Firm & Year-Month
Clustering of errors at company level	YES	YES	YES	YES
R-squared	0.045	0.053	0.045	0.055
Estimation Model	OLS	OLS	OLS	OLS

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Note: The sample is based on a dataset of company-year-month observations for companies that have been researched by at least one analyst at any time in the considered time-window. More accurate details on the sample construction are available in Section 2. Standard errors are always clustered at the company level and fixed effects are as indicated in each model. All models are OLS estimations and report the Adjusted R-squared. Statistical significance is based on two-tailed tests and is indicated as follows: ***p-value < 0.01, **p-value < 0.05, *p-value < 0.1.

esma European Securities and Markets Authority



GUEST COLUMN

Examining Best Execution and Trading in the Current Landscape

By Ari Burstein, President, Capital Markets Strategies*

Posted to IAA Today on February 10, 2021

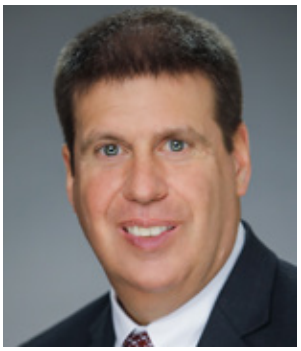
There is no shortage of issues for investment advisers to consider when examining the impact of changes to trading and market structure on an adviser's best execution responsibilities and other responsibilities relating to the trading function. Regulators and policymakers, as well as market participants themselves, in the U.S. and globally, continue to move forward on initiatives that will change the structure of the markets and how trading occurs.

Best execution itself also continues to receive attention. Several SEC Commissioners have reiterated the need to look at best execution, including considering what constitutes best execution in today's trading environment, and market participants continue to roll out products and services for investment advisers to help address their best execution obligations.

It is therefore important that advisers understand the implications of market structure changes for their businesses, operations, and legal and compliance responsibilities. Summarized below are some of the recent developments in this area related to market data, fixed income market structure, consolidated audit trail, and disclosure of order handling information.

1. Market Data – Content, Dissemination and Governance

Maybe the most debated issue, in the U.S. and globally, continues to be the examination of the regulatory structure for market data to address concerns expressed by investors around the content of "core" data available, the dissemination of data, as well as the governance structure surrounding market data. Reforms have been designed to increase competition and transparency, which in turn would improve data quality and data access for investment advisers and other market participants.



Ari Burstein, President, Capital Markets Strategies

"Many market participants have expressed concerns that there continues to be no viable alternatives for broker-dealers to paying exchanges for their proprietary market data, both to provide competitive execution services to investment advisers and to meet best execution obligations, raising costs for broker-dealers to provide such services."

Market Data Infrastructure

In December 2020, the SEC adopted long awaited rules to modernize the infrastructure for the collection, consolidation, and dissemination of market data for exchange-listed national market system ("**NMS**") stocks. The rules update and expand the content of market data to include information not previously available through the public data feeds including about orders in share amounts smaller than the current round lot size (*e.g.,* 100 shares); information about certain orders that are outside of an exchange's best bid and best offer (*i.e.,* certain depth of book data); and information about orders that are participating in opening, closing, and other auctions.

In addition, the rules establish a decentralized consolidation model in which "competing consolidators," rather than the exclusive securities information processors ("**SIPs**"), will be responsible for collecting, consolidating, and disseminating consolidated market data to the public, and that is geared towards reducing latency in the dissemination of market data.

The proposal also renews the debate around the "Order Protection Rule" or "OPR", which requires trading centers to have policies and procedures that are reasonably designed to prevent "trade-throughs" on that trading center of protected bids or protected offers in NMS stocks, in effect, to ensure that orders are executed at no worse than the NBBO. The SEC has developed a phased transition plan that will begin in 2021.

Governance

The self-regulatory organizations ("**SROs**") also recently submitted a plan to the SEC to modernize the

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governance structure of NMS plans for equity market data, for which the SEC recently requested additional comment. Significantly, the reforms would add meaningful representation to the governance structure for non-SROs by providing voting rights (and allowing them to have a role in the decision-making processes and therefore help address conflicts of interest), recognizing exchange operators as a single entity for purposes of voting, providing additional checks into controlling market data costs, and helping to ensure the fairness and reasonableness of market data fees.

Global Focus on Market Data

Global regulators also are focusing on issues surrounding market data. IOSCO recently issued a consultation requesting comment on several market data issues. The consultation notes that participants in many jurisdictions have raised concerns about the content, costs, accessibility, fairness and consolidation of market data, and that market data and access to market data are intrinsically tied to secondary market issues, including investor protection and market integrity. Other global regulators also are examining similar issues related to market data.

Impact on Investment Advisers

Providing market participants with accurate and robust market data is critical to efficient trading and ultimately best execution. In addition, the conflicts of interest that currently exist relating to the provision of market data goes to the heart of the issues that investment advisers are facing in this area. Many market participants have expressed concerns that there continue to be no viable alternatives for broker-dealers to paying exchanges for their proprietary market data, both to provide competitive execution services to investment advisers and to meet best execution obligations, raising costs for broker-dealers to provide such services.

"Many have argued that institutional investors can get better pricing, and therefore better meet their best execution requirements, with electronic trading. The SEC recently issued a concept release soliciting comment on the regulatory framework for electronic platforms that trade corporate debt and municipal securities."

While reforms to the current structure for market data will take time to be implemented (*e.g.*, the market data infrastructure rule will be implemented over several years), the goal of ensuring the prompt, accurate, reliable, and fair dissemination of market data to investors and other market participants is an important one for investment advisers.

2. Fixed Income Market Structure Reform

The trading of fixed income securities, like equities, has evolved rapidly over the past few years. While these changes arguably have brought certain benefits to investment advisers, they also have raised questions relating to how advisers should consider best execution in the fixed income markets in the context of these changes.

The SEC and other regulators and policymakers continue to examine these issues. In late 2017, the SEC established the Fixed Income Market Structure Advisory Committee (**FIMSAC**), which has considered issues around, among other things, the impact of transparency and the growth of electronic trading, and FINRA and the MSRB have continued to focus on fixed income transparency, technology issues, and the best execution responsibilities of broker-dealers.

SEC Concept Release on Electronic Corporate Bond and Municipal Securities Market

Many have argued that institutional investors can get better pricing, and therefore better meet their best execution requirements, with electronic trading. The SEC recently issued a concept release soliciting comment on the regulatory framework for electronic platforms that trade corporate debt and municipal securities.

The concept release is very broad and requests comment on a wide variety of issues about fixed income electronic trading platforms, many of significance for investment advisers, including their operations, services, fees, market data, and participants. Comments on the concept release are due to the SEC by March 1.

Proposed Amendments to Regulation ATS for Government Securities ATSs

At the same time, it issued the concept release, the SEC issued a proposal to enhance the operational transparency, system integrity, and regulatory oversight for alternative trading systems ("**ATSs**") that trade government securities as well as repurchase and reverse repurchase agreements on government securities (**Government Securities ATSs**). The SEC noted that ATSs have become a significant source of orders and trading interest for government se-

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curities and now operate with complexity similar to that of markets that trade equities. Nevertheless, these ATSs are exempt from exchange registration and are not required to comply with Regulation ATS. The proposed amendments would eliminate the exemption to provide more oversight for these trading platforms.

Other Fixed Income Issues

The SEC, FINRA and other regulators continue to focus on a number of other issues relating to fixed income. For example, SEC Commissioner **Elad Roisman** recently stated that while the ATS proposal is an important step in strengthening the oversight of certain Treasury trading venues, this oversight framework may not extend to all trading venues that utilize request-for-quote (**RFQ**) or streaming quote protocols and that the same concerns motivating the ATS proposal (operational transparency, system resiliency, and fair access) also apply to such venues. He added that most principal trading firms (**PTFs**) which are large players in the cash Treasury market are not SEC-registered dealers and that disparate treatment exposes the market to potential risk and can lead to unfair burdens on competition.

Implications for Investment Advisers

The definition of, and factors surrounding, the duty to seek best execution is no different in relation to the fixed income markets than in the equities markets. At the same time, given the unique characteristics of fixed income securities, advisers must consider how to adequately tailor their processes for fixed income. For example, given the differences in the amount and type of data available about trading in fixed income securities, advisers should not rely on the same approaches or transaction cost analysis used for measuring trade execution in the equities markets. Similarly, while tools have become more readily available relating to the pricing of fixed income securities, the different types of fixed income instruments make it more difficult to utilize those tools. Advisers also need to ask their brokers specific questions related to fixed income and the unique characteristics of the fixed income markets, such as the brokers' processes for executing transactions in fixed income securities.

"[G]iven the unique characteristics of fixed income securities, advisers must consider how to adequately tailor their processes for fixed income. For example, given the differences in the amount and type of data available about trading in fixed income securities, advisers should not rely on the same approaches or transaction cost analysis used for measuring trade execution in the equities markets. . . Advisers also need to ask their brokers [about their] processes for executing transactions in fixed income securities."

Historically, fixed income best execution has not received the same attention by advisers as has equity best execution. Advisers, however, should be prepared for more scrutiny by clients and regulators on this issue, particularly given some of the market structure changes being considered.

3. Consolidated Audit Trail

Issues surrounding the consolidated audit trail ("**CAT**") continue to be discussed. Recent proposals have addressed enhancing the security of the CAT and limiting the scope of sensitive information required to be collected by the CAT, key concerns for investment advisers and other investors.

Specifically, the SEC has issued a proposal to provide for better safeguards and protection around information contained in the CAT, including susceptibility to cyberattack or other forms of information misappropriation, as well as mitigating the risk of data security breaches. The proposal provides greater oversight, consistency and transparency regarding the use of CAT data; incorporates restrictions for the access and analysis of customer and account information; removes sensitive information from CAT reporting requirements so that the requirements do not include social security numbers, account numbers and dates of birth; and preserves and enhances existing security requirements.

The SROs also recently filed a proposed amendment to the CAT NMS Plan that would insert limitation of liability provisions applicable to the CAT LLC and the SROs in the event of a breach or misuse of CAT data. Concerns have been raised that the proposal would shift all potential liability to industry members and lead to inefficiencies in addressing the risk of breach or misuse of CAT data, as well as eliminate incentives for SROs to invest in insurance and other risk mitigation measures.

Finally, the reporting of customer identifying information as it relates to "Large Traders," *i.e.,* market participants that conduct a substantial amount of trading activity, as measured by volume or market value, in NMS securities, begins on April 26, 2021. On that date, large broker-dealers are required to report to the CAT certain account information regarding account holders with a LTID or an Unidentified Large Trader Identification number.

Implications for Investment Advisers

Data security and cybersecurity surrounding the CAT have been some of the top concerns for investment advisers. The recent proposed changes to the CAT directly impact the planning, develop-

Continued on page 10

Continued from page 9

ment and maintenance of the CAT with respect to data security and potential information misappropriation. It will be important for investment advisers to follow developments in this area.

Also, the SEC's examination staff recently reminded investment advisers and broker-dealers about their obligations to comply with the Large Trader Rule (Rule 13h-1 under the Exchange Act). The Risk Alert notes that some investment advisers and broker-dealers are not aware of the Rule or are not familiar with certain obligations, including the requirement to file and update Form 13H.

4. Disclosure of Order Handling Information

The SEC's amended Rule 606 under Regulation NMS, which requires broker-dealers to disclose to investors new and enhanced information regarding the handling of their orders, continues to be important as markets become more automated and as routing and execution practices evolve in response.

Vendors and other service providers continue to roll out services to address the need for investment advisers to analyze the vast amounts of data that is now provided from enhanced broker disclosures under the Rule and to provide insights into how their broker-dealers route orders, providing more transparency around each broker's routing and execution practices.

"The disclosure requirements under Rule 606 are intended to help investment advisers better understand how their broker-dealers route and handle their orders and how those activities may impact execution quality, including how broker-dealers manage the potential for information leakage and conflicts of interest."

Implications for Investment Advisers

The disclosure requirements under Rule 606 are intended to help investment advisers better understand how their broker-dealers route and handle their orders and how those activities may impact execution quality, including how broker-dealers manage the potential for information leakage and conflicts of interest.

At the very least, the increased transparency of information will provide advisers with an additional tool to assess the impact and quality of their trades, and to verify that their broker-dealers are following their order handling instructions. It also will help advisers engage with their broker-dealers on order routing practices and conflicts management.

Given the large amount of additional information, and the variety of new tools and services, now available, advisers will need to determine the best and most efficient way to digest the information, whether internally or through the new tools and services created for this purpose. Either way, advisers should be prepared for more scrutiny by clients and regulators on this issue.

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IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

COVID-19 Impacts

Lee Faria, *Chief Compliance Officer and Vice President*, Columbia Management Investment Advisers, LLC
Christopher Hayes, *Principal and Chief Compliance Officer*, 1919 Investment Counsel, LLC
Jennifer L. Klass, *Partner*, Baker McKenzie
Laura Grossman, *Associate General Counsel*, Investment Adviser Association, Moderator

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

New Challenges

- Larger vs. smaller firms
  - Risks
  - Conflicts
  - Technology vs. manual work

Compliance Program Changes

- Permanent
- Temporary
- Regulatory guidance
- New Risk Alerts
- Privacy, PII
- Trading errors

Work Environment

- Culture
- How do you know things are working
- Being proactive
- Onboarding new employees

Communications

- Formal and informal
- Approvals
- Recordkeeping and monitoring
- Clients
  - Online meetings
  - Electronic delivery

Remote Supervision

- Monitoring without a physical presence
- Vendor due diligence without onsite visits
- Integrating acquired firms
- SEC focus areas

Silver Linings

- The post-pandemic legacy
- Operational resiliency – staying nimble
- Doing more with less
- Embracing the electronic

The Future of Work

- Uncertain timing of re-opening
  - Testing
  - Vaccines
- Deciding whether to change business model to permit remote work
  - HR
  - Tax implications
  - Policies and procedures


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

Baker McKenzie.

COVID-19 Impacts

Investment Adviser Association
2021 Annual Compliance Conference

Jennifer L. Klass*

March 2021

A year into the COVID-19 global pandemic, investment advisers have largely adjusted their operations and infrastructure to address the challenges associated with conducting business remotely. However, the business disruptions caused by COVID-19 will have a lasting impact on the way investment advisers operate their compliance programs, manage risk, interact with clients, and supervise employees. The following outline provides a summary of select regulatory and operational considerations for investment advisers that are evaluating the impact of COVID-19, including the transition to work-from-home arrangements and the implications of dispersed work locations.

1. Supervision of Remote Personnel

In August 2020, the Division of Examinations ("OCIE") published a risk alert highlighting select COVID-19 compliance risks for investment advisers and broker-dealers.[1] One of the key considerations raised by OCIE is the supervision of remote personnel.[2] In particular, the COVID Risk Alert suggests that advisers may need to modify their practices to address:

(a) Supervisors not having the same level of oversight and interaction with supervised persons when they are working remotely;

(b) Supervised persons making securities recommendations in market sectors that have experienced greater volatility or may have heightened risks for fraud;

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* This material is provided for informational purposes only and does not constitute legal advice or create an attorney-client relationship. This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.

[1] *Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers* (Aug. 12, 2020), available at: https://www.sec.gov/files/Risk%20Alert%20-%20COVID-19%20Compliance.pdf [the "COVID Risk Alert"].

[2] Advisers Act Section 203(e)(6) authorizes the SEC to sanction investment advisers that fail to reasonably supervise its personnel.

(c) The impact of limited on-site due diligence reviews and other resource constraints associated with reviewing of third-party managers, investments and portfolio holding companies;

(d) Communications or transactions occurring outside of the firms' systems due to personnel working from remote locations and using personal devices;

(e) Remote oversight of trading, including reviews of affiliated, cross and aberrational trading, particularly in high-volume investments; and

(f) The inability to perform the same level of diligence during background checks when onboarding personnel or to have personnel take requisite examinations.

In an effort to further highlight the compliance considerations associated with remote supervision, in November 2020 OCIE published an additional risk alert summarizing the outcome of a 2018 sweep of investment advisers operating from numerous branch offices with operations that are geographically dispersed from the adviser's principal or main office.[3] Among other things, this risk alert reinforced the importance of implementing written compliance policies and procedures that specifically address the unique aspects of individual branch offices and compliance practices necessary for effective branch oversight.

2. Licensing and Registration

The significant relocation of employees requires investment advisers to reconsider the states in which supervised persons are subject to investment adviser agent registration. Supervised persons of federally registered investment advisers that meet the definition of an investment adviser representative under Advisers Act Rule 203A-3 are subject to state registration if they maintain a place of business in a state.[4] "Place of business" for this purpose refers to: (1) and office at which the investment adviser representative regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) any other location that is held out to the general public as a location at which the investment adviser representative provides investment advisory services, solicits, meets with, or otherwise communicates with clients.[5]

As a result of COVID, the "place of business" of supervised persons may have changed. For example, supervised persons who work in one state and live in an adjoining state may now have to be registered in the adjoining state or in other states in which their primary residence is located. Similarly, supervised persons with vacation homes may now be considered to have a place of business in the

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[3] *Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices* (Nov. 9, 2020), available at: https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf.

[4] Advisers Act Section 203A(b)(1)(A).

[5] Advisers Act Rule 203A-3(b).

state of their vacation home. Others may have simply moved to a more hospitable location. In addition, as remote work locations and extended alternative work schedules become more common place in the future, investment advisers will have to consider the implications for state licensing requirements.

3. Business Continuity and Operational Resilience

Despite the fact that financial services firms, transitioned relatively seamlessly to remote operations, in its COVID Risk Alert, OCIE highlights the importance of further modifying and enhancing compliance policies and procedures to address the unique risks and conflicts of interest present in remote operations. This includes the need to reevaluate security and resources for remote sites. Extended periods of remote operations also requires firms to consider additional resources or other measures to secure servers and systems, maintain the integrity of vacated facilities, relocate infrastructure and support for personnel operating from remote sites, and protect remote location data. The COVID Risk Alert also encourages investment advisers to consider appropriate redundancies for key operations and key personnel, as well as the need to provide disclosure to clients if operations are materially impacted.

4. Cybersecurity and Data Protection in a Remote Work Environment

Cybersecurity and the protection of personally identifiable information have long been significant priorities and areas of concern for OCIE.[6] However, these risks take on a new dimension in the remote work environment where investment advisers have less control over the systems and technology that their employees are using to conduct business. According to the COVID Risk Alert, the remote work environment creates risks associated with:

(a) Remote access to networks and the use of web-based applications;

(b) Increased use of personally owned devices;

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[6] *See, e.g., Cybersecurity: Safeguarding Client Accounts against Credential Compromise* (Sept. 15, 2020), available at: https://www.sec.gov/files/Risk%20Alert%20-%20Credential%20Compromise.pdf; *Cybersecurity: Ransomware Alert* (July 10, 2020), available at: https://www.sec.gov/files/Risk%20Alert%20-%20Ransomware.pdf; *Safeguarding Customer Records and Information in Network Storage – Use of Third Party Security Features* (May 23, 2019), available at: https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Network%20Storage.pdf; *Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P - Privacy Notices and Safeguard Policies* (April 16, 2019), available at: https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Regulation%20S-P.pdf; and *Observations from Cybersecurity Examinations* (Aug. 7, 2017), available at: https://www.sec.gov/files/observations-from-cybersecurity-examinations.pdf. In addition to the many risk alerts addressing these issues, OCIE has identified cybersecurity and data protection as a priority in a number of annual examination priority letters.

(c) Less control over physical records, such as sensitive documents being printed in remote locations; and

(d) Increased opportunities for phishing and improper access to systems and accounts.

The COVID Risk Alert offers a number of different considerations for ways that firms can enhance their cybersecurity and data protection controls. Of course, any risk assessment should take into consideration service providers, including third-party providers that support teleworking (e.g., videoconferencing services).

5. Acceleration of Digital Transformation and Modernization

One of the most significant impacts of COVID-19 has been to accelerate digital transformation and modernization. Investment advisers, like all financial services firms, have been relying heavily on new technologies, such as video- and text-based collaborative tools to interact internally. Similarly, virtual communications have become the norm and advisers are leveraging all manner of electronic communications to interact with clients. While the SEC and other securities regulators have been flexible in providing short-term relief from a number of different filing and other regulatory requirements[7], the pandemic has renewed calls for modernization of electronic delivery requirements, including reliance on electronic signatures, electronic notarization, and establishing digital delivery as the default option for client communications and regulatory documents, with paper delivery as an alternative option available upon request.[8]

6. Tax Considerations[9]

Advisers should also consider that a remote and geographically diverse employee workforce may result in expanded tax filing obligations in states where a company otherwise may not have been required to file. A single telecommuting employee could establish "nexus" (i.e., a jurisdictional requirement for tax filings) for an out-of-state adviser simply by working from a location where the adviser is not currently

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[7] *See, e.g., Order Under Section 206A of the Investment Advisers Act of 1940 Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder*, Advisers Act Release No. 5463 (March 13, 2020) available at: https://www.sec.gov/rules/other/2020/ia-5463.pdf; and *Division of Investment Management Coronavirus (COVID-19) Response FAQs*, available at: https://www.sec.gov/investment/covid-19-response-faq.

[8] *See, e.g.*, *Letter dated Sept. 8, 2020 to Jay Clayton, Chairman of the U.S. Securities and Exchange Commission, from Fidelity Investments, The Charles Schwab Corporation, and BlackRock, Inc.*, available at: https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/about-fidelity/digital-delivery-letter.pdf.

[9] This information is an excerpt from the "Working from Home: State Tax Impact of a Growing Remote Workforce" article, which was written by Anne Batter, Garrett Kinkelaar, David Pope, and Mike Shaikh from Baker & McKenzie's Tax Practice Group. The full version of the article is attached to this outline.

located, resulting in unanticipated income tax, franchise tax, sales and use tax, and other tax exposures and filing obligations for the adviser.

The concept of "nexus" describes the minimum contacts a person or business entity must have with a state or jurisdiction before it can be subjected to taxation. For sales tax purposes, a business with taxable nexus must remit a jurisdiction's sales or use tax. For income tax purposes, a business with taxable nexus must file and pay income tax on income derived from activities conducted in that state—typically through some method of allocation and apportionment of the taxpayer's total income. Over time, states have developed and applied differing nexus standards, subjecting companies to tax based on physical presence (e.g., through employees or property in the state) or certain economic connections to the state.

Historically, a physical presence was required to establish nexus as a universal rule. However, while physical presence still remains as one way to create nexus, many states have broadened their nexus standards through a combination of efforts—varying by tax-type—that now result in many states also having an "economic" nexus standard (e.g., having a fixed dollar threshold of sales that create nexus in the state or having intangibles in the state that create nexus). Nearly all states have adopted an economic nexus standard for sales tax purposes, but a more limited number have adopted such a rule for income tax purposes.

The end result of these varying nexus standards has a profound impact on how advisers should react to an expanding telecommuting workforce--due to COVID or otherwise. However, for purpose of COVID specifically, many states have issued guidance stating that a telecommuting workforce would *not* create nexus. Unfortunately, not all states have provided such guidance. Therefore, advisers should first determine the states in which they currently have filing obligations. These obligations should be reviewed for income tax, sales and use tax, gross receipts tax, and other potential state and local taxes. In certain states, such as where combined reporting is not required, these analyses may be required on an entity-by-entity basis. From there, advisers may wish to review the potential tax outlays as well as compliance burdens that would result from having an employee who triggers a filing obligation where none existed previously. For example, if an employee chooses—because of COVID or otherwise—to work from a state where the adviser is not currently filing, the adviser would have to consider whether that employee is creating a physical presence in the state and the tax implications it will have on the adviser.

7. Employment Considerations for Reopening[10]

Although it is clear that investment advisers, like other financial services companies, are not moving toward full-scale reopening in the near term, many firms are starting to put together a reopening plan. There are a number of employment considerations associated with reopening, including the following.

[10] This information is an excerpt from the "Employment Concern for Financial Cos. During COVID-19" article, which was written by Susan Eandi and Paul Evans from Baker & McKenzie's Global Employment and Labor Law

(a) Government/Agency Guidelines. Advisers should follow state and local reopening requirements and recommendations for businesses and office spaces, as well as the Centers for Disease Control and Prevention's COVID-19 office building recommendations for employers[11], and the Occupational Safety and Health Administration's return-to-work guidance[12] and COVID-19 FAQ guidance.[13] Be certain to have a plan in place that complies with these guidelines if an employee in the workplace tests positive for COVID-19. Guidance changes frequently, so advisers should check the CDC, OSHA, and applicable state and local government/agency websites regularly and update their reopening plans as necessary.

(b) Testing and Screening. Advisers should determine how, whether and when they will screen employees before they enter the workplace. Options include COVID-19 diagnostic tests for active virus, temperature scanning and symptom/exposure certification. Advisers should also determine how to handle employees who do not want to come to work. Certain employees may request to continue working from home because, according to the CDC, they are at increased risk for severe illness from COVID-19. Others may not want to come to work because they have a generalized fear of becoming ill from COVID-19. Determine how to handle these employees, and stay on top of U.S. Equal Employment Opportunity Commission guidance[14] regarding high-risk employees who are protected by the Americans with Disabilities Act.

(c) Travel Restrictions. Advisers should consider how to handle employees who travel to locations requiring quarantine upon arrival or hot spots requiring their quarantine upon return home. This could extend an employee's time out of the office, and raise the question of whether they should be paid during quarantine. Please refer to the Baker McKenzie U.S. shelter-in-place and reopening orders site[15], which includes links to the relevant quarantine requirements/recommendations for incoming travelers in each state and Washington, D.C.

(d) Employee Relations and Employee Morale. There may be employees who are reluctant to return for reasons that have nothing to do with the actual workspace, such as those

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Practice Group, available at: https://www.law360.com/articles/1309126/employment-concerns-for-financial-cos-during-covid-19.

[11] https://www.cdc.gov/coronavirus/2019-ncov/community/office-buildings.html.

[12] https://www.osha.gov/sites/default/files/publications/OSHA4045.pdf.

[13] https://www.osha.gov/coronavirus/faqs.

[14] https://www.eeoc.gov/wysk/what-you-should-know-about-covid-19-and-ada-rehabilitation-act-and-other-eeo-laws.

[15] https://www.bakermckenzie.com/en/insight/publications/resources/us-shelter-in-place-tracker.

employees who rely on public transportation, or those whose children will be at home at least part of the week during the school year. Consider being flexible and working with employees individually to make their return to work as painless as possible, being careful not to discriminate — especially against those who are in a protected class under Title VII or applicable state and local law. For example, many companies are reimbursing employees who wish to take private transportation, such as Uber or Lyft, instead of using public transportation, or allowing employees to continue to work from home part of the week if their children will remain at home.

RISK ALERT
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

August 12, 2020

Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers*

I. Introduction

In response to the broad and varied effects of, and the public and private sector responses to, COVID-19, SEC registrants have been faced with new operational, technological, commercial, and other challenges and issues. In many cases, these challenges and issues have created important regulatory and compliance questions and considerations for SEC registrants.

Through this period, OCIE has remained operational nationwide and continues to execute on its mission. As described in more detail in our March 23, 2020 statement, OCIE has worked with SEC registrants to address the timing of its requests, availability of registrant personnel, and other matters to minimize disruptions.[1] Specifically, OCIE has worked with SEC registrants to ensure that its work can be conducted in a manner consistent with maintaining normal operations and appropriate health and safety measures. OCIE has also actively engaged in on-going outreach and other efforts with many SEC registrants to assess the impacts of COVID-19 and to discuss, among many other things, operational resiliency challenges.

Through these and other efforts, as well as consultation and coordination with our SEC colleagues and other regulators, OCIE has identified a number of COVID-19-related issues, risks, and practices relevant to SEC-registered investment advisers and broker-dealers (collectively, "Firms"). Additionally, market volatility related to COVID-19 may have heightened the risks of misconduct in various areas that the staff believe merit additional attention.

The purpose of this Risk Alert is to share some of these observations with Firms, investors, and the public generally. OCIE's observations and recommendations fall broadly into the following six categories: (1) protection of investors' assets; (2) supervision of personnel; (3) practices relating to fees, expenses, and financial transactions; (4) investment fraud; (5) business continuity; and (6) the protection of investor and other sensitive information.

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* The views expressed herein are those of the staff of OCIE. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by OCIE staff and is not legal advice.

1 OCIE, Statement on Operations and Exams – Health, Safety, Investor Protection and Continued Operations are our Priorities (March 23, 2020).

II. Staff Observations on Areas of Risk and Focus

A. Protection of Investor Assets

Each Firm has a responsibility to ensure the safety of its investors' assets and to guard against theft, loss, and misappropriation.[2] In light of the current environment, the staff has observed that some Firms have modified their normal operating practices regarding collecting and processing investor checks and transfer requests. OCIE encourages Firms to review their practices, and make adjustments, where appropriate, including in situations where investors mail checks to Firms and Firms are not picking up their mail daily. Firms may want to update their supervisory and compliance policies and procedures to reflect any adjustments made and to consider disclosing to investors that checks or assets mailed to the Firm's office location may experience delays in processing until personnel are able to access the mail or deliveries at that office location.[3]

OCIE also encourages Firms to review and make any necessary changes to their policies and procedures around disbursements to investors, including where investors are taking unusual or unscheduled withdrawals from their accounts, particularly COVID-19 related distributions from their retirement accounts.[4] Firms may want to consider:

- Implementing additional steps to validate the identity of the investor and the authenticity of disbursement instructions, including whether the person is authorized to make the request and bank account names and numbers are accurate; and

- Recommending that each investor has a trusted contact person in place, particularly for seniors and other vulnerable investors.[5]

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[2] Investment Advisers Act of 1940 ("Advisers Act") Rule 206(4)-2 ("Custody Rule") requires investment advisers that are registered or required to be registered with the SEC and that have custody of their clients' funds or securities to safeguard those funds against theft, loss, misappropriation, or financial reverses of an adviser. Securities Exchange Act of 1934 ("Exchange Act") Rule 15c3-3 requires SEC-registered broker-dealers to obtain and maintain possession and control of all fully paid securities and excess margin securities.

[3] Investment advisers and certain broker-dealers have an obligation to promptly transmit investor checks. S*ee* Custody Rule and Exchange Act 15c3-3-(k)(2), respectively. Commission staff have addressed certain provisions of the broker-dealer financial responsibility rules and investment adviser Custody Rule, among other things. This Risk Alert provides a list of SEC resources for references to COVID-19-related temporary relief and other topics discussed herein.

[4] *See*, *e.g.*, Congressional Research Services, In Focus: Withdrawals and Loans from Retirement Accounts for COVID-19 Expenses (updated March 27, 2020) and SEC Public Statement, Chairman Clayton, "Confirmation of June 30 Compliance Date for Regulation Best Interest and Form CRS" (June 15, 2020) ("The Coronavirus Aid, Relief and Economic Security (CARES) Act allows eligible participants in certain tax-advantaged retirement plans to take early distributions of up to $100,000 during this calendar year without being subject to early withdrawal penalties and with an expanded window for paying the income tax they owe on the amounts they withdraw.").

[5] *See*, *e.g.*, FINRA Rules 2165 (FINRA exploitation rule) and 4512(a)(1)(F) (FINRA rule on trusted contact person) and SEC Office of the Investor Advocate, "How the SEC Works to Protect Senior Investors" (May 2019).

B. Supervision of Personnel

Firms have an obligation to supervise their personnel, including providing oversight of supervised persons' investment and trading activities.[6] A Firm's supervisory and compliance program should include policies and procedures that are tailored to its specific business activities and operations and should be amended as necessary to reflect the Firm's current business activities and operations.[7]

As Firms need to make significant changes to respond to the health and economic effects of COVID-19 – such as shifting to Firm-wide telework conducted from dispersed remote locations, dealing with significant market volatility and related issues, and responding to operational, technological, and other challenges – OCIE encourages Firms to closely review and, where appropriate, modify their supervisory and compliance policies and procedures.

For example, Firms may wish to modify their practices to address:

- Supervisors not having the same level of oversight and interaction with supervised persons when they are working remotely.
- Supervised persons making securities recommendations in market sectors that have experienced greater volatility or may have heightened risks for fraud.[8]
- The impact of limited on-site due diligence reviews and other resource constraints associated with reviewing of third-party managers, investments, and portfolio holding companies.
- Communications or transactions occurring outside of the Firms' systems due to personnel working from remote locations and using personal devices.

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[6] Advisers Act Rule 206(4)-7 (the "Compliance Rule") requires SEC-registered investment advisers to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act. Advisers Act Section 203(e)(6) also authorizes the Commission to institute proceedings to determine whether it is in the public interest to sanction an investment adviser if it has failed reasonably to supervise a person subject to its supervision, with a view to preventing violations of the provisions of such statutes, rules, and regulations by that person. FINRA Rule 3110 requires FINRA member broker-dealers to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. Strong compliance programs incorporate legal requirements and essential controls that are periodically reviewed and updated.

[7] Advisers Act Rule 206(4)-7(b) requires investment advisers to review, at least annually, the adequacy of their established policies and procedures. FINRA Rule 3110(b)(1) states that "each member shall establish, maintain, and enforce written procedures to supervise the types of business in which they engage." *See also* FINRA Regulatory Notice 20-16: Transition to Remote Work and Remote Supervision (May 28, 2020) (sharing practices implemented by FINRA member firms to, for example, supervise in a remote work environment during the pandemic). Significant compliance events, changes in business arrangements, and regulatory developments, among other things, may lead to the need for a review.

[8] *See*, *e.g.*, SEC Press Release 2020-11, SEC Charges Companies and CEO for Misleading COVID-19 Claims (May 14, 2020) (The SEC alleges that two firms "sought to take advantage of the COVID-19 crisis by misleading investors about their ability to provide medical solutions."). *See also* FINRA Notice to Members 20-14: Sales Practice Obligations with Respect to Oil-Linked Exchange-Traded Products (May 15, 2020).

- Remote oversight of trading, including reviews of affiliated, cross, and aberrational trading, particularly in high volume investments.

- The inability to perform the same level of diligence during background checks when onboarding personnel – such as obtaining fingerprint information and completing required Form U4 verifications – or to have personnel take requisite examinations.[9]

C. Fees, Expenses, and Financial Transactions

Firms have obligations relating to considering and informing investors about the costs of services and investment products, and the related compensation received by the Firms or their supervised persons.[10] The recent market volatility and the resulting impact on investor assets and the related fees collected by Firms may have increased financial pressures on Firms and their personnel to compensate for lost revenue. While these incentives and related risks always exist, the current situation may have increased the potential for misconduct regarding:

- Financial conflicts of interest, such as: (1) recommending retirement plan rollovers to individual retirement accounts, workplace plan distributions, and retirement account transfers into advised accounts or investments in products that the Firms or their personnel are soliciting; (2) borrowing or taking loans from investors and clients; and (3) making recommendations that result in higher costs to investors and that generate greater compensation for supervised persons, such as investments with termination fees that are switched for new investments with high up-front charges or mutual funds with higher cost share classes when lower cost share classes are available.

- Fees and expenses charged to investors, such as: (1) advisory fee calculation errors, including valuation issues that result in over-billing of advisory fees;[11] (2) inaccurate calculations of tiered fees, including failure to provide breakpoints and aggregate household accounts; and (3) failures to refund prepaid fees for terminated accounts.

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[9] *See*, *e.g.*, Order Under Section 17A and Section 36 of the Securities Exchange Act of 1934 Extending Temporary Exemption from Specified Provisions of the Exchange Act and Certain Rules Thereunder, Exchange Act Release No. 89170 (June 26, 2020) and related FINRA FAQs.

[10] Advisers Act Section 206 imposes a fiduciary duty on investment advisers. S*ee*, *e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers ("Fiduciary Interp."), Advisers Act Release No. 5248 (June 5, 2019) ("The cost (including fees and compensation)… associated with investment advice would generally be one of many important factors… to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client."). Regulation Best Interest requires a broker-dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer, to act in the best interest of the retail customer and not place its interests ahead of the retail customer. Among other obligations, a broker-dealer must understand and consider the potential costs associated with a recommendation, make relevant disclosures and address its conflicts of interest associated with the cost of investing. S*ee* Exchange Act Rule 15l-1(a)(2)(ii) and Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 86031 (June 5, 2019) ("Reg BI Adopting Release") (A broker-dealer's general obligation under Regulation Best Interest is satisfied only if the broker-dealer complies with four specified component obligations, relating to disclosure, care, conflicts of interest, and compliance.).

[11] The Commission has brought enforcement actions against advisers for causing the overvaluation of certain holdings maintained in clients' accounts, which also may result in clients paying higher asset-based advisory fees and inflated portfolio performance returns (*see*, *e.g.*, In re Semper Capital Management, Advisers Act Release No. 5489 (April 28, 2020) (settled)).

Firms may wish to review their fees and expenses policies and procedures and consider enhancing their compliance monitoring, particularly by:

- Validating the accuracy of their disclosures, fee and expense calculations, and the investment valuations used.

- Identifying transactions that resulted in high fees and expenses to investors, monitoring for such trends, and evaluating whether these transactions were in the best interest of investors.

- Evaluating the risks associated with borrowing or taking loans from investors, clients, and other parties that create conflicts of interest, as this may impair the impartiality of Firms' recommendations.[12] Also, if advisers seek financial assistance, this may result in an obligation to update disclosures on Form ADV Part 2.[13]

D. Investment Fraud

The staff has observed that times of crisis or uncertainty can create a heightened risk of investment fraud through fraudulent offerings. Firms should be cognizant of these risks when conducting due diligence on investments and in determining that the investments are in the best interest of investors.[14] Firms and investors who suspect fraud should contact the SEC and report the potential fraud.

E. Business Continuity

Certain firms are required to adopt and implement compliance policies and procedures that are reasonably designed to prevent violation of the federal securities laws.[15] As part of this process, Firms should consider their ability to operate critical business functions during emergency events.[16] Due to the pandemic, many Firms have shifted to predominantly operating from

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12 *See*, *e.g.*, SEC Staff Speech, Peter Driscoll, "How We Protect Retail Investors" (April 29, 2019). The Commission has brought enforcement actions against advisers for fraudulently inducing clients to invest in their businesses and for recommending investments with undisclosed financial incentives for the firms, their supervised persons, or both (*see*, *e.g.*, In re Fieldstone Financial Management Group, LLC, Advisers Act Release No. 5263 (July 1, 2019) (settled)).

13 *See* Division of Investment Management Coronavirus (COVID-19) Response FAQs, Question II.4. (Posted April 27, 2020).

14 The SEC has suspended trading for many issuers due to false and misleading claims (e.g., purporting to have cures, vaccines, or curative drugs for COVID-19 infections, or access to personal protective equipment, testing, or other preventatives such as hand sanitizers). Firms have an obligation to provide advice that is in the best interest of each investor, which requires a reasonable understanding of both the investor and the proposed investment. *See* Fiduciary Interp; Reg BI Adopting Release; FINRA Notice to Members 20-08: Business Continuity Planning (March 9, 2020); and Exchange Act Rule 15l-1 (provides a new best interest standard for broker-dealer recommendations to retail investors).

15 *See supra* notes 6 and 7.

16 *Id.* In adopting the Compliance Rule, the Commission stated that an investment adviser's compliance policies and procedures should generally address business continuity plans. FINRA Rule 4370 requires broker-dealers that are members of FINRA to create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption.

remote sites, and these transitions may raise compliance issues and other risks that could impact protracted remote operations, including:[17]

- Firms' supervisory and compliance policies and procedures utilized under "normal operating conditions" may need to be modified or enhanced to address some of the unique risks and conflicts of interest present in remote operations. For example, supervised persons may need to take on new or expanded roles in order to maintain business operations. These and other changes in operations may create new risks that are not typically present.

- Firms' security and support for facilities and remote sites may need to be modified or enhanced. Relevant issues that Firms should consider include, for example, whether: (1) additional resources and/or measures for securing servers and systems are needed, (2) the integrity of vacated facilities is maintained, (3) relocation infrastructure and support for personnel operating from remote sites is provided, and (4) remote location data is protected. If relevant practices and approaches are not addressed in business continuity plans and/or Firms do not have built-in redundancies for key operations and key person succession plans, mission critical services to investors may be at risk.

OCIE encourages Firms to review their continuity plans to address these matters, make changes to compliance policies and procedures, and provide disclosures to investors if their operations are materially impacted, as appropriate.

F. Protection of Sensitive Information

Firms have an obligation to protect investors' personally identifiable information ("PII").[18] The staff has observed that many Firms require their personnel to use videoconferencing and other electronic means to communicate while working remotely. While these communication methods have allowed Firms to continue their operations, these practices create:

- Vulnerabilities around the potential loss of sensitive information, including PII.[19] These risks are attributed to, among other things: (1) remote access to networks and the use of web-based applications; (2) increased use of personally-owned devices; and (3) changes in controls over physical records, such as sensitive documents printed at remote locations and the absence of personnel at Firms' offices.

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[17] *See, e.g.,* Chairman Clayton testimony, "Capital Markets and Emergency Lending in the COVID-19 Era" (June 25, 2020) ("OCIE has continued its efforts in examining registered entities for compliance with the federal securities laws, with a focus on the resiliency of critical market systems and verification of investor assets with financial professionals. Since mid-March, OCIE has supplemented its examinations with hundreds of outreach calls to registrants nationwide to assess the impact of COVID-19 on operational resiliency and business continuity planning.").

[18] The Safeguards Rule of Regulation S-P requires every SEC-registered broker-dealer and investment adviser to adopt written policies and procedures to address administrative, technical, and physical safeguards for the protection of investor records and information. The Identity Theft Red Flags Rule of Regulation S-ID requires certain firms to develop and implement a written identity theft prevention program that is designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account.

[19] National Institute of Standards Technology, ITL Bulletin: Security for Enterprise Telework, Remote Access, and Bring Your Own Device (BYOD) Solution (March 2020).

- More opportunities for fraudsters to use phishing and other means to improperly access systems and accounts by impersonating Firms' personnel, websites, and/or investors.[20]

OCIE recommends that Firms pay particular attention to the risks regarding access to systems, investor data protection, and cybersecurity. In particular, Firms should assess their policies and procedures and consider:

- Enhancements to their identity protection practices, such as by reminding investors to contact the Firms directly by telephone for any concerns about suspicious communications and for Firms to have personnel available to answer these investor inquiries.

- Providing Firm personnel with additional trainings and reminders, and otherwise spotlighting issues, related to: (1) phishing and other targeted cyberattacks; (2) sharing information while using certain remote systems (e.g., unsecure web-based video chat); (3) encrypting documents and using password-protected systems; and (4) destroying physical records at remote locations.

- Conducting heightened reviews of personnel access rights and controls as individuals take on new or expanded roles in order to maintain business operations.

- Using validated encryption technologies to protect communications and data stored on all devices, including personally-owned devices.

- Ensuring that remote access servers are secured effectively and kept fully patched.

- Enhancing system access security, such as requiring the use of multifactor authentication.

- Addressing new or additional cyber-related issues related to third parties, which may also be operating remotely when accessing Firms' systems.[21]

III. Conclusion

OCIE encourages Firms to remain informed regarding fraudulent activities that may affect investors' assets and, when fraud is observed, to report such activities. Below are some SEC resources that may be helpful.

Reporting Fraudulent Activities. Submit a tip or ask a question using the SEC's tips, complaints and referral system or by phone at (202) 551-4790.

Reaching out to the SEC's Office of Investor Education and Advocacy. Ask questions by phone at 1-800-732-0330 or using this online form, or email at Help@SEC.gov.

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[20] *Id*. *See also* OCIE, Risk Alert: Cybersecurity: Ransomware Alert (July 10, 2020) and Department of Homeland Security, Cybersecurity and Infrastructure Security Agency Alert: Enterprise VPN Security (updated April 15, 2020) (When personnel access non-public electronic resources from external locations, the data security protections may be compromised by, among other things, the remote access methods used.).

[21] *See*, *e.g.*, OCIE, Cybersecurity and Resilience Operations (January 2020).

Staying Informed Regarding the SEC's Response to COVID-19 and Related Activities:

- SEC's Coronavirus (COVID-19) Response.
- COVID-19 Quick Reference Guide for Investors and Market Participants.
- Information regarding fighting COVID-19-related financial fraud.
- Investor Alert: Frauds Targeting Main Street Investors.
- Frequently Asked Questions Concerning the COVID-19 Pandemic and the Broker-Dealer Financial Responsibility Rules.
- Division of Investment Management Coronavirus (COVID-19) Response FAQs.
- List of recent trading suspensions.

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

RISK ALERT
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

November 9, 2020

Observations from OCIE's Examinations of Investment Advisers: Supervision, Compliance and Multiple Branch Offices*

I. Introduction

The Office of Compliance Inspections and Examinations ("OCIE") conducted a series of examinations that focused on SEC-registered investment advisers operating from numerous branch offices and with operations geographically dispersed from the adviser's principal or main office ("Multi-Branch Initiative" or "Initiative").[1] This Initiative focused on, among other things, the assessment of the compliance and supervisory practices relating to advisory personnel working within the advisers' branch offices.[2]

This Risk Alert contains observations resulting from the examinations under the Initiative, including nearly 40 examinations of advisers' main offices combined with one or more examinations of each adviser's branch offices. These advisers collectively managed approximately $110 billion in assets for about 185,000 clients, the majority of whom were retail investors. Most firms selected for examination under the Initiative conducted their advisory business out of 10 or more branch offices.

The staff generally observed a range of deficiencies across the examinations. More specifically, some of the advisers had not fully implemented policies and procedures addressing advisory activities occurring in branch offices and in geographically dispersed operations. This Risk Alert discusses common deficiencies identified by OCIE staff. It also discusses examples of practices

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* This statement represents the views of the staff of the Office of Compliance Inspections and Examinations. It is not a rule, regulation, or statement of the U.S. Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved of its content. This statement, like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

1 For purposes of this Initiative, the term branch means an office or "place of business" other than the adviser's "principal office and place of business" – both of which are defined in Rule 222-1 under the Investment Advisers Act of 1940 ("Advisers Act"). An adviser's principal office is where the firm regularly provides advisory services, solicits, meets with, or otherwise communicates to clients. The risks associated with multi-branch advisers were first highlighted in OCIE's 2016 Examination Priorities (*see* OCIE, "Examination Priorities for 2016" (January 11, 2016)) and became an examination initiative later that year (*see* OCIE Risk Alert, "Multi-Branch Adviser Initiative" (December 12, 2016)). These advisers continue to be an area of interest for examinations because they: (1) often advise retail clients; and (2) have unique risks and challenges related to the design and implementation of their compliance programs and oversight of advisory services provided through remote offices.

2 The examinations under this Initiative were concluded in 2018. OCIE will continue to monitor industry trends and practices, including telework conducted from dispersed remote locations, and will provide its observations to its colleagues in the Division of Investment Management. We note that staff in the Division of Investment Management stated that it would not recommend enforcement action if a firm does not update its Form ADV in order to list the temporary teleworking addresses of its employees (*see* Form ADV and IARD Frequently Asked Questions: Form ADV Item 1.F).

certain advisers implemented which aimed to improve compliance and supervisory practices at those firms.

II. Initiative Focus and Relevant Regulations

The Multi-Branch Initiative focused on certain practices of advisers in the following areas:

- *Compliance programs and supervision*, including whether the adviser had adopted and implemented reasonably designed written policies and procedures under the "Compliance Rule."[3] The staff focused on advisers' compliance programs in both their main offices and branch offices, as well as on the oversight by the main offices of advisory services provided through branch offices. In particular, the staff reviewed firms' main and branch office practices for: (1) compliance with certain rules, such as the "Code of Ethics Rule"[4] and "Custody Rule";[5] and (2) consistency with fiduciary obligations, such as those related to fees, expenses, and advertising.[6]

- *Investment advice*.[7] The staff evaluated the processes by which firms' supervised persons located in branch offices provided investment advice to advisory clients, including the formulation of investment recommendations and the management of client portfolios. In conducting these examinations, the staff focused on the advisers': (1) oversight of investment recommendations, both within specific branch offices and across all of the advisers' branch offices; (2) management and disclosure of conflicts of interest; and (3) allocation of investment opportunities.

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3 Advisers Act Rule 206(4)-7 requires SEC-registered advisers to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and rules thereunder by advisers and their supervised persons. Advisers Act Section 203(e)(6) also highlights that establishing supervisory procedures reasonably designed to prevent and detect such violations and following these procedures are important steps advisers should take in supervising persons subject to their oversight.

4 Advisers Act Rule 204A-1 requires SEC-registered advisers to establish, maintain, and enforce their codes of ethics.

5 Advisers Act Rule 206(4)-2 requires SEC-registered advisers that have custody of their clients' funds or securities to safeguard those funds against theft, loss, misappropriation, or financial reverses of an adviser.

6 *See, e.g.*, In re Transamerica Financial Advisors Inc., Advisers Act Rel. No 3808 (April 3, 2014) (settled). In Transamerica, the Commission brought an enforcement action against an adviser that did not apply advisory fee discounts to certain retail clients in several of its programs, contrary to its disclosures to clients and its policies and procedures. A branch office mistakenly believed that the main office was automatically aggregating the accounts without the branch office's direction. As a result, the branch office did not notify the appropriate staff at the main office which accounts should be aggregated or whether certain clients had requested account aggregation. Advisers Act Section 206(4) and Rule 206(4)-1 prohibit SEC-registered advisers from using any advertisement that contains any untrue statement of material fact or that is otherwise misleading. Also, Advisers Act Sections 206(1) and (2) make it unlawful for an adviser "to employ any device, scheme or artifice to defraud any client or prospective client … [or] engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."

7 Advisers Act Section 206 imposes a fiduciary duty on advisers (*see, e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 (June 5, 2019)). An adviser must provide advice to a client that is in the best interest of the client, including advice that is suitable based on a reasonable understanding of the client's objectives. Advisers also must eliminate or at least expose through full and fair disclosure all conflicts of interest that might cause them – consciously or unconsciously – to render advice which is not disinterested.

III. Staff Observations

The staff observed that the branch office model may pose certain risk factors that advisers should consider in designing and implementing their compliance programs and in supervising personnel and processes occurring in branch offices. These risks may be heightened when the main and branch offices have different practices. For example, advisers that do not monitor, review, and/or test their branch office activities may not be aware that the compliance controls they have adopted are not effectively implemented or do not appropriately address the intended risks and conflicts in these remote locations. While many of the issues discussed below are not unique to advisers that use the branch office model, such entities may be more susceptible to the issues discussed herein because, among other things, geographically dispersed personnel may develop different practices or disparate ways of communicating.

A. Compliance and Supervision

- *Compliance programs.* The vast majority of the examined advisers were cited for at least one deficiency related to the Compliance Rule. In particular, the staff observed that more than one-half of these advisers had compliance policies and procedures that were: (1) inaccurate because they included outdated information, such as references to entities no longer in existence and personnel that had changed roles and responsibilities; (2) not applied consistently in all branch offices; (3) inadequately implemented because, among other things, the compliance department did not receive records called for in the policies and procedures; or (4) not enforced. The Compliance Rule issues often were related to the advisers failing to recognize that they had custody of clients' assets, failing to adequately implement and oversee their fee billing practices, or both.[8] Examples of compliance program-related shortcomings in these two areas are discussed below.

    - *Custody of client assets.* Advisers did not have policies and procedures that limited the ability of supervised persons to process withdrawals and deposits in client accounts, change client addresses of record, or do both.

        - Advisers had custody of their clients' assets due to a variety of practices, including instances where the adviser: (1) comingled its assets with those of its clients; (2) was the trustee for client accounts (or its supervised persons were trustees); (3) was the general partner to an advised limited partnership; (4) received client checks in branch offices and deposited these checks with the client custodians; and/or (5) had various arrangements in place that gave it broad disbursement authority over client assets. By taking these actions, the examined advisers, perhaps unknowingly, had custody of client assets and were therefore required to follow the provisions of the Custody Rule.

    - *Fees and expenses*. Advisers did not have policies and procedures that included identifying and remediating instances where undisclosed fees were charged to clients. In addition, policies and procedures governing such fees, including those related to wrap fee

[8] OCIE issued a Risk Alert that highlighted custody-related issues, including failure by advisers to recognize that they have custody (*see* OCIE, "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets" (March 4, 2013)) and a Risk Alert that addressed advisory fee-related issues (*see* OCIE, "Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers" (April 12, 2018)).

programs, were not enforced. Most fee billing issues were related to the lack of oversight over fee billing processes, and in some cases, this resulted in overcharges to clients.

  - Clients were overcharged advisory fees in a variety of ways, such as when the adviser: (1) used inaccurate fee calculations by, for example, misapplying tiered fee structures or employing incorrect valuations for the calculations; (2) inconsistently applied fee reimbursements, including for advisory fee offsets for 12b-1 fees from certain mutual fund purchases and refunds for prorated fees paid in advance by clients who terminated their accounts; and (3) charged fees different than the rates included in advisory agreements or on assets that were to be excluded from advisory fees.

- *Oversight and supervision of supervised persons*. Supervision deficiencies related to: (1) the failure to disclose material information, including disciplinary events of supervised persons; (2) portfolio management, such as the recommendation of mutual fund share classes that were not in the client's best interest; and (3) trading and best execution, including enforcing policies and procedures the adviser had in place. Supervision deficiencies were particularly prevalent when the advisers oversaw branch office personnel with higher-risk profiles, and this included instances related to the identification and documentation of disciplinary events.[9]

- *Advertising*. Advisers often had deficiencies related to advertising, both generally and specifically regarding the materials prepared by supervised persons located in branch offices and/or supervised persons operating under a name different than the primary name of the adviser (also known as "doing business as" or "DBAs"). Examples of problematic advertisements included: (1) performance presentations that omitted material disclosures; (2) superlatives or unsupported claims; (3) professional experience and/or credentials of supervised persons or the advisory firm that were falsely stated; and (4) third-party rankings or awards that omitted material facts regarding these accolades.

- *Code of ethics.* Several of the advisers were cited for code of ethics deficiencies because they failed to: (1) comply with reporting requirements, including by submitting transactions and holdings reports less frequently than required by the rule or not submitting such reports at all; (2) review transactions and holdings reports; (3) properly identify access persons; or (4) include all required provisions in their codes of ethics. Examples of provisions omitted from codes of ethics include those requiring: a review and approval process prior to supervised persons investing in limited or private offerings; initial and annual holdings report submissions; and/or quarterly transaction report submissions.[10]

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[9] OCIE issued a Risk Alert of findings from its "Supervision Initiative" that highlighted weaknesses identified in oversight practices of SEC-registered advisers that previously employed, or currently employ, any individual with a history of disciplinary events (*see* OCIE, "Observations from Examinations of Investment Advisers: Compliance, Supervision, and Disclosure of Conflicts of Interest" (July 23, 2019)). This Risk Alert also provided examples of processes that could help firms address similar weaknesses identified during the Multi-Branch Initiative examinations.

[10] OCIE issued a Risk Alert highlighting deficiencies or weaknesses with respect to advisers' compliance with the Code of Ethics Rule (*see* OCIE, "The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers" (September 14, 2017)).

B. Investment Advice

- *Portfolio management*. More than one-half of the examined advisers were cited for deficiencies related to portfolio management practices. These often were related to: (1) oversight of investment decisions, including the oversight of investment decisions occurring within branch offices; (2) disclosure of conflicts of interest; and (3) trading allocation decisions. Examples of the issues observed are discussed below.

    - *Oversight of, or reasonable basis for, investment recommendations.* Observations of deficiencies associated with the oversight or assessments of investment recommendations were often related to mutual fund share class selection practices and disclosures of such practices, as well as investment recommendations and disclosures associated with wrap fee programs. For example, the staff identified:

        - *Mutual fund share class selection and disclosure issues.* Advisers purchased share classes of mutual funds that charged 12b-1 fees instead of lower cost share classes of the same mutual funds that were available to clients. The advisers stood to benefit from the clients paying for higher cost share classes, which created a conflict of interest that was not disclosed to clients.

        - *Wrap fee program issues.* Advisers failed to adequately assess whether programs were in the best interests of clients, erroneously charged commissions, misrepresented or failed to have appropriate disclosures regarding their wrap fee program (*i.e.*, fees, trading away practices, and delegation of responsibility), or failed to implement appropriate oversight of trading away practices, including monitoring whether sub-advisers traded away. These practices typically caused clients to incur additional costs, such as ticket charges and other fees.

        - *Rebalancing issues*. Advisers implemented automated rebalancing of accounts that caused clients to incur short-term redemption fees from mutual funds. Certain advisers did not consider whether these automated processes, which caused clients to pay additional fees, were in the best interest of the clients.

    - *Conflicts of interest disclosures*. Several advisers were cited for issues related to conflicts of interest that were not fully and fairly disclosed, such as expense allocations that appeared to benefit proprietary fund clients over non-proprietary fund clients. Several advisers also did not fully and fairly disclose financial incentives for the advisers and/or their supervised persons to recommend specific investments.[11]

    - *Trading and allocation of investment opportunities.* Advisers were cited for: (1) the lack of documentation demonstrating the advisers' analysis regarding obtaining best execution for their clients; (2) completing principal transactions involving securities sold from the firms' inventory without prior client consent; and (3) inadequate monitoring of

[11] *See* supra n. 7. The Commission provided the following guidance on what constitutes full and fair disclosure of conflict of interest: (1) the appropriate level of specificity, including the appropriateness of stating that an adviser "may" have a conflict, and (2) considerations for disclosure regarding conflicts related to the allocation of investment opportunities among eligible clients.

supervised persons' trading, including the improper allocation of block trade losses to clients rather than to the supervised persons.[12]

C. Staff Observations Regarding Compliance Practices

During the course of these examinations, the staff observed a range of practices with respect to branch office activities that firms may find helpful in their compliance oversight efforts. The practices noted below do not constitute a comprehensive list of practices necessary for a firm to meet its legal obligations and not every practice on the list may be applicable to all types of firms. Rather, the list contains a sample of observed practices that that may assist advisers in designing and implementing policies and procedures under the Compliance Rule.

- *Advisers adopted and implemented written compliance policies and procedures that: (1) were applicable to all office locations and all supervised persons – regardless of whether these individuals were independent contractors or employees of the adviser; (2) include unique aspects associated with individual branch offices; and (3) specifically address compliance practices necessary for effective branch office oversight.* The staff observed that some advisers had policies and procedures to oversee all of their office locations (*i.e.*, main and branch offices) and to address the specific activities taking place at, and the clients managed by, their branch offices. Regardless of whether the advisers had policies and procedures that were tailored for their branch offices, many firms had policies and procedures for compliance monitoring and oversight of branch offices, which typically included compliance reporting by their branch offices. For example, some advisers established:

    - *Uniform policies and procedures regarding main office oversight for monitoring and approving advertising*, particularly in instances where branch offices were permitted to advertise through DBA websites.

    - *Centralized, uniform processes to manage client fee billing*. Advisers with centralized, uniform processes tended to limit exceptions from these approved processes. These centralized processes mitigated instances in which supervised persons or branch offices had independent billing options or fee arrangements that deviated from client agreements or disclosures.

    - *Centralized processes for monitoring and approving personal trading activities for all supervised persons located in all office locations.* For some advisers, the centralized process included an automated review and approval of personal trading

[12] *See* supra n. 7. As a fiduciary, an adviser has the duty to seek best execution of a client's transactions, including where the adviser has the responsibility to select broker-dealers to execute client trades. It also must disclose any conflicts related to the allocation of investment opportunities among eligible clients. An adviser's compliance program should "include procedures by which the adviser satisfies its best execution obligation" and the firm should document its annual review of this obligation. *See* Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (December 17, 2003) and Advisers Act Rule 204(2). In addition, a variety of legal requirements and provisions may be implicated when executing principal and cross trades, including Advisers Act Sections 206(1), (2), and (3) and Rules 206(3)-2 and 206(4)-7. S*ee* OCIE, "Investment Adviser Principal and Agency Cross Trading Compliance Issues" (September 4, 2019).

requests and transactions. Many of these advisers also provided supervised persons with training related to their codes of ethics and personal trading policies.

- *Uniform portfolio management policies and procedures, portfolio management systems, or both, across all office locations*. For some advisers, trade orders were also centralized through the main office.

- *Advisers performed compliance testing or periodic reviews of key activities at all branch offices at least annually, with some firms conducting reviews more frequently.* Examples of compliance oversight and testing of branch office activities included:

  - *Validating that branch offices undertook compliance or supervision reviews of their portfolio management decisions*, both initially and on an on-going basis.

  - *Designating individuals within branch offices to provide portfolio management monitoring*, primarily to assess whether investment recommendations were consistent with clients' investment objectives or recommendations.

  - *Consolidating the trading activities occurring within branch offices into the advisers' overall testing practices.*

  - *Conducting compliance reviews that did not solely rely on self-reporting by personnel.*

- *Advisers established compliance policies and procedures to check for prior disciplinary events when hiring supervised persons and periodically confirming the accuracy of disclosure regarding such information*. In addition to initially reviewing for disciplinary histories when hiring personnel, some advisers also had procedures that included periodically reviewing disciplinary histories, documenting such reviews, and providing heightened supervision of individuals with disciplinary histories.[13]

- *Advisers required compliance training for branch office employees*. Most advisers required compliance-related training for branch office employees, targeting areas identified as needing improvement based on their branch office reviews. Typically such training was required semi-annually or at least annually.

IV. Conclusion

The examinations within the scope of this review resulted in a range of actions. In response to the staff's observations, advisers elected to amend disclosures, revise compliance policies and procedures, or change certain practices. In sharing the information in this Risk Alert, OCIE encourages advisers, when designing and implementing their compliance and supervision frameworks, to consider the unique risks and challenges presented when employing a business model that includes numerous branch offices and business operations that are geographically dispersed and to adopt policies and procedures to address those risks and challenges.

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[13] *See* supra n. 9. All registered advisers must promptly disclose in Form ADV certain legal or disciplinary events that would be material to a client's or a prospective client's evaluation of the adviser's integrity (*see* Amendments to Form ADV, Advisers Act Release No. 3060 (July 28, 2010)).

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

WORKING FROM HOME: STATE TAX IMPACT OF A GROWING REMOTE WORKFORCE

ANNE BATTER, GARRETT KINKELAAR, DAVID POPE, AND MIKE SHAIKH

Recent advances in technology have made remote working easier than ever, which resulted in a steady growth of the remote workforce even before COVID-19. Of course, the COVID-19 pandemic virtually made remote working the norm for most employees who are not considered "essential workers" under state or local guidelines. However, COVID-19 is likely to be a catalyst to expand the work from home environment, rather than a temporary blip in the growth of remote work. We have already seen many companies very publicly announce that remote work will be the permanent norm for at least some subset of the workforce. Many considerations go into these decisions. These include reduced costs, reduced social interaction, potentially increased morale, and a larger employee pool. Nevertheless, truly remote employment can have significant impacts on tax outlays and compliance burdens. This article will introduce and identify just three areas of state and local tax that are affected by an increased remote workforce: additional tax filing and payment obligations; shifts in amount of tax owed; and increased burdens on employee withholding and other payroll tax obligations.[1]

Remote Employees May Expand State and Local Tax Filing Obligations

A remote and geographically diverse employee workforce may result in expanded filing obligations in states where a company otherwise may not have been required to file. A single telecommuting employee could establish "nexus" (i.e., a jurisdictional requirement for tax filings) for an out-of-state business simply by working from a location where the business is not currently located, resulting in unanticipated income tax, franchise tax, sales and use tax, and other tax exposures and filing obligations for the employer.

The concept of "nexus" describes the minimum contacts a person or business entity must have with a state or jurisdiction before it can be subjected to taxation. For sales tax purposes, a business with taxable nexus must remit a jurisdiction's sales or use tax. For income tax purposes, a business with taxable nexus must file and pay income tax on income derived from activities conducted in that state—typically through some method of allocation and apportionment of the taxpayer's total income. Over time, states have developed and applied differing nexus standards, based on the Constitutional limitations,[2] subjecting companies to tax based on physical presence (e.g., through employees or property in the state) or certain economic connections to the state.

Historically, a physical presence was required to establish nexus as a universal rule.[3] However, while physical presence still remains one way to create nexus, many states have broadened their nexus standards through a combination of efforts—varying by tax-type—that now result in many states also having an "economic" nexus standard (e.g., having a fixed dollar threshold of sales that create nexus in the state or having intangibles in the state that create nexus).[4] Nearly all states have adopted an economic nexus standard for sales tax purposes, but a more limited number have adopted such a rule for income tax purposes.

The end result of these varying nexus standards has a profound impact on how compa-

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nies should react to an expanding telecommuting workforce—due to COVID-19 or otherwise. However, for purposes of COVID-19 specifically, many states have issued guidance stating that a telecommuting workforce would *not* create nexus.[5] Unfortunately, not all states have provided such guidance. Therefore, companies must first determine the states in which they currently have filing obligations. These obligations should be reviewed for income tax, sales and use tax, gross receipts tax, and other potential state and local taxes. In certain states, such as where combined re-porting is not required, these analyses may be required on an entity-by-entity basis. From there, companies should review the potential tax outlays as well as compliance burdens that would result from having an employee who triggers a filing obligation where none existed previously. For example, if an employee chooses—because of COVID-19 or otherwise—to work from a state where an employer is not currently filing, the employer must confirm whether that employee is creating a physical presence in the state and the tax implications it will have on the employer.

Corporate Income Tax Apportionment and Other Issues

While an expanded nexus footprint exposes an employer to additional tax filing obligations, the movement of employees from one state to another could also impact the amount of tax owed in states. This may result in a change in the amount of income apportioned to some states, particularly in states that look to the taxpayer's payroll in determining the apportionment. However, the biggest impact for many taxpayers can be on tax credits.

States offer various forms of income tax credits and other incentives for creating in-state jobs. For example, California has a limited hiring credit available for hiring certain new employees.[6] States also provide credits for expenses—including payroll costs—incurred for research activities. Staying with California, the state provides a credit against income tax due for a portion of qualified research expenses for business-based research.[7] States may also provide other credits for hiring and retaining employees in the state. California, for example, offers the California Competes Credit for businesses that move to California or stay and grow in the state.[8]

Whether looking at California or other states with similar incentives, credits are typically only available to offset costs of employees hired to work in the taxing state.[9] Thus, an employer may find it beneficial to bring on new remote employees in a state if those employees would be conducting qualifying research. Conversely, the same employee moving out of the state to work remotely could reduce the

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1 As a threshold matter, employers should assess the employment status of individuals who provide remote services to determine if any would be considered a statutory or common law employee in the state or states where they work. Workers who are employed by staffing companies or contractually labeled as independent contractors may still be considered employees by some taxing agencies. Moreover, at least one state has taken an aggressive stance by attempting to significantly narrow the definition of an independent contractor. See, e.g., Assembly Bill No. 5 (2019-20 Reg. Sess.); *People of the State of California v. Uber Technologies Inc.; Lyft Inc.; and Does 1-50 Inclusive*, Case No. CGC-20-584402 (San Francisco Sup. Ct., Aug. 10, 2020).

2 Generally, the Due Process Clause and the Commerce Clause establish constitutional standards for states seeking to tax out-of-state businesses. Specifically, the Due Process Clause has been interpreted to require sufficient minimum connections between the entity's activities and the taxing jurisdiction. *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980).

3 Note, with regard to state income taxes, Congress limited the breadth of physical nexus standards through Public Law 86-272, establishing a safe harbor for out-of-state businesses. Specifically, P.L. 86-272 prohibits a state from imposing income tax on an out-of-state business if its only activity in the state is the solicitation of sales of tangible personal property and orders are approved and shipped from outside the state. Congress could limit the nexus and withholding impact of remote employees, either generally or during the COVID-19 pandemic, as the Senate recently proposed to do in draft legislation released July 27, 2020, but has as of yet not done so.

4 It was not until 2018 that the U.S. Supreme Court permitted a broader standard than physical presence when it upheld South Dakota's nexus threshold of $100,000 of sales or 200 transactions. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2099 (2018); S.D. Codified Laws Ann. § 10-64-2 (a seller without a physical presence in the state is subject to the state's sales tax obligations if "[t]he seller's gross revenue from the sale of tangible personal property, any product transferred electronically, or services delivered into South Dakota exceeds one hundred thousand dollars; or [t]he seller sold tangible personal property, any product transferred electronically, or services for delivery into South Dakota in two hundred or more separate transactions.").

5 States with issued guidance generally provide that the presence of an employee working in the state due to a shelter-in-place restriction or an emergency order will not create nexus for corporate income tax purposes unless the business elects otherwise. However, businesses should carefully monitor these rules as states vary for when this type of guidance expires (e.g., as of a specified date, removal of emergency order, etc.). See, e.g., OTR Tax Notice 2020-07, *COVID-19 FRANCHISE TAX NEXUS*, District of Columbia Office of Tax and Revenue (Sept. 3, 2020) (https://otr.cfo.dc.gov/page/notices-tax-law-and-guidance); Massachusetts Technical Information Release, No. 20-10, (July 21, 2020); *COVID-19 tax relief options*, Oregon Department of Revenue (https://www.oregon.gov/dor/Pages/COVID19.aspx); *COVID-19 FAQs for Businesses*, Minnesota Department of Revenue (Aug. 20, 2020) (https://www.revenue.state.mn.us/covid-19-faqs-businesses).

6 Cal. Rev. & Tax. Cd. § 23626.

7 Cal. Rev. & Tax. Cd. § 23609.

8 Cal. Rev. & Tax. Cd. § 23689.

amount of credit available where the employee was previously working.

Many credits awarded by states also include a claw-back provision. The California Competes Credit, for example, requires the Franchise Tax Board to determine if a taxpayer was in compliance with certain agreed-upon benchmarks—and, if the taxpayer is out of compliance, the credits it earned may be recaptured. Similarly, Michigan provided an attractive income tax credit worth up to 100% of the state's income tax rate multiplied by the actual wages and employer-paid health care costs on qualifying new or retained jobs.[10] However, Michigan retains the power to recapture this credit if an employer removes 51% of the qualifying jobs from the state within three years of the first year the employer claims the tax credit.[11] In this instance, an employee's transition to a remote status out of state could cost an employer the ongoing use of the tax credit as well as result in the claw back of the previously used tax credit.

Beyond credits, employee location can also impact the amount of income apportioned to a state. Generally, when a business entity has income that is taxable in multiple states, the business must apportion its income to each state where it has sufficient income tax nexus based on that state's apportionment formula. States have recently trended towards using a single-sales factor formula to apportion income (i.e., the state looks to only the taxpayer's in-state sales compared to total sales), but many states still use a three-factor formula, which apportions income to a state based on the percentage of property, payroll, and sales in that state. For instance, Florida, Massachusetts, and Virginia apply a three-factor apportionment formula when allocating a business's income to each respective state.[12] Each of these state's formulae is weighted similarly to the Multistate Tax Commission's ("MTC") model rules to apportion a business's income by multiplying its total income by a fraction composed of property, payroll, and sales attributed to the particular state, with the sales factor given double weight.[13] For purposes of the payroll factor, the MTC's model rules provide that employee compensation is sourced to a state if the services are performed entirely in that state. If services are performed in and out of the state, then they are sourced to a state if the services performed outside the state are incidental to the services performed in the state. Otherwise, the MTC provides cascading rules that look first to the location of the employee's principal base of operations, then to the location where his or her services are directed or controlled, and finally to the employee's residence.[14] Thus, in some instances—such as when employees perform all their services from their home state—remote employees may cause a shift in the payroll factor.

Additionally, while there is a trend towards sourcing sales to the location of the market, some states still use a "costs of performance" method. This method attributes the sales of services to where the income producing activity is performed, which may be the location of the employee performing the service.[15] Thus, remote workers, due to COVID-19 or otherwise, could have the effect of shifting the location of sales, which would affect the taxpayer's apportionment in such states. For some taxpayers, this could be a benefit, particularly if the state where the employee is working sources its sales to the location of the market (i.e., the result could feasibly result in "nowhere" sales that could create a tax benefit depending on the jurisdiction). For others, this could be a detriment given the opposite fact pattern.

Similar to the items considered when looking at nexus, when considering remote working options, employers should consider the effects on tax liabilities from employees working in other states. Special consideration should be given to employees who directly impact the

[9] See Cal. Rev. & Tax. Cd. § 23609(c)(2) (Research activities, for which credits are available, "shall include only research conducted in California".); see also Cal. Rev. & Tax. Cd. § 23626(b)(7)-(8) (Credits are allowed for qualifying taxpayers hiring qualified full-time employees in a designated census tract or economic development area, which are designated within the state by the California Department of Finance.).

[10] Mich. Comp. Laws Ann. § 208.1431(1)(a).

[11] Mich. Comp. Laws Ann. § 208.1431(6).

[12] Fla. Stat. § 220.15; Mass. Gen. L. Chapter 63 § 38(c); Va. Code Ann. § 58.1-408.

[13] Model Multistate Tax Compact art VI.9 (Multistate Tax Comm'n 2015) (http://www.mtc.gov/getattachment/The-Commission/Multistate-Tax-Compact/Model-Multistate-Tax-Compact-with-Recommended-Amendments-to-Art-IV.PDF.aspx) ("All apportionable income shall be apportioned to this State by multiplying the income by a fraction, [State should define its factor weighting fraction here. Recommended definition: 'the numerator of which is the property factor plus the payroll factor plus two times the receipts factor, and the denominator of which is four.']").

[14] Model General Allocation & Apportionment Regulations, Reg. IV.14. (Multistate Tax Comm'n, 2018) (http://www.mtc.gov/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf).

[15] See, e.g., Va. Code Ann. § 58.1-416.

amount of credit received by the employer, such as employees performing research activities or for whom a hiring credit was earned. Additional consideration should also be given when an employer must count the number of employees or wages paid to employees in reaching benchmarks to avoid a recapture of credits. Finally, consideration should be given to the effects that the location of employees will have on apportioning income.

Complex Withholding and Other Payroll Tax Requirements

When an employer hires an employee who works or lives in a state where the employer is not currently filing, or an existing employee transitions to another state, the employer must consider and comply with each state's income tax withholding and other payroll tax obligations.[16] As a result of COVID-19, 14 states have provided limited relief from these withholding requirements to differing degrees.[17] However, in states that have not yet provided relief, employers will likely have to comply with myriad withholding standards and added complexity due to their remote workforce.

States without COVID-19 guidance. Although many states have provided temporary COVID-19 relief, as discussed below, the majority of states have remained silent on this issue. Therefore, employers must work through the complex withholding rules currently in effect and attempt to conform the present COVID-19 environment to such rules. Absent COVID-19, states generally require personal income tax withholding if the employee works in that state, noting that the employee will likely also be subject to tax where the employee lives.[18] If an employee lives in one state and works in another, many states will require the employer to withhold in the state where the employee worked, and then the employee would likely receive a credit in his or her resident state. We note that personal income taxation and withholding obligations vary across states and may be affected by other laws, such as reciprocal agreements between the states. For the states that tax non-residents, such states will generally require employers to withhold personal income tax on any income earned in the state, while other states may provide a threshold before requiring withholding. As an example, New York is notorious for taxing workers who perform services in the state and for requiring employer income tax withholding in cases where the worker exceeds New York's 14-day per year threshold.[19] These rules become particularly important during COVID-19, when workers may be working remotely in a jurisdiction that is outside of the normal workplace.

Even for employees based in New York, the rules could create complexities. Take for example, a situation where an employer based in New York has an employee seeking to relocate and work remotely from Texas, a state without an income tax. Naturally, this plausible circumstance would seem advantageous to both the employee and the employer, potentially reducing the employee's state income tax burden to nothing while reducing the employer's administrative costs for withholding New York state income tax. However, the New York State Department of Taxation and Finance would show both parties just how misguided they are.

Specifically, New York imposes its personal income tax on a nonresident's taxable income that is derived from New York sources.[20] The state applies a "convenience of the employer test" to determine whether income is derived from New York sources.[21] Under this misnamed standard, if an out-of-state employee works remotely for his or her own convenience, and not the employer's necessity, then that remote employee's income will be considered derived from New York sources. New York provides guidance on how out-of-state remote employees may be exempted from paying New York income tax, requiring employees to show their out-of-state home office is a "bona fide employer office."[22] An em-

[16] As noted above, there may also be nexus concerns for other tax types depending on the facts.

[17] See *AICPA Recommendations for Administrative, Filing and Payment Relief for State and Local Taxes during the Coronavirus Pandemic*, American Institute of CPAs (Updated as of Sept. 22, 2020) (https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/coronavirus-aicpa-list-of-recommendations-for-state-societies.pdf) (i.e., Alabama, Georgia, Illinois, Indiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Nebraska, New Jersey, Pennsylvania, Rhode Island, and South Carolina).

[18] Most states impose tax on residents based on the resident's worldwide income earned, noting certain states do not impose a personal income tax on wages (i.e., Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming).

[19] New York Technical Service Bureau Memorandum TSB-M-12(5)I, 7/5/2012. It is worth noting that even though New York requires withholding at a 14-day threshold, the obligation for the employee to remit personal income tax is not based on such threshold (i.e., personal income tax is due for income earned in the state regardless of number of days worked in New York).

[20] N.Y. Tax Law § 601(e).

[21] N.Y. Comp. Codes R. & Regs. tit. Dep't. of Tax. and Fin. § 132.18(a); New York Technical Service Bureau Memorandum No. TSB-M-06(5)I, 05/15/2006.

[22] New York Technical Service Bureau Memorandum No. TSB-M-06(5)I, 05/15/2006.

ployee's home office will be considered a "bona fide employer office" if certain factors exist, most of which are unlikely to apply to the majority of remote employees under ordinary circumstances.[23]

As a result, in the above example, the employer would still be required to withhold New York income tax for the remote employee now working from home in Texas. Failure to comply with New York's income tax withholding requirements exposes the employer to liability for the remote employee's personal income tax as well as potential penalties.[24] However, this example, and application of the convenience of the employer test, becomes significantly more complex as a result of COVID-19—particularly if New York is not permitting the business to open. The New York State Department of Taxation and Finance just recently published an "FAQ" stating that a nonresident employee whose primary office is in New York, but is telecommuting as a result of COVID-19, must source such days to New York unless the employer established a bona fide office in the employee's telecommuting location.[25] Despite this guidance, there is a strong argument that the employee is not working from home out of "convenience" as there is no option to work at the office (i.e., the employee *must* be working from home out of necessity if they are to work). Accordingly, the employer is now forced to make a choice as to where to withhold personal income tax, and the employee could feasibly be taxed twice on the same income (e.g., if the state where the employee is telecommuting sources the income based on place of performance or interprets the convenience of employer test differently than New York).[26]

We note that this example only addresses a single state with aggressive withholding requirements and another state without an income tax. Many situations involve employees working between two states with income taxes. Additionally, many states have very different withholding requirements. In some states, the rules are robust, but in many states employers are required to interpret potentially grey areas of law to determine the correct amount of payroll tax withholding without specific guidance for the scenarios the employer is facing. Significantly more complicated situations could arise where both states impose conflicting withholding requirements.

States with COVID-19 income tax guidance. Presently, a number of states have issued guidance stating that personal income tax withholding will not be required for workers that are temporarily in the state due to the COVID-19 pandemic.[27] Although this is a step in the right direction, there has not been much uniformity in the guidance issued by the states as to when the "temporary presence" withholding exception applies. For example, the withholding exceptions in some states (e.g., Georgia, California, and others) apply only to the extent there is a stay-at-home order in effect in the state where the employee is physically residing. If the employee is living in a state with a stay-at-home order, but working in a state that is open, there is a question over how each state's guidance will comport with one another. The inverse creates similar complexities (i.e., the employee works in a state with a stay-at-home order, but lives in a state that is open). Because these stay-at-home orders are continually evolving, with orders being lifted in states as the states reopen, only to be put in place again (sometimes just in a locality) when a COVID-19 hotspot develops, it is difficult to track whether and for how long the relief applies.

This situation is further complicated because, in addition to personal income tax withholding, other payroll tax obligations exist, such as obligations for unemployment insurance contributions, state disability insurance, and other

[23] *Id.* at 3-5 (A remote employee's home office may be considered a bona fide employer office if it contains or is near a specialized facility of the employer, or at least four of six secondary factors are met *and* three other factors exist. Secondary factors include: (1) the home office is required or a condition of employment; (2) the employer has a bona fide business purpose for the employee's home office location; (3) the employee performs some of the core duties of his or her employment at the home office; (4) the employee meets or deals with clients, patients or customers on a regular and continuous basis at the home office; (5) the employer does not provide the employee with designated office space or other regular work accommodations at one of its regular places of business; and (6) employer reimbursement of expenses for the home office. The list of other factors includes items, such as: the employer maintains a separate home office telephone line; the home office is listed on business letterhead; the employee keeps inventory in the home office for wholesale or retail purposes; business records are stored at the home office; and advertising shows the home office as a place of business for the employer.). We note that COVID-19 could affect the analysis of whether a bona fide employer office exists (e.g., working from home is now required, employer now has a business purpose for employee's home office, the employee is no longer provided with designated office space, etc.).

[24] N.Y. Tax Law § 676.

[25] https://www.tax.ny.gov/pit/file/nonresident-faqs.htm.

[26] See e.g., *Zelinsky v. Tax App. Trib.*, 1 N.Y.3d 85 (N.Y., 2003), *cert. denied* 541 U.S. 1009 (2004).

[27] See *AICPA Recommendations for Administrative, Filing and Payment Relief for State and Local Taxes during the Coronavirus Pandemic,* American Institute of CPAs (Updated as of Sept. 22, 2020) (https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/coronavirus-aicpa-list-of-recommendations-for-state-societies.pdf).

taxes.[28] In many jurisdictions that provided temporary COVID-19 relief for income tax withholding, the jurisdiction was silent for the remaining payroll tax obligations. This reason for this is that state unemployment insurance obligations often use a different test for determining whether a worker should be covered than is used for determining whether income tax withholding applies. The test for determining where a worker's wages should be allocated for state unemployment tax purposes depends on where the employee's services are "localized." Other factors may be considered, especially for an employee that is mobile, including the location that serves as the employee's base of operations. In close cases, the determining factor can be the location from which the employee is directed and controlled or the location of the employee's residence. The issue of direction and control can be directly affected by COVID-19—e.g., if a state reopens, but an employer voluntarily decides to keep its office closed.

Conclusion

Though COVID-19 forced many employers to deal with the realities of remote workers, in the long run this appears to be a catalyst towards a greater remote national workforce. As employers grapple with these realities, they must consider the impact remote workers will have on state and local tax filing, compliance, and outlays and ensure a proper program is in place to avoid overwhelming internal departments and reducing negative tax impacts. Due to the fiscal impact of COVID-19, states will likely enforce existing tax laws aggressively, which should prompt employers to assess their current tax liabilities and concerns due to remote employees, while preparing adequately for future remote employees. ■

[28] *Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax*, New York State Department of Taxation and Finance, NYS-50 (8/19) (https://www.tax.ny.gov/pdf/publications/withholding/nys50.pdf); *2020 California Employer's Guide*, State of California Employment Development Department, DE 44 Rev. 46 (1-20) (https://www.edd.ca.gov/pdf_pub_ctr/DE44.pdf).

IAA COVID-19 Relief Resource Chart

Updated January 5, 2021

This chart will be updated frequently. We will inform members of developments related to the coronavirus pandemic through IAA Member Alerts and Coronavirus Updates on our online newsletter IAA Today. This Chart is focused on issues of interest for SEC-registered investment advisers and does not reflect the entirety of each SEC order or relief.

This chart is not intended to be a comprehensive treatment of each issue an adviser must consider in response to regulatory requirements and is not a substitute for legal advice. The IAA undertakes no responsibility to update this chart.

- Government / Health Agencies
- SEC & Other Regulators
- Law Firms / Legal Resources
- Coronavirus Updates / *IAA Today*
- Coronavirus Response Resources

Filing/Report	Date	Order Name and Link	Relief/Time	Conditions/Guidance	Notes
SEC					
Filing Form ADV (Rule 204-1) Delivery of brochure, summary of material changes, or brochure supplement (Rule 204-3(b)(2) and (b)(4)) Filing Form PF (Rule	3/25/20	Release No. IA-5469 Order Under Section 206A of the Investment Advisers Act of 1940 Granting Exemptions from Specified Provisions of the Investment Advisers Act and Certain Rules Thereunder See also: SEC Update on COVID-19 Relief (updated	**45 day** extension Covered March 13 - June 30, 2020 *This relief was not extended*	Adviser must: (a)Be unable to meet a filing deadline or delivery requirement due to COVID-19. (b) **Form ADV:** (i) promptly notify SEC staff via email at IARDLive@sec.gov and (ii)disclose on its public website (or if it does not have a public website, promptly notify clients and/or private fund investors) that it is relying on this Order.	Superseded March 13 Order IA-5463 Extended the period covered from due dates through April 30, 2020 to due dates through **June 30, 2020** No longer required a brief explanation for why adviser is relying on the relief No longer required an estimated

204(b)-1)		1/5/21)		(c) **Form PF:** promptly notify SEC staff via email at FormPF@sec.gov that it is relying on this Order. (d) File or deliver as soon as practicable, but not later than **45 days** after the original due date	filing/delivery date
Delivery of brochure, summary of material changes, or brochure supplement by participating advisers in certain wrap fee programs where the sponsor is unable to meet its contractual commitment to deliver the brochure due to COVID-19	4/27/20	Staff FAQs (reliance on SEC Order Release No. IA-5469) Division of Investment Management Coronavirus (COVID-19) Response FAQs See also: SEC Update on COVID-19 Relief	**45 day** extension Covered March 13 - June 30, 2020 *This relief was not extended*	Participating adviser in wrap program must: • Be unable to meet a filing deadline or brochure delivery requirement due to COVID-19. • **Form ADV**: (i) disclose on its public website (or if it does not have a public website, promptly notify clients) that it is relying on this Order [for brochure delivery]; and (ii) promptly notify the SEC staff via email at IARDLive@sec.gov that the participating adviser is relying on the Order *The notification to the SEC may be done by the sponsor on behalf of the participating adviser if the sponsor represents that it has authority to submit the email on behalf of the participating adviser. • Deliver as soon as practicable, but not later than **45 days** after the original due date (*i.e.*, June 13 for 12/31 FYE filers)	Staff states sponsor should consider posting on its website that the participating adviser is relying on the Order
Disclosure of Paycheck Protection Loan in Form ADV Brochure	4/27/20	Division of Investment Management Coronavirus (COVID-19) Response FAQs - SEC FAQ II.4	N/A	The staff stated that, as a fiduciary under federal law, an adviser must make full and fair disclosure to clients of all material facts relating to the advisory relationship. If the circumstances leading a firm to seek a PPP loan or other type of financial assistance constitute material facts relating to the	See changes to PPP in H.R.133 - Consolidated Appropriations Act, 2021 (12/27/20); See also: Small Business Administration (SBA) PPP Webpage; SBA/Treasury Department FAQs on PPP loan eligibility and other guidance,

				advisory relationship with clients, it is the staff's view that the firm should provide disclosure of, for example, the nature, amounts and effects of such assistance. If, for instance, the adviser requires such assistance to pay the salaries of its employees who are primarily responsible for performing advisory functions for clients, it is the staff's view that the adviser would need to disclose this fact. In addition, if the firm is experiencing conditions that are reasonably likely to impair its ability to meet contractual commitments to its clients, the adviser may be required to disclose this financial condition in response to Item 18 (Financial Information) of Part 2A of Form ADV (brochure), or as part of Part 2A, Appendix 1 of Form ADV (wrap fee program brochure).	including but not limited to: • SBA guidance on a borrower's good faith "necessity certification" that it must take into account its current business activity and ability to access other sources of liquidity sufficient to support its ongoing operations in a manner that is not significantly detrimental to the business; • For a borrower that received PPP loans with an original principal amount of less than $2 million (together with its affiliates): New SBA guidance announced in FAQ 46 on May 13, 2020 that such a borrower will be deemed to have made the required certification concerning the necessity of the loan request in good faith. • SBA has determined that this safe harbor is appropriate because borrowers with loans below this threshold are generally less likely to have had access to adequate sources of liquidity in the current economic environment than borrowers that obtained larger loans. This safe harbor will also promote economic certainty as PPP

					borrowers with more limited resources endeavor to retain and rehire employees. In addition, given the large volume of PPP loans, this approach will enable SBA to conserve its finite audit resources and focus its reviews on larger loans, where the compliance effort may yield higher returns; and • For a borrower that received PPP loans with an original principal amount of more than $2 million (together with its affiliates): SBA guidance announced in FAQ 46 on May 13, 2020 that SBA will review borrower's access to other sources of liquidity under guidance in FAQs 31 and 37. However, if SBA determines the certification was improperly made, and the loan proceeds are then repaid, SBA will not pursue enforcement or referrals to other agencies based on the certification.
No-Action Relief for Item 1.F of Form ADV Part 1A (reporting principal office and place of business) and Section 1.F of Schedule D (reporting each	3/16/20	Staff Responses to Questions about IARD and Form ADV	No-action position for reporting temporary teleworking addresses of its employees operating under BCP plan due to COVID-19	An adviser's employees are temporarily conducting investment advisory business from a temporary location other than their usual place of business (*e.g.*, their homes) as part of the adviser's business continuity plan due to circumstances related to COVID-19	

office, other than your principal office and place of business, at which you conduct investment advisory business)					
Custody Rule (206(4)-2) - Surprise Exam	3/30/20	Staff Responses to Questions About the Custody Rule - Question IV.7	No-action position related to failure of independent public accountant to complete its surprise exam and submit Form ADV-E to file its certificate of accounting within 120 days after the date chosen by the independent public accountant **45 day** extension	a. Adviser must have reasonably believed that its independent public accountant would complete its surprise examination under the custody rule and submit Form ADV-E to file its certificate of accounting within 120 days after the date chosen by the independent public accountant, but failed to do so due to logistical disruptions related to COVID-19; and b. The independent public accountant files the report: (i) as soon as practicable; and (ii) not later than 45 days after the original due date.	
Custody Rule (206(4)-2) - Audited Financial Statements for Pooled Vehicles	4/27/20	Staff Responses to Questions About the Custody Rule - Question VI.9	No-action position if an adviser relying on Rule 206(4)-2(b)(4) failed to have the pooled vehicle's audited financial statements distributed in time under certain **unforeseeable circumstances**	a. Adviser reasonably believed that the pooled vehicle's audited financial statements would be distributed within 120 days (or 180 days in the case of a fund of funds or a pool investing in a fund of funds) (or 260 days in the case of a "top tier" pooled investment vehicle investing in one or more funds of funds) after the end of its fiscal year; and b. "Failed to have them distributed in time under certain unforeseeable circumstances".	The staff indicated that this FAQ is responsive to concerns about delays in obtaining audited financial statements under the COVID-19 circumstances
Custody Rule (206(4)-2) - Definition of Custody	3/16/20	Staff Responses to Questions About the Custody Rule - Question II.1	The staff would not consider the adviser to have received client assets at its office location until	Where an adviser's personnel may be unable to access mail or deliveries at an office location due to the firm's business continuity plan put	

			firm personnel are able to **access** the mail or deliveries at the office location	in place in response to COVID-19, the staff would not consider the adviser to have received client assets at its office location until firm personnel are able to access the mail or deliveries at the office location	
Custody Rule (206(4)-2) - Condition to be held by a Qualified Custodian	4/2/20	Staff Responses to Questions About the Custody Rule - Question VII.4	No-action position related to an adviser not maintaining physical certificates with a qualified custodian	An adviser is not able to place physical certificates with a qualified custodian due to business disruptions related to COVID-19 affecting the vaulting of physical certificates, and these conditions are met: a. The physical certificates can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer; b. Ownership of the security is recorded on the books of the issuer or its transfer agent (or person performing similar functions) in the name of the client; c. The physical certificates contain a legend restricting transfer; d. The physical certificates are appropriately safeguarded by the adviser and can be replaced upon loss or destruction; and e. The adviser makes and keeps (in accordance with the terms of Advisers Act Rule 204-2) a record of the custodian's closure.	
EDGAR Filings - Signatures	11/17/20	Electronic Signatures in Regulation S-T Rule 302	Rule amendments permit the use of e-signatures when executing authentication documents in connection with EDGAR filings.	EDGAR Filer Manual includes full requirements including that the process must provide for:	

				- Signatory to present a physical, logical, or digital credential that authenticates the signatory's individual identity; - Non-repudiation of the signature; and - Signature to be attached, affixed, or otherwise logically associated with the signature page or document being signed; and - A timestamp to record the date and time of the signature.	
Form ID notarization requirement	3/26/20	Release No. 33-10768 Relief for Form ID Filers and Regulation Crowdfunding and Regulation A Issuers Related to Coronavirus Disease 2019 (COVID-19)	Covered March 26 -July 1, 2020 Provides relief from notarization requirement SEC will issue codes necessary to file on EDGAR *After July 1, 2020, the EDGAR Business Office will work with filers to continue to accept electronic and remote online notarizations*	(a) Filer may upload the manually signed PDF copy of the attachment to the Form ID filing without the notarization provided that it indicates on the face of the signed document that it could not provide the required notarization due to circumstances relating to COVID-19. (b) The required notarized document must be submitted as correspondence via EDGAR **within 90 days of EDGAR codes issuance**. If it is not, the Commission staff is authorized to inactivate the filer's EDGAR codes.	
Form 13F (Exchange Act Rule 13f-1) Schedule 13G (Exchange Act Rule 13d-1) Proxy statements, annual reports, and other soliciting materials (Exchange Act Rules 14a-101, Rule 14f-1))	3/25/20	Release No. 34-88465 Order Under Section 36 of the Securities Exchange Act of 1934 Modifying Exemptions from the Reporting and Proxy Delivery Requirements for Public Companies See also: SEC Update on COVID-19 Relief	**45-day** extension Covered March 1 - July 1, 2020 *The Form 13F and Schedule 13G relief was not extended* *The proxy material delivery relief remains available*	**Form 13F and Schedule 13G:** Filer must: (a) Be unable to meet a filing deadline due to COVID-19. (b) File within **45 days** of the original due date; and (c) Adviser must disclose on its Form 13F or Schedule 13G that it is relying on this Order and state the reasons why it could not timely file. **Proxy solicitation materials:** Exempt from requirement to furnish if: (a) security holder has a mailing address located in an area where the customary delivery service has been suspended due to COVID-19; and	Supersedes March 4 Order 34-88318 Extends the period covered from March 1 - April 30 to March 1 - **July 1** Does not apply to Schedule 13D or amendments to Schedule 13D Does not apply to Form 13H For questions regarding Form 13F confidential treatment requests for the quarter ended March 31, including whether requests can be submitted electronically, email IM-EmergencyRelief@sec.gov

				(b) made a good faith effort to furnish the materials.	
Annual shareholder meetings Proxy materials		Staff Guidance for Conducting Shareholder Meetings in Light of COVID-19 Concerns See also: SEC Update on COVID-19 Relief	In circumstances where delays in printing and mailing full sets of proxy materials and challenges in complying with the proxy notice and access rule (Rule 14a-16) are unavoidable due to COVID-19 related difficulties, an issuer may use the notice-only delivery and not meet all aspects of the Rule's notice and timing requirements	The issuer provides shareholders with proxy materials sufficiently in advance of the meeting to review these materials and exercise their voting rights under state law.	Guidance on changes in date, time, and location of a shareholder meeting apply to annual and special meetings Similar guidance applies to a meeting held by an investment company in connection with a business combination or other transactions registered on Form N-14
Form N-CEN Form N-PORT	3/25/20	Release No. IC-33824 Order Under Section 6(c) and Section 38(a) of the Investment Company Act of 1940 Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder; Commission Statement Regarding Prospectus Delivery See also: SEC Update on COVID-19 Relief	**45-day** extension Covered March 13 - June 30, 2020 *This relief was not extended*	Adviser must: (a) Be unable to meet a filing deadline due to COVID-19; (b) Promptly notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this Order; (c) Include a statement on public website briefly stating that it is relying on this Order; (d) File within 45 days of the original due date; and (e) Include a statement in the form that the filer relied on this Order and the reasons why it was unable to timely file.	Superseded March 13 Order IC-33817 Extended the period covered from March 13 - April 30 to March 13 - **June 30, 2020** No longer required a brief description in the notice or on the website of the reasons why it is unable to timely file (but reasons are required to be explained in the form) No longer required an estimated filing date
Investment Company Annual and semi-annual reports	3/25/20	Release No. IC-33824 See also: SEC Update on COVID-19 Relief	**45-day** extension to transmit report to shareholders (Must file the report within **10 days** of transmission to shareholders) Covered March 13 - June 30, 2020	Adviser must: (a) Be unable to prepare or transmit the report due to COVID-19; (b) Promptly notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this Order; (c) Include a statement on public website stating that it is relying on this Order; and	Extended the period covered from March 13 - April 30 to March 13 - **June 30, 2020** No longer required a brief description in the notice or on the website of the reasons why it is unable to timely file No longer required an estimated

			This relief was not extended	(d) Transmit the reports to shareholders within **45 days** of the original due date and files the report within **10 days** of transmission to shareholders.	filing date
Form N-23C-2	3/25/20	Release No. IC-33824 See also: SEC Update on COVID-19 Relief	Could file a Notice of intention to call or redeem securities fewer than 30 days in advance Covered March 13 - August 15, 2020 *This relief was not extended*	Adviser must: (a) Promptly notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this Order; (b) Ensure that filing the Notice on an abbreviated time frame is permitted under state law and governing documents; and (c) File a Notice under Rule 23c-2 prior to: (i) Any call or redemption of existing securities; (ii) The commencement of any offering of replacement securities; and (iii) Providing notification to the existing shareholders whose securities are being called or redeemed.	Extended the period covered from March 13 - June 15 to March 13 - **August 15, 2020** No longer required a brief description in its email to SEC staff of the reasons why it needs to file a Notice of intention to call or redeem securities fewer than 30 days in advance
In-person Investment Company Board meetings	6/19/20	Release No. IC-33897 See also: SEC Update on COVID-19 Relief	Exempt from holding in-person Board meetings Began March 13, 2020 The period covered was extended through no earlier than **December 31, 2020** *The SEC will issue a public notice giving at least two weeks' notice before terminating the relief.*	(a) Necessary or appropriate due to COVID-19; (b) Votes are cast at a meeting in which all participating directors can hear each other simultaneously during the meeting; and (c) The Board, including a majority of the independent directors, ratifies the action at the next in-person meeting.	Superseded March 25 Order, Release No. IC-33824, with respect to the In-person Board Relief Only
Fund Prospectus delivery		Release No. IC-33824 See also: SEC Update on COVID-19 Relief	No-action relief if a registered fund does not deliver current prospectus to investors **45-day** extension	(a) Prospectus is not able to be timely delivered because of COVID-19; (b) The sale of shares to the investor was not an initial purchase by the investor of the fund's shares;	No longer required a brief description in its email to SEC staff or on the website of the reasons why it or another person could not timely deliver the prospectus

			Covered March 13 – June 30, 2020 *This relief was not extended*	(c) Notify SEC staff via email at IM-EmergencyRelief@sec.gov stating that it is relying on this SEC position; (d) Publish on public website that it intends to rely on the SEC position; (e) Publish current prospectus on fund's public website; and (f) Deliver prospectus within **45 days** of the original date required.	No longer required an estimated delivery date
International mailing	6/24/20	Staff Statement Regarding Temporary International Mail Service Suspensions to Certain Jurisdictions Related to the COVID-19 Pandemic See also: SEC Update on COVID-19 Relief	The relief will expire when the respective jurisdiction resumes mail delivery	(a) Notify SEC staff via email at IM-EmergencyRelief@sec.gov (for IM) or tradingandmarkets@sec.gov (for T&M); (b) Prominently publish the notice on its website; (c) Use "reasonable best efforts" to deliver the documents electronically; (d) Maintain records of complying with these steps; and (e) Monitor the postal service websites regularly for updates and mails the document within seven days of service resuming if it was unable to deliver the mailing electronically or the client requests a paper copy.	Mailings covered by this relief include: • Annual and semi-annual reports to shareholders • Prospectuses and prospectus supplements • Form ADV brochures (or summary of material changes) and brochure supplements • Form CRS • Reg Best Interest written disclosures • Written confirmations and alternative periodic reporting Written statements with respect to free credit balances
Short-term funding (borrowing and lending) for open-end funds and insurance company separate accounts	3/23/20	Release No. IC-33821 Order Under Sections 6(c), 12(d)(1)(J), 17(b), 17(d) and 38(a) of the Investment Company Act of 1940 and Rule 17d-1 Thereunder Granting Exemptions from	Began March 23, 2020 (*the SEC will issue a public notice giving at least two weeks' notice before expiry)* Four sets of exemptions: **Borrowing from Affiliated**	The fund must e-mail SEC staff at IM-EmergencyRelief@sec.gov prior to relying on the relief stating that it is relying on the order. **Borrowing from Affiliated Persons:** The fund's board must make certain findings, included that the borrowing will be used to	Covers March 23, 2020 to at least **June 30, 2020** (a future SEC notice will specify the termination date)

		Specified Provisions of the Investment Company Act and Certain Rules Thereunder See also: SEC Update on COVID-19 Relief	**Persons:** Can borrow money from certain affiliates, other than RICs, and can make collateralized loans to funds and separate accounts.	satisfy shareholder redemptions.	
			Interfund Lending for Funds with Existing Interfund Lending Orders: A fund that has an order that permits an interfund lending and borrowing facility (**IFL**) is permitted to: • Make loans through the IFL in an aggregate amount that does not exceed 25% of its current net assets, even if there is a lower limit in the fund's IFL order; • Borrow (if permitted under the IFL order) or make loans through the IFL for any term notwithstanding conditions in the IFL order that limit the terms of loans, provided that certain requirements are satisfied; and • Rely on relief related to fundamental investment policies.	**Interfund Lending for Funds with Existing Interfund Lending Orders:** (a) Any loan is otherwise made in accordance with the terms and conditions of the existing IFL order; and (b) Prior to relying on the relief, the fund must disclose on its public website that it is relying on an SEC exemptive order that modifies the terms of the existing IFL order to permit additional flexibility to or provide or obtain short-term funding from its IFL.	
			Interfund Lending Arrangements for Funds without Existing Interfund Lending Orders: May establish and participate in an IFL as described in any IFL order issued by the SEC order	**Interfund Lending Arrangements for Funds without Existing Interfund Lending Orders:** (a) Satisfies the terms and conditions of the recent IFL order, except for certain requirements; and (b) Prior to relying on the relief, the fund must	

			within the past 12 months	disclose on its public website that it is relying on the order to use an IFL. If the fund makes certain filings, it must update its disclosure regarding its participation in the IFL.	
			Ability to Deviate from a Fundamental Policy: A fund is permitted to enter into a lending or borrowing transaction that deviates from a fundamental policy without obtaining shareholder approval	**Ability to Deviate from a Fundamental Policy:** (a) Fund board reasonably determines that the lending or borrowing is in the best interest of the fund and its shareholders; and (b) Fund files a prospectus supplement and includes a statement on its public website.	
No-Action Relief for Money Market Funds	3/19/20	Investment Company Institute See also: SEC Update on COVID-19 Relief	In effect until notice provided by SEC staff Permits affiliated person of a money market fund that is subject to certain bank regulations to purchase securities from the fund	(a) The purchase price of the purchased security would be its fair market value as determined by a reliable third-party pricing service; (b) The purchases satisfy the conditions of Rule 17a-9 under the Act except to the extent that the terms of such purchases would otherwise conflict with (i) applicable banking regulations or (ii) the exemption issued by the Board of Governors of the Federal Reserve System on March 17, 2020, defining "covered transaction" for purposes of section 23A of the Federal Reserve Act to not include the purchase of assets from an affiliated money market fund; and (c) The Fund timely files Form N-CR reporting such transaction under Part C and reports in Part H that the purchase was conducted in reliance on this letter.	
No-Action Relief for Purchases of Debt Securities by Affiliated Persons	3/26/20	Investment Company Institute See also: SEC Update on COVID-19 Relief	In effect until notice provided by SEC staff Permits affiliated persons that are not registered investment companies to purchase debt securities from a fund	(a) The purchase price is paid in cash; (b) The price of the purchased debt security is its fair market value under Section 2(a)(41) of the Investment Company Act, provided that this price is not materially different from the fair market value of the security indicated by a reliable third-party pricing service;	

				(c) In the event that the purchaser sells the purchased security for a higher price than the purchase price paid to the fund, the purchaser shall promptly pay to the fund the amount by which the subsequent sale price exceeds the purchase price paid to the fund. If the purchaser is subject to Sections 23A and 23B of the Federal Reserve Act, this condition does not apply to the extent that it would otherwise conflict with (i) applicable banking regulations or (ii) any applicable exemption from such regulations issued by the Board of Governors of the Federal Reserve System; and (d) Within one business day of the purchase of the security, the fund publicly posts on its website and informs the Staff via email to IM-EmergencyRelief@sec.gov stating the name of the fund, the name of the purchaser, the security(s) purchased (including a legal identifier if available), the amount purchased, and the total price paid.	
CFTC					
Form CPO-PQR Annual Pool Reports to Pool Participants Pool Periodic Account Statements	3/20/20	CFTC Letter No. 20-11 No-Action Positions for Commodity Pool Operators in Response to the COVID-19 Pandemic	Extended deadline for small and mid-sized CPOs to file an annual report on Form CPO-PQR to May 15, 2020 Extends deadline for large CPOs to file a quarterly report on Form CPO-PQR for Q1 2020 to July 15, 2020 45-day extension to file annual audited pool financial statements and distribute them to investors (April 30, 2020 deadline extended to June 14, 2020) 45-day extension to distribute periodic account statements to pool participants on either a		Pool Annual Reports relief did not foreclose a CPO from requesting an additional hardship extension of up to 180 days from the end of the pool's fiscal year-end under CFTC regulation 4.22(f) CFTC expects firms to establish and maintain a supervisory system that is reasonably designed to supervise the activities of personnel while acting from an alternative or remote location during the COVID-19 pandemic (citing NFA's NTM on branch offices)

			monthly or quarterly basis Covered reporting periods ending on or before April 30, 2020		
Fingerprinting	4/24/20 (updated 9/29/20)	Email Alert from DSIO Director on 9/29/20 No-Action Position in Response to the COVID-19 Pandemic for Persons Required to Submit Fingerprints in Connection with Applying for Registration as an Associated Person or Being Listed as a Principal of a Registrant Time Extension for No-Action Position in Response to the COVID-19 Pandemic for Persons Required to Submit Fingerprints in Connection with Applying for Registration as an Associated Person or Being Listed as a Principal of a Registrant	***This temporary relief expired as of 9/30/20:*** Prior No-action relief issued on 4/24/20 and extended 7/14/20 for registrants and applicants for registration listing a principal, and for applicants for associated person (AP) registration, from the fingerprinting requirements in CFTC Regulations 3.10(a)(2) (for natural person principals) and 3.12(c)(3) (for APs)	(a) Conduct a criminal history background check that would reveal all matters listed under Sections 8a(2)(D) or 8a(3)(D), (E), or (H) of the Commodity Exchange Act (CEA); (b) Submit a certification to the NFA that it completed the background check and that it did not disclose any matters that constitute a disqualification under Sections 8a(2) or 8a(3) of the CEA; (c) Maintain records documenting the completion and results of the background check, in accordance with CFTC Regulation 1.31; and (d) Submit the required fingerprints to the NFA within **30 days** of the NFA announcing the resumption of fingerprint processing.	Regulation 3.10(a)(2) requires each applicant for registration as a CPO or CTA to accompany its registration application with a Form 8-R for each natural person listed as a principal of the applicant, along with the fingerprints of the natural person on a fingerprint card provided by the NFA Regulation 3.12(c)(3) requires each person applying for registration as an AP to accompany his or her Form 8-R with the applicant's fingerprints on a fingerprint card provided by the NFA Any person finding it impossible or inordinately difficult to obtain fingerprints should contact NFA's Information Center (1-800-621-3570 or 312-781-1410 or information@nfa.futures.org).
NFA					
Form PQR Form PR Annual Pool Reports to NFA Pool Periodic Account Statements	3/23/20	Notice I-20-15 Coronavirus (COVID-19) Update—Regulatory Relief for CPOs and CTAs	Extended due date for the Q4 PQR filing from March 30, 2020 to May 15, 2020 Extended due date for the Q1 PQR filing (for small, mid, and large-sized CPOs) from May 30, 2020 to July 15, 2020 Extended due date for the Q1 CTA-PR filing from May 15, 2020 to June 30, 2020		Large CPOs had already filed their Q4 2020 PQR filing This filing relief was automatic. CPOs were able to seek extensions up to 180 days from fiscal year-end for Pool Annual Reports CPOs that were in compliance with the CFTC's no-action relief were deemed to be in compliance with NFA Rule 2-13 if the reports were filed with the NFA and distributed

			45-day extension to file Pool Annual Reports with the NFA and distribute them to pool participants Extended the time period to distribute Pool Periodic Account Statements to 45 days after the end of the reporting period		to pool participants, or if the statements were distributed to pool participants, by the date specified in the CFTC relief
Branch Offices	3/13/20	Notice I-20-12 Coronavirus Update—NFA Branch Office Requirements	The NFA will not pursue a disciplinary action against a member that permits its associated persons to temporarily work from locations not listed as a branch office and without a branch manager	(a) Implement alternative supervisory procedures to adequately supervise APs and meet member's recordkeeping requirements; (b) Document supervisory procedures; and (c) APs are expected to return to the member's main office or listed branch location once the firm is no longer operating under contingencies pursuant to its business continuity plan.	
Fingerprinting	4/27/20 (updated 10/6/20)	Notice I-20-37 October 6, 2020 Coronavirus Update—Expiration of Temporary Relief from Fingerprinting Requirements	***This temporary relief expired as of 9/30/20.*** Temporary relief from fingerprinting requirements for registrants and applicants for registration that satisfy the requirements of the CFTC's no-action letter (see Fingerprinting in CFTC section above)		NFA Registration Rules 204(a)(2)(A) and 206(a)(1)(A) impose fingerprinting requirements for natural person principals of registrants and applicants for registration and AP applicants Any person finding it impossible or inordinately difficult to obtain fingerprints should contact NFA's Information Center (1-800-621-3570 or 312-781-1410 or information@nfa.futures.org).
Bureau of Economic Analysis					
Form BE-10	4/20/20	Email confirmation from BEA's Chief, Foreign Operations Section	Could request an extension of the due date for Form BE-10 from May 29, 2020 (for U.S. reporters required to file fewer than 50 forms BE-10B, BE-10C, and/or BE-10D) and June 30,	Filer must request an extension in the BEA eFile System at www.bea.gov/efile. All extension requests should be considered approved unless you hear otherwise from BEA.	Form BE-10 is a benchmark survey of U.S. direct investment abroad for fiscal years ended in 2019. The BEA conducts this benchmark survey every five years

			2020 (for U.S. reporters required to file 50 or more of those forms) until August 31, 2020	See BEA's FAQs on the BE-10 survey at www.bea.gov/be10.	Required to be filed by any U.S. person that had a **foreign affiliate** at the end of fiscal year 2019 A U.S. person is deemed to have a foreign affiliate if the person has direct or indirect ownership or control of 10 percent or more of the voting stock of a foreign business enterprise

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE
EFFECTIVE STRATEGIES & BEST PRACTICES

GameStop, Reddit, What's Next? Oh My!

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EFFECTIVE STRATEGIES & BEST PRACTICES

Speakers

Linda Shirkey
Managing Director, Bates Compliance – Bates Group

Alex Russell
Managing Director, White Collar, Regulatory and Internal Investigations – Bates Group

Robert E. Burks Jr., CCO, Brown Capital Management

A. Valerie Mirko, Partner, Baker McKenzie LLP

Gamestop (GME) Timeline

- December 8th, 2020 – Earnings Reported
- January 11th, 2021 – Chewy to the Rescue!
- January 13th, 2021 – Start of the Surge
- January 15th, 2021 – Shorts are Covering…
- January 19th, 2021 – …But Not All Shorts
- January 22nd, 2021 – Long Investors Push Back
- January 25th, 2021 – Intraday Run Up
- January 26th, 2021 – Gamestonk!! And Significant Shorts Cover
- January 27th, 2021 – Stratospheric Rise
- January 28th, 2021 – Retail Trading Restrictions
- January 29th, 2021 – SEC Comments
- January 31st, 2021 – Movie Announced
- February 1st, 2021 – Decline Day
- February 2nd, 2021 – Decline Day II
- February 4th, 2021 – Yellen Comments
- February 18th, 2021 – Congressional Hearing

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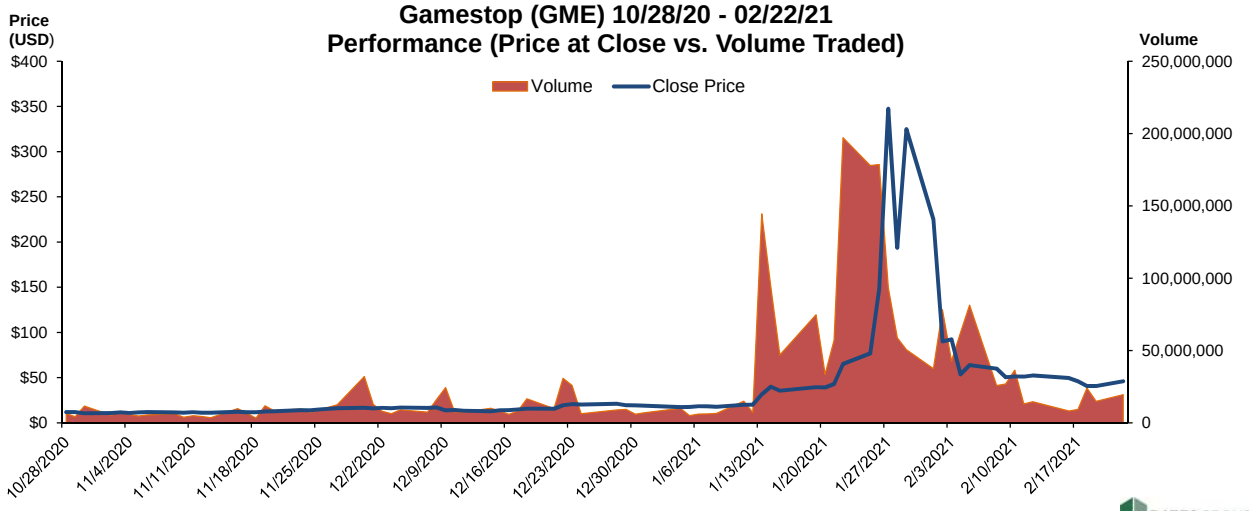

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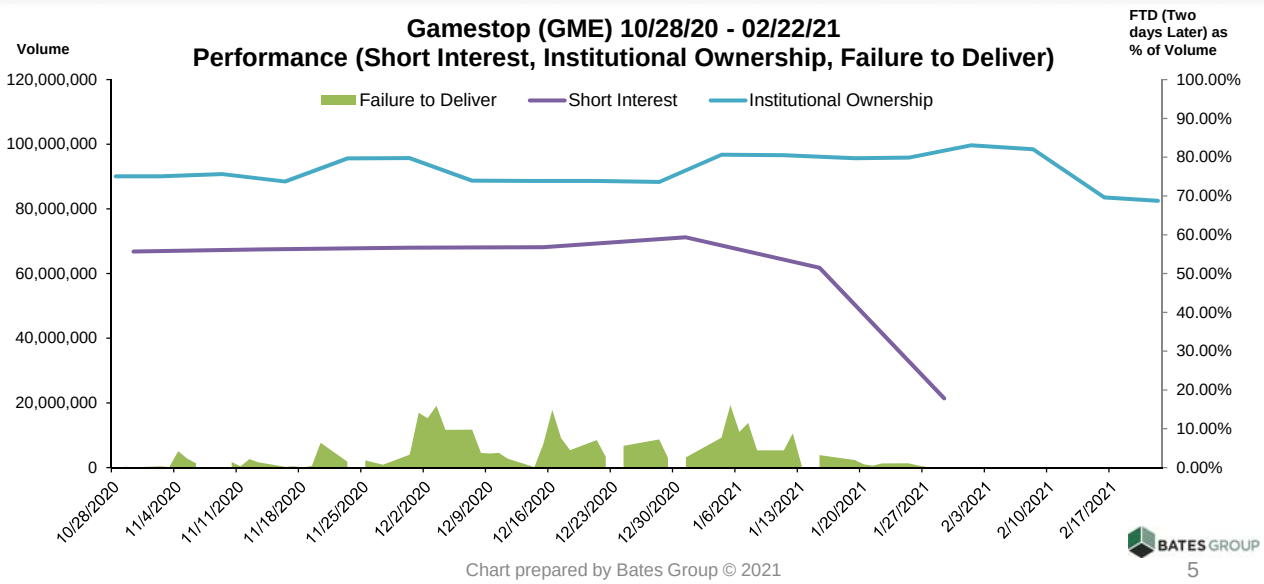
EFFECTIVE STRATEGIES & BEST PRACTICES



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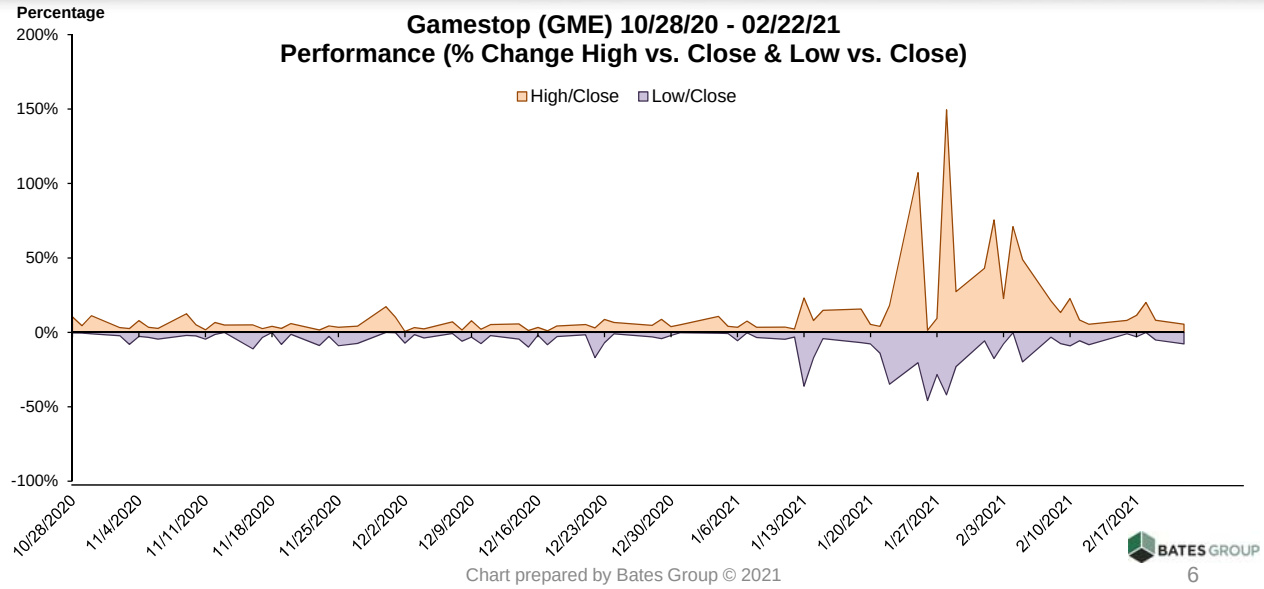
EFFECTIVE STRATEGIES & BEST PRACTICES



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IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Thank You

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EFFECTIVE STRATEGIES & BEST PRACTICES

Investment Advisory Firm Insights from Broadridge Fi360 Solutions

Broadridge®

CEFEX
CENTRE FOR FIDUCIARY EXCELLENCE

Today's Speaker & Topics

Agenda

I. About CEFEX® and Investment Advisory Firm Assessments

II. Insights, Observations and Trends from Assessments

III. How Broadridge Fi360 Solutions can help IAA members

Speaker

Michael Muirhead

Broadridge Fi360 Solutions and Investment Advisory Firm Assessments

Broadridge

Broadridge Fi360 Solutions

FIDUCIARY CARE FOR EVERY INVESTOR, MADE SIMPLE

Broadridge Fi360 Solutions empowers financial intermediaries to use the Prudent Practices® to profitably gather, grow and protect investors' assets with a fiduciary standard of care. Our training, certification, technology and analytics make implementing a prudent process for all clients easier at every step.

U.S. Legislation

ERISA:
Employee Retirement Income Security Act (qualified retirement plans)

UPIA:
Uniform Prudent Investor Act (private trusts, the default standard if nothing else "fits")

UPMIFA:
Uniform Prudent Management of Institutional Funds Act (foundations, endowments, and government sponsored charitable institutions)

MMPERSA:
Uniform Management of Public Employees Retirement Systems Act (state, county, and municipal retirement plans)

IAA:
The Investment Advisers Act of 1940

Global Fiduciary Precepts

01 Follow laws and governing documents

02 Diversify to manage risk and return

03 Prepare and follow an investment policy statement

04 Prudently select fiduciary and non-fiduciary service providers

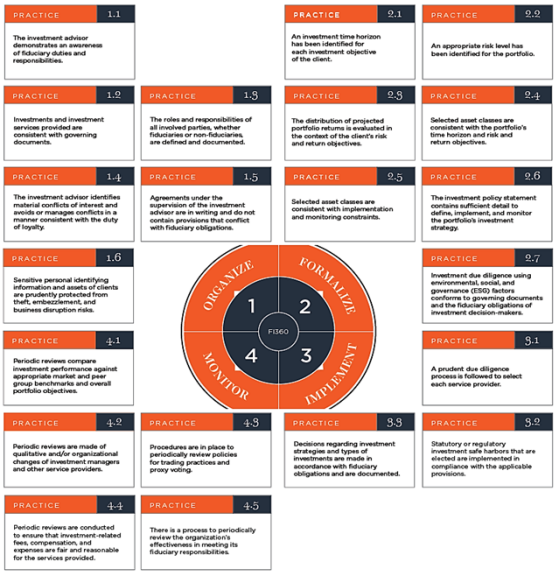
05 Control and account for costs

06 Avoid or manage conflicts of interest

07 Monitor service providers

08 Monitor and assure conformity to fiduciary obligations

Periodic Table of Fiduciary Practices



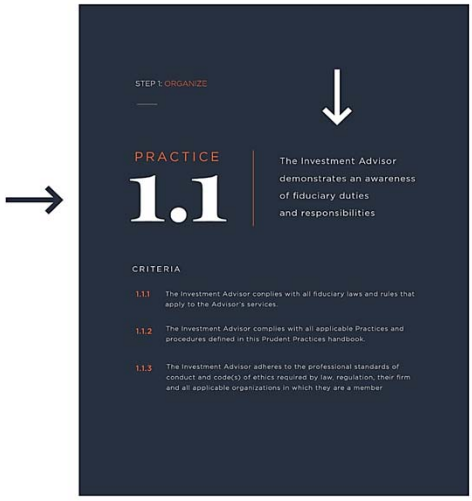
The Fiduciary Handbook Series

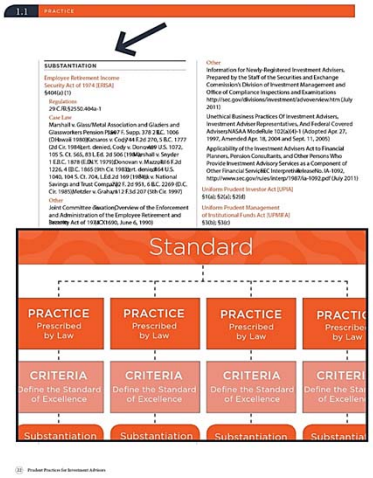
Investment Stewards
(U.S. Edition)

Investment Advisors
(U.S. Edition)

Investment Managers
(U.S. Edition)

Components of a Standard: Practices and Criteria





Fiduciary Assessment is a Key Responsibility

PRACTICE

4.5

There is a process to periodically review the organization's effectiveness in meeting its fiduciary responsibilities.

4.5.1 Fiduciary assessments are conducted at planned intervals to determine whether appropriate policies and procedures are in place to address all fiduciary obligations and that such policies and procedures are effectively implemented and maintained.

4.5.2 The investment policy statement is reviewed at least annually to ensure it is aligned with current facts and circumstances.

Insights, Observations and Trends from Assessments

Broadridge

Where Does The Data Come From?

CEFEX annually certifies Investment Advisors, Stewards, Managers, Service Providers and Investment Support Services firms for adherence to the fiduciary standard.

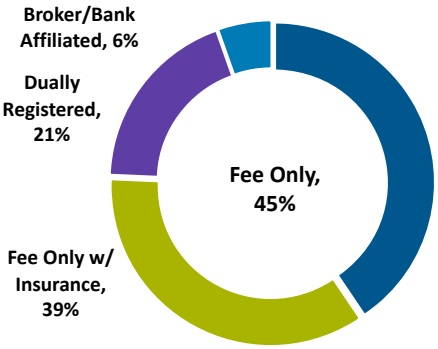
All work is competed by a CEFEX Analyst and reviewed by the CEFEX Registration Committee.

Data in this report comes from 141 firm assessments through February 2020.

Advisor Background Data

CEFEX® certified advisor firms come from a variety of business models; overall they have an average of 28 and median of 8 employees within the scope of the assessment.

Business Models Represented



CEFEX® Certified Firms Support Retirement & Non-Retirement Clients

CEFEX® Certified firms support over 22,000 retirement plans ($277B+ AUA) and 53,000 non-retirement accounts ($66B+).

Retirement Plan Clients

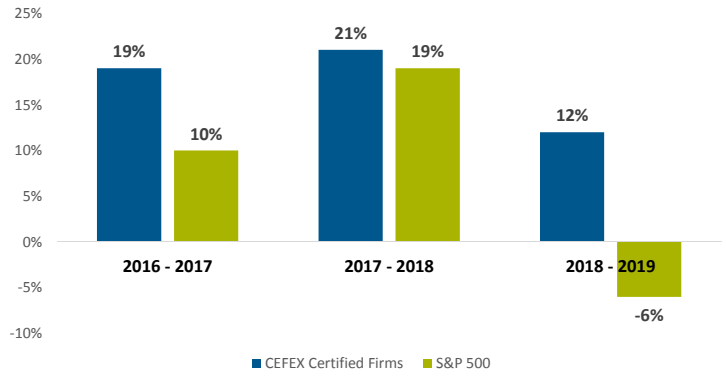
	# Plans	Total Assets	$ Per Plan
ERISA DB	527	$6.8b	$13m
ERISA DC	6,857	$180.0b	$26m
ERISA DC – FA	153	$3.8b	$25m
ERISA DB – 3(38)	12,223	$33.3b	$3m
Public DB	17	$1.5b	$90m
Public DC	137	$17.1b	$125m
Taft Hartley	20	$1.5b	$74m
403b/Church Exempt	695	$31.8b	$46m
Other	453	$1.5b	$3m
Total	**22,082**	**$277.3b**	**$13m**

Non-Retirement Accounts

	Clients	Total Assets	$ Per Account
Eleemosynary	1,104	$2.8b	$2.5m
Personal Trusts	4,333	$5.2b	$1.2m
High Net Worth	33,905	$43.8b	$1.3m
Other	13,888	$14.5b	$1.0m
Total	**53,230**	**$66.3b**	**$1.2m**

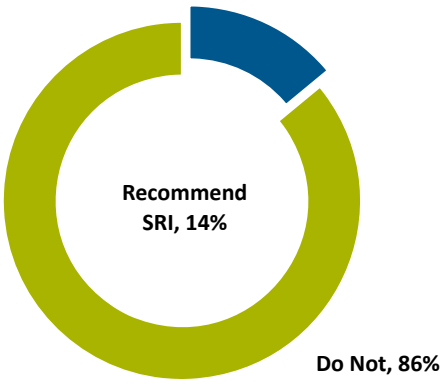
CEFEX® Certified Advisor Firm Growth Outpaces the S&P 500

From 2016 – 2019 CEFEX® certified advisor firms experienced 13% asset growth compared to 8% for the S&P 500.



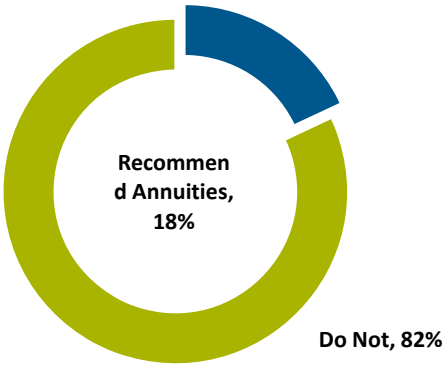
Implementation of Socially Responsible Investments

14% of firms recommend Socially Responsible Investment strategies (an increase from 10% previously).



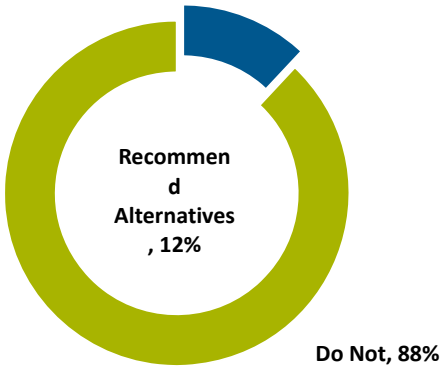
Investing in Annuities

18% of firms recommending investing in annuities or similar insurance products.



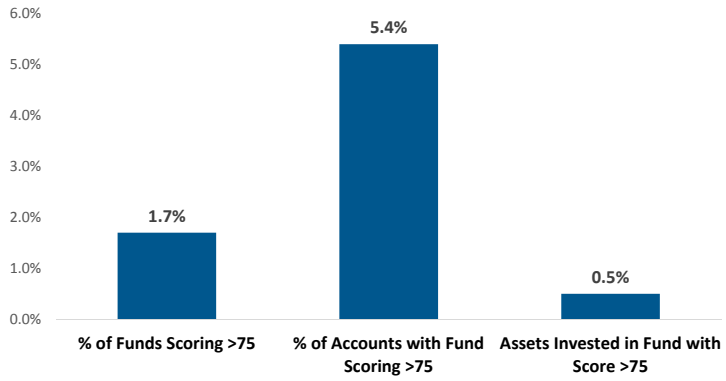
Investing in Alternative Investments

12% of firms make or recommend investments in alternative vehicles.



Poorly Performing Investments

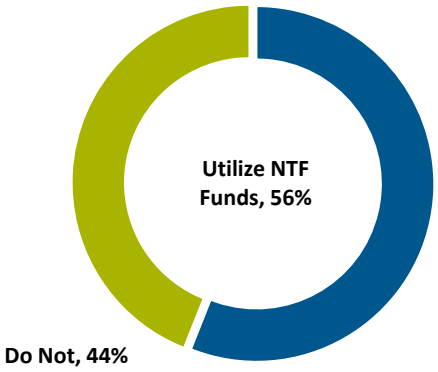
Few current investments receive a Fi360 Score® of 75 or higher.*



*A score of 75 or higher represents an investment in the 4th quartile of its peer group

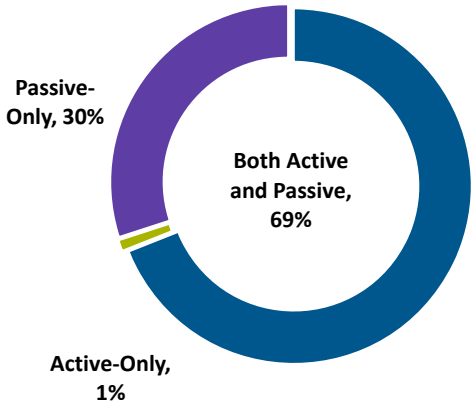
Use of No-Transaction Mutual Funds

56% of advisor firms utilize No-Transaction Fee (NTF) funds.



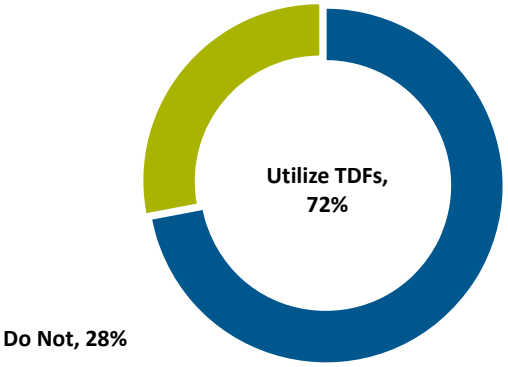
Active vs. Passive Philosophies

Most advisory firms use a mix of active and passive investment management strategies.



Target Date Fund Utilization

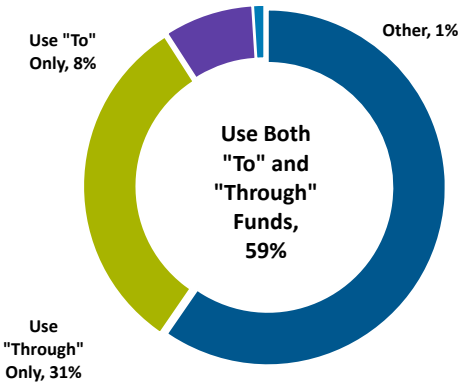
Nearly three-quarters of CEFEX® certified advisor firms use Target Date Funds (TDFs).



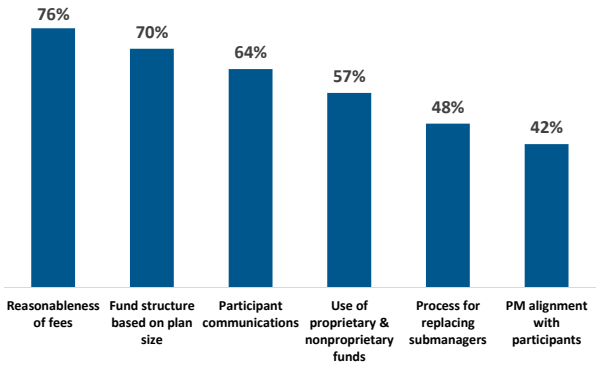
Target Date Fund Details

Firms look at multiple aspects of the Target Date Funds they recommend.

"To" versus "Through" Funds

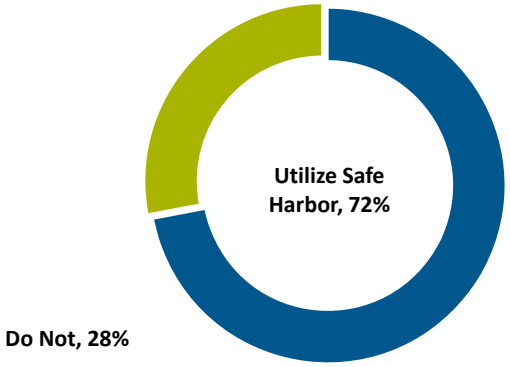


TDF Evaluation Criteria



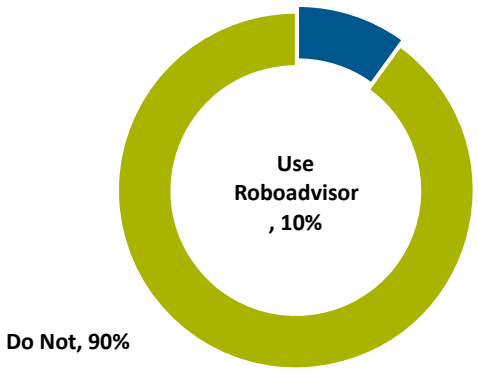
ERISA 3(38) Safe Harbor Protection

Nearly three-quarters of firms use safe harbor protections by relying on a 3(38) investment manager.



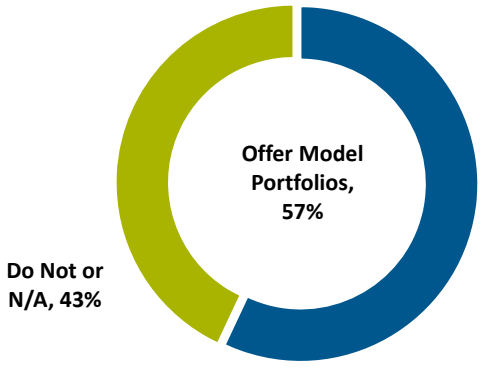
Digital Investment Advisory Program

Few certified advisor firms use a digital investment advisory program (i.e. “roboadvisor”).



Model Portfolio Services

Over half of CEFEX® certified advisor firms offer model portfolio services.



Voting Proxies

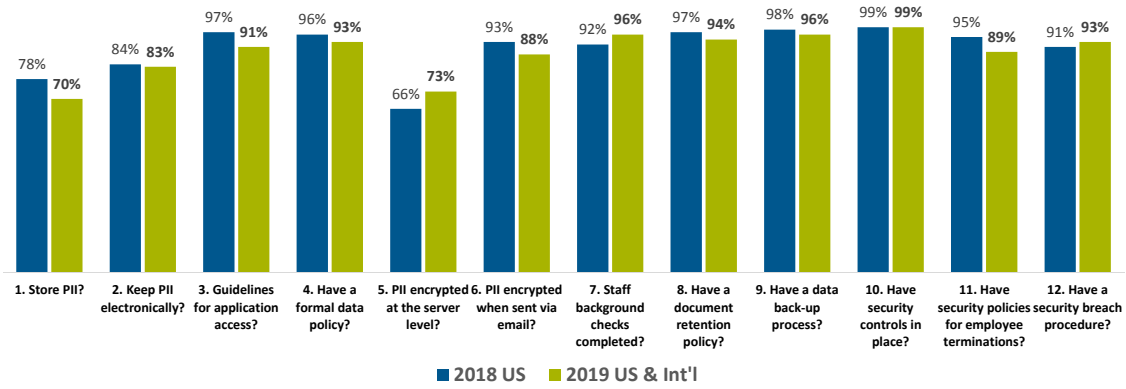
A formal policy should specify who votes proxies.

Criteria	Yes	No	N/A
Properly considered whether the authority to vote proxies pertaining to plan assets should be delegated to the investment manager.	89%	0%	11%
Delegation of authority to vote proxies documented in writing.	45%	1%	54%
Have a log for recording proxy voting.	19%	1%	80%

Data Security

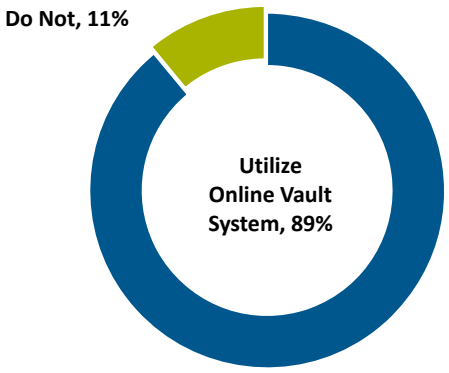
Data security policies and procedures continue to grow in importance for brokers, dealers, investment companies and investment advisors.

Prevalence of Security Measures



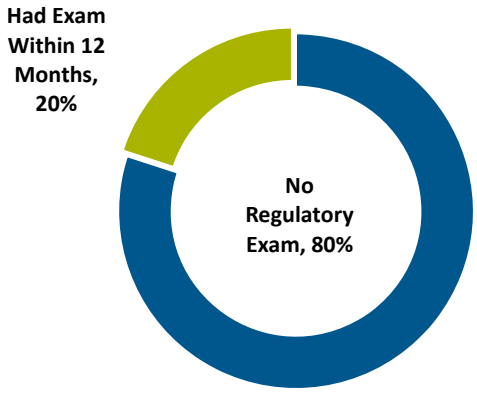
Use of Online Client Vaults

The majority of advisors utilize an online client vault for storing and accessing client documents.



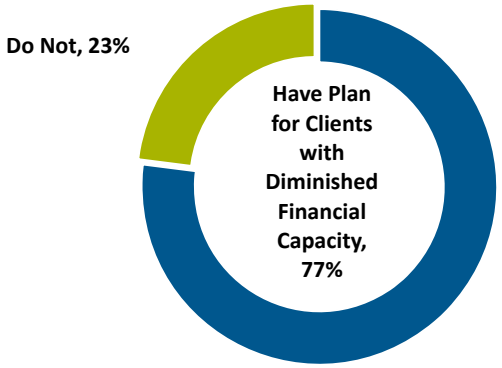
Regulatory Examinations

One-fifth of clients have been subject to a regulatory examination (SEC or State) in the past year.



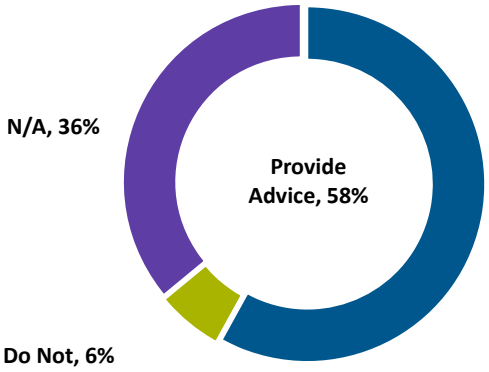
Serving Clients with Diminished Financial Capacity

More than three-quarters of advisor firms who serve individual clients have practices and procedures in place to manage situations where clients have a diminished financial capacity.



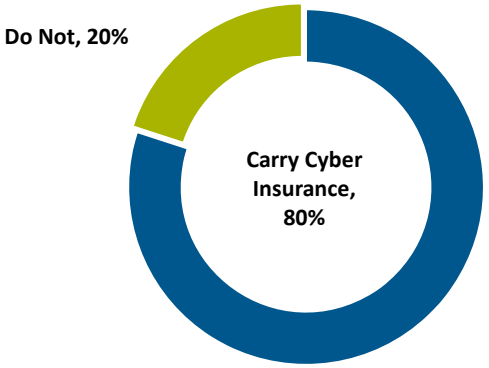
Ability to Advise Departing Employees

Of those serving individuals, nearly all CEFEX® certified advisor firms have the capability to advise employees departing the plan in a way that serves the employee's best interests.



Cyber Insurance

80% of CEFEX® certified advisor firms have a cyber insurance policy.



How We Can Help

Designations & Certifications

From fiduciary basics to thorough mastery, our learning and development programs are designed to empower financial professionals with the knowledge they need to effectively serve all clients and grow their business.

Software

Analytical and reporting features to document a prudent investment process, win new business and reduce liability.

Data & Analytics

Data-centered products, including Broadridge Fi360 Solutions investment product score and Business Intelligence data aggregation for advisor home offices.

QUESTIONS?

fi360sales2@broadridge.com

Broadridge

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SEC Hot Topic: Compliance Tips for Evaluating Your Firm's *Advisory Fees* and *Expenses*

Presenter:
Michelle L. Jacko, CSCP
Managing Partner, Jacko Law Group, PC
CEO, Core Compliance & Legal Services, Inc.
Janice M. Powell, IACCP®
Sr. Compliance Consultant, Core Compliance & Legal Services, Inc.

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Agenda

- Takeaways from the SEC *Risk Alert* (Apr. 12, 2018)
  - Disclosure
  - Exam Observations
  - What to Expect in an Exam
  - Common Exam Document Requests
- Advisory Fees and Expenses - Case Study
- Are You Prepared to Answer These New Exam Questions?
- Key Takeaways
- Questions

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Advisory Fees and Expenses

Risk Alert: The Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers (Apr. 2018)

- The SEC is concerned about the disclosures clients received regarding advisory fees and expenses
  - Typically, fees and expenses are detailed in advisory contracts and Form ADV
  - Examinations find that advisers are not adhering to the terms of the agreement or disclosures are inappropriate with actual practices

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Advisory Fees and Expenses

Risk Alert: Advisory Fee and Expense Compliance Issues (cont.)

- Exam observations include:
  - Fee-Billing on Incorrect Account Valuations
  - Billing Fees in Advance or with Improper Frequency
  - Applying Incorrect Fee Rate
  - Omitting Rebates and Applying Discounts Incorrectly
    - Not aggregating "households" for fee-billing purposes
    - Not adjusting for "breakpoints"
  - Disclosure Issues Involving Advisory Fees
    - Not disclosing certain additional fees, markups or revenue share
    - Adviser Expense Misallocations

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Advisory Fees and Expenses

- What to Expect in An Exam
  - Examiners are reviewing policies and procedures from two (2) to five (5) years ago related to advisory fee billing protocols
- Common Exam Document Requests Include:
  - A description of current fee billing processes, including:
    - Identity of person(s) who calculates advisory fees
    - Who sends the invoice to the custodian
    - Who tests advisory fee calculations
    - Which software programs or systems are used in calculating fees
    - Description of reconciliations
    - Whether any of the processes have changed in the last five years

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Advisory Fees and Expenses

- Recent SEC Fee and Expenses Document Requests (cont.)
  - Provide all current standard contracts or agreements
  - For the last billing period provide a spreadsheet that includes advisory fee calculations for each advisory client, including:
    - Billing rate
    - Market value used to calculate the advisory fee
    - Total nominal fee billed
    - Which accounts were grouped together for fee billing purposes
    - From which account was the advisory fee paid
  - Provide a copy of any ongoing analysis during the last year of fee billing analysis to ensure clients were billed correctly
  - Provide a list of revenue sharing and expense sharing agreements

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Advisory Fees and Expenses – Case Study

During the onsite exam, Chuck learns that Exposed has been in business since 2000. Since that time, the firm has used three different investment management agreements ("IMAs"), all of which have differing disclosures and advisory fee structures. In the beginning, Bobby Axe wanted to charge all clients a flat rate of 100 bps. Over time as the firm came to service higher net worth families, Exposed moved to a tiered schedule; but in all IMAs the firm never disclosed whether they householded assets for fee billing purposes. In practice, it was left to each adviser to determine which accounts would be aggregated together. Chuck asks for the oldest client account and to review all IMAs associated with the account. Chuck is provided with one IMA, which provides a fixed 1% AUM billing fee. However, when reconciling the billing of the account with Finance, Chuck discovers that the account is being billed 1.1%.

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Advisory Fees and Expenses – Case Study

Chuck asks Finance why the client is being invoiced this amount and he receives the following reply, "In 2008 we moved to a tiered fee billing schedule and based on assets, this family should be charged 1.1%." Chuck asks Taylor to pull all reconciliation documents on Exposed's fee billing practices for this and 10 other accounts. Taylor replies, "It may take a few days as I have not gotten to this yet."

Q1: What issues do you see?

Q2: What actions should Exposed take?

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Are You Prepared to Answer these New Exam Questions?

- How does the firm handle fee billing for deceased clients and terminated client accounts?
- Has the firm's supervisory oversight of fees and expenses changed due to COVID-19 or as a result of a merger or acquisition?
- What controls are in place to monitor fee billing in remote branch offices?
- How do you document "exceptions" to your disclosed fee structure?

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Advisory Fees and Expenses – Takeaways

- Inventory all advisory fee revenue sources of the firm on what fees are received for any and all products and services
- Next, review your disclosures for how the firm describes its advisory fees and expenses
  - If you find that clients have been assessed fees inappropriately (due to overbilling, non-aggregation of assets or inadequate disclosures), contact legal counsel and consider if fee rebates are appropriate
- Implement supervisory checks and balances at all points where advisory fees are entered and calculated
  - Through account opening, in billing and operations and compliance audits

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Advisory Fees and Expenses – Takeaways

- Ensure that policies and procedures articulate how the firm determines and calculates advisory fees and what protocols are in place to ensure that advisory fees are correctly billed to clients
  - TIP: Inventory your advisory contracts to look for legacy "customization" where fees and expenses are atypical to ensure there are no "smoking guns"

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Q&A – Let's Discuss and Thank You for Attending!

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Why Advisory Fees and Expenses Remain a Continued Regulatory Focus

By Michelle L. Jacko

About the Author:

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This article was originally published in Jacko Law Group in November 2020.

Introduction

In recent years, firms in the industry have needed to increase their focus on disclosures related to fees and expenses, particularly in light of the U.S. Securities and Exchange Commission's ("SEC") April 2018 *Risk Alert*.[1] The same compliance issues outlined in that 2018 Risk Alert continued to be echoed in the staff's examination priority letters of 2019 and 2020. In 2019, one of the most impactful statements of the SEC Exam Priority summary highlights the importance of this topic, "Every dollar an investor pays in fees and expenses is a dollar not invested. [Therefore,] it is critically important that investors are provided with proper disclosures of the fees and expenses they pay for products and services…"[2] This issue was further highlighted in the 2020 SEC Exam Priority when the staff emphasized that examiners will "continue to examine RIAs to assess whether, as fiduciaries, they have fulfilled their duties of care and loyalty….[D]uty of care concerns may arise when an RIA does not aggregate certain accounts for purposes of calculating fee discounts in accordance with its disclosures."[3]

Fast forwarding to the 2020 *Risk Alerts*, the SEC's Office of Compliance Inspections and Examinations ("OCIE") continued its crusade for protecting investors' assets. In the August 12, 2020 *Risk Alert*, "Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers" the staff highlighted the need for compliance efforts to focus on practices relating to fees and expenses during the pandemic. Specifically, the staff noted the concern for misconduct involving advisory fee calculation errors resulting in overbilling, inaccurate calculation of tiered fees from failure to aggregate client accounts and provide breakpoints and failure to refund prepaid fees for terminated accounts.[4] These issues were further reiterated just three months later in the November 9, 2020 *Risk Alert,* "Observations from OCIE's Examination of Investment Advisers: Supervision, Compliance and Multiple Branch Offices." The staff shared that they observed weaknesses in policies and procedures related to fees and expenses and stressed, "most fee billing issues were related to the lack of oversight over fee billing processes… [which] resulted in overcharges to clients."[5]

In this article, we will focus on why calculation of advisory fees and expenses remain at the top of the SEC's examination priority list. We will consider the challenges that investment advisers face and using a case study, explore potential internal controls that compliance programs may wish to consider going forward to address these concerns.

Why Advisory Fee and Expense Issues are So Prevalent

When an investment adviser commences business, strategic decisions are made about what products and services will be offered and the fees that will be assessed. In order to remain competitive in the marketplace, some investment advisers decided to have a tiered fee schedule, so that as a client's asset size grew, the adviser would lower the client's advisory fee. Frequently, as clients gained confidence in the adviser's capabilities, over time those clients would add additional assets for the investment adviser to manage. Other times, to encourage additional asset transference, the advisory firm's sales team would stress that when additional assets were added to the client's account, that could entitle all accounts to a breakpoint (or lower fee). The lower tiered fees were generally memorialized in the adviser's Form ADV Part 2A and the client's investment advisory agreement.

1. *See* https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf.
2. *See* https://www.sec.gov/files/OCIE%202019%20Priorities.pdf at page 6.
3. *See* https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf at page 10.
4. *See* https://www.sec.gov/files/Risk%20Alert%20-%20COVID-19%20Compliance.pdf at page 4.
5. *See* https://www.sec.gov/files/Risk%20Alert%20-%20Multi-Branch%20Risk%20Alert.pdf at page 4.

Over time, particularly as advisory businesses grew and geographically dispersed branch offices opened, the methodology for aggregating client accounts for purposes of achieving a breakpoint were not consistently applied or communicated. In some instances, advisory firms allowed the investment adviser representative ("IAR") to bill the client directly and "negotiate" the client's fees. In other instances, the IAR decided not to aggregate certain client accounts because the client was concerned that the household members would be able to calculate how much in assets that individual client had, which the client did not wish to disclose. Alternatively, some IARs did not wish to aggregate accounts due to the amount of servicing that the IAR provided to the end client. However, in nearly all cases the compliance issue was easy to identify: investment advisers failed to define and disclose who is in a "household," failed to disclose when a higher or lower advisory fee could be assessed and how this would be communicated; failed to disclose when and under what circumstances an additional fee or expense could be assessed and failed to have a uniform policy for consistently calculating the firm's advisory fee.

As the SEC and state regulators continue to examine advisory fee and expense issues, it is important for advisory firms to assess how they are calculating advisory fees. Consider how the firm:

- Values client assets and by whom (e.g., as of the last day of the calendar quarter as calculated by the qualified custodian);
- Defines a household (e.g., by all persons living at the same residential address or by relational definition – husband/wife/partner and minor offspring);
- Reimburses terminated client accounts;
- Offsets 12b-1 fees from certain mutual fund purchases;
- Discloses additional expenses that it may impose on clients (e.g., an additional client reporting fee);
- Allows for and documents exceptions for fees charged differently than the published tiered fee schedule; and
- Trains IARs on how to present the concept of fee aggregation and related conflicts of interest to clients.

Advisers have a fiduciary obligation to do what is in the best interest for all of the firm's clients. This duty must be viewed at an enterprise level and not on an individual IAR by IAR level. During regulatory exams, if the staff determines that clients have been inappropriately charged (e.g., due to the fee billing schedule in an advisory contract being lower than what the client was actually assessed), the advisory firm is encouraged to make investors whole. Dependent upon whether there has been a systemic problem over a period of years, the reimbursement to investors could be significant.

Challenges Faced by Investment Advisers

For those investment advisers that may have independent contractor IARs, or who have recently merged with another adviser, it can be challenging to come up with a unified tiered fee schedule that is consistently applied (particularly, when historical behaviors are to negotiate advisory fees on a client by client basis). It is perhaps even more challenging to disclose in the firm's brochure, contracts and other collateral the conflicts of interest that exist if a unified fee schedule is *not* employed and consistently applied and how, under that schematic, the RIA is fulfilling its duties of loyalty and care.

Aggregation of client accounts also can pose a problem.[6] If, for example, a long-term client refers a family member (such as a brother or sister) to the firm, the IAR may be inclined to negotiate aggregation of those accounts with the other family members' accounts – even if that is counter

6. Consider other advisory fee issues highlighted *In the Matter of Transamerica Financial Advisors, Inc.*, Advisers Act Rel. No. 3808 (Apr. 3, 2014), whereby the adviser failed to apply advisory fee discounts to certain retail clients contrary to disclosures to clients and its policies and procedures.

to the firm's household policy. While exceptions can perhaps be made (dependent upon disclosures, facts and circumstances) the question remains - if an exception is granted, should it be extended to *all clients* so that they would be given an opportunity to receive their own fee discount.

Finally, the culture of the firm may not be conducive for unified fee billing. If, for example, IARs have been permitted for years to independently bill or negotiate client fees as the IAR sees fit, it will be challenging – but not impossible – to now go back and aggregate client accounts, as appropriate, for purposes of calculating fee discounts in accordance with a unified tiered fee schedule. In some cases, this could result in clients paying a lower advisory fee; but in others, this could lead to a higher fee, which will reduce the client's returns and negatively impact the client relationship.

Ultimately, each investment adviser must evaluate how it will assess advisory fees. This requires analysis of what fee schedule should be used, how client assets will be valued, what operation systems can be used to calculate fees and who will oversee the process to ensure that advisory fees are calculated accurately and in accordance with client contracts. To be effectively implemented, the advisory firm must develop internal controls to: (i) supervise fee billing, (ii) address consistent application of aggregation of client accounts, (iii) document fee billing exceptions and (iv) implement policies and procedures for supervising IARs (particularly in remote locations) and assessing their compliance with the fee billing protocols set forth by the firm, including adherence to terms of the client's investment advisory agreement.

Case Study

You are the new CCO of an East Coast advisory firm that has just acquired a large team in Arizona. You discover that the way the Arizona-based IARs traditionally have provided advisory services to their clients is very different. Each Arizona-based IAR can negotiate advisory fees directly with his/her client and has the ability to determine how accounts are aggregated. Conversely, the main office uses a uniform tiered fee schedule, aggregates accounts based on residence, typically limits exceptions and does not negotiate fees.
During COVID-19, you are challenged. Unable to travel to Arizona, you are trying to determine how to supervise the Arizona IARs and assess:

- Whether the fees being assessed are consistent with client agreements and disclosures;
- If there are risks associated with the Arizona-based advisors' fee calculation practices
- If there is a clear definition of "household" for purposes of account aggregation; and
- Whether any Arizona-based clients were overbilled as a result of potential inconsistent billing practices.

Q: What steps would you take to assess whether compliance issues exist?

There are numerous approaches that could be taken. One of the most important steps is to interview the Arizona-based IARs to determine if advisors used different approaches for aggregating client accounts that differed from disclosures provided in the client agreements. Sample the investment advisory agreements and see whether the stated advisory fee amounts

(particularly in older, legacy agreements) differ from the current fees assessed to client accounts. If they do differ, determine if the fee is greater or less than specified in the client agreement, and if higher, ascertain whether the client should receive a refund for overbilling. Throughout the process, document who was interviewed, what records were reviewed, the time period for the analysis and your findings. Involve Operations and Finance for additional feedback and

historical information. Review any standard operating procedures that the Arizona office used for calculating advisory fees and billing of clients and determine if gaps exist. Finally, determine the effectiveness of client communications when changes in advisory fee billing occurred. See if client agreements were amended to reflect the new advisory fee. Verify if training on advisory fee billing occurred and what systems, if any, were used to assist in the fee billing process. Provide findings to senior management with recommendations on how to best centralize processes for the entire organization.

Conclusion

No compliance program is one-size fits all. It is imperative for investment advisers to customize policies, procedures and practices to their firm based on the organization's business model. However, when testing and assessing internal controls, it is important to consider those higher risk areas identified by the SEC and consider the staff's observations regarding compliance best practices. This may help the adviser to determine if enhancements should be considered for a particular area.

Based on the regulatory guidance provided in 2020 for advisory fees and expenses, if possible, implementation of a centralized, uniform processes to manage client fee billing is important. This approach can help to set expectations with clients and your IARs, allow for easier implementation of systematic controls, and could help to enhance compliance monitoring and supervisory oversight. The SEC exam staff continues to focus on this area because it is directly correlated with the protection of investors. Therefore, it is prudent for all advisers to reassess their fee billing controls in accordance with the regulatory guidance provided to date. ■

JACKO LAW GROUP, PC

Legal Risk Management Tip
June 2018

The SEC Reminds Advisers of the Importance of Proper Understanding, Disclosure and Assessment of Advisory Fees

While it may seem obvious, proper disclosure and assessment of advisory fees is one of the most important aspects of the adviser-client relationship that some advisers are deficient in the eyes of the SEC staff. Disclosures concerning fees are paramount in allowing clients to make informed decisions as to whether to engage an adviser. Consequently, the fees actually assessed by the adviser should mirror those disclosed in advisory contracts and Form ADV. While conceptually this sounds straightforward, advisers continually find themselves in the cross-hairs of regulators for violations regarding fees. As a result, the SEC recently notified the financial industry that fees assessed to clients will be a point of emphasis during reviews. Specifically, the SEC is focusing attention on those advisers who are overcharging clients based upon fee disclosures made as part of the advisory firm's Form ADV and/or client agreement.[1]

Importance of Establishing Proper Advisory Fees

Prior to starting an advisory firm, and thereafter as the business model evolves, investment advisers must determine the type and amount of fees it will assess its clients for the performance of advisory services. While such fee types and amounts widely vary, firms should be mindful of applicable guidance in this area. For example, if assessing fees based upon a client's assets under management with the firm, the SEC has taken the position that advisers who charge fees that exceed industry norms (which, per the SEC, is no more than two percent (2%) of a client's assets under management[2]) may violate section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"), unless the firm discloses to existing and prospective clients that such a fee is higher than that charged by other advisers that provide the same or similar services. Certain state regulatory authorities have taken a similar approach in determining when advisory fees based upon assets under management may be excessive.[3]

There also are specific requirements that must be followed for particular fee arrangements. For example, with certain exemptions, Section 205(a) of the Advisers Act explicitly establishes a ban on performance-based fees for investment advisers. To assess such fee types, advisers must follow specific requirements set forth in exemptions within Section 205-3 of the Advisers Act.

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[1] See *Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers*, Office of Compliance Inspections and Examinations (Apr. 12, 2018) (pub. avail. at https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf).

[2] *See* Equitable Communications Co., SEC Staff No-Action Letter (Feb. 26, 1975); Consultant Publications, Inc., SEC Staff No-Action Letter (Jan. 29, 1975); Financial Counseling Corporation, SEC Staff No-Action Letter (Dec. 7, 1974); John C. Kinnard & Co., Inc., SEC Staff No-Action Letter (Nov. 30, 1973).

[3] The State of Utah for example views advisory fees based upon assets under management that exceed 2% as "an unreasonable advisory fee" that is deemed a dishonest or unethical business practice under R164-6-1g(E)(10) of the Utah Administrative Code.

Once the fee types and amounts are established, it is paramount that such fees are properly disclosed and assessed to the firm's clients. These processes carry several opportunities for violations of applicable regulations by advisory firms.

Common Compliance Issues Related to Advisory Fees

In April of 2018, OCIE published a Risk Alert[4] that detailed the most frequent advisory fee and expense compliance issues identified in recent examinations of investment advisers. The areas discussed by OCIE in its report include the following:

- Fee-Billing Based on Incorrect Valuations;
- Billing Fees in Advance or with Improper Frequency;
- Applying Incorrect Fee Rate;
- Omitting Rebates and Applying Discounts Incorrectly;
- Disclosure Issues; and
- Adviser Expense Misallocations.

This is not an exhaustive list however. We've seen several instances where fees may be viewed as having been improperly assessed or disclosed. For example, OCIE has made known[5] that disclosures should be provided in the firm's Form ADV, detailing whether the firm includes cash and cash equivalents in tabulations for "assets under management" when assessing fees. Additionally, for firms utilizing margin accounts, it is very important to disclose whether the firm assesses fees on "gross" or "net" assets. In other words, will the firm only charge fees on the amount of assets in the underlying client account, or the margin portion of the account? For example, in an account reflecting $100K in equities, but $25K is attributable to margin, will only
$75K will be included when determining fees or the full $100K? It is assumed that unless expressly disclosed otherwise, firms who utilize margin will only charge fees on the net amount (or the $75K amount, in the example above). Firms charging fees on the gross amount of assets must disclose this in their Form ADV and/or client agreement.

Practical Steps for Ensuring Compliance Related to Advisory Fees

The amount and types of advisory fees can also vary between firms and among clients or client types within a single firm, based on factors such as services provided, types of investments and structure, or type of client (*i.e.*, organized as a separate account versus private fund). Thus, the exact methodology employed by firms for the review, testing and disclosure of fees will also vary. That being said, there are steps that all firms should take to ensure compliance in this area. The following, while not an exhaustive list, provides some practical steps to be followed:

A. Review Current Disclosures

While they may occur elsewhere, disclosures related to fees must always be provided to clients as part of the firm's Form ADV disclosures and be included as part of the client agreement (often as an attached fee schedule but sometimes addressed or modified through a side letter or amendment). While advisory firms are required to update their Form ADV filings at least annually, there is no such

[4] https://www.sec.gov/files/ocie-risk-alert-advisory-fee-expense-compliance.pdf).Id.
[5] *Id.*

requirement for client agreements. As such, firms will often make revisions to their Form ADV to update and amend their fee disclosures, but fail to make the corresponding revisions to their client agreement. The fees schedule that is detailed in an investment adviser's client agreements must generally match the fee schedule discussed in Item 5 of ADV Part 2A[6] and marked in Item 5.E. of Form Part 1. However, advisers may disclose that fees are negotiable without disclosing what precise lower rates have been agreed to with particular clients. If an investment adviser's business model changes, the investment adviser must ensure that any clients affected by the change enter into new advisory agreements or an addendum to the current advisory agreement is made. Additional disclosures are required where fees include a performance component.[7]

B. Review Relationships with Third-Parties

Depending upon the business model of the firm, advisers will often utilize third parties to assist in certain aspects of firm activities. For example, most firms utilize the services of an unaffiliated qualified custodian to maintain custody of client assets. Often, such custodians will facilitate having advisory fees paid directly to the adviser from the client account[8] to save the adviser from having to invoice the client directly. The billing valuation and methodology employed by such custodians can vary, so it is important not to assume a particular billing practice. For instance, while it is common to value the client's assets under management as of the close of business on the last business day of the preceding calendar quarter; certain custodians instead employ an "average daily balance" valuation methodology. It is important to understand the utilized method to ensure that proper disclosures are made as part of the firm's Form ADV and client agreement.

Another example can be found when applying third-party advisers ("TPAs") to manage all or a portion of their client's assets. In these situations, the firm should disclose whether its fees are inclusive of, or in addition to, fees assessed by the TPA. If the TPA's fees are in addition to the firm's fees, it is important to also disclose when and how such fees are to be collected by the TPA.

C. Review Contracts

Advisers should periodically review client contracts, fee schedules and any related side letters to assure that fees are being billed as and at the rates set forth therein. The methods for calculating the fees and the assets on which they are charged sometimes vary and, for each client, must be as stated in the applicable agreements. This is particularly important when fees are subject to asset based breakpoints which may apply on a "householding" basis, such that the total value of a relationship might trigger a different fee rate when a breakpoint is reached at the relationship level, although no breakpoint might have been reached in any particular account within the relationship on a stand-alone basis. Additionally, advisers who agree to "most favored nation" clauses ("MFN") should make sure that they are vigilant in reviewing future contracts and contract amendments to determine if any MFN is triggered, particularly as MFNs often require a degree of similarity as to size and type of account (or exclude certain types of other clients) as a condition precedent to a notice or fee rate adjustment. Where an MFN is triggered, advisers should promptly notify the impacted client(s) benefiting from the MFN and/or proactively adjust the fee rate, as required by the particular MFN. Advisers should consider maintaining an easy reference such as a matrix of all their client contracts, including such relevant data as fee rates,

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[6] Such information may be omitted for any brochure offered only to certain "qualified purchasers."

[7] In particular, advisers should describe the fees used as well as relevant risks and conflicts and, if some but not all clients pay performance-based fees, further disclosure related to "side-by-side" management conflicts must be included. *See* Form ADV, Part 2A, Item 6.

[8] Advisers who perform such billing practices are subject to 206(4)-2, the "custody rule," under the Advisers Act.

breakpoints and MFNs to facilitate compliance with contractual requirements and to help in testing the adviser's billing practices.

D. Testing of Billing Practices

Advisory firms registered with the SEC are required by the Compliance Program Rule to perform an annual review of the firm's policies and procedures. Part of that review should include firm billing practices. What tests should be performed will differ based upon the activities of the firm. However, at a minimum, the following tests should be considered:

- Sample a statistically relevant number of client accounts that were previously billed to ensure that fees assessed match with fees disclosed in the respective client agreement and the firm's Form ADV;
- If a "sliding" or "tiered" fee schedule is utilized, test to make sure clients are being billed such amounts as may be dictated by the schedule, and that any growth/reduction in client accounts that would cause the client to receive higher/lower fees as a result is properly monitored and reflected in the billing;[9]
- Review any unique client billing arrangements or fee structures whereby the client has negotiated fees that may differ from the firm's traditional fee structure to ensure accurate billing practices;
- Review the firm's polices related to aggregation of client accounts for billing and breakpoint purposes (i.e., by household, by client, etc.) and sample a statistically relevant number of client accounts to ensure such aggregation practices have been followed; and
- Test any performance-based fee arrangement for conformity with the advisory contract and disclosures, proper calculation and compliance with Section 205(a)(1) of the Advisers Act or the available exceptions thereunder (i.e., the qualified client exception).
- Confirm that any MFNs have not been triggered or, if triggered, an appropriate notice and/or adjustment has been provided to impacted clients.

As mentioned above, while firms should be performing such reviews no less than annually, changes in firm practices or regulatory changes could cause the firm to perform such reviews more often. The timing and frequency should be predicated upon the facts and circumstances unique to the firm.

E. Utilize Software

For those firms that employ a quarterly or monthly billing schedule, the client billing process can be onerous. Furthermore, billing clients based on the average daily account balance becomes even more difficult without technology support. It's also important to note that many state-registered advisory firms are required to send separate billing invoices to clients in addition to statements sent by the client's custodian. Investing in the proper technology can help simplify and automate the client fee billing and invoicing process to improve operational efficiency and reduce errors.

[9] As noted earlier, it is important to also be cognizant of the basis on which breakpoints are measured.

Conclusion

With the SEC's increased focus on the disclosures and assessment of advisory fees, it is critical that firms review their current practices to ensure they are in alignment with all applicable regulations. As stated by OCIE in their Risk Alert, "in response to OCIE staff's observations, some advisers have elected to change their practices, enhance policies and procedures, and reimburse clients by the overbilled amount of advisory fees and expenses." Whether, some or all of these, outcomes are applicable to a given firm depends on the facts and circumstances surrounding the firm's current practices. Working with an attorney, or other compliance professional familiar with these rules and regulations can assist in the review process.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298- 2880. Also, please visit our website at www.jackolg.com/News-Room/ for additional Legal Risk Management Tips.

For more information on how JLG can assist in evaluating your valuation practices, please contact us at (619) 298-2880.

Jacko Law Group, PC. JLG works extensively with investment advisers, broker-dealers, investment companies, private equity and hedge funds, banks and corporate clients on securities and corporate counsel matters. For more information, please visit https://www.jackolg.com/.

FORESIDE

Exam Deficiencies for Private Fund Advisers

IAA COMPLIANCE CONFERENCE 2021

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Introduction

FORESIDE

Foreside pairs best-in-class technology with comprehensive advice to help our 2,200+ clients in the investment management space continue to innovate and grow

Foreside's suite of outsourced consulting solutions and platform-based model for broker-dealers and investment advisors automate and simplify compliance and marketing for firms, and are designed to scale as clients grow

Foreside taps state-of-the-art technology and harnesses these tools to help clients drive operational efficiency and flourish in today's regulatory environment

Foreside operates 17 affiliated broker-dealers that are registered with the SEC and members of FINRA which currently distribute over $1 trillion of product

Headquartered in Portland, ME with offices in New York, NY, Boston, MA, Columbus, OH, Milwaukee, WI and other regional locations

SINCE 2005

2,200+ CLIENTS

30+ SERVICE OFFERINGS

275 EMPLOYEES

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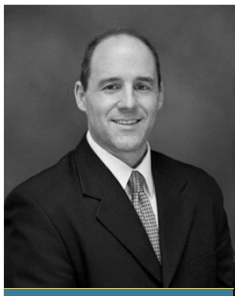
Our Panelists

FORESIDE

Curtis Flippen
Senior Director



Craig Moreshead
Managing Director

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Agenda

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- INTRODUCTION
- COMPLIANCE PROGRAM
- CONFLICTS OF INTEREST
- FEES AND EXPENSES
- REGULATORY FILINGS
- OTHER COMMON DEFICIENCIES
- QUESTIONS
- CONTACT INFORMATION

4

Compliance Program

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DEFICIENCY ROADMAP

—Common deficiencies.
—Private fund focused deficiencies.

TAKEAWAY:
Bake the roadmaps into your monitoring and testing to limit risk exposure and deficiencies.

THE FORGOTTEN SET OF POLICIES AND PROCEDURES

—Fund Documentation.
—SEC Deficiencies (Q4 2020):
- The ABC LPA states that all partnership expenses paid by the Partnership will be made against appropriate supporting documentation.
- ABC's PPM states that the fund's target market will be companies…The SEC Staff sampled due diligence materials and found that ABC did not comply with its PPM terms.

TAKEAWAY:
Failure to have an appropriate monitoring program around fund documents can lead to deficiencies.

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Compliance Program

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PROPER POLICIES AND PROCEDURES MITIGATE AND MINIMIZE DEFICIENCIES

—https://www.sec.gov/news/press-release/2020-123
—https://www.sec.gov/enforce/ia-5441-s
—Due diligence and oversight of investments, including alternative assets specifically cited by the SEC as a common deficiency or weakness (SEC Risk Alert, November 2020).

TAKEAWAY:
Policies and Procedures must be tailored to your private fund investment advisory activities and thoughtfully considered on a regularly basis (not periodically).

THE FORGOTTEN SET OF POLICIES AND PROCEDURES

—Greater chance of limiting deficiencies when the CCO is integrated into the firm's business (e.g., participate in weekly deal meetings, investor due diligence, review deal memos > generally are not brought in at that last moment) tend to be more effective in spotting issues earlier.
—For an excellent reminder on the role of the CCO, see Peter Driscoll, The Role of the CCO – Empowered, Senior and With Authority (November 20, 2020 https://www.sec.gov/news/speech/driscoll-role-cco-2020-11-19).

TAKEAWAY:
CCO must be fully empowered to discharge their responsibilities.

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Conflicts of Interest

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DEFICIENCY ROADMAP – NOT MITIGATING OR ELIMINATING CONFLICTS OF INTEREST CAN LEAD TO HEADLINE AND MONETARY RISK:

SEC has a long history of focusing on how private fund advisers handle conflicts of interest.

In 1963, in SEC v. Capital Gains Research Bureau:

AN ADVISER MUST ELIMINATE OR AT LEAST EXPOSE THROUGH FULL AND FAIR DISCLOSURE ALL CONFLICTS OF INTEREST THAT MIGHT INCLINE IT – CONSCIOUSLY OR UNCONSCIOUSLY – TO RENDER ADVICE THAT IS NOT DISINTERESTED.

In a May 2011 Speech:

- *"THE SEC HAS FOR MANY DECADES BEEN CHARGED WITH ADDRESSING A WIDE RANGE OF CONFLICTS OF INTEREST…"*
- *"WITH REGARD TO INVESTMENT ADVISERS' THEIR FIDUCIARY DUTY REQUIRES THAT THEY ACT AT ALL TIMES IN THE BEST INTEREST OF THEIR CLIENTS, OR THAT THEY DISCLOSE THE CONFLICT."*

In a June 2020 SEC Risk Alert the SEC observed several conflicts of interest that appeared to be inadequately disclosed resulting in deficiencies including:

CONFLICTS RELATED TO MULTIPLE INVESTORS INVESTING IN THE SAME PORTFOLIO COMPANY.

CONFLICTS RELATED TO CO-INVESTMENTS AND MORE

Core information request in routine SEC examination:

INVENTORY OF COMPLIANCE RISKS AND CONFLICTS OF INTERESTS THAT FORMS THE BASIS FOR THE COMPLIANCE MANUAL AND CODE OF ETHICS.

— Conflicts of interest are all around in the investment advisory business and the SEC's focus on managers to private funds management of those conflicts of interest is not going away.

— Therefore, private fund advisers must understand their business model and continually evaluate the risks and conflicts that are inherent in your business model to prevent failure to identify and disclose type deficiencies.

Conflicts of Interest

FORESIDE

TO MITIGATE OR ELIMINATE CONFLICTS OF INTEREST IS THE QUESTION AND, OUR ONLY OPTIONS:

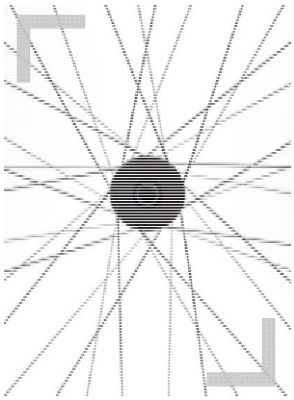
— Baked into compliance program to continually identify and mitigate (or eliminate) conflicts of interest (e.g., annual updating of inventory of conflicts of interest and compliance risks).

— Conflicts of interest between the firm and fund investors (e.g., compensation arrangements, contractual agreements).

— Conflicts in the fundraising stage (i.e., failure to notify investors of the use of a placement agent and then allocating the placement agent costs to the investors).

— Conflicts with co-investments by general partners (i.e., firm entering into co-investment arrangement son different terms to those offered to fund investors).

— In general, follow the money.



TAKEAWAY:

Disclosure, Disclosure, Disclosure reduces the likelihood of the SEC finding deficiencies or weaknesses.

Fee and Expenses

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COMMON DEFICIENCIES

—Failure to clearly disclose

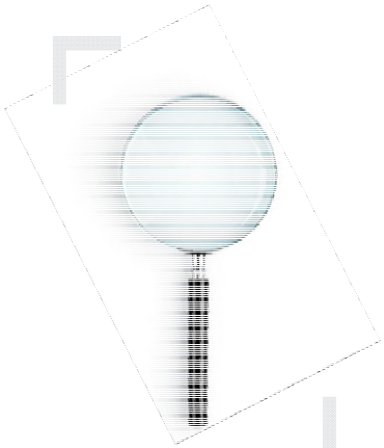
—Failure to calculate accurately

—Preference of some funds/investors over others

—Discounts off common vendor expenses not shared with funds

—Utilization of affiliated providers for the benefit of the firm (and to the detriment of the funds)

—No fee/expense allocation policy (or failure to follow)



Fee and Expenses

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PRACTICE TIPS TO AVOID PROBLEMS

—Ensure that disclosure is clear and unambiguous (plain English)

—Only charge expenses to the Funds if it's clear and unambiguous

—Conduct Due Diligence on affiliated providers as you would an unaffiliated vendor

—Leverage the LP Advisory Board/Council for any potential conflict or ambiguity

—Consider periodic independent fee/expense reviews

—Develop clear allocation policy and periodically test

Regulatory Filings

FORESIDE

COMMON DEFICIENCIES RELATED TO FORM ADV

Compensation Disclosure. Be sure to disclose not only asset-based fees and performance fees (carry), but also any other forms of compensation and fees (ex. monitoring, administrative, liquidation).

Reporting of RAUM and GAV. RAUM = GAV, both of which should include uncalled capital.

Reporting under 7B(1) vs 7B(2). In sub advisory arrangements, only one RIA need report under 7B(1) with the other reporting under 7B(2).

Umbrella Registration. Failure to properly identify relying advisers under Schedule R or comply with ABA Letters (2005 and 2012). Must be a single CPP, COE and CCO.

Custody. Failure to verify PCAOB registration number. Failure to properly report "cash and securities" assets under Item 9 (do not include uncalled capital or other assets).

Conflicts disclosure. Failure to disclose conflicts of interest in the firm brochure (for PE these conflicts can evolve at the Fund level or the PC level).

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Regulatory Filings

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COMMON DEFICIENCIES RELATED TO FORM PF

Reporting of RAUM, GAV and NAV. Tie back to ADV. AUM = GAV, both of which should include uncalled capital.

Fair Valuation Table. Tie back to audited financials. For PE all assets typically Level 3 and Cost-based. Do not include uncalled capital in table.

Borrowings. Include short selling, securities lending, variation margin, and other traditional lending activity. Do not include borrowings leverage through use of derivatives (covered elsewhere in form).

Investor Types. Pick the category that best fits (only one category type per investor). Try and avoid "other" category if possible.

Performance. Must show at a minimum annual gross and net (plus quarterly or monthly if calculated). Miscellaneous comment should be added to describe the firm's process for calculation (for PE typically cumulative IRR).

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Other Common Deficiencies

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- **Inadequate Valuation Process**
- **Misleading Advertising and Marketing**
- **Lack of Custody Audits** *(or failure to deliver within 120 days)*
- **Inadequate Portfolio Management Due Diligence**
- **Failed Oversight of OBAs** *(especially investment-related)* **and Political Contributions**

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Questions

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IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE
EFFECTIVE STRATEGIES & BEST PRACTICES

Cybersecurity and Data Privacy

- **Keith E. Cassidy**, *Associate Director, Technology Controls Program*, SEC Division of Examinations
- **Tess Macapinlac**, *Privacy Legal Associate*, OneTrust
- **Tim Villano**, CISA, CISM, CGEIT, CRISC, *Chief Information Officer*, Artemis Global Security, LLC
- **Kirk Nahra**, *Partner*, WilmerHale, Moderator

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Latest Developments

- Legislative – State law developments
- Legislative – Federal legislation
- Key developments on policy and enforcement

SEC Developments

- Risk Alerts
  - Ransomware
  - Credential stuffing
- Trends
- Cyber 3 initiative

Vendor Risks

- Supply chain risks
- SolarWinds attack
  - Implications for advisers

Managing Different Laws

- Practical tips
- Strategies
- Resources

Questions


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

Privacy Law for Security Professionals

By Kirk J. Nahra
ICIT Fellow and Partner, WilmerHale

Security existed as a business norm long before it became a legal and compliance requirement. Doctors' offices locked their doors at night to ensure no one could access their records. Stores took precautions when they walked the daily cash receipts to the bank. Now, it is enormously more complicated to guarantee data security, which is the physical and technological protection of both personal data and sensitive proprietary information. Appropriate best practices and legal requirements are growing every day, across all industries, and around the world.

At the same time, in a somewhat parallel development that has slightly preceded data security as a legal obligation, companies all over the world now need to make sure they are following appropriate practices relating to how personal information is collected, used, and disclosed. This growing range of privacy obligations should be understood generally by information security professionals, and an effective partnership with company privacy officials is critical to the appropriate protection of companies, their employees, their customers, and any other individuals whose data is being collected by these companies.

> *"Security existed as a business norm long before it became a legal and compliance requirement."*
>
> - Kirk Nahra

We should start with a few definitions. Privacy, data security, and cybersecurity are similar terms, yet have distinct definitions. While these terms are not defined in any specific law, the following definitions reflect common usage in the field. The term "*Privacy*" relates to the laws, regulations, and practices surrounding how personal data is used, gathered, maintained, and disclosed. "*Security*" (or "*Data Security*") refers to the laws, regulations, and practices surrounding how personal information is protected from unintended and unpermitted activity. More succinctly, it encapsulates the practices that protect data.

Of course, we have all heard the term "*Cybersecurity*," which relates to the protection of overall technological infrastructure. This term tends to be focused on national security and internet interconnections, which may or may not involve personal data. This means cybersecurity can be broader than data security, but also narrower in some ways because it does not include the security of paper records or physical information containers such as people. "Information

Security" encapsulates physical, cyber, and contextual processes and procedures governing the confidentiality, availability, integrity, and access of data and data containers.

Today, most privacy laws follow an approach established under a concept called *"Fair Information Practices*." This set of five principles dictates certain practices that should be included in privacy laws. The practices are:

1. Notice - Consumers should be notified of how companies will use and disclose their personal data.
2. Choice/Consent - Consumers have some right to choose how their data will be used.
3. Access - Consumers can see or copy their personal information.
4. Security - Sensitive data is appropriately protected from unpermitted or unauthorized uses and disclosures.
5. Enforcement – Controls must be implemented to ensure that the law is followed.

> "It will be critical for privacy and security professionals to work together to provide appropriate business strategies and effective protections for both companies and consumers."
>
> - Kirk Nahra

What are the Key Legal Principles in Modern Privacy Law?

The privacy framework in the United States is as follows.

- There are a large (and growing) number of laws and regulations at state, federal, and international levels.
- These laws have (to date) been specific by industry segment (e.g., health care, banking) or by practice (e.g., telemarketing).
- Today, there is no generally applicable US national privacy law covering all industries and all data.
- Because of the volume of laws and the fact that they are not "generally applicable," there is an increasing complexity of the regulatory environment.
- Many privacy laws have detailed obligations for contracts with vendors.
- There has been relatively limited enforcement, despite there being many agencies with enforcement authority; however, this enforcement seems to be growing.
- There also has been a relatively limited but growing range of litigation concerning privacy and security practices (focused primarily on data breach situations)
- There is an increasing concern, from privacy advocates, consumers, regulators, and others, about "big data," artificial intelligence, and otherwise unregulated personal data.

There also is an expanding international framework for privacy law. At the international level,

- There are separate privacy and security rules related to data in and coming from foreign countries.

- Where these laws exist, the rules usually are tougher in other countries – meaning that they are more protective of individual privacy (e.g., the General Data Protection Regulation in the European Union).
- An increasing number of countries do have privacy rules – and the rules are changing dramatically on an ongoing basis.
- Because of this complexity and ongoing change, there is significant disarray for companies operating on a global level to adjust to these changes in real-time.
- Many of these international laws apply to US companies, even if they have no physical presence in those countries.

There also are separate legal requirements related to data security. Security is now a separate legal requirement in the US – connected to privacy but with different rules and issues. Accordingly, data security has moved from a business-driven "best practice" to a legal requirement in all industries in the United States, and is developing as a global issue, but more slowly.

Which Laws are Most Important?

A critical challenge for most companies is identifying the laws that are relevant to their operations. These can be directly relevant, meaning that the law applies to a company in its own right, or can be applicable to companies through service-provider relationships, either by law or by contract. In thinking about most privacy laws, it is typically important to ask several key questions to assess how the law could potentially apply to a company or a consumer. These questions include:

- Who does the law apply to?
- Who does the law protect?
- What information is covered by the law? If you are covered by the law, what can and cannot be done with the personal information subject to the law?
- What rights apply to the information?
- What is the enforcement mechanism for the law?
- What does this law impact?
- Who does this law benefit or harm?
- What happens when the law does not apply or does not tell you what to do?

A small sampling of these laws is below, but any security professional should work with their company's privacy or legal teams to understand which laws are relevant to their company.

Industry Laws

US privacy law often is directed at specific industries. The *Health Insurance Portability and Accountability Act* (HIPAA) includes privacy and security rules which primarily apply to health care providers and public and private companies who store, process, or transfer health data. This law also applies to service providers to these entities, called "business associates."

The *Gramm-Leach-Bliley Act* (GLBA) protects the privacy and security of consumer information held by "financial institutions" such as banks, insurers, credit card companies, and other defined financial entities. The law requires these companies to give consumers privacy notices explaining their information-sharing practices. The law also gives consumers the right to "opt-out" of sharing information with some nonaffiliated third parties.

The *Family Educational Rights and Privacy Act* (FERPA) guards the privacy of student education records. The law applies to all schools that receive funds under an applicable program of the US Department of Education, meaning virtually all colleges, universities, and public high schools. This law gives parents certain rights with respect to their children's education records, but primarily gives students the ability to control how their educational information is used and disclosed outside of the education environment.

Practice-Specific Laws

In addition to these “industry” laws, many US laws address particular practices. For example, the *Children's Online Privacy Protection Act* (COPPA) is designed to limit the collection and use of personal information about children under the age of 13 by the operators of internet services and websites.

The *Telephone Consumer Protection Act* (TCPA) is one of the many laws applicable to marketing activities, restricting telemarketing calls, the use of automatic telephone dialing systems, and artificial or prerecorded voice messages, even outside of the marketing context.

The *Controlling the Assault of Non-Solicited Pornography and Marketing* (CAN-SPAM) *Act* regulates the use of e-mail for marketing purposes.

“Overall” Privacy Laws

In recent years, we also have seen increased attention being paid to “overall” privacy laws; in other words, laws that impose regulations across industries and across practices. First, we have the *General Data Protection Regulation* ("GDPR") that protects the privacy of individuals in Europe, replacing a previous European Privacy Directive. The GDPR applies across industries, protecting all personal information. It has meaningful extra-territorial reach and applies to many US companies that do not have a physical presence in Europe.

The most recent development in this area involves the US. Currently, most attention is being paid to the *California Consumer Privacy Act* (CCPA). This law, which went into effect on January 1, 2020, protects the privacy rights of all California residents. While it does not apply in all contexts (e.g., non-profits are excluded from coverage, the law does not currently apply to employee data, and there are other exceptions), it is neither sector-specific nor practice-specific. Many states are evaluating whether to pass similar laws. This discussion has also led to a significant debate at the federal level about a national US privacy law.

Data Breach Notification Laws

One area with critical and direct overlap between privacy and security involves a broad range of laws that dictate a company's actions following a data breach. These laws began at the state level, starting with California, and now apply in all 50 states and the District of Columbia. There are a separate set of data breach notification rules as part of HIPAA, and new data breach reporting provisions in Europe as part of GDPR. In the US, these laws generally require notification of individuals when certain categories of personal information (e.g., Social Security Number, credit card number or bank account information, along with other data elements depending on the state) are the subject of a data breach, and there is some meaningful level of risk to the individual from the data breach. Many of these laws also require reporting to state government officials, such as a state attorney general.

Enforcement

The enforcement of US privacy law is dispersed across a wide number of government agencies. Many of the laws designate a specific enforcement agency. For example, the US Department of Health and Human Services' Office for Civil Rights is the primary enforcement agency for HIPAA. State attorneys general have broad enforcement authority over privacy and security, both through specific laws, like data breach notification laws, and through their general authority over consumer protection. The US Department of Justice often has criminal authority in, particularly egregious situations.

> "Privacy issues increasingly impact virtually all companies in all industries."
>
> - Kirk Nahra

In addition to specific agencies, the Federal Trade Commission (FTC) has a "catch-all" authority on privacy and security practices. The basic consumer-protection statute enforced by the FTC is Section 5(a) of the *FTC Act*, which prohibits unfair or deceptive acts or practices in or affecting commerce. Generally, misrepresentations or deceptive omissions of material fact constitute deceptive acts or practices and are thus prohibited by Section 5(a) of the FTC Act. Also, acts or practices are deemed unfair under Section 5 of the FTC Act if they cause, or are likely to cause, substantial injury to consumers that consumers cannot reasonably avoid themselves, and that is not outweighed by countervailing benefits to consumers or the competition. The FTC has acted in multiple cases involving data security and conducts a wide range of investigations into privacy practices across industries. The FTC does not regulate everyone, as they have no authority over non-profits or the insurance industry, but they do cover a wide range of industries and companies.

How does Privacy Law impact Security professionals?

Privacy issues increasingly impact virtually all companies in all industries. Security professionals can help implement privacy laws in multiple areas.

Overall Compliance

Privacy compliance usually requires effective information security controls. Information Technology resources are increasingly relevant for individual privacy rights, such as the right to access or delete personal information.

Litigation

Personal data is becoming entwined in a growing range of litigation. Security professionals are often required to gather, retrieve, analyze, and evaluate this personal data in connection with litigation.

Mergers and Acquisitions

Privacy and security compliance is now a first-tier business issue in mergers and acquisitions. Companies interested in acquisitions, investments or other business partnerships are spending significant resources to evaluate the privacy and security practices of their targets, and are making decisions based on whether the businesses they are scrutinizing have effective security, strong privacy management, data rights, and a broad range of other areas critical for these transactions.

Product Design

"Privacy by Design" is an increasingly important concept that means that privacy controls and effective security practices need to be built into products. This integration needs to start during the design phase; it can no longer be assessed at the end of the product development lifecycle. Additionally, because of the sector-specific nature of most US laws today, companies need to evaluate data-flows, and other data-gathering efforts (for both privacy and security) to assess which set of laws is applicable to company activities.

Corporate Strategy

Companies are assessing data issues as a key element of corporate strategy. Aside from questioning which laws apply where data assets are now a critical corporate asset. Companies must evaluate data rights, the ability to exchange data, effective security activities, and a broad range of data exchange issues as key elements of corporate strategy.

> "Your role is critical and can be directly useful to the company's success in its overall business activities."
>
> - Kirk Nahra

Business Relationships

Companies have begun incorporating privacy and security considerations into their general business relationships. This includes service providers, other business partners, and situations where the company itself is a service provider to its clients. All of these activities involve data security issues and overall privacy assessments.

Marketing

Privacy laws often target marketing practices. Companies need to evaluate technical data-flows, data exchange with partners, and an overall approach to marketing, along with effective controls, to ensure that critical information is not the subject of data breaches. Marketing profiles of consumers now involves detailed and sensitive information, and they must be protected from unauthorized access.

Thinking About Vital Security Issues

As you think about how you best can partner with your privacy, colleagues, also think about these key areas. Your role is critical and can be directly useful to the company's success in its overall business activities.

Validation of Data-Flows

As the Internet of Things expands, companies are collecting data through new technologies without necessarily knowing or planning for it. Effective security controls are critical if companies want to ensure that their data collection is appropriate, targeted within existing rules and consistent with the company's obligations and interests. At the same time, this effort needs to include an evaluation of data sources. Where are outside data coming from? Do those partners have the appropriate permissions and rights to the data?

Consideration of Sensitive Data Categories

While a growing range of laws protects all forms of personal information, not all personal data is the same. Many laws create categories of "sensitive" data, and the impact of certain sensitive data clearly carries greater risks for companies in the event of a privacy or security breach. Security professionals should work with their companies to assess situations where sensitive data are collected and stored, to ensure this data is appropriately protected. Sensitive data categories clearly include health and financial information, but also genetic information, biometrics, facial recognition, and location data (and part of what makes data sensitive is how it can be combined with other data).

> "An effective partnership with company privacy officials is critical to appropriate protection of companies, their employees, their customers and any other individuals whose data is being collected by these companies."
>
> - Kirk Nahra

Aggregation

Companies need to evaluate whether they are permitted to aggregate data for purposes such as analytics or product improvement and often need technical and security assistance to ensure that data can effectively be integrated if permissible. A related question is whether a company is permitted to legally or practically de-identify data, which often expands the permitted uses of

that data. However, security professionals should keep in mind that this also creates security risks if the data is accessed inappropriately.

Data Usage

Companies need to assess how their data is being used, both internally and externally. Security professionals are critical to understanding both internal and external data flows as well as assisting with effective controls. This ensures that data usage is consistent with company strategy and legal obligations.

Client Relationships

As part of these data rights issues, companies are evaluating what their rights are when a client relationship ends. This involves a combination of legal and contractual rights, as well as the ability to locate, isolate, and manage client data. An effective “termination” approach usually requires the input of a security professional.

The Future of Privacy Law

Privacy and data-security law are still in their infancy. In the US, this field is barely 20 years old. At the same time, the law is evolving at an incredibly rapid pace, creating ongoing, changing obligations in real-time for virtually all industries across the globe. We can expect this evolution to continue, likely with the addition of other state "overall" privacy laws, potentially including a US national privacy law in the next few years. As the types of personal data grow and the range of companies that gather, collect, and analyze personal data expands, it will be critical for privacy and security professionals to work together to provide appropriate business strategies and effective protections for both companies and consumers. While these issues may seem daunting, building effective partnerships between security, privacy, and legal colleagues will provide businesses with the necessary background, information, and support to effectively guard the personal data of their clients and consumers.

About the Author

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About ICIT

The Institute for Critical Infrastructure Technology (ICIT) is a 501c(3) cybersecurity Think Tank with a mission to cultivate a cybersecurity renaissance that will improve the resiliency of our Nation's 16 critical infrastructure sectors, defend our democratic institutions, and empower generations of cybersecurity leaders.

RISK ALERT
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

July 10, 2020

CYBERSECURITY: RANSOMWARE ALERT

The Office of Compliance Inspections and Examinations (OCIE)* is committed to working with financial services market participants, federal, state and local authorities, and others, to monitor cybersecurity developments, improve operational resiliency, and effectively respond to cyber threats. Recent reports indicate that one or more threat actors have orchestrated phishing and other campaigns designed to penetrate financial institution networks to, among other objectives, access internal resources and deploy ransomware. Ransomware is a type of malware designed to provide an unauthorized actor access to institutions' systems and to deny the institutions use of those systems until a ransom is paid.

OCIE has also observed an apparent increase in sophistication of ransomware attacks on SEC registrants, which include broker-dealers, investment advisers, and investment companies. The perpetrators behind these attacks typically demand compensation (ransom) to maintain the integrity and/or confidentiality of customer data or for the return of control over registrant systems. In addition, OCIE has observed ransomware attacks impacting service providers to registrants.

In light of these threats, OCIE encourages registrants, as well as other financial services market participants, to monitor the cybersecurity alerts published by the Department of Homeland Security Cybersecurity and Infrastructure Security Agency (CISA), including the updated alert published on June 30, 2020 relating to recent ransomware attacks.[1] OCIE further encourages registrants to share this information with their third-party service providers, particularly with those that maintain client assets and records for registrants.

CISA Alert – Dridex Malware available at https://www.us-cert.gov/ncas/alerts/aa19-339a

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* The views expressed herein are those of the staff of OCIE. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the SEC or the Commission). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by OCIE staff and is not legal advice.

[1] CISA is responsible for protecting the Nation's critical infrastructure from physical and cyber threats. This mission requires effective coordination and collaboration among a broad spectrum of government and private sector organizations. (www.cisa.gov)

The CISA alert referenced above highlights tactics and techniques used by certain threat actors, along with related indicators of compromise (IOCs) and key mitigation strategies to reduce overall vulnerability.

Recognizing that there is no such thing as a "one-size fits all" approach, and that not all of these practices may be appropriate for every organization, we are also providing the following observations to assist market participants in their consideration of how to enhance cybersecurity preparedness and operational resiliency to address ransomware attacks.[2] We have observed registrants utilizing the following measures:[3]

- ***Incident response and resiliency policies, procedures and plans.*** Assessing, testing, and periodically updating incident response and resiliency policies and procedures, such as contingency and disaster recovery plans. These policies and procedures may include, for example:
    - Response plans for various scenarios, including, among others, ransomware and other denial of service attacks.
    - Procedures for the timely notification and response if an event occurs, a process to escalate incidents to appropriate levels of management (including legal and compliance functions), and communication with the registrant's key stakeholders.
    - Procedures for addressing compliance with federal and state reporting requirements for cyber incidents or events, such as financial institution suspicious activity report filing requirements or reporting of material events under the federal securities laws.
    - Procedures to contact law enforcement, inform regulators and promptly notify new and existing customers and clients, as appropriate.
- ***Operational resiliency.*** Determining which systems and processes are capable of being restored during a disruption so that business services can continue to be delivered.
    - Focusing on a capability to continue to operate critical applications in the event that the primary system is unavailable.

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[2] Additional ransomware "cyber defense best practices" can be found at FBI Public Services Announcement – High Impact Ransomware Attacks Threaten U.S. Businesses and Organizations. (https://www.ic3.gov/media/2019/191002.aspx)

[3] A number of these measures are also described in our January 27, 2020 report on Cybersecurity and Resiliency Observations, available at https://www.sec.gov/files/OCIE-Cybersecurity-and-Resiliency-Observations-2020-508.pdf.

- Ensuring geographic separation of back-up data and writing back-up data to an immutable storage system in the event primary data sources are unavailable.

- ***Awareness and training programs.*** Providing specific cybersecurity and resiliency training, and considering undertaking phishing exercises to help employees identify phishing emails. Training provides employees with information concerning cyber risks and responsibilities and heightens awareness of cyber threats such as ransomware.

- ***Vulnerability scanning and patch management.*** Implementing proactive vulnerability and patch management programs that take into consideration current risks to the technology environment, and that are conducted frequently and consistently across the technology environment.

    - Ensuring all firmware, operating systems and application software (*i.e.,* in-house developed, custom off-the-shelf, and other third-party software), and anti-virus and other host-based security tools have the most current updates.

    - Ensuring anti-virus and anti-malware solutions are set to update automatically and that regular scans are conducted, and considering upgrading anti-malware capability to include advanced endpoint detection and response capabilities.

- ***Access management.*** Managing user access through systems and procedures that: (i) limit access as appropriate, including during onboarding, transfers, and terminations; (ii) implement separation of duties for user access approvals; (iii) re-certify users' access rights on a periodic basis (paying particular attention to accounts with elevated privileges including users, administrators, and service accounts); (iv) require the use of strong, and periodically changed, passwords; (v) utilize multi-factor authentication leveraging an application or key fob to generate an additional verification code; and (vi) revoke system access immediately for individuals no longer employed by the organization, including former contractors. Configuring access controls so users operate with only those privileges necessary to accomplish their tasks (*i.e.,* least privilege access).

- ***Perimeter security.*** Implementing perimeter security capabilities that are able to control, monitor, and inspect all incoming and outgoing network traffic to prevent unauthorized or harmful traffic. These capabilities include firewalls, intrusion detection systems, email security capabilities, and web proxy systems with content filtering.

    - Employing best practices for use of Remote Desktop Protocol (RDP), including auditing networks for systems using RDP, closing unused RDP ports, and monitoring RDP login attempts. Exposing RDP to the Internet is a significant vulnerability and risk, which can be addressed by supporting RDP only through an encrypted Virtual Private Network connection.

- Using an application control capability that ensures only approved software can be executed.
- Using a security proxy server to control and monitor access to the Internet to address potential security vulnerabilities of Internet connections.

The SEC has focused on cybersecurity issues for many years, with particular attention to market systems, customer data protection, disclosure of material cybersecurity risks and incidents, and compliance with legal and regulatory obligations under the federal securities laws. Among other resources, the SEC maintains a Cybersecurity Spotlight webpage that provides cybersecurity-related information and guidance.[4] Cybersecurity has been a key examination priority for OCIE for many years, identifying information security as a key risk area on which registrants should focus. In addition to the Cybersecurity and Resiliency Observations Report noted above, OCIE has also published several additional cybersecurity-related risk alerts.[5]

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

4 "Spotlight on Cybersecurity, the SEC and You" available at www.sec.gov/spotlight/cybersecurity. This page contains information for investors, issuers, and registered firms and organizations, including the Commission Statement and Guidance on Public Company Cybersecurity Disclosures, guidance from the Division of Investment Management, the Division of Trading and Markets, and Investor Alerts and Bulletins.

5 Additional OCIE Risk Alerts that address cybersecurity and other examination issues are available at www.sec.gov/ocie.

September 15, 2020

Cybersecurity: Safeguarding Client Accounts against Credential Compromise

I. Introduction

This Risk Alert highlights "credential stuffing" — a method of cyber-attack to client accounts that uses compromised client login credentials, resulting in the possible loss of customer assets and unauthorized disclosure of sensitive personal information.

The Office of Compliance Inspections and Examinations ("OCIE") has observed in recent examinations an increase in the number of cyber-attacks against SEC-registered investment advisers ("advisers") and brokers and dealers ("broker-dealers," and together with advisers, "registrants" or "firms") using credential stuffing. Credential stuffing is an automated attack on web-based user accounts as well as direct network login account credentials.[1] Cyber attackers obtain lists of usernames, email addresses, and corresponding passwords from the dark web[2] and then use automated scripts to try the compromised user names and passwords on other websites, such as a registrant's website, in an attempt to log in and gain unauthorized access to customer accounts.

Credential stuffing is emerging as a more effective way for attackers to gain unauthorized access to customer accounts and/or firm systems than traditional brute force password attacks.[3] When a credential stuffing attack is successful, bad actors can use the access to the customer accounts to gain access to firms' systems, where they are able to steal assets from customer accounts, access confidential customer information, obtain login credential/website information that they can sell to other bad actors on the dark web, gain access to network and system resources, or monitor and/or take over a customer's or staff[4] member's account for other purposes.

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1 The views expressed herein are those of the staff of OCIE. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by OCIE staff and is not legal advice.

2 The "dark web" is a subset of the Internet, oftentimes used anonymously, that can only be accessed using specialized software.

3 A "brute force" attack is an attempt to guess a password using numerous combinations, such as attempting all of the words in a dictionary.

4 The term "staff" includes firm employees and contractors.

II. Summary of Observations

OCIE staff has observed an increase in the frequency of credential stuffing attacks, some of which have resulted in the loss of customer assets and unauthorized access to customer information. The failure to mitigate the risks of credential stuffing proactively significantly increases various risks for firms, including but not limited to financial, regulatory, legal, and reputational risks, as well as, importantly, risks to investors.

Firms' information systems, particularly Internet-facing websites, face an increased risk of a credential stuffing attack. This includes systems hosted by third-party vendors. Firms' Internet-facing websites are vulnerable to attack because they can be used by attackers to initiate transactions or transfer funds from a compromised customer's account. In addition, Personally Identifiable Information (PII) is often available via firms' Internet-facing websites. Obtaining a customer's PII from one firm's website can facilitate an attacker's ability potentially to take over a customer account or attack accounts held by the account owner at other institutions.

Successful attacks occur more often when (1) individuals use the same password or minor variations of the same password for various online accounts, and/or (2) individuals use login usernames that are easily guessed, such as email addresses or full names.

OCIE encourages registrants to consider reviewing and updating their Regulation S-P and Regulation S-ID policies and programs to address the emergent risk of credential stuffing.[5]

III. Firms' Response to Credential Stuffing

OCIE observed a number of practices that firms have implemented to help protect client accounts, including:

- Policies and Procedures. Periodic review of policies and programs with specific focus on updating password policies to incorporate a recognized password standard[6] requiring strength, length, type, and change of passwords practices that are consistent with industry standards;
- Multi-Factor Authentication ("MFA"). Use of MFA,[7] which employs multiple "verification methods" to authenticate the person seeking to log in to an account. The strength of authentication systems is largely determined by the number of factors

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5 Regulation S-P requires firms to adopt written policies and procedures that address certain safeguards for the protection of customer records and information. Regulation S-ID prescribes certain requirements for firms to establish identity theft preventions programs. *See generally*, 17 CFR 248.30(a) and 248.201.

6 *See e.g.*, NIST Information Technology Laboratory- Computer Security Resources Center, SP 800-63-3 Digital Identity Guidelines, available at https://csrc.nist.gov/publications/detail/sp/800-63/3/final.

7 NIST Information Technology Laboratory/Applied Cybersecurity Division, "Back to Basics: Multifactor Authentication (MFA), available at https://www.nist.gov/itl/applied-cybersecurity/tig/back-basics-multi-factor-authentication.

incorporated by the system — the more factors employed, the more robust the authentication system.[8] In this regard, MFA may provide more robust authentication than two or one-factor methods of authentication.

- Properly implemented, MFA can offer one of the best defenses to password-related attacks and significantly decrease the risk of an account takeover.
    - Although the use of MFA can prevent bad actors from successfully logging into a customer's account or into a system to which a staff member has access, it cannot prevent bad actors from identifying which accounts are valid user accounts on the targeted website.
    - Identified accounts may become the targets of future attacks and information concerning the existence and validity of the accounts may be sold to other bad actors, who may attempt to pass the final MFA verification step through other means, such as phishing emails, online research of targeted individuals, and social engineering;
- Completely Automated Public Turing test to tell Computers and Humans Apart ("CAPTCHA"). To combat automated scripts or bots used in the such attacks, deployment of a CAPTCHA, which requires users to confirm they are not running automated scripts by performing an action to prove they are human (e.g., identifying pictures of a particular object within a grid of pictures or identifying words spoken against a background of other noise);
- Controls to Detect and Prevent.
    - Implementation of controls to detect and prevent credential stuffing attacks. This can include monitoring for a higher-than-usual number of login attempts over a given time period, or a higher-than-usual number of failed logins over a given time period.[9]
        - Firms then use tools to collect information about user devices and create a "fingerprint" for each incoming session. The fingerprint is a combination of parameters such as operating system, language, browser, time zone, user agent, etc. For example, if the same combination of parameters logged in several times in rapid sequence, it is more likely to be a brute force or credential stuffing attack;
    - Use of a Web Application Firewall ("WAF") that can detect and inhibit credential stuffing attacks;

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[8] *See* NIST SP 800-63-3, supra note 6.

[9] For example, some firms have implemented account monitoring controls to identify and escalate anomalous activity.

- Offering or enabling additional controls that can prevent damage in the event an account is taken over, such as controls over, or limiting online access to, fund transfers and accessing PII; and,

- Monitoring the Dark Web. Surveillance of the dark web for lists of leaked user IDs and passwords, and performance of tests to evaluate whether current user accounts are susceptible to credential stuffing attacks.

IV. Other Considerations in Preparing for Credential Stuffing Attacks

As firms prepare for credential stuffing attacks, OCIE staff encourages firms to consider their current practices (e.g., MFA and other practices described above) and any potential limitations of those practices, and to consider whether the firm's customers and staff are properly informed on how they can better secure their accounts.

Informed Customers

Most firms require customers and staff to create and use strong passwords. However, the use of passwords is less effective if customers and/or staff re-use passwords from other sites. To be more effective, some firms have informed and encouraged clients and staff to create strong, unique passwords and to change passwords if there are indications that their password has been compromised.[10]

Firm Defenses: Multi-Factor Authentication and the Use of Mobile Phones

Mobile phone text messages are often used as a verification method for MFA but this method is not foolproof. Mobile phone text messages rely on the use of proper security by mobile phone providers to authenticate account holders properly when transferring phone numbers between devices. Some firms highlight for account owners and staff that they should be alert to instances where their mobile devices no longer work, as someone may have attempted fraudulently to transfer their phone number to another device.

V. Conclusion

Financial institutions should remain vigilant and proactively address emergent cyber risks. OCIE encourages firms to review their customer account protection safeguards and identity theft prevention programs and consider whether updates to such programs or policies are warranted to address emergent risks. In addition, firms are encouraged to consider outreach to their customers to inform them of actions they may take to protect their financial accounts and personally identifiable information.

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[10] Recent NIST password guidelines note that password changes are not required unless there is evidence that an account has been compromised. *See e.g.*, NIST Special Publication 800-63-B, Digital Identity Guidelines: Authentication and Lifecycle Management, available at https://pages.nist.gov/800-63-3/sp800-63b.html.

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

10 Areas Of Privacy Law That Look Ripe For Change In 2021

By **Kirk Nahra** (January 3, 2021)

Kirk Nahra

While still in its relative infancy, privacy law has quickly become a turbulent teenager, with constant change around the world.

At a minimum, 2021 will require meaningful efforts to implement the changes of 2020, with a reasonable likelihood of even more substantial change.

What are the major issues to be watching in 2021?

1. California

Jan. 1, 2020, brought the beginning of the formal era of the California Consumer Privacy Act, or CCPA.

Because enforcement could not begin until July 1, companies faced a reasonable implementation period, to develop policies that addressed the certainly complicated and most likely confusing and awkward provisions of the hastily drafted law.

Draft regulations were issued — and issued again — and then finalized, only to be revised again. The California Legislature, meanwhile, further amended the law.

Then came the California Privacy Rights Act, or CPRA, referendum passing in November.

Chaos is probably too strong a word — more on that later. Implementation and compliance challenges are real and continue, even for companies trying hard to do the right thing.

Consumer attitudes have been mixed. The law is poorly written in many places, regardless of your view on the substance. Some of the CCPA makes little sense as it applies to certain kinds of business practices.

And now we will await not only the new substantive provisions of the CPRA but also the creation of a new enforcement entity to replace the California attorney general.

Will there be meaningful enforcement?

Will the plaintiffs bar be able to use its creative energy to expand the reach of the private cause of action?

Will the California Legislature reach a lasting solution on the employee and B2B exemptions in both the CCPA and CPRA that will expire on Jan. 1, 2023?

How long will we have to wait for CPRA regulations now that we finally have some clarity on the CCPA?

2. Other States

Since the CCPA's passage, those of us in the privacy bar have expected other states to follow suit. So far, they haven't.

Apparently, its hard to pass a broad privacy law without the gun to the head of an aggressive referendum. Not too many states have really even tried at this point.

We expect Washington state to revive its efforts in 2021. New York looks poised to try again as well, this time with the It's Your Data Act, which was proposed in October.

I would expect several more states also get moving in 2021, although we don't really know which states. It's going to be hard — and, even more important, any laws that result are not likely to look much like California.

Will the first state after California set the model?

That's a key issue to watch. If not, we may see states going off in different directions. What seems to be easier, and where I would expect activity in 2021, is on narrower laws targeted at specific practices or data — like additional laws targeting facial recognition or biometrics.

3. A National Privacy Law

And then there's the chance of a national privacy law. This effort began in earnest in 2018, and continued for about two years with the full Washington experience — white papers, briefing statements, stakeholder press conferences, congressional hearings, and draft legislation. Some progress, but not much.

Then COVID-19 hit — and all legislative efforts on a privacy law stopped, other than the possibility (not yet fulfilled) of a pandemic privacy law focused on contact tracing.

It is safe to say that this effort will begin again in 2021. Both parties in the U.S. Senate are trying to develop full scale bills.

The U.S. House of Representatives has been a little quieter, but some meaningful efforts are underway. There are large scale overall bills, and narrower bills focused on things like giving the Federal Trade Commission more authority.

It is clear that the two big issues where there is yet no consensus involve (1) preemption of state law and (2) creation of a private cause of action.

The real meat of a privacy law is very much up in the air — what the relevant use and disclosure principles will be, what individual rights will be created, who the enforcement agency will be, what will happen with the other federal laws, and whether the law will take on discrimination issues related to artificial intelligence and big data.

2021 is likely to be a year of modest but important progress.

The Biden administration presumably will be supportive, but will have a lot of other things to be doing.

A wild card involves Vice President Kamala Harris — who made her reputation at least in part through actions on privacy when she was the California attorney general.

My bet is that there's a good chance of a law, before the end of the first term of a Biden administration. The timing wild card involves the states — if three to five meaningful states pass their own laws, corporate America will need to get behind a reasonable consensus bill

as it will be extremely challenging to meet the standards of multiple states.

4. Schrems II and the Data Transfer Mess

Chaos is a reasonable word to describe the current situation involving data transfer out of Europe. The decision in Data Protection Commissioner v. Facebook Ireland and Maximillian Schrems, or Schrems II, from the European Court of Justice threw out the EU-U.S. Privacy Shield program.

There's no clear movement toward a replacement program — although we can at least expect reasonable negotiations with Europe under a Biden administration.

The alternative option — the standard contractual clauses — is now clearly on its last legs, as various signals from EU authorities are creating impossible to meet standards for appropriate implementation of the standard contractual clauses.

There is a real possibility of a vast data island in Europe — and meaningful attention needs to be addressed to the question of whether this is in fact good for either European citizens or businesses, I think it's a lose-lose at this point.

There's clearly some disconnect between the European courts and the data regulators but no clear path toward a resolution of these differences.

It does not seem likely that the U.S. will give up its surveillance options. But we may see increasing attention toward the potential hypocrisy of European authorities that both rely on this same kind of surveillance authority and engage in very similar efforts themselves.

For now, companies need to figure out a way to tread water provide reasonable protections, stay out of the limelight and be reasonable in dealings with vendors and data partners.

5. The Rest of the World

While Europe creates its own problems, the rest of the world is continuing to make privacy law a global phenomenon.

We saw a new Brazilian law in 2020.

Brexit's fallout will continue — and perhaps be resolved in 2021, although the U.K. may face American problems on data transfer issues if the U.K. standards are not found to be adequate.

India, China and Canada are pursuing expansive new laws.

There is some slight movement toward a global standard similar to General Data Protection Regulation, but there are enough differences in different places that a true global approach is not near.

6. FTC/Data Security and the FTC in General

Part of Europe's concern with U.S. privacy protections involves the role of the FTC. Typically viewed as the primary privacy regulator at the national level, the FTC is relying primarily on a more than 100-year-old statute that obviously intended nothing specific about privacy or security.

The FTC — through the magic of unimpeded enforcement – has created an extensive body of law related to appropriate data security protections. That unimpeded effort will not be feasible in the privacy area.

Privacy lawyers have read both the U.S. Court of Appeals for the Third Circuit's 2015 decision in FTC v. Wyndham and the U.S. Court of Appeals for the Eleventh Circuit's 2019 decision in LabMD v. FTC, and know the courts skepticism about the FTC's actions.

Those uncontested settlements likely won't be easy to come by on privacy issues. So, many of the national proposals are directed in large part to giving the FTC more specific authority in the privacy and security areas, including both the ability to draft regulations and the ability to impose fines in the first instance (remember that the record shattering Facebook fine was due to a prior settlement).

Recent statements by two of the FTC commissioners have encouraged a more aggressive path, including more substantial settlement terms, additional attention to privacy protections and even litigation where necessary. Under a Biden administration, these dissenters likely will become the majority.

At the same time, the FTC is pursuing a rulemaking proceeding under the Gramm-Leach-Bliley Act that may blow up existing data security law.

The original GLB Safeguards rule created the overall approach to a "reasonable and appropriate" data security program, and became the model for the FTC's approach outside of financial institutions regulated by GLB.

It is now pursuing a more explicit set of security requirements for GLB. If that approach is enacted and followed in other areas, that could create a monumental change to how companies must develop and implement their data security programs.

7. Attorney General Enforcement

The FTC also has a strong competitor to the title of primary privacy regulator. The state attorneys general are taking significantly more aggressive action involving privacy and data security claims.

These cases can be individual, in small or large groups of states, or in a handful of 50-state cases.

They are taking follow-on enforcement action after other agencies have acted, focusing on particular practices of concern that typically have some kind of consumer harm, and are at times creating new bodies of law to fill in current gaps.

Both the New York attorney general's efforts at filling the gaps of the Health Insurance Portability and Accountability Act and the California attorney general's effort to impose new standards for apps from the September Glow Inc. settlement are examples of both aggressive enforcement and use of enforcement to impose new standards.

The attorneys general are using their authority on consumer protection to build new bodies of law — in potentially retroactive ways.

Keep watching them in 2021, in a wide variety of settings. Companies need to be thinking

about reactions in developing privacy practices, even if there is no obvious law that is being violated.

Privacy lawyers are going to need to pay closer attention to the creepiness factor that arises in data collection activities, as an additional element of legal advice beyond just reading the rules.

8. New Administration Priorities

In addition to these state level issues, we can expect somewhat more aggressive enforcement overall at the federal level due to the incoming administration. Privacy issues have not occupied a lot of campaign attention. In addition, the relevant enforcement agencies often are somewhat limited in their ability to take aggressive enforcement action.

Similarly, even under an Obama administration, privacy and security enforcement was reasonable and limited, as regulators took appropriate action to address both reasonable compliance activities (particularly on data security, where perfection is not expected) as well as more problematic actions.

Some agencies will bring in significantly different personnel. At the same time, it is important to recognize that different priorities do not necessarily mean more enforcement. The U.S. Department of Health and Human Services' Office for Civil Rights, for example, has undertaken careful, thoughtful enforcement throughout its tenure under different administrations.

Where companies have been trying to do the right thing, OCR does not tend to take action even if something goes wrong. My colleagues in the privacy bar may criticize me for saying this, but we have seen the same kinds of actions from the FTC — they work hard at their cases and take action on enforcement when a company is really out of line with appropriate behavior.

We will be watching the new administration in its enforcement, in its consideration and encouragement of a national law and for its thoughtful activity on issues like big data discrimination — where careful attention to developing the right approach likely is more important that just passing something.

9. Private Cause of Action/Ongoing Litigation

The role of the plaintiffs bar in the privacy and security debate remains a critical element of any discussion of future law. Today, we are seeing increased litigation, motivated by three things:

1. Security breaches — of virtually any kind, with little consideration of fault or reasonable security practices.

2. Cases filed under state or federal laws with specific statutory damage provisions — mainly the Telephone Consumer Protection Act, the Biometric Privacy Act and now the CCPA.

3. Various policy-oriented cases driven by potentially problematic privacy or data practices.

This isn't only a U.S. issue. In the U.K. under GDPR and the Data Protection Act, there has

been a recent rise in the U.K.'s form of class action litigation, where the courts have been more supportive of individual consumer claims.

Many of these cases have faced an uphill battle, particularly the data breach cases. Courts have been careful and thoughtful. The plaintiffs bar has been creative and aggressive.

As more laws are passed, and as more cases are brought, we will need to pay careful attention to whether there is a true breakthrough case that opens the floodgates for litigation. If that case happens soon, it may impact the debate in a national law about both preemption and a private cause of action (remember the fallout from the Fair and Accurate Credit Transactions Act cases involving truncated credit card numbers).

10. Ransomware/Security Attacks

While legislative attention has been focused on privacy issues, data security continues to be a growing and actual problem on a regular basis, across industries.

Certain industries have been targeted — in some settings there was significant attention for the government to credible threats of ransomware attacks directed at the hospital industry.

Hackers have been getting more aggressive and more organized. Companies need to be paying substantial attention to these risks — through better monitoring, improved training, appropriate and aggressive incident — response and meaningful prebreach planning. For example, the recent volume of ransomware attacks has placed renewed attention on the need for data recovery and appropriate back-up systems.

Data security risks are real and can have a major impact on companies in real time – independent of subsequent litigation and/or litigation activity. Careful thoughtful planning is necessary now, to protect data and company systems.

Conclusion

Privacy law is becoming more complicated every year. There are real questions about whether the current state of U.S. law in particular is good for either consumers or businesses — with the increasing likelihood of a lose-lose situation.

Consumers cannot possibly understand the law, and companies are facing increasing complexity and burdensome detail just simply to understand and apply the law.

It's a great time to be a privacy lawyer, but we may be the only people benefiting from the current state of the law.

Kirk J. Nahra is a partner at WilmerHale.

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CPRA Qualifies for November Ballot in California

JUNE 25, 2020

The California Privacy Rights and Enforcement Act ("CPRA")—the latest ballot initiative spearheaded by Alastair MacTaggart and his group Californians for Consumer Privacy—has qualified for the November 3, 2020 ballot, according to an email sent by the California Secretary of State's office. The ballot initiative reached more than the 623,212 signatures it needed to qualify. Early polling data released by Californians for Consumer Privacy indicates that the CPRA will overwhelmingly be voted into law.

There was some uncertainty earlier in the month as to whether California counties would be able to count and certify enough signatures for the CPRA to make the November ballot before the June 25 deadline. Mactaggart, however, filed a lawsuit against the California Secretary of State Alex Padilla on June 8, alleging that his office had not "immediately" notified county officials to begin the random-sampling verification process for signatures. A California judge issued a writ of mandate on June 19 that required the California Secretary of State to direct counties in California to report the results of their random-sample signature verification on or before June 25, which led to the CPRA qualifying for the ballot in time.

The CPRA qualified for the November ballot a week before the California Attorney General can begin enforcing the California Consumer Privacy Act ("CCPA") on July 1st, and all indications are that the CPRA will replace the CCPA as the new privacy law in California. The CPRA builds upon the CCPA's framework by creating additional rights for consumers and further compliance obligations for businesses.

The good news for businesses is that, should the CPRA be voted into law, the CCPA's current business-to-business and employee data exceptions (which are set to expire on January 1, 2021) would now expire on January 1, 2023. This means that the California legislature would have between November 2020 and January 2023 to decide how to address those exemptions on a permanent basis.

Should it pass, the substantive portions of the CPRA would not become operative until January 1, 2023, and most of the law would apply to information that a business collects after January 1, 2022 (with the exception being the right to access).

Key differences between the CCPA and CPRA include:

1. **The establishment of the California Privacy Protection Agency**, which would be in charge of enforcing the law instead of the California AG's office.
2. **The addition of a new right of correction for consumers.**
3. **A slightly broader private right of action for data breaches**: In addition to what is currently protected under California's data breach statute, the CPRA expands the CCPA's private right of action for data breaches so that it also applies to consumers whose email addresses in combination with a password or security question that would permit access to the account are compromised.
4. **An expanded right to know**: Under the CPRA, businesses must inform consumers if they have been "profiling" them using automated processes (this is similar to the General Data Protection Regulation in the EU) and whether they have used a consumer's personal information for the business's own political purposes.
5. **An expanded right to opt-out**: Instead of only applying to "sales," the CPRA provides consumers with the right to opt-out of any sharing of their data with third parties.
6. **Distinguishing between "personal information" and "sensitive personal information"**: The latter receives additional protections under the law.

We will continue to provide updates as we learn more about the CPRA.

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Virginia Set to Become Second State to Pass a Comprehensive Privacy Law

FEBRUARY 4, 2021

The long wait to see if any state would join California in passing a comprehensive privacy law is finally coming to an end, as the Virginia Senate passed the Virginia Consumer Data Protection Act (CDPA) on February 3. An identical version of the bill had already passed the Virginia House of Delegates on January 29, which means that reconciling the two versions of the bill before the February 11 deadline will likely be a mere formality. The bill will then be sent to the governor of Virginia for his signature. Should it be signed into law, the Virginia CDPA will go into effect on January 1, 2023, the same day as the California Privacy Rights Act (CPRA).

The CDPA borrows principles from the CPRA, the California Consumer Privacy Act (CCPA) and the General Data Protection Regulation (GDPR) but also differs from all three in key respects. Below we have summarized the key provisions of the CDPA. We will continue to provide updates as the bill moves through the Virginia legislature.

1. ***Applicability***. The CDPA borrows from the CCPA in terms of using threshold requirements to determine applicability. The law applies to "persons that conduct business in [Virginia] or that produce products or services that are targeted to residents of [Virginia] and that: 1) during a calendar year, control or process personal data of at least 100,000 Virginia residents or 2) control or process personal data of at least 25,000 Virginia residents and derive over 50 percent of gross revenue from the sale of personal data."
2. ***Exemptions***. Despite being labeled a "comprehensive" privacy law, the CDPA has a number of exemptions (much like the CCPA and CPRA). Some of these exemptions are similar to those in the CCPA and CPRA, but in some cases they are broader than those in the other two laws. For example, instead of only exempting information that is subject to the Gramm-Leach-Bliley Act (GLBA) or protected health information under the Health Information Portability and Accountability Act (HIPAA), the CDPA does not apply to "financial institutions . . . subject to [the GLBA]" or to any "covered entity or business associate governed by [HIPAA]." The law also exempts information subject to most other federal laws, such as information regulated by the Family Education and Privacy Act, the Fair Credit Reporting Act, the Farm Credit Act, the Children's Online Privacy Protection Act (COPPA), and the Driver's Privacy Protection Act.

3. ***Controller/processer distinction***. Like the GDPR (and unlike the CCPA, which distinguishes between "businesses" and "service providers"), the CDPA uses a controller/processor dichotomy to distinguish between entities that are responsible for determining the purposes and means of processing personal data and the entities that process personal information on their behalf. Like the GDPR, the CDPA creates specific obligations for both controllers and processors (and both can be held liable under the law).
4. ***Broad definition of personal data***. Similar to the other three privacy laws discussed, the CDPA has a broad definition of "personal data." It defines the term as "any information that is linked or reasonably linkable to an identified or identifiable natural person." The definition of personal data explicitly excludes publicly available information and de-identified data (and the law has specific standards for how businesses must treat de-identified data).
5. ***Inclusion of sensitive data category***. The CDPA has a separate category labeled "sensitive data" that is defined as 1) personal data revealing racial or ethnic origin, religious beliefs, mental or physical health diagnosis, sexual orientation, or citizenship or immigration status; 2) genetic or biometric data (used for the purpose of identifying a natural person); 3) personal data collected from a child; or 4) precise geolocation data. Controllers may only process sensitive data with consumer consent (or with parental consent in accordance with COPPA, in the case of children's data).
6. ***Individual rights***. Like all three laws previously discussed, the CDPA creates individual rights for Virginia residents that are protected under the law. These include 1) the right to access; 2) the right to amend; 3) the right to delete; 4) the right to data portability; and 5) the right to opt out of the processing of personal data for the purposes of targeted advertising, sale and profiling in furtherance of decisions that produce legal or similarly significant effects concerning the consumer.
7. ***Data protection assessments***. Like the GDPR and CPRA, the CDPA requires entities to conduct data protection assessments when processing data in certain contexts. Specifically, the CDPA requires a data protection assessment when a controller is 1) processing personal data for the purposes of targeted advertising; 2) selling personal data; 3) processing personal data for purposes of profiling (in certain contexts); 4) processing sensitive data; and 5) conducting any processing activity that presents a heightened risk of harm to consumers.
8. ***Enforcement***. Like the CCPA, the CDPA is enforceable through civil actions brought by the attorney general and also includes a 30-day cure provision. Penalties under the CDPA for both controllers and processors can be as high as $7,500 per violation. Unlike the CCPA, the CDPA does not have any private right of action, even for security incidents.

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Thermal Testing: Privacy Considerations for Businesses

JULY 28, 2020

*I*n the wake of COVID-19, businesses have a host of health regulations and recommendations to consider before they resume in-person activity. Some employers plan to screen for symptoms, including regular thermal testing (or temperature taking) of employees and site visitors before those individuals enter a facility. In the U.S., there are states that are requiring employers to conduct thermal tests of their employees as part of their reopening plans,[1] while others are recommending it as a best practice.[2] Internationally, guidance regarding thermal testing also varies, but the process is nevertheless being used by businesses around the world in an attempt to foster a safer work environment and to absolve potential legal liability associated with the pandemic.

In addition to employment and health and safety law concerns, none of which we address in this Blog post but which our firm has covered here and here, employers should also be aware of privacy law considerations related to thermal testing, especially because thermal data may be categorized as "sensitive" or as a "special category" of information under certain privacy laws, such as under the EU's General Data Protection Regulation (GDPR). This means that employers should consider whether they are checking the right boxes from a privacy law perspective regarding the collection, use, dissemination, and disposal of thermal data.

While specific obligations for thermal tests may vary by jurisdiction, below are a list of best practices that employers should consider from a privacy law perspective when conducting thermal tests of employees and others. The list below is not intended to be exhaustive; rather, it should be used as a starting point for employers that are looking to implement thermal testing in a way that complies with various privacy rules that may be applicable to them.

1. **Provide appropriate notice.** Businesses should provide notice to employees and site visitors prior to collecting their thermal data. Ideally, this notice should also be given to employees periodically and be readily accessible as a resource. The notice should state what information will be collected and the purposes for its collection and the fact that the individual's temperature will be deleted immediately after it is collected (see No. 5 below). To the extent that a business chooses to retain an individual's thermal data (for instance, if a test indicates that a visitor might be sick), the notice should provide additional information, such as how the information is stored, the fact that the information will not be shared with any other third party (if this is the case), and

that the collection and storage of this information is subject to protection under the jurisdiction's data privacy laws, if applicable. Businesses should also note that additional content in these notices might be required under specific privacy laws, such as the GDPR or the California Consumer Privacy Act (both of which have broad definitions of "personal data" or "personal information" and likely apply to thermal data).

2. **Obtain consent, if possible.** Some privacy laws may require you to obtain consent when it comes to processing sensitive personal information like thermal data (or may require consent for collecting personal information in general). It is possible that consent may be implied in some jurisdictions based on the fact that the employee or on-site visitor is actively taking the thermal test. Still, explicit and informed consent is likely the best approach, especially in situations where thermal data is considered a special category of information and the business is relying on explicit consent as its proper legal basis for processing (as may be the case under the GDPR). Even in jurisdictions where consent is not required, obtaining consent (especially for employees whose medical information may be subject to additional regulations) can offer businesses an extra layer of protection.
3. **Check *all* the boxes.** Certain privacy laws require more than others in terms of the steps that a business must take in order to properly process information, especially sensitive information like thermal data. Under the GDPR, for example, a business generally needs a legitimate basis to process data in the first place. With regards to thermal data (which is likely considered a "special category of information" that receives further protection under the law), a business may need to take additional steps in order to ensure that its processing is legitimate. This could include conducting a data protection impact assessment that identifies the proposed activity and its associated data protection risks, whether processing the data is necessary and proportionate, mitigating actions that can be implemented, and a plan or confirmation that mitigation has been effective.
4. **Practice data minimization.** Data protection authorities will likely be understanding of a business's need to collect sensitive information to ensure the safety of their workplace during a global pandemic. They will be less forgiving, however, if a business collects a litany of information that is unrelated to this well-intentioned purpose. To the extent possible, businesses should only collect the information they need to conduct thermal testing.
5. **Dispose of the data immediately and only store the information when absolutely necessary (and with appropriate safeguards).** Whereas our previous guidance noted that OSHA guidelines require employers to retain records when health tests are conducted by health care professionals, data resulting from thermal tests conducted by employers (or other workforce members) do not need to be stored, and should be immediately deleted. Even with regards to employees or visitors that have a high temperature (one that crosses a threshold for entry), there is still likely not a need to store the thermal data itself. Employers can deny entry, recommend quarantine for two weeks (or whatever the internal policy or regulatory requirement is), and then test again the next time the employee or site visitor attempts to enter the premises. This avoids legal obligations associated with storing sensitive information.
6. **Limit sharing.** To the extent that a business stores the thermal data that it collects (on employees or otherwise), it should be careful not to share this information with any third party (except as required by law). Even internally, thermal data should only be shared on a need-to-know basis. To the extent that a business uses a third-party vendor to administer thermal tests, it should ensure contractually that the vendor cannot use the data for its own purposes or further share the information that it collects.

Again, there is no one size fits all approach to conducting thermal tests, especially since the rules in this area are rapidly changing. We will continue to monitor updates and can provide clients advice with regards to their business's specific reopening plans and goals.

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[1] *See* Arizona, Georgia, Idaho (for select businesses), and Colorado (if feasible, otherwise employees self-screen), among others.

[2] *See* Maryland, North Dakota, and Oregon, among others. We also provided guidance on Massachusetts's reopening guidelines, which included testing recommendations/requirements.

Solar Winds Questions

1. Does your company or the services/products you provide have exposure (direct or indirect) to SolarWinds Orion or other SolarWinds products?

2. Do any of your critical vendors or sub-service providers have exposure to SolarWinds products or the current breach?

3. Are you continuing to monitor developments of the SolarWinds breach to determine whether or not your company or services/products have exposure?

4. Do you currently run Microsoft's O365 or Azure Platforms?

   i. Have you run a recent security audit of these platforms using publicly available tools published by CISA or CrowdStrike?
   ii. Were any indicators of compromise identified during recent audits?
   iii. Do you leverage a Cloud Solution Provider ("CSP")?
   iv. Have you engaged your CSP to assess any impact from the SolarWinds compromise?

Detection for the Windows Environment

CISA Article
Detecting Post-Compromise Threat Activity in Microsoft Cloud Environments | CISA

CISA Tool
GitHub - cisagov/Sparrow: Sparrow.ps1 was created by CISA's Cloud Forensics team to help detect possible compromised accounts and applications in the Azure/m365 environment.

Crowdstrike Article
CrowdStrike Launches Free Tool to Identify & Mitigate Risks in Azure Active Directory | CrowdStrike

Crowdstrike Tool
CRT (CrowdStrike Reporting Tool for Azure) | crowdstrike.com

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

INDIVIDUAL CLIENTS: RETAIL AND SENIOR CLIENT MATTERS

Julius Leiman-Carbia, *Weathfront Inc.*
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IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

INDIVIDUAL CLIENTS: RETAIL AND SENIOR CLIENT MATTERS

Agenda

- ❑ Onboarding the Individual Client
- ❑ Advising the Individual Client
- ❑ Special Considerations for Senior Investors
- ❑ Special Considerations for Novice Investors
- ❑ Robo-advising
- ❑ Parting Ways with the Individual Client
- ❑ Resources

Onboarding the Individual Client: Marketing

- The new Advisers Act Marketing Rule may affect the way an adviser attracts retail clients.
  - Prohibitions against false, misleading or insupportable statements or omissions and duty to convey information in a fair and reasonable manner are scaled to the intended audience.
  - The traditional ban on testimonials has been replaced with a series of conditions on the use of testimonials and endorsements.
  - Displays of hypothetical performance must be relevant to and capable of being understood by the intended audience.

Onboarding the Individual Client: Establishing Investment Objectives

- The fiduciary duty of care entails an obligation to render advice that is in the best interest of the client based on the client's investment objectives.
- This includes an obligation to make a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience and financial goals.

Onboarding the Individual Client: Providing Advice to Prospective Clients

- Although fiduciary duty depends on a client relationship, the Advisers Act antifraud provision applies a parallel standard of conduct to interactions with *prospective* clients.
- An adviser needs sufficient information about a prospective client and her objectives to form a reasonable basis for advice about account type or retirement asset roll-overs.
- These considerations do not apply where the *client* makes the account or roll-over decision without the adviser's recommendation.

Onboarding the Individual Client: The Advisory Contract

- Defining the Scope of the Advisory Relationship
  - Fiduciary duty cannot be waived, but its contours can be shaped by contract.
  - Clearly articulate what services the adviser will and will not provide.
  - Establish the frequency and timing of ongoing account monitoring.

Onboarding the Individual Client: The Advisory Contract

- Managing Expectations
  - In the SEC's view, there are "few, if any circumstances" in which a hedge clause can be used with a retail investor.
  - Hedge clause substitutes might include "no guarantees" language and reminders of investment risk.

Onboarding the Individual Client: The Advisory Contract

- Adding a "trusted contact" authorizes the adviser to:
  - provide the contact with information about client and/or her account
  - ask about the client's current contact information and/or health status
  - ask whether another person or entity, such as a legal guardian, conservator or trustee, has legal authority to act on the client's behalf.

A trusted contact has no authority to transact business in the client's account.

Advising the Individual Client

- The fiduciary duty of care entails an obligation to advise and monitor the client's account over the *full course of the relationship*.
- This includes a duty to evaluate whether the client's type of account or program continues to be in the client's best interest.
- In order to satisfy this standard, the adviser must reasonably ensure it has timely information about changes to a client's investment objectives or financial situation.
- Periodically review advisory agreements on a risk basis.

Special Considerations for Senior Investors

- Senior Safe Act
  - Provides limited immunity from liability to advisers and their supervised persons when they disclose suspected financial exploitation of a person 65 years or older
  - Law *encourages,* but does not *require* disclosure
  - Immunity is conditioned on training compliant with the Act

Special Considerations for Senior Investors

- Senior Safe Act Reporting
  - Reports may be made to a broad array of "covered" agencies, including state financial regulatory agencies, federal agencies such as the SEC, SROs, law enforcement, and adult protective services
- Senior Safe Act Training
  - Must be provided as soon as ***reasonably practicable and within one year*** from date of employment/affiliation with financial institution
  - Must instruct about how to **identify** and **report** suspected exploitation
  - Must address client privacy/integrity
  - Must be tailored to the job responsibilities of the employee

Special Considerations for Senior Investors

- State Adult Protective Services (APS) Statutes (all 50 states)
- State financial exploitation statutes (30 states and counting)
  - Protect persons 60 or 65 years and older (varies state to state)
  - Protect persons 18 years and older who have diminished physical or mental capacity
  - Criteria vary state to state

APS Statutes

- ***All*** states have laws related to how and when to report elder abuse
- Some states **require** reporting by **all persons**
- Other states **permit** reporting by **all persons**
- States have different **protocols** and **time frames** for reporting
- ***Good faith*** reporting triggers immunity from civil/criminal liability

State Financial Regulation Statutes

- **Required or permissive** reporting to state APS, securities commissioner and/or other agencies
- **Permissive** temporary hold of suspicious disbursements and/or transactions
- **Permissive** third party disclosures
- **Required** training provisions
- **Holds** are allowed **only** where there is:
  - A senior or vulnerable investor *and* exploitation
  - Diminished capacity alone is *not* enough to warrant a disbursement hold

Recognized Signs of Diminished Capacity

- ❑ Memory loss
- ❑ Disorientation
- ❑ Making decisions inconsistent with history or stated goals
- ❑ Interest in "get rich quick" schemes
- ❑ Inability to understand important or basic aspects of account
- ❑ Problems with written or spoken words
- ❑ Inability to pay bills or multiple bills at the same time, bouncing checks
- ❑ Repeated calls and/or resetting of online account access passwords

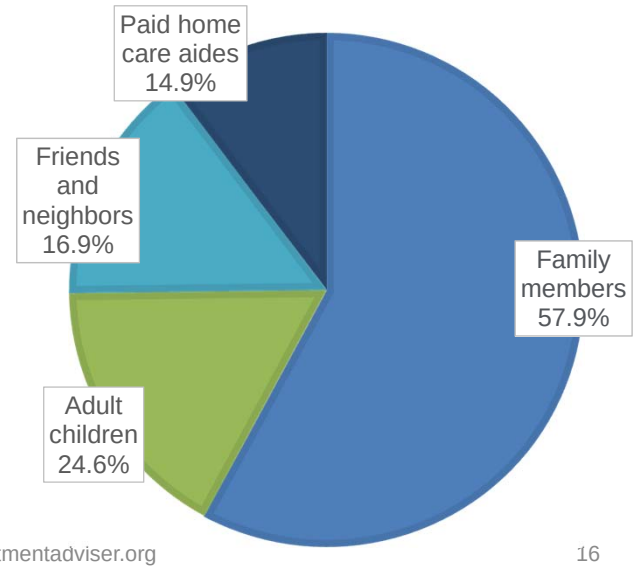
For a comprehensive treatment of red flags, see NASAA, *A Guide for Developing Practices and Procedures for Protecting Senior Investors and Vulnerable Adults from Financial Exploitation* (September 2016

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021
EFFECTIVE STRATEGIES & BEST PRACTICES

90% of Bad Actors are Close to Their Victims

Mistreatment Breakdown

- ❑ Family members – 57.9%
- ❑ Adult children – 24.6%
- ❑ Friends & neighbors – 16.9%
- ❑ Paid home care aides – 14.9%
- ❑ Guardians and POAs create additional risk



Source: Peterson, J., Burnes, D., Caccamise, P., Mason, A., Henderson, C., Wells, M., & Lachs, M. (2014). *Financial exploitation of older adults: a population-based prevalence study.* Journal of General Internal Medicine, 29(12), 1615–23.

Red Flags Indicating Possible Exploitation

- Dramatic, unexplained shifts in investment style or unusual transactions
- Sudden withdrawals or changes in amount/frequency of withdrawals
- Requests to transfer assets to suspicious parties or locations
- Family/friends/new acquaintances who pay extraordinary interest in assets/belongings
- Suspicious signatures or documents
- Abrupt changes in trusted contact, beneficiary or estate planning documents

Recommended Best Practices

- Structure your training program according to your advisory practice
- Keep records and document communications with clients
- Build into your compliance P&P an escalation process of how and when to report
- Review existing advisory agreements for POA to delay or stop distributions
- Consider state laws and regulations
- FINRA considerations for dually registered firms

Special Considerations for Young Investors: Communication

- Customizing regulatory disclosures to reach an e-generation
  - Using video, audio, QR codes, mouse-over windows, pop-up boxes and chat functionality and other electronic tools
- Communicating through social media
  - Adviser not responsible for third-party commentary posted to the adviser's website or social media page if the adviser does not
    - prepare or edit content
    - selectively delete or rearrange postings, or
    - endorse or approve postings

Special Considerations for Young Investors: Communication

- Adviser may be responsible for content posted on supervised persons' personal social media pages. Mitigate this risk by
  - Forbidding the use of personal accounts to conduct advisory business
  - Training and testing through review of publicly available social media pages
- Electronic communications are "records" for purposes of the Advisers Act recordkeeping rule
  - Before adopting new methods of electronic communication, make sure the content can be captured, reviewed and archived

Special Considerations for Young Investors: Managing Expectations

- Make sure the client understands
  - the portfolio strategy the adviser uses to manage the account
  - the implications of granting investment discretion to the adviser
  - the dangers of basing investment decisions on internet chatter

Robo-Advising

- Robo-advisers provide discretionary asset management services to clients through online algorithmic-based programs.
- Robo-advisers are subject to all requirements of the Advisers Act, including the fiduciary duties of care and loyalty.
- While robo-advising is an efficient way to provide advisory services to tech-savvy clients of modest means, it may entail special regulatory considerations

Robo-Advising

- Robo-advisers must ensure their disclosures are sufficiently specific and easy to read and understand, especially if the adviser's business model does not allow for human interaction.
- Robo-advisers should consider specific disclosure of their algorithms, including the assumptions and limitations of the algorithms and what level of human involvement takes place in investment strategies.

Robo-Advising

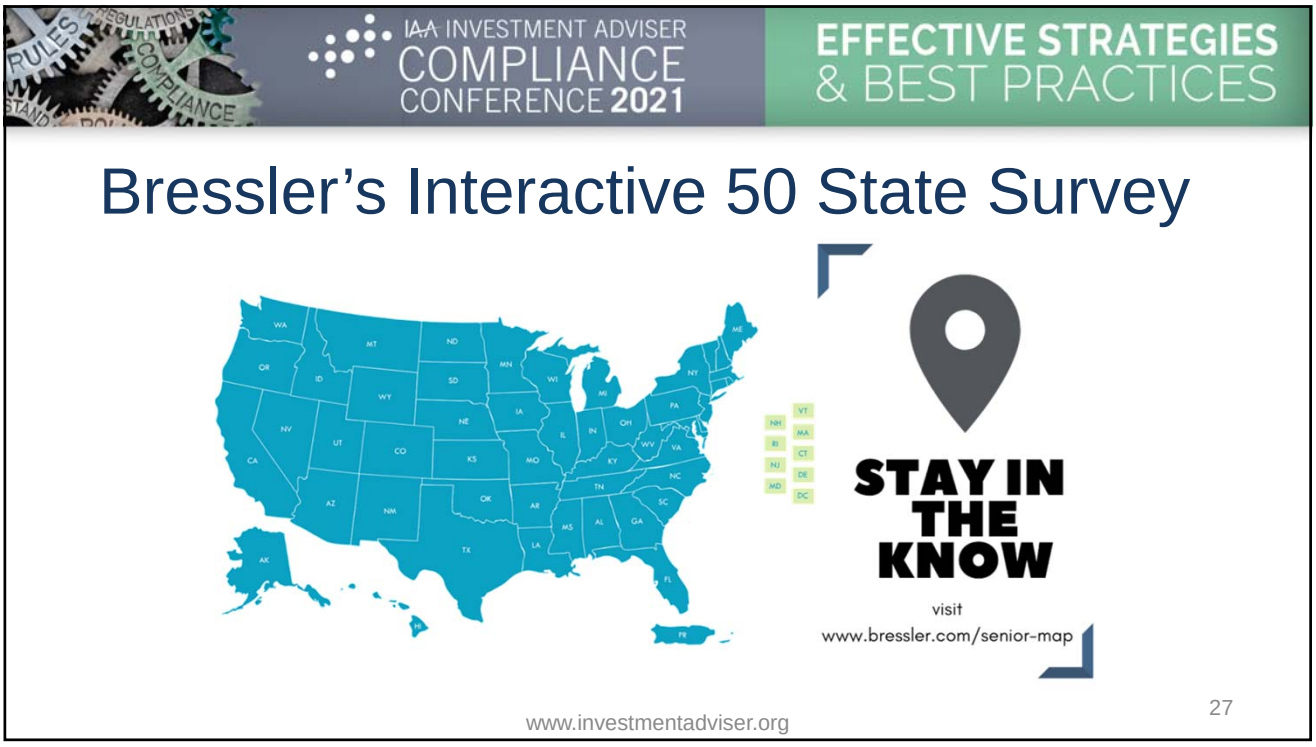
- The robo-adviser must gather sufficient information about the client to ensure that the investment advice rendered is in the client's best interest. To meet this standard, the adviser may give the clients the opportunity to furnish additional information or context concerning the client's selected responses.
- A robo-adviser's business model may present unique risk exposures which should be addressed through targeted policies and procedures. These include oversight of algorithmic codes, disclosing changes in the algorithmic codes, and monitoring for cybersecurity threats.

Parting Ways With the Individual Client

- Knowing when to go
  - Unrealistic client expectations
  - Instructions and demands inconsistent with management style
  - Account no longer in client's best interest
- Fiduciary Considerations
  - Reasonable notice
  - Assistance in transferring account
  - Refund of unearned advisory fees
- Ongoing recordkeeping requirements

Resources

- https://www.oysterllc.com/wp-content/uploads/2018/10/Protection-of-Seniors-from-Financial-Exploitation-Congress-Enacts-the-Senior-Safe-Act.pdf
- https://www.sifma.org/resources/general/senior-investor-protection-toolkit/
- https://www.investor.gov/senior-safe-act-fact-sheet
- https://www.sfhsa.org/services/protection-safety/adult-abuse
- Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 2019), *available at https://www.sec.gov/rules/interp/2019/ia-5248.pdf*
- Division of Investment Management, Robo Advisers, IM Guidance Update No. 2017-02 (Feb. 2017), *available at https://www.sec.gov/investment/im-guidance-2017-02.pdf*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BOOMERS TO ZOOMERS:
Serving the Individual Client

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As Baby Boomers drive a rapid increase in the 65-and-older population and the leading edge of Gen Z investors—weaned on technology and social media—dips a toe in the securities markets, investment advisers with an individual client base face a number of challenges. This outline explores various aspects of the regulatory regime established under the Investment Advisers Act of 1940 (Advisers Act) as they relate to individual investors and addresses some unique issues that may arise when dealing with such a clientele.

A. Treatment of Individual Clients Under the Advisers Act

1. An investment adviser's fiduciary duties of care and loyalty under the Advisers Act apply equally to institutional and individual clients. However, as addressed in this outline, the ways in which the adviser satisfies these duties may differ depending on the nature of the client.

2. The Advisers Act and related rules take a varied approach to classifying individual clients, sometimes focusing on the way the client uses an advisory service and other times focusing on the client's wealth or investment experience.

3. Individual clients are variously referred to as
   - retail investors
   - qualified clients
   - qualified purchasers
   - excepted persons
   - consumers and customers

4. In many cases, these client designations entail heightened responsibilities for the investment adviser, while in other cases, they afford the adviser more leeway in conducting its advisory business.

B. Registration Implications

1. While having a retail client base does not affect an investment adviser's obligation to register under the Advisers Act, it may affect the adviser's duty to register its supervised persons as investment adviser representatives (IA Reps) under state law.

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* The author appreciates the assistance of Aleaha N. Jones, Associate, Pickard Djinis and Pisarri LLP in the preparation of this outline. Please note that this outline is intended as a general discussion of compliance issues. It is not an exhaustive treatment of the topics discussed, nor does it provide legal advice regarding fact-specific issues an investment adviser may face.

a. IA Rep registration may be required in a state in which a supervised person has a place of business if more than 10% of the supervised person's clients are natural persons other than ***excepted persons***, and the supervised person has more than 5 such clients. [Advisers Act Rule 203A-3.]

b. An ***excepted person*** is a natural person who fits the definition of **qualified client** in Rule 205-3. This is a person who:

i. has at least $1 million in asset under management with the adviser immediately after entering into the advisory contract;

ii. the adviser reasonably believes has either a net worth in excess of $2.1 million at the time the contract is entered into or is a ***qualified purchaser*** under § 2(a)(51)(A) of the Investment Company Act of 1940 (Company Act) at that time; or

iii. is an executive officer, director, trustee or general partner of the adviser or another knowledgeable employee who has participated in investment activities for at least 12 months.

iv. A ***qualified purchaser*** includes an individual who owns not less than $5 million in total investments.

c. Even if the conditions in paragraph a. are met, a supervised person will not be considered an investment adviser representative if she does not on a regular basis solicit, meet with or otherwise communicate with the adviser's clients or if the supervised person provides only impersonal investment advice.

C. The Lifecycle of an Advisory Relationship with an Individual Client

1. Marketing to the Individual Client

In 2020, the SEC overhauled the Advisers Act advertising and solicitation rules, folding the latter into the former and christening the combined rule, "Investment Adviser Marketing." In so doing, the SEC abandoned its proposal to base the performance advertising standards on whether the ads were directed to "retail persons" or "non-retail persons," the latter of whom would have been defined as qualified purchasers and knowledgeable employees of certain private funds.

Revised Rule 206(4)-1 is designed to adapt the regulation of marketing activities to both recent developments and future changes in technology and the investment advice industry. While a comprehensive examination of the new rule is beyond the scope of this outline, a few aspects specifically affecting the individual client merit attention.

a. *Definition of "Advertisement"*

There are two prongs to the new definition of "advertisement."

i. The first includes an adviser's direct or indirect communication that offers the adviser's investment advisory services to prospective clients or investors in a private fund advised by the adviser or offers new advisory

services to current clients or private fund investors. The term excludes:

- Extemporaneous, live, oral communications;
- Information contained in, and reasonably designed to satisfy, a statutory or regulatory notice, filing or other required communication;
- 1-on-1 communications, except communications that portray hypothetical performance in certain cases.

ii. The second prong covers compensated testimonials and endorsements, and includes activities similar to those covered under the current cash solicitation rule [206(4)-3], which will now be eliminated. This prong does capture 1-on-1 communications but excludes information contained in, and reasonably designed to satisfy, a statutory or regulatory notice, filing or other required communication.

b. *General Prohibitions*

All investment adviser advertisements are subject to a set of general prohibitions [Rule 206(4)-1(a)]. This includes bans on

i. false or misleading statements or omissions;

ii. material statements of fact the adviser does not reasonably believe it can support if the SEC asks it to;

iii. information that would reasonably be likely to cause a client or prospective client to draw an untrue or misleading implication or inference about a material fact regarding the adviser; and

iv. statements about past advice, the adviser's performance or the potential benefits of dealing with the adviser unless those statements are fair and balanced.

The application of these general prohibitions is a facts-and-circumstances exercise that depends on the audience to which the advertisement is directed. The type and amount of information that should be included in an advertisement directed at retail investors may differ from that needed in an advertisement whose target audience is composed of sophisticated institutional investors.

c. Testimonials and Endorsements

Recognizing that consumers today rely on the internet, mobile applications and social media to gather information—including reviews and referrals—when selecting service providers, the revised marketing rule abandons the 60-year-old absolute prohibition against testimonials found in the previous version of 206(4)-1. Instead, the new rule facilitates marking to the individual investor by allowing testimonials and endorsements to be included in advertisements subject to the general prohibitions and the following additional conditions: [Rule 206(4)-1(b)]

i. The adviser must make clear and prominent disclosure that

(a) the testimonial was given by a current client or private fund investor or the endorsement was given by someone other than a current client or investor;

(b) cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and

(c) a brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the person's relationship with the adviser.

- In order to be "clear and prominent," the disclosure must be in the advertisement itself and must be at least as prominent as the testimonial or endorsement.

- In the case of an oral testimonial or endorsement, the disclosure must be provided at the same time as the testimonial or endorsement.

ii. Additional disclosure is required of the material terms of any compensation arrangement between the adviser and the person providing the testimony or endorsement. Disclosure is also required of material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person and/pr any compensation arrangement.

iii. The adviser must have a reasonable basis for believing that all testimonials and endorsements comply with the requirements of Rule 206(4)-1.

iv. The adviser must have a written agreement with any person giving a testimonial or endorsement in exchange for more than *de minimis* compensation (*i.e.,* $1000 or less during the preceding 12 months).

v. A person who has engaged in certain types of misconduct cannot be paid more than *de minimis* compensation for a testimonial or endorsement.

vi. The marketing rule provides other limited exemptions, including exemptions for an adviser's partners, officers, directors, employees and certain affiliates; broker-dealers whose testimonials or endorsements qualify as "recommendations" subject to Regulation Best Interest; and persons covered by Rule 506(d) of the Securities Act of 1933 with respect to a Rule 506 securities offering.

vii. Definitions

(a) A "testimonial" is a statement by a current client or investor in a private fund advised by the adviser about the client or investor's experience with the adviser or its supervised persons, or that solicits a

current or prospective client or investor for, or refers a current or prospective client or investor to, the adviser or a private fund it advises.

(b) An "endorsement" is similar to a testimonial, except it is spoken by a person other than a current client or investor, and may include a general indication of approval, support or recommendation of the adviser or its supervised persons.

d. *Performance*

Revised Rule 206(4)-1(d) replaces the tangled web of sub-regulatory guidance on performance advertising with explicit standards requiring the presentation of net performance alongside any gross performance portrayals, and the presentation of performance data over 1-, 5- and 10-year periods (or the life of the portfolio if less than the specified periods). The rule also addresses the presentation of extracted performance, hypothetical performance, predecessor performance and related performance. In the case of hypothetical performance, the rule establishes three conditions that might require special care in the case of individual investors.

i. In order to advertise hypothetical performance, the adviser must:

(a) adopt and implement policies and procedures reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience;

(b) provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the performance;

(c) provide sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions. (If the intended audience is an investor in a private fund, the adviser may simply offer to provide this last information.)

ii. These conditions are designed to ensure that hypothetical performance information is distributed to only those clients who have the resources and financial expertise necessary to understand the information. As a practical matter, this may prohibit the presentation of hypothetical returns to an unsophisticated retail audience.

iii. In order to permit SEC examiners to test compliance with these requirements, an adviser will be required to maintain a record of who the "intended audience" of a hypothetical performance portrayal is. [Rule 204-2(a)(19)]

iv. Definitions [Rule 206(4)-1(e)]

(a) "Extracted performance" means the performance results of a subset of investments extracted from a portfolio.

(b) “Hypothetical performance” means performance results not actually achieved by any of the adviser’s managed portfolios. This includes model performance, backtested performance and targeted or projected performance. Subject to certain conditions, it does not include an interactive analysis tool that allows a client or investor (or prospective client or investor) to produce simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or strategies are followed. Note that actual performance of the adviser’s proprietary portfolios and seed capital portfolios is not considered to be hypothetical.

(c) “Predecessor performance” means performance achieved by a group of investments consisting of an account or private fund that was not advised at all advertised time periods by the adviser advertising the performance. In past sub-regulatory guidance, this was known as “tacking” performance.

(d) “Related performance” means the performance results of one or more portfolios with substantially similar investment policies, objectives and strategies as those advertised, either on a portfolio-by-portfolio basis or as a composite aggregation of all portfolios falling within stated criteria.

2. Disclosure – Fiduciary Standard

a. An investment adviser’s fiduciary duty of loyalty forbids the adviser to place its own interests ahead of those of its clients. To fulfill this duty, the adviser must make “full and fair disclosure” of all material facts relating to the advisory relationship. These include any conflict of interest that might incline the adviser to render advice that is not disinterested.

b. In order for disclosure to be full and fair, it must be clear and detailed enough to form the basis for a client's informed consent. The sufficiency of disclosure depends on the nature of the client, the scope of the advisory relationship and the nature of the fact or conflict being disclosed. Where an individual client is involved, the adviser should tailor its disclosure to the client’s level of financial sophistication.

c. The SEC takes the position that it is not sufficient simply to disclose that a conflict “may” exist, when the conflict already exists. If the adviser wishes to convey the fact that the conflict exists in some circumstances but not others, it also should specify the types or classes of clients, advice, or transactions with respect to which the conflict exists. *Commission Interpretation Regarding Standard of Conduct for Investment Advisers,* Advisers Act Release No. 5248 (June 5, 2019), 25 (Fiduciary Standards Release).

d. Some conflicts may not lend themselves to adequate disclosure. According to the SEC, “[f]or retail clients in particular, it may be difficult to provide disclosure regarding complex or extensive conflicts that is sufficiently specific, but also understandable.” [Fiduciary Standards Release at 28.] In such a case, the adviser must either eliminate the conflict or mitigate it to a level where adequate disclosure is possible.

e. A client's informed consent may be either explicit or implicit, depending on the circumstances. For example, consent may be inferred where a client enters into or continues an investment advisory relationship after having received full and fair disclosure. But that is not the case where the adviser is aware, or reasonably should be, that the client does not understand the nature and import of the conflict.

3. Disclosure – Form CRS

An adviser's duty to deliver a disclosure brochure [Form ADV, Part 2A] applies to all clients other than registered investment companies or business development companies, unless the adviser provides solely impersonal advisory services. As of June 2020, a duplicate layer of disclosure—known as a Customer Relationship Summary, or Form CRS or ADV, Part 3—is required for ***retail investors***. [Form ADV, Part 3]

a. Definitions

i. A ***retail investor*** is any "natural person, or the legal representative of such natural person, who seeks to receive or receives services primarily for personal, family or household purposes."

- This definition does not distinguish between high-net-worth, sophisticated individuals and individuals of more modest means and experience.

ii. "Legal representative" means only non-professional representatives such as executors, trustees, conservators and persons holding a power of attorney for a natural person. Regulated financial services professionals such as investment advisers, banks, trust companies, *etc.* are not considered legal representatives for CRS purposes.

iii. "Personal, family or household purposes" include retirement, education, and other personal, family or household savings or investing objectives. The term does not apply where individuals seek services for commercial or business purposes, or where they seek services on behalf of an entity such as a charitable trust.

- A natural person who seeks services for a mix of business and personal reasons is treated as a retail investor.

b. Special situations

i. A retail investor includes a person who seeks services for her retirement account, including an IRA or an individual account in a workplace retirement plan, but does not include a person who makes ordinary plan elections that do not involve selecting or retaining a firm to provide advisory services.

ii. Ordinary plan elections include whether to enroll in a plan, or make or increase plan contributions, as well as how to allocate contributions among a menu of investment options.

iii. An individual who seeks advice about whether to take a distribution from a retirement plan and how to invest that distribution is a retail investor.

iv. Workplace retirement plans and representatives of such plans (such as plan sponsors and trustees) are not considered retail investors.

- *Exception:* A retirement plan representative who is a sole proprietor or self-employed individual and who also participates in the plan IS a retail investor for Form CRS purposes.

c. Delivery Requirements

Instead of adding Form CRS delivery requirements to Advisers Act Rule 204-3, which governs the delivery of brochures and brochure supplements, the SEC adopted a new rule – identified as Rule 204-5 – governing delivery of Form CRS.

i. An initial relationship summary, like a brochure, must be provided to a retail client before or at the time the adviser enters into an investment advisory contract with that client.

- A dual registrant must supply Form CRS to a retail investor at the *earliest* of: entering into an advisory services contract; opening a brokerage account; placing an order; or recommending an account type, securities transaction or securities investment strategy.

- An adviser whose supervised persons also function as registered representatives of an affiliated broker-dealer must deliver both its and its affiliate's Form CRS to retail investors at the same time, whether or not those investors qualify for all the services and accounts. Each relationship summary must reference and provide a means of facilitating access to the other.

ii. Every time an adviser amends Form CRS, it must communicate the changes to each existing retail client within 60 days after the amendment is required to be made. This requirement can be satisfied by delivering either an amended Form CRS with the revised text marked or another communication summarizing the changes.

iii. Even if there is no change to Form CRS, a new copy of the form must be distributed to an existing client every time:

- a client opens an additional advisory account;

- the adviser recommends that the retail investor roll over assets from a retirement account into a new or existing account; or

- the adviser recommends or provides a new advisory service that does not necessarily involve the opening of a new account and would not be held in an existing account (*e.g.,* a first-time purchase of a direct-sold mutual fund).

iv. An adviser must also deliver a new Form CRS to a retail investor within 30 days of a client request.

> ❍ ***Compliance Tip:*** For ease of administration, consider distributing Form CRS to all clients who are natural persons rather than trying to establish the use to which the client intends to put the advisory service. Also, establish a procedure to ensure that an additional CRS is delivered whenever a natural-person client opens a new account.

4. Rendering Advice to Prospective Clients

a. The first component of the investment adviser's fiduciary duty of care is a duty to act in clients' best interest, based on the clients' investment objectives.

b. The duty of care generally applies to advice about whether a client should open or invest through a fee-based advisory account as opposed to a commission-based brokerage account, as well as advice about whether the client should roll assets over from a retirement account into another account that adviser or its affiliate would manage. Although an adviser's fiduciary duty arises only in the context of a client relationship, the antifraud provision of the Advisers Act (*i.e.,* Section 206) applies a parallel standard of conduct to an adviser's interactions with *prospective* clients.

c. In order to avoid liability under this antifraud provision, an investment adviser should have sufficient information about the prospective client and its objectives to form a reasonable basis for advice before providing any advice about account type, including advice about rollovers.

d. When the prospective client becomes an actual client, the fiduciary duty of care applies to all subsequent advice rendered to that investor.

> ❍ ***Compliance Tip:*** Before allowing a supervised person to recommend that a prospective client roll over assets from an ERISA plan to an IRA, transfer one IRA to another or switch from a commission-based to a fee-based account, make sure the supervised person gathers and assesses sufficient information to determine that such a recommendation is in the prospective client's best interest. Better yet, consider refraining from making such recommendations altogether. If the prospective client hires you to manage retirement assets that have been rolled-over, transferred from another IRA, or distributed from a retirement account without having first recommended such rollover, transfer or distribution to the client, make sure to obtain the client's acknowledgement that the rollover, transfer or distribution was not the result of the firm's recommendation.

5. Contracting with the Retail Client

While the Advisers Act does not mandate written advisory contracts, a well-drafted client agreement is one of the best risk-management tools an adviser can have.

a. The contract is an ideal spot to manage client expectations by clearly articulating what services the adviser will and will not provide. This includes not only portfolio

management, but also related services, such as proxy voting or tax advice. Although the fiduciary nature of the adviser-client relationship cannot be negotiated away or waived, the parties may shape the contours of their relationship, and by extension, the contours of the fiduciary duty.

b. Managing client expectations is particularly important in light of the SEC's views on the use of hedge clauses (liability limitations) in retail contracts. In the 2019 Fiduciary Standards Release, the Commission opined that although the question of whether a hedge clause violates the antifraud provisions of the Advisers Act depends on facts and circumstances, there are few, if any circumstances in which a hedge clause can safely be used with a retail investor. This is so, in the Commission's view, even if the clause preserves the client's non-waivable rights under federal or state law.

> ❍ ***Compliance Tip:*** Instead of limiting liability in a retail client contract, consider confirming the client's understanding that there is no guarantee that a specific result will be achieved through your management of the client's assets, and that all investment programs have risks that the client must be prepared to bear. Also, make sure you clearly articulate any limits on your services.

c. A good contract can also help the adviser satisfy its fiduciary duty of care by providing a mechanism through which the adviser can develop a reasonable understanding of a retail client's investment objectives, financial situation, investment experience and risk tolerance.

d. The Advisers Act generally forbids advisers from charging compensation based on capital gains or appreciation of funds in a managed account. However, by virtue of Rule 205-3, performance-based compensation may be charged to individuals (and companies) who are ***qualified clients***, as that term is defined above. Before charging such fees, the adviser must make full disclosure of all material information about the proposed fee arrangement and any conflicts of interest posed thereby.

e. In addition to specifying who has the authority to issue instructions to the adviser on the client's behalf, the contract is also an ideal place to have the client designate a "trusted contact" the adviser can reach out to if it has questions or concerns about the client's health or welfare due to potential diminished capacity, financial exploitation or abuse, endangerment, and/or neglect. By designating a trusted contract, the client authorizes the adviser to:

- provide the trusted contact(s) with information about client and/or her account(s), including notice of a temporary hold on such accounts.
- ask about the client's current contact information and/or health status.
- ask whether another person or entity, such as a legal guardian, conservator or trustee, has legal authority to act on the client's behalf.

A trusted contact has no authority to transact business in the client's account.

6. Privacy

a. Regulation S-P, the federal Privacy Rule, requires an adviser to: notify clients of the firm's practices relating to the release of clients' nonpublic personal information; (depending on the release-of-information practices) afford clients the choice of opting out of disclosure of their personal information; and refrain from disclosing client information under certain circumstances. In connection with protecting client confidentiality, the adviser is also obligated to adopt policies and procedures reasonably designed to protect client records and information.

i. The first step is to identify which clients and potential clients are covered by the Privacy Rule. Different obligations apply with regard to ***consumers*** and ***customers.***

- ***Consumers*** are natural persons who obtain a financial product or service for personal, family or household uses. This term covers potential clients who divulge nonpublic personal information in the course of inquiring about financial services, whether or not they ultimately obtain those services.

- ***Customers*** are consumers who maintain a continuing relationship with the adviser. Most advisory client fall into this latter category.

❍ ***Compliance Tip:*** For purposes of simplicity, consider treating *all* clients and potential clients as "customers" entitled to the higher degree of protection.

ii. The second step is to identify the types of information the adviser possesses about its customers. Regulation S-P protects only *nonpublic personal information*, which includes personally identifiable financial information and any list, description or other grouping of consumers that is derived from same. Examples of personally identifiable financial information include: client's name, address and social security number; information about income or assets; investment activity; account balances; trade confirmations; credit reports; and the fact that a person is or was a customer of the adviser. The Privacy Rule does not protect publicly available information, but the adviser cannot assume, without checking, that information about a particular customer is publicly available just because information of that type is usually public.

iii. The next step is to identify the third parties with whom the adviser shares customers' nonpublic personal information and the purposes of such sharing. Different requirements are imposed depending on whether or not disclosure of protected information is subject to one of the exceptions under the Privacy Rule. Exceptions exist where disclosure is made:

(a) to service providers and joint marketers, so long as the adviser enters into a contract with the third party that prohibits that party from disclosing or using the information other than to carry out the purposes of the contract;

(b) as necessary in the course of business, such as where needed to effect trades, to provide a financial service that the customer requests, or at the customer's direction;

(c) with the customer's consent;

(d) to protect the confidentiality or security of records pertaining to the customer or the adviser's services;

(e) to prevent fraud, unauthorized transactions, claims or other liability;

(f) to persons acting in a fiduciary capacity on behalf of the customer;

(g) to persons holding a legal or beneficial interest relating to the customer;

(h) for institutional risk control or certain law enforcement purposes;

(i) to the adviser's attorneys, accountants and auditors;

(j) to a consumer reporting agency in accordance with the Fair Credit Reporting Act;

(k) to law enforcement agencies, federal regulators, self-regulatory organizations and certain other parties;

(l) to comply with applicable laws, rules and other legal requirements; and

(m) in connection with a proposed or actual sale, merger, transfer or exchange of all or a portion of the adviser's business.

iv. Privacy notices (with opt-out provisions, if applicable) generally must be provided to customers not later than when the customer relationship is established, and once a year thereafter.

❍ ***Compliance Tip:*** For purposes of simplicity, consider using the SEC's Model Privacy Notice Form, available at: https://www.sec.gov/rules/final/2009/34-61003_modelprivacyform.pdf

b. In addition to Regulation S-P, an adviser may be subject to a host of other privacy rules that impose far stricter standards. These include the European Union's General Data Protection Regulation (GDPR) and state privacy laws such as the California Consumer Privacy Act (CCPA).

❍ ***Compliance Tip:*** Privacy laws generally depend on the location of the client, not the adviser. Advisers with a geographically dispersed clientele may find themselves subject to a host of inconsistent privacy requirements. If practical, consider defaulting to the highest standard

for all clients. Also, before deciding to offer services in a new geographic market, consider the privacy law implications of doing so.

7. Managing the Individual Client's Account on an Ongoing Basis

a. An adviser's fiduciary duty of care entails a duty to advise and monitor the client's account over the full course of the advisory relationship. The extent of this duty depends on the scope of the services the adviser and the client have agreed to. The frequency and timing of monitoring is a material aspect of the advisory relationship, requiring full disclosure and informed client consent.

b. Since all advice over the course of the relationship must be in the client's best interest, the adviser must reasonably ensure that it has information about any changes to a client's investment objectives and financial situation. The timing of such updates depends on facts and circumstances.

c. The adviser's ongoing obligation to monitor the client's account includes a duty to evaluate whether the client's type of account or program continues to be in the client's best interest.

> ❍ ***Compliance Tip:*** Establish a procedure to periodically review clients' investment objectives and financial situations. Consider adding a request to notify the adviser of any changed circumstances to routine client mailings.

8. Parting Ways with the Individual Client

Sometimes, despite everyone's best efforts, an investment advisory relationship does not work out. A client's expectations may consistently exceed what the adviser is willing and able to deliver. The client's instructions concerning what investments should be bought and sold for an account or frequent demands for cash withdrawals may interfere with the adviser's ability to exercise discretion over the account's management. Or, the adviser may determine that an asset-based-fee account is no longer in the client's best interest. Whatever the reason, there may come a time when retaining an individual client poses an unacceptable level of risk for the adviser. Because the adviser's fiduciary obligations extend throughout the advisory relationship, parting ways with such a client should be done with care.

a. The duty to act in the client's best interest means the adviser cannot just abandon a client when the advisory relationship becomes risky or inconvenient. Instead, the adviser must give a reasonable termination notice to the client (or the amount of notice required by contract, if applicable), clearly articulate how the account will be monitored and traded during the notice period, and provide reasonable assistance to the client in making other arrangements for managing the account going forward. This may entail helping the client transfer assets to a different custodian or returning the assets to the client directly.

b. The adviser may not disadvantage the client financially by charging fees for services not rendered. Thus, the adviser should make arrangements to refund prepaid and unearned advisory fees. Where the client initiates a termination, the adviser should refrain from imposing a termination fee. Ending an advisory

relationship in a manner that penalizes the client may constitute a violation of the antifraud provisions of the Advisers Act.

c. Keep in mind that the recordkeeping requirements of Rule 204-2 require an adviser to maintain certain books and records for a period of time after the advisory relationship ends. Most books and records must be kept for five years from the last day of the fiscal year in which the last entry was made on the document or the document was disseminated.

D. Special Situations: Senior Clients

As clients age, they may suffer diminished capacity which makes them vulnerable to financial exploitation. Fiduciaries like investment advisers are often in an excellent position to identify such situations. A number of federal and state laws provide tools advisers can use to protect seniors and in some cases, other vulnerable investors.

1. Senior Safe Act

a. This federal law affords limited immunity to covered financial institutions (including investment advisers) and their employees or representatives who disclose suspected financial exploitation of persons 65 years and older, so long as certain required training has been provided to the firm's employees. While such disclosure is encouraged, it is not mandatory.

i. Protected disclosure may be made to federal agencies like the SEC, SROs, state financial regulatory agencies, law enforcement and/or adult protective services.

ii. Training must be tailored to the job responsibilities of the subject employee and must be furnished as soon as reasonably practicable, but at least within 1 year from the date of employment by or affiliation with the adviser (or other financial institution). Training must address client privacy and must instruct about how to identify and report suspected exploitation.

2. State Adult Protective Services (APS) and Financial Exploitation Laws

a. All states have laws relating to reports of abuse of elders and persons 18 years and older who have diminished physical or mental capacity. These laws generally define "elders" as persons 60 and older, but this threshold may vary by state.

b. In some states, reporting is mandatory, while in others, it is merely permissible.

c. The conditions and time frames for reporting vary by state, but the APS laws generally provide immunity from civil and criminal liability for good-faith reports.

d. In addition, a majority of states also have laws protecting seniors and adults with disabilities from financial exploitation. While the specific terms of these laws vary from state to state, they generally have a required or permissive reporting component, a required training component and a component permitting temporary holds of suspicious disbursements and/or transactions in the case of suspected exploitation.

3. *Signs of Diminished Capacity*

- Memory Loss
- Disorientation
- Problems with written or spoken words
- Decision-making inconsistent with history or stated goals
- Interest in “get rich quick” schemes
- Inability to understand basic aspects of the account
- Withdrawal from work or social activities
- Change in appearance
- Inability to pay bills; bouncing checks
- Repeated calls and/or resetting of online account passwords

4. Signs of Possible Exploitation

- Dramatic, unexplained shifts in investment style
- Unusual transactions
- Sudden withdrawals or changes in the amount or frequency of withdrawals
- Suspicious signatures or documents
- Family/friends/acquaintances with an outsized interest in the client’s assets
- Abrupt changes in trusted contact, beneficiary or estate planning documents
- Signs of intimidation or reluctance to speak
- Forged signatures

E. Special Situations: Advising Millennials and Gen Z Investors

Providing advice to novice investors of limited means presents its own challenges in terms of communication, expectation management and delivery of portfolio management services.

1. Communicating with the Novice Investor

Because millennial and Gen Z investors consume information and communicate primarily through electronic means such as social media and mobile apps, an adviser that services this demographic must implement policies and procedures to ensure that its electronic communications are both effective and compliant with regulatory standards.

a. These goals may influence the design of regulatory disclosures. General Instruction 3.A. to Form CRS (Form ADV, Part 3) encourages the use of “charts, graphs, tables, and other graphics or text features” to convey required disclosures. Where CRS is provided electronically, the SEC invites advisers to include: “(i) a means of facilitating access to video or audio messages, or other forms of information” including QR codes or equivalent technologies; “(ii) mouse-over windows; (iii) pop-up boxes; (iv) chat functionality; (v) fee calculators; or (vi) other forms of electronic media, communications, or tools designed to enhance a retail investor’s understanding of the material in the relationship summary.”

b. Hosting a website or social media page that invites the public to post commentary requires particular care. In adopting the new marketing rule

described above, the SEC said that allowing third parties to post public commentary to the adviser's website or social media page would not, by itself, make the adviser responsible for such content, so long as the adviser is not involved in the preparation of the content and does not selectively delete or alter the comments or their presentation. However, a different result obtains where the adviser is involved in the preparation or editing of comments, or where it endorses or approves such postings.

c. Supervised persons' activity on their personal social media accounts may also implicate the adviser, depending on facts and circumstances. In order to avoid responsibility in this area, the SEC suggests that the adviser implement policies and procedures reasonably designed to prevent the use of such personal social media accounts to market the adviser's services. In addition, the adviser should train its staff in this area and periodically test compliance by reviewing content that is publicly available on supervised persons' social media accounts.

d. Electronic communications that fall within the enumerated categories of the Advisers Act recordkeeping rule (204-2) must be maintained for the time and in the format required under that rule. Before adopting new methods of electronic communication, the adviser should ensure that the content of such communication can be appropriately captured and archived.

2. Managing Expectations

As the recent GameStop Corporation frenzy illustrates, strange things happen when investors take their cues from social media. An adviser to a Reddit generation of investors should make sure its clients understand the portfolio strategy(ies) the adviser will use to manage the client's account, including, if applicable, a disclaimer of market timing. The adviser also should make sure clients understand any limits on their ability to override the manager's discretionary management of their accounts.

3. Robo-advisory Services

a. An increasingly popular way to scale the delivery of professional investment management services to retail clients is through the use of online algorithmic-based programs ("robo-advisers"). This investment advice model generally calls for potential clients to enter their personal information into an interactive digital platform, so the robo-adviser can generate a portfolio based on the client's information.

b. The Fiduciary Standards Release confirmed that robo-advisers are subject to all requirements of the Advisers Act, including the fiduciary duties of care and loyalty.

c. Robo-advisers may have unique considerations in at least three areas:

i. *Disclosures to clients.* Robo-advisers—particularly those whose business model entails limited or no human interaction—must ensure their disclosures to clients effectively communicate the limitations, risks, and operational aspects of their advisory services. An adviser may wish to disclose specifics of the algorithmic strategies it employs, including the assumptions and limitations of the algorithm(s) and what level of human involvement is present in the oversight and management of client accounts.

ii. *Obligation to obtain information necessary to provide suitable advice*. Robo-advisers frequently prepare online questionnaires for potential clients to populate with personal information. These questionnaires must elicit sufficient information for the robo-adviser to conclude that its initial recommendations and ongoing investment advice are suitable for each client's financial situation and investment objectives. To ensure the client has provided sufficient information, the adviser may consider providing clients with the opportunity to give additional information or context concerning the client's selected responses.

iii. *Effective compliance program***.** A robo-adviser's business model may present unique risk exposures which should be addressed through the adviser's policies and procedures. These policies and procedures may address, for example, oversight of algorithmic codes, disclosing changes in the algorithmic codes to clients, and monitoring for cybersecurity threats.

* * * * *

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EFFECTIVE STRATEGIES & BEST PRACTICES

Private Equity Fund Update

- **Igor Rozenblit**, Co-Head, Private Funds Unit, Division of Examinations, SEC
- **Letti de Little**, Chief Compliance Officer, Grain Management
- **Alexandria Stuart**, Vice President, Head of Compliance and Senior Counsel, Vista Equity Partners
- **Alpa Patel**, Partner, Kirkland & Ellis

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

An Old Foe of Banks Could Be Wall Street's New Top Cop

THE WALL STREET JOURNAL.

- "Lawyers, regulators and lobbyists say Mr. Gensler would likely be the most active pro-regulatory SEC chairman since William Donaldson ran the agency in the wake of the corporate scandals of the early 2000s . . . ."
- "At the CFTC, Mr. Gensler earned a reputation for an aggressive, sharp-elbow style of management more reminiscent of Wall Street than Washington, at times even clashing with officials in his own party."
- "[Firms] are hopeful Mr. Gensler's understanding of finance and markets would make him a pragmatist when balancing progressive demands against the implications of causing widespread disruption."
- "At the SEC, Mr. Gensler would have to manage a much larger staff —4,500 employees to the CFTC's 700—and a five-member commission that tends to be more partisan. He also has fewer congressionally mandated reforms to tackle than during his tenure at the CFTC, which was dominated by implementation of the Dodd-Frank financial reforms."

Rules Subject to a Regulatory Freeze Pending Review

- On President Biden's first day in office, Assistant to the President and Chief of Staff, Ronald Klain issued a memorandum to the heads of executive departments and agencies (the "**Executive Memorandum**") directing a "regulatory freeze pending review" of certain recently adopted rules
  - Among other things, the Executive Memorandum directs executive departments and agencies to:
    - Withdraw rules that have been adopted but not yet been published in the Federal Register for review and approval; and
    - Postpone the effective date (for 60 days) of rules that are not yet effective, but that have been adopted and published in the Federal Register, and consider re-opening those to public comment (for 30 days)
- If the Executive Memorandum is read to apply to rules recently adopted by the SEC, the following could be delayed, withdrawn, or revised:
  - Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets
  - Investment Adviser Marketing

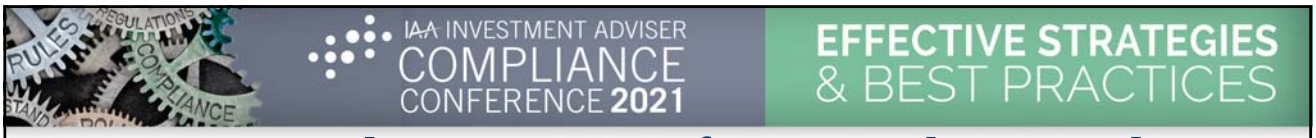
3

Amended Advertising Rule

- Final rule 206(4)-1 was adopted by the SEC in December 2020; combines the advertising and solicitation provisions of the Advisers Act; and replaces the current advertising and cash solicitation rule.
- Clarifies and centralizes permissible marketing practices by investment advisers under the Advisers Act. Now referred to as the "Marketing Rule".
  - Compliance not required until at least Fall 2022 (18 months after publication in the Federal Register)
- *Summary of new Marketing Rule:*
  - Broader definition of "advertisement";
  - Established exclusions from the definition of "advertisement";
  - Expressly prohibited practices with respect to advertisements and marketing; and
  - Guidance and prohibited practices in which performance figures are displayed

Amended Advertising Rule

- Important Differences from the Proposal:
  - No distinction between non-retail and retail investors
  - Removes formal pre-approval requirement for advertisement
  - Eliminations 1-, 5-, 10-year presentations for private funds and the schedule of fees and expenses
- *Key Takeaway:*
  - The new Marketing Rule now explicitly applies to communications to private fund
  - Performance presentation will be the most affected; specific guidance related to:
    - related performance,
    - hypothetical performance (which includes projections and targets),
    - extracted performance,
    - predecessor performance (portability)



SEC Proposed Exemption from Broker-Dealer Registration for Certain Finders

- *Background / Current Regulation:*
  - Absent an exemption, finders who receive compensation for assisting issuers in connection with capital raising activities are generally required to register with the SEC as broker-dealers.
- *Proposal Summary:*
  - The SEC proposed a conditional exemption allowing two "tiers" of natural person finders from registering as broker-dealers.
    - **Tier I Finders**: Activity is limited to providing contact information to investors in one fund raise in a 12-month period, and the person does not contact potential investors directly.
    - **Tier 2 Finders**: Can engage in an unlimited amount of solicitation on behalf of an issuer, but are limited to pure investor identification and outreach without providing investment advice or valuation information regarding the issuer.
  - Tier II Finders are required to disclose a significant amount of information about themselves to potential investors at the time of solicitation.
  - Both Tier I and Tier II Finders are still prohibited from raising capital from state and public plan investors, and issuers would still need to consider the applicability of state broker-dealer laws and regulations.
- *Key Takeaway:*
  - As proposed, this exemption would reduce some of the regulatory hurdles for engaging natural person finders to assist with private fund raises.

FSOC Reemergence and Implications for Private Fund Advisers

- *Background:*
  - The Financial Stability Oversight Council ("FSOC") is a U.S. governmental entity established by Dodd-Frank with broad authority to monitor, investigate and assess any risks to the U.S. financial system.
  - FSOC has authority to designate entities as "systemically important financial institutions" ("SIFIs"), which involves enhanced oversight by, and reporting obligations to, FSOC and other U.S. financial regulators.
  - No private fund adviser and its private fund(s) has yet been designated as a SIFI.
- *Possible Regulatory Issues:*
  - Under the Obama administration, there was a move towards designating certain investment advisers as SIFIs.
  - Designation as a SIFI would likely require an adviser and its fund(s) to be subject to "stress testing" of their ability to uphold themselves in extreme financial market conditions, and other regulatory and reporting requirements.
  - Even if a private fund manager is not designated "systemically important," the private fund industry could be subject to greater oversight under FSOC's "activities-based approach" to assessing systemic financial risk.

Potential Regulations by a New SEC Administration

- *Resurface of Section 956 of Dodd-Frank*
  - U.S. federal banking regulators plan to revive efforts to regulate financial institution incentive compensation, as required by Section 956 of Dodd–Frank.
  - *Potential Impacts:*
    - Could delay the distribution of carried interest for multiple years.
    - Bonus income from fixed management fee pools could be at risk.
- *Heightened Focus on ESG*
  - The SEC is actively seeking recommendations for governing ESG disclosures.
  - ESG disclosures and policies are increasingly an examination priority by the SEC Division of Examinations.
  - Investment advisers should ensure that they maintain backup data and internal written documentation supporting statements made to investors regarding how ESG factors are taken into consideration in their investment decisions.

OCIE Risk Alerts

Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020)

- OCIE published its observations from examinations of managers of private funds (including private equity and hedge funds)
- The risk alert discussed three common areas of deficiencies:
  - (i) conflicts of interest;
  - (ii) fees and expenses; and
  - (iii) policies and procedures relating to adviser code of ethics and MNPI

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OCIE Risk Alerts

Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020) ***(cont.)***

- (i) **Conflicts of Interest:**
  - Allocation of Investments
  - Multiple clients investing in the same portfolio company
  - Financial relationships between investors or clients and an adviser
  - Preferential liquidity rights
  - Co-investments
  - Use of affiliated service providers
  - Fund restructurings
  - Principal and/or cross-fund transactions

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OCIE Risk Alerts

Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020) *(cont.)*

- **(ii) Fees and expenses:**
  - Allocation of fees and expenses
  - Fees and expenses related to operating partners
  - Valuation issues
  - Monitoring, board, deal and other transaction fee offsets
  - Portfolio company fees
- **(iii) Code of Ethics and MNPI deficiencies:**
  - Violations of Section 204A of the Advisers Act
    - Failure to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of MNPI
    - Failure to address risks of employees obtaining MNPI from interactions with (a) insiders of publicly traded companies, (b) outside consultants from expert networks, or (c) value added investors
  - Violations of the Adviers Act's Rule 204A-1 ("Code of Ethics Rule")
    - Failure to enforce trading restrictions on securities that had been placed on the adviser's restricted list
    - Failure to enforce gift and entertainment policies
    - Failure to require access persons to submit timely transaction and holding reports or obtain required pre-clearance

Adapting to COVID and Managing Compliance Challenges


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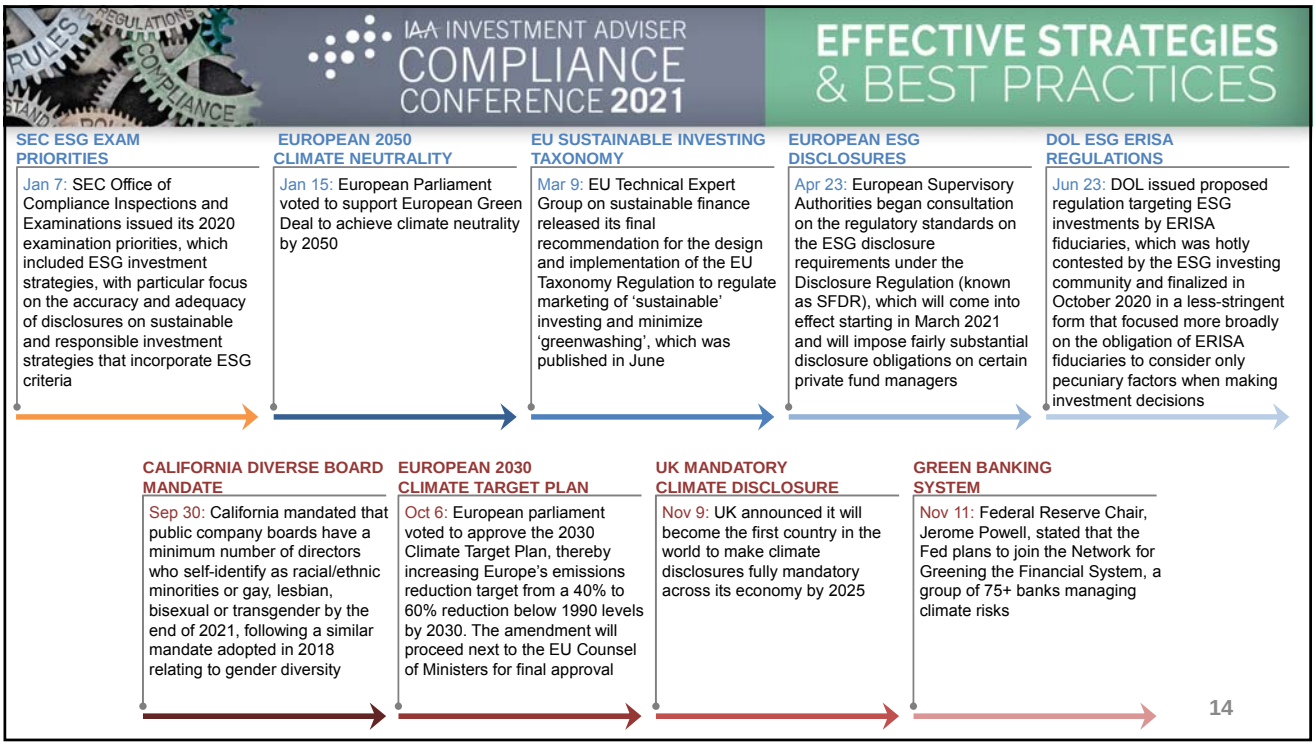
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SEC ESG EXAM PRIORITIES
Jan 7: SEC Office of Compliance Inspections and Examinations issued its 2020 examination priorities, which included ESG investment strategies, with particular focus on the accuracy and adequacy of disclosures on sustainable and responsible investment strategies that incorporate ESG criteria
EUROPEAN 2050 CLIMATE NEUTRALITY
Jan 15: European Parliament voted to support European Green Deal to achieve climate neutrality by 2050
EU SUSTAINABLE INVESTING TAXONOMY
Mar 9: EU Technical Expert Group on sustainable finance released its final recommendation for the design and implementation of the EU Taxonomy Regulation to regulate marketing of 'sustainable' investing and minimize 'greenwashing', which was published in June
EUROPEAN ESG DISCLOSURES
Apr 23: European Supervisory Authorities began consultation on the regulatory standards on the ESG disclosure requirements under the Disclosure Regulation (known as SFDR), which will come into effect starting in March 2021 and will impose fairly substantial disclosure obligations on certain private fund managers
DOL ESG ERISA REGULATIONS
Jun 23: DOL issued proposed regulation targeting ESG investments by ERISA fiduciaries, which was hotly contested by the ESG investing community and finalized in October 2020 in a less-stringent form that focused more broadly on the obligation of ERISA fiduciaries to consider only pecuniary factors when making investment decisions
CALIFORNIA DIVERSE BOARD MANDATE
Sep 30: California mandated that public company boards have a minimum number of directors who self-identify as racial/ethnic minorities or gay, lesbian, bisexual or transgender by the end of 2021, following a similar mandate adopted in 2018 relating to gender diversity
EUROPEAN 2030 CLIMATE TARGET PLAN
Oct 6: European parliament voted to approve the 2030 Climate Target Plan, thereby increasing Europe's emissions reduction target from a 40% to 60% reduction below 1990 levels by 2030. The amendment will proceed next to the EU Counsel of Ministers for final approval
UK MANDATORY CLIMATE DISCLOSURE
Nov 9: UK announced it will become the first country in the world to make climate disclosures fully mandatory across its economy by 2025
GREEN BANKING SYSTEM
Nov 11: Federal Reserve Chair, Jerome Powell, stated that the Fed plans to join the Network for Greening the Financial System, a group of 75+ banks managing climate risks
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Prevention of Misuse of MNPI

- *SEC Staff Areas of Focus:*
  - Effectiveness of an adviser's code of ethics in addressing risks of employees obtaining and/or trading on MNPI;
  - Adviser personnel serving as board members of public companies;
  - Adviser personnel's interactions with expert networks and other third-parties; and
  - Restricted list trading and the submission of timely transaction and holding reports as well as obtaining required pre-clearance.
- *Recent Enforcement Action:*
  - *Private Fund Adviser* (May 2020): The SEC settled charges with an adviser over its alleged failure to implement and enforce adequate policies and procedures to prevent the misuse of MNPI.
  - *Key Takeaway*: Lack of robust, appropriately tailored, and adequately maintained and enforced, compliance controls and oversight regarding the misuse of MNPI and insider trading has often led to SEC scrutiny even where no insider trading or other harm has occurred.

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2021 IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE:

PRIVATE EQUITY FUNDS UPDATE

MARCH 5, 2021

ALPA PATEL

PARTNER, KIRKLAND & ELLIS LLP

1. **SEC Amended Advertising Rule and its Implications for Private Fund Advisers**

(a) *Background:*

(i) Final rule 206(4)-1 was adopted by the SEC in December 2020, combines the advertising and solicitation provisions of the Advisers Act, and replaces the current advertising and cash solicitation rule.

(ii) This new "Marketing Rule" clarifies and centralizes permissible marketing practices by investment advisers under the Advisers Act.

(A) Compliance is not required until at least Fall 2022 (18 months after publication in the Federal Register)

(b) *Key Amendments:*

(i) Broader Definition of "advertisement." The amended definition of "advertisement" contains two prongs: one that captures communications traditionally covered by the existing Advertising Rule (rule 206(4)-1) and another that governs solicitation activities previously covered by the Cash Solicitation Rule (rule 206(4)-3).

(A) First, the definition includes any direct or indirect communication by an adviser that: (1) offers investment advisory services with regard to securities to prospective clients or private fund investors; or (2) offers new investment advisory services with regard to current clients or private fund investors.

(I) This generally excludes most one-on-one communications, but one-on-one communications that contain hypothetical performance (defined to include projections or target returns) would be deemed to be an advertisement unless it was provided in response to an unsolicited request. Also, the scope of what is deemed to be a one-on-one communication is more limited than the current practice in that standard templates or standardized performance inserts would not be considered one-on-one presentation and would be deemed to be advertisements.

(II) This includes communications prepared by third parties if the adviser adopts the communication or becomes involved in the preparation of such material.

(III) The rule contains specific provisions related to the use of social media. Generally, editing or sorting content, such as comments, will likely be deemed to be an advertisement, while allowing a 'like' or 'endorse' feature on the adviser's landing page of an adviser will not be deemed an advertisement.

(B) Second, the definition of "advertisement" generally includes any endorsement or testimonial for which an adviser provides compensation directly or indirectly (*e.g.*, directed brokerage, awards or other prizes, and reduced advisory fees).

(ii) Generally Prohibited Content in Advertising Materials. The amended Marketing Rule will prohibit the following advertising practices:

(A) Making untrue statements or material omissions, including statements that have misleading implications;

(B) Making unsubstantiated claims and statements (this excludes the adviser's opinions on matters);

(C) Making statements likely to cause any untrue or misleading implication or inference to be drawn;

(D) Discussing any potential benefits without providing fair and balanced treatment of associated risks or limitations;

(E) Including or excluding performance results, or performance time periods, in a manner that is not fair and balanced; and

(F) Including information that is otherwise materially misleading.

(iii) Prohibited Disclosures of Performance Figures. The amended Marketing Rule will prohibit the following in any advertisement:

(A) Gross performance figures, unless the advertisement also presents net performance figures with equal prominence;

(B) Performance figures of some, but not all, prior funds with a similar investment strategies;

(C) Performance figures of a subset of investments without offering to provide the same information regarding all portfolio companies;

(D) Hypothetical performance figures (including targeted performance, projections, and model and backtested performance), unless the adviser has adequate policies and procedures in place to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the adviser provides certain information underlying the hypothetical performance; and

(E) Past performance of predecessor funds or investment team members while at different firms, unless there is appropriate similarity with regard to the personnel and funds at the advertising adviser and with adequate disclosure.

(iv) Testimonials and Endorsements. The amended Marketing Rule prohibits the use of testimonials and endorsements in an advertisement, unless the adviser adheres to the following requirements:

(A) *Disclosure.* Advertisements must clearly and prominently disclose whether the person giving the testimonial or endorsement (the "promoter") is a client and whether the promoter is compensated. Additional disclosures are required regarding compensation and conflicts of interest.

(B) *Oversight and Written Agreement.* An adviser that uses testimonials or endorsements in an advertisement must enter into a written agreement with promoters, except where the promoter is an affiliate of the adviser or the promoter receives *de minimis* compensation (*i.e.*, $1,000 or less, or the equivalent value in non-cash compensation, during the preceding twelve months).

(C) *Disqualification.* The rule prohibits certain "bad actors" from acting as promoters, subject to exceptions where other disqualification provisions apply.

(v) Third Party Ratings. The amended Advertising Rule prohibits the use of third-party ratings in an advertisement, unless the adviser provides disclosures and satisfies certain criteria pertaining to the preparation of the rating.

2. **Proposed Conditional Exemption from Broker-Dealer Registration for Certain Finders**

(a) *Background:*

(i) Under the current framework, absent an exemption, finders who receive compensation for assisting issuers in connection with capital raising activities are generally required to register with the SEC as broker-dealers.

(ii) In the "M&A Brokers" No-Action Letter (2014), the SEC provided a limited exception from broker-dealer registration for certain deal finders who assist in sourcing private, control transactions (among meeting other requirements).

(b) *Proposal:*

(i) On October 7, 2020, the SEC proposed a conditional exemption that would permit two "tiers" of natural person finders to engage in certain private capital raising activities targeted solely at accredited investors on behalf of an issuer without registering as a broker-dealer:

(A) Tier I Finders: The Tier I Finder's activity must be limited to providing contact information of potential investors in connection with a single capital raising transaction by a single issuer within a 12-month period; provided the Tier I Finder does not have direct contact with any of the potential investors.

(B) Tier II Finders: The Tier II Finder can solicit on behalf of an issuer, but solicitation-related activities must be limited to: (1) identifying, screening and contacting potential investors; (2) distributing issuer offering materials to investors; (3) discussing issuer information included in any offering materials, provided that the Tier II Finder does not provide advice as to the valuation or advisability of the investment; and (4) arranging or participating in meetings with the issuer and investor.

(ii) Additional Requirements of Both Tier I and Tier II Finders.

(A) A Finder cannot on behalf of an issuer: (1) be involved in structuring the transaction or negotiating the terms of the offering; (2) handle customer funds or securities or bind the issuer or investor; (3) participate in the preparation of any sales materials; (4) perform any independent analysis of the sale; (5) engage in any "due diligence" activities; (6) assist or provide financing for such purchase; or (7) provide advice as to the valuation or financial advisability of the investment.

(iii) Additional Requirements of Solely Tier II Finders.

(A) A Tier II Finder must provide appropriate disclosures of the Tier II Finder's role and compensation prior to or at the time of the solicitation.

(B) A Tier II Finder must obtain from an investor, prior to, or at the time of, any investment in the issuer's securities, a dated written acknowledgment of receipt of the required disclosures.

(c) *Future*: Under a new administration, it remains to be seen if this proposal will actually be adopted.

3. **FSOC Reemergence and Implications for Investment Advisers**

(a) *Background:*

(i) The Financial Stability Oversight Council ("**FSOC**") is a U.S. governmental entity established by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") comprised of the heads of the various financial regulatory agencies, which has broad authority to monitor, investigate, and assess any risks to the U.S. financial system.

(ii) FSOC has authority to designate entities as "systemically important financial institutions" ("**SIFIs**") which involves enhanced oversight by, and reporting obligations to, FSOC and other U.S. financial regulators, including the SEC as the primary regulator of investment advisers.

(iii) No private fund adviser and its private fund(s) has yet been designated as a SIFI.

(iv) In December 2019, under the Trump Administration, FSOC issued revised guidelines (the "**2019 Guidelines**") regarding how it will identify and address systemic financial instability.

(b) *Key Aspects of the 2019 Guidelines:*

(i) Designating Firms as Systemically Important Financial Institutions ("SIFIs").

(A) Under the Obama administration, there was a move towards designating certain nonbank financial entities, including certain large investment advisers, as SIFIs.

(B) Designation as a SIFI would likely require an adviser and its fund(s) to be subject to "stress testing" of their ability to uphold themselves in extreme financial market conditions, and enhanced regulatory and reporting requirements to the SEC (as primary regulator of the adviser) and FSOC.

(ii) Activities-Based Approach.

(A) Prior to the 2019 Guidelines, FSOC primarily engaged in an entity-based approach in which it addressed systemic financial risk by focusing on activities of entities that have specific characteristics that make that make them important to the financial stability, such as large investment banks.

(B) In the 2019 Guidelines, FSOC stated that it would also engage in an activities-based approach, in which it would identify and address, in consultation with relevant financial regulatory agencies (including the SEC), potential risks and emerging threats on a system-wide basis, regardless of type of entities involved.

(c) *Future*:

(i) Under the Trump Administration, FSOC remained in existence and met periodically, but did not pursue any particular focus on the asset management industry. In particular, each of the nonbank financial entities that had been previously designated as SIFIs had such designation removed.

(ii) Under the Biden Administration, FSOC is expected to become more active and will likely reassess the 2019 Guidelines focusing on an activities-based approach.

4. **Potential Regulations by a New SEC Administration**

(a) *Resurface of Section 956 of Dodd-Frank*

(i) Background.

(A) Pursuant to Section 956 of Dodd-Frank, six federal agencies, including the SEC, are required to jointly issue a rule to prohibit incentive-based compensation arrangements that encourage excessive or undesirable risks by leaders of financial institutions.

(B) The agencies jointly proposed a rule in May 2011 and then again re-proposed a substantially different rule in May 2016, which was also never adopted.

(ii) Future.

(A) It is expected that under the Biden Administration, the six federal agencies will re-visit the mandate in Section 956 and propose a new rule to address such incentive-based compensation arrangements.

(b) *Heightened Focus on ESG:*

(i) The SEC's Division of Investment Management is actively seeking recommendations regarding ESG disclosures.

(ii) The ESG Subcommittee of the SEC's Asset Management Advisory Committee has issued preliminary recommendations, including that the SEC mandate new, tailored ESG disclosure rules.

(iii) These new rules will impact registered funds and public companies' reporting requirements, but may also impact the types of requests made by the SEC's Division of Examinations during examinations of private fund sponsors.

(iv) There have been a number of indications that over the long term, the SEC will verify investment advisers' compliance with the ESG values they advertise.

(v) ESG policies have been an exam priority of the SEC's Division of Examinations.

(vi) Investment advisers should ensure that they maintain backup data and internal written documentation supporting statements made to investors regarding how ESG factors are taken into consideration in their investment decisions.

(c) *Potential Rollback of Retail Access to Privately Issued Securities:*

(i) At the SEC's recent Asset Management Advisory Committee meeting in December 2020, Committee members expressed mixed feelings about retail investors' increased access to private investments.

(A) Many members expressed support of regulation based on retail investors' sophistication and asset size / pooling mechanisms.

(B) Others expressed concerns about investor protection and education, and were particularly concerned about advisers communicating performance metrics to retail investors.

(ii) Under the Biden administration, former SEC Chairman Clayton's efforts to expand access to private investments for retail investors (*i.e.*, expanding the "accredited investor" definition and simplifying the exempt offering framework) may be rolled back.

(iii) Former SEC Chairman Clayton's goal of wider access to private markets could also be impacted by the Department of Labor (the "**DOL**").

(A) Ideas advocated by Chairman Clayton, such as a retirement target-date investment product that includes a small (~10%) amount of privately-issued securities may not get support.

(B) The DOL may:

(I) Withdraw guidance that expanded private investment options for 401(k) plans, collective investment trusts and other defined contribution plans.

(II) Further restrict the ability of ERISA plans to invest in private funds.

(d) *Possible Amendments to the Custody Rule:*

(i) The SEC Division of Investment Management has raised the possibility of amending the Custody Rule under the Advisers Act, to better accommodate small advisers and modernize the Rule.

(ii) Specifically, the SEC Division of Investment Management is assessing:

(A) The scope of the Custody Rule;

(B) Surprise examination requirements;

(C) Appropriate requirements for qualified custodians; and

(D) Requirements for custody of digital assets.

5. **SEC Examination Focus Areas**

(a) *Code of Ethics / Prevention of Misuse of Material Non-Public Information ("MNPI")*

(i) *Private Fund Adviser (May 2020):*

(A) The SEC settled charges with an Adviser over alleged failure by the Adviser to implement and enforce adequate policies and procedures to prevent the misuse of material non-public information ("**MNPI**").

(B) The Fund held debt securities in a public company ("**PortCo**"), which allowed the Adviser to appoint two members to the PortCo's Board of Directors.

(C) The Adviser had the following MNPI policies and procedures in place:

(I) The restricted list included the PortCo and any other company where the Adviser had a control position or personnel serving on the board of directors;

(II) Securities on the restricted list were subject to a "hard stop," which required prior review and approval by Adviser's compliance staff before any trading could take place; and

(III) The procedures also required confirmation with the PortCo that the "trading window" was open and documentation of

the reason for the approval of the trade in the comment box in the electronic order management system.

(D) The Fund purchased over 1 million shares of the PortCo in the open market.

(E) Per the policy, the Adviser's compliance staff confirmed that the trading window was open and checked with the Adviser representative who was on the PortCo Board for MNPI.

(ii) According to the SEC, the Adviser's personnel serving on the PortCo's Board were regularly exposed to potential MNPI and had discussions with the Adviser's deal team that potentially exposed the deal team members to MNPI.

(iii) The SEC order alleged that the Adviser's MNPI policy was not adequately implemented and enforced, claiming:

(A) The Adviser did not have sufficient documentation of the MNPI consultations; in some instances, the documentation lacked consistency and detail or was otherwise deemed insufficient;

(B) The policy did not require a broader investigation as to whether information had been communicated to others at the Firm (for example, other deal team members);

(C) The policy did not provide specific guidance on the manner and degree to which the Adviser's compliance staff should explore potential MNPI issues with these parties; and

(D) The policy did not take into account the special MNPI risks created by the Adviser representatives' dual roles as PortCo Board members and Adviser employees involved in trading decisions.

(iv) <u>Other Relevant Enforcement Cases</u>.

(A) *Fifth Street Management* (Dec. 2018): Failure to implement adequate policies and procedures to prevent MNPI from one client being used for the benefit of another;

(B) *Visium Asset Management* (May 2018) Failure to maintain and enforce adequate policies and procedures to prevent insider trading where two portfolio managers made trades based on MNPI received from paid consultants / experts; and

(C) *Brahman Capital* (Dec. 2017) Failure to maintain adequate policies and procedures to prevent an employee from sharing

confidential information with spouse, who operated a different private fund manager and invested using similar strategy.

(v) Key Takeaways.

(A) Lack of robust, appropriately tailored, and adequately maintained and enforced, compliance controls and oversight regarding the misuse of MNPI and insider trading has often led to SEC scrutiny even where no insider trading or other harm has occurred.

(B) Private fund managers with directors appointed at public portfolio companies should consider specific controls regarding trading in public portfolio company securities beyond mere reliance on an open trading window at the company.

(b) *Disclosure of Conflicts of Interest - Operating Partners*

(i) *Private Fund Adviser.* (April 2020):

(A) The SEC settled charges with a private equity Adviser over allegedly charging portfolio companies for the services of its in-house operations group without fully disclosing the practice.

(B) Since 2007, the Adviser provided Fund portfolio companies with services of its in-house operations group.

(C) The Adviser established a practice of billing portfolio companies for the costs of providing services of the operations group rather than covering the costs out of the management fee charged to its Funds.

(D) The SEC alleged that Adviser did not fully disclose that it would charge portfolio companies for the services provided by the operations group and, thus, did not obtain informed consent from its investors with respect to the conflicts of interest it would have with these arrangements.

(E) The Adviser's Form ADV indicated that Adviser's operations group may provide services to portfolio companies and receive reimbursement from portfolio companies for such services. The SEC alleged that these disclosures did not fully and fairly disclose the fact that Adviser was actually charging, and expected to continue to charge, portfolio companies for such services.

(ii) Key Takeaways.

(A) The use of compensation practices with respect to operating partners or similar consultants engaged to provide services to funds

/ portfolio companies needs to be clearly disclosed, particularly where such compensation will not offset management fees paid to the adviser.

(B) Stemming off of its previous guidance, the SEC continues to be focused on the use of "may" to disclose conflicts or practices that actually exist or are reasonably anticipated to exist.

Registered Funds: The Latest Developments

- **J. Christopher Jackson**, Calamos Investments LLC
- **Brian M. Johnson**, SEC Division of Investment Management
- **Naseem Nixon**, Capital Group
- **Nathan Briggs**, Ropes & Gray LLP MODERATOR

Recent Developments

- Valuation Rule
- Derivatives Rule
- Other Developments
  - Fund of Funds
  - Closed-End Fund Offering Reform

Valuation Rule (Rule 2a-5)

- Permits a fund's board to designate the fund's primary investment adviser to perform fair value determinations
- Specifies the minimum requirements of a fair valuation program
- Defines the criteria for concluding that a market quotation is "readily available"
- Rescinds certain previously issued fair valuation guidance

Derivatives Rule (Rule 18f-4)

- Limits on value-at-risk (VaR)
- Derivatives risk management program and derivatives risk manager
- Board oversight and reporting
- SEC reporting
- Limited derivatives user exception

Fund of Funds Rule (Rule 12d1-4)

- Comprehensive exemptive rule regarding fund of funds arrangements
- Conditions
  - Control
  - Voting
  - Required findings
  - Fund of funds investment agreement
  - Complex structures

Closed-End Fund Offering Reform

- Highlights
  - Shelf offering process and new short-form registration statement
  - Ability to qualify for well-known seasoned issuer (WKSI) status
  - Immediate or automatic effectiveness for unlisted closed-end funds
  - Communications and prospectus delivery reforms
  - New method for interval funds to pay registration fees
  - New disclosure and periodic reporting requirements
  - Incorporation by reference
  - Structured data requirements
- How's it working?

Looking Ahead

- New Disclosure Framework Proposal
- Disclosure Practices
- Other Trending Topics
  - Digital Assets
  - ESG
  - Closed-End Fund Activism
  - New Products and Trends

New Disclosure Framework Proposal

- Summary shareholder report
- Prospectus delivery practices
- Rule 30e-3
- Disclosure requirements – Fees, expenses and principal risks

Disclosure Practices

- COVID
- LIBOR transition
- Regulatory developments
- Principal risks
- Exposure to emerging markets

Other Trending Topics

- Digital Assets
- ESG
- Closed-End Fund Activism
- New Products and Trends
  - Mutual fund to ETF conversions
  - Interval funds
  - Retail access to private funds


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
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VIRTUAL CONFERENCE

IAA Investment Adviser Compliance Conference 2021

Registered Funds: The Latest Developments

March 5, 2021

Nathan D. Briggs
Ropes & Gray LLP

ATTACHMENTS

1. **SEC Updates Framework for Fund Fair Valuation Practices**

2. **SEC Adopts Rule 18f-4 Concerning Registered Funds' Use of Derivatives**

3. **SEC Adopts Changes for Fund of Funds Arrangements**

4. **SEC Extends Securities Offering Reforms to Closed-End Funds and Business Development Companies**

5. **SEC Proposes Modernized Fund Reports and Disclosure Amendments**

December 9, 2020

SEC Updates Framework for Fund Fair Valuation Practices

On December 3, 2020, the SEC issued a release adopting Rule 2a-5 (the "Rule") under the 1940 Act (the "Release").[1] The Rule is intended to "address valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered investment company or business development company." The Rule will permit a fund's board to designate the fund's primary investment adviser to perform the fund's fair value determinations, which will be subject to board oversight and certain reporting and other requirements intended to ensure that the board receives the information it needs to oversee the investment adviser's fair value determinations. Most notably:

- The Rule specifies the minimum requirements of a program for determining the fair value of fund investments in good faith for purposes of the 1940 Act.
- The Rule permits a fund's board[2] to formally designate the fund's primary investment adviser as its "valuation designee" to perform fair value determinations for the fund.[3]
- If a fund's investment adviser is designated as the board's fair valuation designee, the Rule provides that the investment adviser will be subject to board oversight and detailed reporting, recordkeeping and other requirements intended to enhance the board's oversight of the investment adviser's fair value determinations.
- The Release rescinds certain previously issued fair valuation guidance, including guidance on the role of a fund's board in determining the fair value of fund investments.
- The Rule defines the criteria for concluding that a market quotation is "readily available," which is currently undefined under the 1940 Act or rules thereunder. The definition will apply ***for all*** 1940 Act purposes, including Rule 17a-7 transactions. As a result, depending on further guidance from the SEC regarding the status of various no-action letters and/or potential revisions to Rule 17a-7, ***Rule 17a-7 may no longer be available*** for cross trades in most fixed income securities and other securities without "readily available market quotations" as defined in the Rule beginning no later than the compliance date.

The Rule reflects some modifications from the April 2020 proposing release (the "proposing release"), largely to address issues raised regarding more prescriptive elements of the initial proposal. We have noted changes from the proposing release in the footnotes to this Alert.

SUMMARY OF THE RULE

Requirements to determine fair values in good faith. The Rule provides that determining the fair value of a fund's portfolio investments in good faith requires:

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[1] The Release also includes new Rule 31a-4 under the 1940 Act, which addresses recordkeeping requirements relating to the Rule.
[2] The Rule provides that "board" means either the fund's entire board of directors/trustees or a designated committee composed of a majority of directors/trustees who are not interested persons of the fund.
[3] In a change from the proposing release, a fund's board may not assign fair value determinations to one or more sub-advisers. As adopted, the Rule permits a board to designate, as its "valuation designee," (i) the fund's adviser or (ii) if the fund does not have an investment adviser, an officer or officers of the fund. The definition of valuation designee expressly excludes a fund's sub-adviser. The second option is available only to an internally managed fund. In this Alert, we assume that a board's valuation designee will be the fund's primary investment adviser. Unit investment trusts ("UITs"), which do not have a board or an investment adviser, normally rely on the trustee or depositor to perform fair value functions and, as discussed below, are treated separately under the Rule.

1. Periodically assessing any material risks associated with fair value determinations, including material conflicts of interest, and managing those identified valuation risks.

2. Establishing and applying fair value methodologies by performing each of the following, taking into account the fund's valuation risks (a) selecting and applying in a consistent manner an appropriate methodology for determining (and calculating) the fair value of fund investments, including specifying the key inputs and assumptions specific to each asset class or portfolio holding, (b) periodically reviewing the appropriateness and accuracy of the methodologies selected and making any necessary changes or adjustments thereto and (c) monitoring for circumstances that may necessitate the use of fair value. A selected methodology may be changed "provided [the new] methodology is equally or more representative of the fair value of fund investments."[4]

3. Testing the appropriateness and accuracy of the fair value methodologies that have been selected, including identifying the testing methods to be used and the minimum frequency with which such testing methods are to be used.

4. Overseeing and evaluating any pricing services used, including establishing the process for approving, monitoring and evaluating each pricing service provider and initiating price challenges.[5]

Valuation designee. A fund's board may choose to designate the fund's primary investment adviser as its "valuation designee" to perform the fair value determinations of any or all fund investments by carrying out all of the functions required in items 1–4 above, subject to the board's oversight.[6] The definition of valuation designee expressly excludes a fund's sub-adviser.

Oversight and reporting. If a fund's board designates the fund's investment adviser as its valuation designee, the Rule requires the board to oversee the investment adviser with respect to its fair value determinations, and the investment adviser is required to:

1. Inform the board in writing of the titles of the persons responsible for determining the fair value of the fund's portfolio holdings, including the particular functions for which they are responsible and any material changes to the roles or functions of these persons.

[4] This is a change from the proposing release, which did not include the proviso. In another change from the proposing release, the Release omits a requirement that would have required the board or investment adviser to consider the applicability of the selected fair value methodologies to types of investments a fund does not currently own but in which the fund intends to invest.

[5] This is a change from the proposing release, which would have required a fund to adopt and implement written policies and procedures addressing the determination of the fair value of fund investments that are reasonably designed to achieve compliance with the requirements described in items (1)–(4). The Rule does not include this requirement. In the Release, the SEC recognized that, with the adoption of the Rules 2a-5 and 31a-4, Rule 38a-1 would require the adoption and implementation of written policies and procedures reasonably designed to prevent violations of the Rule's requirements.

[6] The Rule provides that a board may "designate" a valuation designee (to perform fair value determinations), which is a change from the proposing release's use of the word "assign." In the Release, the SEC stated that "[s]ome commenters believed that the term 'assign' could suggest that the board has completely delegated the entire valuation function and related obligations to the adviser." For internally managed funds, which do not have an investment adviser, the definition of valuation designee permits an officer or officers of the fund to be the valuation designee. In this Alert, we assume that a board's valuation designee will be the fund's primary investment adviser.

2. Reasonably segregate fair valuations from the fund's portfolio management "such that the portfolio manager(s) may not determine, or effectively determine by exerting substantial influence on, the fair values ascribed to portfolio investments."[7]

3. At least quarterly, provide the board in writing with any reports or materials requested by the board related to the fair value of the fund's investments or the investment adviser's process for fair valuing fund investments, as well as a summary or description of material fair value matters that occurred in the prior quarter, including: (a) any material changes in the assessment and management of valuation risks, including material changes in conflicts of interest of the investment adviser (and any other service provider), (b) any material changes to, or material deviations from, the fair value methodologies employed and (c) any material changes to the process for selecting and overseeing pricing services, as well as any material events related to the investment adviser's oversight of pricing services.

4. At least annually, provide the board in writing with an assessment of the adequacy and effectiveness of the investment adviser's process for determining the fair value of the designated portfolio of investments, including (a) a summary of the results of the testing of fair value methodologies employed and (b) an assessment of the adequacy of resources allocated to the process for determining the fair value of the fund's investments, including any material changes to the roles or functions of the persons responsible for determining fair value.[8]

5. Notify the board of the occurrence of matters that materially affect the fair value of the fund's investments, including any significant deficiency or material weakness in the effectiveness of the investment adviser's fair value determination process or material errors in the calculation of a fund's NAV (each a "material matter"), within five business days after the adviser becomes aware of the material matter (or shorter period determined by the board), along with timely follow-on reporting as the board may determine to be appropriate.[9] According to the Release, this "standard is similar to that of 'material compliance matter' found in rule 38a-1."[10]

Recordkeeping. The Release simultaneously adopts companion Rule 31a-4 regarding records related to fair value determinations.[11] Rule 31a-4 requires an investment adviser to maintain "appropriate" documentation to support its fair

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[7] In a change from the proposing release, the Release added the quoted text because the Release simultaneously deleted "process of making," which preceded "fair market valuations." In the Release, the SEC recognized that portfolio managers may have "unique insights . . . regarding the value of fund holdings" and, therefore, limited the segregation requirement to focus on undue influence. The Release indicates that ascribing fair values to portfolio investments based solely on information provided by the portfolio manager would not satisfy the segregation requirement.

[8] The Rule requires that these items be reported annually to a board. This is a change from the proposing release, which would have required quarterly reports of these items. In another change from the proposing release, the Rule clarifies that the annual assessment may contain a summary of testing results and removes a requirement, which appeared in the proposing release, to report service provider changes or price overrides as *per se* material events related to the investment adviser's oversight of pricing services.

[9] This is a change from the proposing release, which specified a maximum of three business days instead of five. The Release acknowledges that the materiality of some matters may not be immediately apparent. The Release provides that the valuation designee should promptly determine the materiality of matters it identifies consistent with its fiduciary duties and then notify the board within five business days after determining that the matter is material. If a valuation designee has not been able to determine a valuation matter's materiality after 20 business days of becoming aware of the matter, the Release indicates that the SEC would expect the designee to then notify the board of its ongoing evaluation of the matter within five business days.

[10] The Release states that material matters in this context would generally be matters about which a fund board "would reasonably need to know in order to exercise appropriate oversight of the valuation designee's fair value determination process," including matters that "could have materially affected" the fair value of the fund's investments.

[11] In a change from the proposing release, the Release does not specify the newly required records in the text of the Rule. Instead, the SEC adopted Rule 31a-4. If a fund's board does not designate a valuation designee, the fund is required to maintain the appropriate documentation to support its fair value determinations.

value determinations, as well as the various periodic reports to a fund's board described above.[12] Existing Rule 31a-2 already requires a fund to maintain "all schedules evidencing and supporting each computation of net asset value of the investment company shares." However, the Release states that "[w]hile some records currently required to be maintained . . . may be the appropriate documentation to support fair value determinations in some circumstances, they may not always be sufficient to meet that standard." The Release also acknowledged that a separate recordkeeping rule would ensure that a recordkeeping failure does not mean that a board has not fair valued in good faith.

Definition of "readily available." Under Section 2(a)(41) of the 1940 Act, if a market quotation is "readily available" for a portfolio holding, it must be valued at its market value. If market quotations are not readily available, a holding's value is its "fair value as determined in good faith by the board." However, the term "readily available" was not previously defined in the 1940 Act or rules thereunder. To fill this gap, the Rule provides:

> For purposes of section 2(a)(41) . . . 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.

The Release notes that ASC Topic 820 defines level 1 inputs as "[q]uoted prices (unadjusted) in active markets for identical assets . . . that the reporting entity can access at the measurement date" and states that the Rule's definition

> is consistent with the definition of a level 1 input in the fair value hierarchy outlined in U.S. GAAP. Thus, under the final definition, a security will be considered to have readily available market quotations if its value is determined solely by reference to these level 1 inputs. Fair value, as defined in the Act and further defined in rule 2a-5, therefore must be used in all other circumstances.

Thus, for purposes of the Rule, for a quotation to be "readily available," a security's value must be determined solely by reference to level 1 inputs under U.S. GAAP. The Release specifically states that evaluated prices, indications of interest and accommodation quotes would not be "readily available market quotations" for purposes of the Rule. The Release notes that whether a market quotation would be "unreliable" is also informed by U.S. GAAP, noting that "we will generally presume that a quote would be unreliable under [the Rule] where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security."

Additionally, the Release states that the Rule's definition of readily available market quotations will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7. The Release recognizes that, as a result, certain transactions that could formerly have been effected in reliance on Rule 17a-7 may no longer be deemed to have readily available market quotations and, therefore, may not be eligible for trading in reliance on Rule 17a-7. The Release cites certain SEC staff no-action letters that permitted transactions involving municipal fixed-income securities in reliance on Rule 17a-7 where market quotations were not readily available and the transaction was effected at a price provided by an independent pricing service.[13] The Release goes on to state that the SEC staff is "reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn [and] [s]eparately, consideration of potential revisions to rule 17a-7 is on the rulemaking agenda. We welcome input from the public as we undertake our consideration of rule 17a-7."

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[12] In another change from the proposing release, the Release states that appropriate documentation does not require detailed records relating to the specific methodologies that a pricing service applied nor the assumptions or inputs used by such pricing service. However, consistent with the proposing release, the Release states that "the requirement to maintain appropriate documentation to support fair value determinations should include documentation that would be sufficient for a third party, such as the [SEC] staff, not involved in the preparation of the fair value determinations to verify, but not fully recreate, the fair value determination."

[13] *See, e.g.*, United Municipal Bond Fund, SEC No-Action Letter (pub. avail. Jan. 27, 1995) and Federated Municipal Funds, SEC No-Action Letter (pub. avail. Nov. 20, 2006).

Unit investment trusts. The Rule provides that, if the initial deposit of portfolio securities into a UIT occurs after the Rule's effective date, the UIT's trustee or depositor is responsible for carrying out the requirements to determine fair values in good faith (*i.e.*, items 1–4 above). If the initial deposit occurs before the Rule's effective date, and an entity other than the fund's trustee or depositor has been designated to carry out the fair value determinations, that entity must carry out those requirements.

Board oversight. The Release provides extensive guidance on board oversight of the fair value determination process where it designates a valuation designee under the Rule. Following are selected excerpts:

> Where the board designates a valuation designee to perform fair value determinations under the final rule, the board will fulfill its continuing statutory obligations through active oversight of the valuation designee's performance of fair value determinations and compliance with the other requirements of the final rule.
>
> Boards should approach their oversight of the performance of fair value determinations by the valuation designee of the fund with a skeptical and objective view that takes account of the fund's particular valuation risks, including with respect to conflicts, the appropriateness of the fair value determination process, and the skill and resources devoted to it.
>
> The board should view oversight as an iterative process and seek to identify potential issues and opportunities to improve the fund's fair value processes.
>
> We expect that boards engaged in the process would use the appropriate level of scrutiny based on the fund's valuation risk, including the extent to which the fair value of the fund's investments depend on subjective inputs. . . . As the level of subjectivity increases and the inputs and assumptions used to determine fair value move away from more objective measures, we expect that the board's level of scrutiny would increase correspondingly.
>
> [C]onsistent with their obligations under the Act and as fiduciaries, boards should seek to identify potential conflicts of interest, monitor such conflicts, and take reasonable steps to manage such conflicts.
>
> Boards should probe the appropriateness of the valuation designee's fair value processes. In particular, boards should periodically review the financial resources, technology, staff, and expertise of the valuation designee, and the reasonableness of the valuation designee's reliance on other fund service providers, relating to valuation.
>
> Boards should also consider the type, content, and frequency of the reports they receive . . . While a board can reasonably rely on the information provided to it in summaries provided by the valuation designee and other service providers in conducting appropriate oversight, it is incumbent on the board to request and review such information as may be necessary to be informed of the valuation designee's process for determining the fair value of fund investments. Further, if a board becomes aware of material matters . . . we believe that in fulfilling its oversight duty the board must inquire about such matters and take reasonable steps to see that they are addressed.

EFFECTIVE AND COMPLIANCE DATES

Rules 2a-5 and 31a-4 become effective 60 days after publication of the Release in the *Federal Register*.[14] The compliance date will be eighteen months following the effective date. The Release provides that funds will have the option of complying with the Rules before the compliance date once the Rules become effective. However, to promote regulatory consistency, the Release states that any fund that elects to rely on Rules 2a-5 and 31a-4 before the compliance

[14] As of the date of this Alert, the Release has not been published in the *Federal Register*.

date may rely only on those rules, and may not also rely on other SEC guidance and staff letters and other guidance that will be withdrawn or rescinded on the compliance date.

In addition, on the effective date, the SEC will rescind ASRs 113 and 118, various no-action letters and staff guidance identified in the Release, as well as the "Last paragraph of Section III.D.2.(a) and the entirety of Section III.D.2.(b) of the 2014 Money Market Fund Release"[15] and "Valuation Guidance Frequently Asked Questions (FAQ 1 only)." The rescinded portions of the 2014 Money Market Fund Release and FAQ 1 contain the SEC and SEC staff's identical assertions that "a fund's board of directors has a non-delegable responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security."

OBSERVATIONS

Readily available market quotation definition. The Release states that the Rule's definition of readily available market quotations will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7. As noted in the Release, "[f]or a fund to engage in a cross trade under Rule 17a-7, the security first must have a 'readily available market quotation' and then the transaction must meet the other conditions of that rule." As noted above, the Release also indicates that evaluated prices, indications of interest and accommodation quotes would not be "readily available market quotations" for purposes of the Rule. This suggests that – depending on further guidance from the SEC, including the results of the SEC's review of the line of no-action letters permitting transactions effected at prices provided by independent pricing services and any revisions to Rule 17a-7 – funds may no longer be able to effect cross trades in most fixed income securities in reliance on Rule 17a-7 beginning no later than the Rule's compliance date. This would have a major impact on the current cross trading practices of many fund complexes.

Separately, through a line of no-action letters,[16] the SEC staff has permitted various affiliated persons, at least one of which is a fund, to effect in-kind transactions in which transferred securities are valued identically by the participants for purposes of determining their NAVs (such that neither participant experiences an artificial loss or gain simply due to different valuation procedures). The no-action letters did not exclude securities that were valued for NAV purposes based upon independent pricing services from being transferred in these transactions, and the industry has not interpreted the no-action letters as containing such an exclusion. It is not obvious why pricing service prices may be relied upon by funds in these affiliated transactions but not in Rule 17a-7 transactions.

Changes in selected methodology. The Rule provides that a fair valuation methodology may be changed "if a different methodology ***is*** equally or more representative of the fair value of fund investments." (Emphasis added). In some cases, it may be difficult to conclude with any certainty that a new method will be at least as representative of fair value as its predecessor. The wording of the Rule suggests that, if a new methodology proves inferior, the determinations based on the new methodology could be deemed a violation of the Rule. The Release draws on ASC Topic 820-10-35-25, which the SEC describes as "requiring consistent application of valuation techniques, but providing that a change in a valuation technique . . . is appropriate if the change results in a measurement that is equally or more representative of fair value." It is not clear whether a reasonable determination at the time a methodology is changed suffices and avoids *ex post* criticism and even strict liability.

Segregation of portfolio management personnel. The Release added text to the segregation requirement to clarify that the segregation of portfolio management staff is intended to prevent portfolio managers from exerting undue influence on the fair values ascribed to portfolio investments. Nonetheless, the SEC recognized in the Release that portfolio managers can participate "in the process of fair value determinations because of the unique insights that portfolio management may have regarding the value of fund holdings." Permitting portfolio management to participate in fair valuations, while

[15] Money Market Fund Reform; Amendments to Form PF, Rel. No. IC-31166 (Jul. 23, 2014) ("2014 Money Market Fund Release").
[16] *See, e.g.*, Signature Financial Group, Inc., SEC no-action letter (pub. avail. Dec. 28, 1999) and GE Institutional Funds, SEC no-action letter (pub. avail. Dec. 21, 2005).

assuring that that participation does not amount to substantial influence may be difficult, especially if judged in hindsight. This is may be an area where the industry will want to seek clarification from the SEC staff.

Significant deficiency or material weakness. In 2007, following a directive of the Sarbanes-Oxley Act, the SEC adopted a release in which it defined, for purposes of Regulation S-X, the terms "significant deficiency" and "material weakness." The Rule requires an investment adviser to notify a fund's board of the occurrence of matters that materially affect the fair value of the fund's investments, including any significant deficiency or material weakness in the effectiveness of the investment adviser's fair value determination process ("material matter," which the Release states is a standard "similar to that of 'material compliance matter' found in rule 38a-1"), and the Release notes that material matters under the Rule "would generally include, for example, material weaknesses and significant deficiencies as defined in [Regulation S-X] that are related to fair value determinations."

Both defined terms in Regulation S-X concern internal controls over financial reporting and underlie Rules 30a-2 and 30a-3 under the 1940 Act. However, it remains unclear how accounting rules, which apply in the context of preparing financial reports and to a discrete set of fund holdings at the end of a financial reporting period over a period of up to 60 days, translate to the daily calculations of the fair value of a significantly greater number of fund holdings over a much shorter time horizon.[17] At a minimum, the expertise of individuals performing daily fair value determinations may differ from the expertise of individuals preparing financial reports and assuring compliance with Rules 30a-2 and 30a-3.

A requirement, not a safe harbor. While perhaps less prescriptive than the SEC's recent liquidity risk management and derivatives risk management rules, the Rule imposes a mandatory, minimum framework for fair valuations. Many commenters had recommended that the proposed rule be recast as a non-exclusive safe harbor or otherwise be reworked to provide greater flexibility but, in rejecting these recommendations, the Release notes that it was "important to establish a minimum and consistent framework for fair value practices across funds." While the Rule was unanimously approved by the SEC's commissioners, Commissioner Hester M. Peirce issued a statement observing that "[a]long with many commenters, I see value in allowing fund boards the freedom to tailor their valuation assessment processes to their funds' individual needs and circumstances by redrawing the provisions of rule 2a-5 as a non-exclusive safe harbor" and that "[t]he prescriptive nature of the rulemaking could stifle fund boards' and advisers' initiative and innovation."

Fair value policies and procedures. Although the Rule omits the specific provisions in the proposing release that would have separately required that a fund adopt written policies and procedures addressing the determination of fair value, funds and investment advisers will still need to consider changes to existing fair value polices and procedures that are reasonably designed to prevent violation of Rules 2a-5 and 31a-4. The Release notes that, because Rules 2a-4 and 31a-4 are new rules under the 1940 Act with new fair value determination requirements, and given the intrinsic relationship of the Rules to the board's own statutory functions relating to valuation, the fair value policies and procedures must be approved by the board pursuant to Rule 38a-1.

Determining when a market quotation is no longer reliable. As adopted, the Rule changed a requirement in the proposing release to the effect that a fair valuation program must include "criteria for determining when market quotations are no longer reliable." To explain this change, the Release states that "to satisfy the requirement to monitor for circumstances that may necessitate the use of fair value . . . boards and valuation designees would have to take into account the circumstances that may cause market quotations to be no longer reliable." In addition, the Release notes that requiring, in advance, "a list of specific criteria for determining when market quotations may no longer be reliable could limit the board's or valuation designee's flexibility."

* * *

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

[17] A similar observation was made in the ABA Comment Letter, which was cited in the Release.

November 6, 2020

SEC Adopts Rule 18f-4 Concerning Registered Funds' Use of Derivatives

On October 28, 2020, the SEC adopted Rule 18f-4 (the "Rule"), which will dramatically change the regulation of the use of derivative instruments and certain related transactions by mutual funds (other than money market funds), exchange-traded funds ("ETFs"), closed-end funds and business development companies (collectively, "funds"). The adopting release (the "Release") follows a proposal of the Rule in December 2015 and a re-proposal of the Rule in November 2019 (the "2019 Proposal," which is described in this Ropes & Gray Alert). Both proposals received extensive comments.

I. OVERVIEW OF RULE 18f-4

The Rule supplants a patchwork of SEC no-action letters and other guidance stretching back to Release 10666 (issued in 1979) and ensuing SEC staff guidance. Generally, the Rule permits a fund to enter into "derivatives transactions," notwithstanding prohibitions and restrictions on the issuance of senior securities under Section 18 of the 1940 Act, provided the fund complies with the Rule's conditions, which are described below.[1] The Rule also addresses a fund's ability to (i) enter into reverse repurchase agreements and similar financing transactions, (ii) enter into "unfunded commitment agreements" and (iii) purchase securities that trade on a when-issued or forward-settling basis, or with a non-standard settlement cycle.

Key aspects of the Rule are as follows:

- ***Limits on value-at-risk ("VaR").*** The Rule imposes a VaR-based limit on a fund entering into derivatives transactions, based on either of two VaR limits – a "relative VaR" limit or an "absolute VaR" limit.

- ***Derivatives risk management program and derivatives risk manager.*** Unless it is a limited derivatives user (detailed below), a fund that uses derivatives is required to adopt and implement a derivatives risk management program (the "Program") that includes policies and procedures that are reasonably designed to manage the fund's "derivatives risks."[2] In addition, the Rule requires the fund's board to approve the designation of a Derivatives Risk Manager for the fund, who is responsible for administering the Program, including required stress testing and backtesting.

- ***Board oversight and reporting.*** At least annually, the Derivatives Risk Manager is required to report to the fund's board on the Program's effectiveness. The Derivatives Risk Manager must also provide reports to the fund's board regarding stress test results, backtesting results and breaches of the fund's risk guidelines related to the fund's use of derivatives.

- ***SEC reporting.*** The Release requires both public and confidential reporting related to a fund's use of derivatives.

- ***Limited derivatives user exception.*** Subject to conditions, the Rule exempts a fund that is a "limited derivatives user" from the Program requirement and the VaR-based limits. Limited derivatives users must adopt and implement written policies and procedures reasonably designed to manage the fund's derivatives risks.

II. DIFFERENCES FROM THE 2019 PROPOSAL

Key differences between the 2019 Proposal and the Rule include the following:

- The SEC maintained the basic framework of the relative and absolute VaR tests, with some modifications, including increasing the outer limits on fund leverage risk. Under the Rule, a fund will satisfy the ***relative VaR test*** if its

portfolio VaR does not exceed ***200%*** of the VaR of its "designated reference portfolio" (***250%*** in the case of a closed-end fund that has outstanding shares of a class of senior security that is a stock). A fund will satisfy the ***absolute VaR test*** if its portfolio VaR does not exceed ***20%*** of the value of the fund's net assets (***25%*** in the case of a closed-end fund that has outstanding shares of a class of senior security that is a stock). Under the 2019 Proposal, the VaR limits were 150% and 15%, respectively, including for closed-end funds.

- The Rule employs the term "designated reference *portfolio*," instead of the proposed "designated reference *index*," because the Rule permits a fund to use either a "designated index" or its "securities portfolio" (defined as the fund's investment portfolio, excluding derivatives transactions) as the fund's designated reference portfolio for the relative VaR test.

- Under the Rule, a fund is permitted to engage in reverse repurchase agreements and similar financing transactions so long as the fund meets the asset coverage requirements under Section 18. Alternatively, a fund may elect to treat such transactions as "derivatives transactions" under the Rule, which would allow a fund to apply a consistent set of requirements to its derivatives transactions and any reverse repurchase agreements or similar financing transactions. The 2019 Proposal did not allow funds to elect to treat these transactions as derivatives transactions.

- In approving the designation of a Derivatives Risk Manager, the Rule omits the 2019 Proposal's requirement that a fund board must take into account "the derivatives risk manager's relevant experience regarding the management of derivatives risk." The Rule still requires that the individuals designated have "relevant experience regarding the management of derivatives risk."

- The Rule permits money market funds (and other funds) to invest in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle, provided that the fund intends to settle the transaction physically, and that the transaction will settle within 35 days of the trade date. If these conditions are satisfied, these transactions are deemed not to involve a senior security.

- Under the Rule, leveraged/inverse funds may seek leveraged/inverse market exposure of no more than 200% of the return/inverse return of an index, subject to compliance with a relative VaR test and certain other conditions.[3] The SEC also amended Rule 6c-11 (the "ETF Rule") to permit these funds to rely on the ETF Rule.

- The SEC chose not to adopt the sales practice rules that would have required investment advisers and broker-dealers to exercise due diligence with respect to retail investors before approving retail investor accounts to invest in shares of a "leveraged/inverse investment vehicle."

III. DETAILED INFORMATION ON RULE 18f-4

Outer Limits on Value-at-Risk

The Rule requires a fund (other than a limited derivatives user) that engages in derivatives transactions[4] to comply with either a "***relative VaR***" limit or an "***absolute VaR***" limit. The applicable limit (*i.e.*, relative or absolute VaR) depends on whether a fund's Derivatives Risk Manager can identify a "***designated reference portfolio***" (as described below) for the fund.

- VaR is defined in the Rule as "an estimate of potential losses on an instrument or portfolio, expressed as a percentage of the value of the portfolio's assets (or net assets when computing a fund's VaR), over a specified time horizon and at a given confidence level."[5]

- The Rule employs the term "designated reference portfolio," instead of the 2019 Proposal's "designated reference index," because the Rule permits a fund to use, as its designated reference portfolio ("DRP"), either a "designated

index" ***or*** its "securities portfolio"[6] (excluding any derivatives transactions) for the relative VaR test.[7] The Release states that a fund's DRP "is designed to create a baseline VaR that functions as the VaR of a fund's unleveraged portfolio."

- A designated index is an unleveraged index that (i) is approved by the Derivatives Risk Manager for purposes of the relative VaR test and that reflects the markets or asset classes in which the fund invests and (ii) is not administered by an organization that is an affiliated person of the fund, its investment adviser, or principal underwriter, or created at the request of the fund or its investment adviser (each, an "Affiliate"), unless the index is widely recognized and used.[8]

If a fund's Derivatives Risk Manager has approved a DRP for the fund, the fund must comply with a "***relative VaR test***," which compares the fund's VaR to the VaR of its DRP. A fund with a DRP is required to limit its VaR to no more than 200% of the VaR of its DRP (250% in the case of a closed-end fund that has outstanding shares of a class of senior security that is a stock).

Alternatively, if a fund's Derivatives Risk Manager reasonably determines that a DRP would not provide an appropriate reference portfolio for purposes of the relative VaR test (taking into account the fund's investments, investment objectives and strategy), the fund must comply with the "***absolute VaR test***." A fund without a DRP is required to limit the VaR of the fund's portfolio to no more than 20% of the value of the fund's net assets (25% in the case of a closed-end fund that has outstanding a class of senior security that is a stock).

Testing requirements. The Rule requires a fund to determine its compliance with the applicable VaR test at least once each business day.

Consequences of being out of compliance with the applicable VaR test. If a fund determines that it is not in compliance with the applicable VaR test, the Rule requires the fund to return to compliance promptly, in a manner that is in the best interests of the fund and its shareholders.[9]

If the fund remains out of compliance for more than five business days,[10] the Derivatives Risk Manager (i) must provide a written report to the fund's board and explain how and when (number of business days) the Derivatives Risk Manager reasonably expects the fund will return to being in compliance and (ii) must determine what caused the fund to be out of compliance for more than five business days and, if appropriate, make changes to the Program to address the identified causes. Additionally, the Derivatives Risk Manager must provide a second written report to the fund's board within 30 calendar days of the fund's determination that it is out of compliance with its applicable VaR test explaining the results of the analysis and updating the reports described above and, if the fund has come into compliance with its VaR test, explaining how the fund was able to come back into compliance. If the fund remains out of compliance with the applicable VaR test at that time, this second report must update the explanation of how and when the fund would come into compliance that was included in the initial report provided to the board, and the Derivatives Risk Manager must update the fund's board regarding the fund's progress in coming back into compliance at regularly scheduled intervals determined by the board. Funds also are required to report information about VaR-based limit breaches to the SEC staff on a confidential basis (see discussion of Form N-RN, below, for more information).

Derivatives Risk Management Program and Its Administration

The Rule requires funds that engage in derivatives transactions (other than limited derivatives users) to have a Program, which must include policies and procedures that are reasonably designed to manage the fund's derivatives risks, taking into account the fund's derivatives and other investments. The Rule requires the Program to identify and manage leverage, market, counterparty, liquidity, operational and legal risks, in addition to any other risks the Derivatives Risk Manager deems material. Under the Rule, a fund's board is not required to approve the Program (including initially)[11] or to approve any material changes to the Program, but the Derivatives Risk Manager is required to provide regular reporting to the board regarding the Program.

The Rule requires a fund to "reasonably segregate" the functions of the Program from the fund's portfolio management. The Release notes that the reasonable segregation requirement does not mean that the Derivatives Risk Manager and portfolio management must be separated by a communications "firewall." Instead, the SEC recognized "the important perspective and insight regarding the fund's use of derivatives that the portfolio manager can provide and generally understand[s] that the fund's [Derivatives Risk Manager] would work with the fund's portfolio management in implementing the [Program]."

Derivatives Risk Manager. The Rule requires a fund's board, including a majority of its members who are not interested persons, to approve the designation of the Derivatives Risk Manager. The Derivatives Risk Manager must be an officer (or group of officers)[12] of the fund's adviser (including any sub-adviser) with "relevant experience regarding derivatives risk management," who will be responsible for administering the Program. If a single officer serves in the position, the Derivatives Risk Manager may not be a portfolio manager of the fund. If a group of officers serve in the position, portfolio managers of the fund may not comprise a majority of the Derivatives Risk Manager group. The Derivatives Risk Manager also may not be a third party, but third parties may assist with the Program's administration or provide relevant data.

While a fund's board is required to approve the designation of the Derivatives Risk Manager, the Rule does not prescribe specific qualifications, training or experience for the Derivatives Risk Manager. The Release notes that its use of the term "relevant experience" is intended to provide flexibility such that the person(s) who serve in this role have experience that is relevant in light of the derivatives risks unique to the fund, instead of requiring a specific amount or type of experience in derivatives risk management. With respect to the approval requirement, the SEC stated that "[w]e continue to believe that requiring the board to designate the [Derivatives Risk Manager] is important to establish the foundation for an effective relationship and line of communication between a fund's board and its [Derivatives Risk Manager]."

Required elements of a Program. The Rule requires a fund to adopt and implement a written program that includes policies and procedures reasonably designed to manage the fund's derivatives risks. The Program must include the following components:

- ***Risk identification and assessment.*** The Program must identify and assess a fund's derivatives risks taking into account the fund's derivatives transactions and other investments.

- ***Risk guidelines.*** The Program must establish, maintain and enforce investment, risk management or related guidelines that include "quantitative or otherwise measureable criteria, metrics, or thresholds" related to the fund's derivatives risks (the "Guidelines"), but the Rule does not prescribe specific criteria or risk limits. The Guidelines must specify levels of the given criteria that the fund does not normally expect to exceed and the measures to be taken if they are exceeded.

- ***Stress testing.*** The Program must include stress testing to evaluate potential losses to a fund's portfolio in response to "extreme but plausible market changes or changes in market risk factors that would have a significant adverse effect on the fund's portfolio, taking into account correlations of market risk factors and resulting payments to derivatives counterparties." The frequency of the testing must take into account the fund's strategy and investments and current market conditions, and must be conducted at least weekly.

- ***Backtesting.*** The Program must provide for backtesting, to be conducted no less frequently than weekly,[13] of the results of the VaR calculation model used by the fund in connection with the applicable VaR test by comparing the fund's gain or loss that occurred on each business day during the backtesting period with the corresponding VaR calculation for that day, estimated over a one-trading-day time horizon. The backtesting must identify as an exception any instance in which the fund experiences a loss exceeding the VaR calculation's estimated loss. The backtesting requirement is intended to require a fund to monitor the effectiveness of its VaR model.

- ***Internal reporting.*** The Rule requires that the Program identify when a fund's portfolio management personnel will be informed about the operation of the Program, breaches of the Guidelines and the results of fund stress tests.

- ***Escalation of material risks.*** The Derivatives Risk Manager must inform a fund's portfolio management personnel in a timely manner, and also directly inform the fund's board, as appropriate, of material risks arising from the fund's derivatives transactions, including material risks identified when a fund exceeds any of the criteria included in the Guidelines or through stress testing. The Rule does not require the Derivatives Risk Manager to automatically inform the fund's board but, instead, requires that the Derivatives Risk Manager directly inform the board of these material risks if the Derivatives Risk Manager determines board escalation to be appropriate.

- ***Periodic review of the Program.*** The Derivatives Risk Manager must review the Program at least annually to evaluate its effectiveness and to reflect changes in the fund's derivatives risks over time, including regulatory, market or fund-specific developments affecting the Program. The periodic review must include a review of the VaR calculation model used by the fund (including the required backtesting) and an evaluation of whether the fund's DRP (if any) remains appropriate.

Board Oversight and Reporting

While the Rule does not require a fund's board to approve its Program, the Release notes that fund directors should "understand the [Program] and the derivatives risks it is designed to manage." Moreover, the Release notes that directors "should ask questions and seek relevant information regarding the adequacy of the [Program] and the effectiveness of its implementation" and that the Rule's board reporting requirements are "designed to equip board members with the information they need to provide effective oversight." However, the SEC stated that "the role of the board under the rule is one of general oversight, and consistent with that obligation, [the SEC] expect[s] that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors."[14]

To assist with the board's oversight of the fund's Program, the Rule requires the Derivatives Risk Manager to provide a written report on the effectiveness of the Program to the board at least annually and to provide regular written reports at a frequency determined by the board. Specifically:

- ***Reporting on Program implementation and effectiveness.*** Before or when the Program is implemented, and at least annually thereafter, the Rule requires the Derivatives Risk Manager to provide a written report to a fund's board including a representation that the Program is reasonably designed to manage the fund's derivatives risks and that the Program incorporates the elements listed above (risk identification and assessment, risk guidelines, stress testing, backtesting, internal reporting, escalation of material risks and periodic review of the Program). The Derivatives Risk Manager's representation may be based on the Derivatives Risk Manager's reasonable belief after due inquiry. The written report also must include, as applicable, the Derivatives Risk Manager's basis for the approval of any DRP or any change in the DRP during the period covered by the report, or an explanation of the basis for the Derivatives Risk Manager's determination that a DRP would not provide an appropriate reference portfolio for purposes of the relative VaR test.

- ***Regular board reporting.*** The Derivatives Risk Manager also must provide to the board, at a frequency determined by the board, a written report analyzing the instances in which the fund has exceeded its Guidelines, the results of the fund's stress tests and the results of the fund's backtesting. Each such report must include information necessary for the board to evaluate the fund's responses to exceeding the Guidelines and to the results of the stress tests.

Reverse Repurchase Agreements and Unfunded Commitment Agreements

Reverse repurchase agreements. The Rule permits, but does not require, a fund to treat reverse repurchase agreements and other similar financing transactions as derivatives transactions.[15] The Rule permits a fund to enter into reverse

repurchase agreements or other similar financing transactions, if the fund (i) complies with the asset coverage requirements of Section 18, and combines the aggregate amount of indebtedness associated with all reverse repurchase agreements or similar financing with the aggregate amount of any other senior securities representing indebtedness when calculating the relevant asset coverage ratio or (ii) treats all reverse repurchase agreements or similar financing transactions as derivatives transactions for all purposes under the Rule. A fund is permitted to switch between these options. The Rule requires a fund to maintain a written record that documents the fund's choice of alternative (i) or alternative (ii), including any switch to the other option.[16]

Unfunded commitment agreements. The Rule permits a fund to enter into an unfunded commitment agreement,[17] provided the fund reasonably believes that, at the time it enters into such an agreement, it will have sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements as they come due. For each unfunded commitment agreement that a fund enters into relying on the Rule, the fund is required to document the basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its unfunded commitment agreement. Unfunded commitment agreements are not "derivatives transactions" for purposes of the Rule.

When-Issued, Forward-Settling, and Non-Standard Settlement Cycle Securities Transactions

The Rule also permits money market funds (and other funds) to invest in securities on a when-issued or forward-settling basis or with a non-standard settlement cycle, provided (i) the fund intends to physically settle the transaction and (ii) the transaction will settle within 35 days of its trade date (the "delayed-settlement securities provision"). The Release states that "[p]hysical settlement may occur electronically through the Depository Trust Company or other electronic platforms" and that "[t]his condition distinguishes these investments from bond forwards and other derivatives transactions where a fund commonly intends to execute an offsetting transaction rather than to actually purchase (or sell) the security."[18] If the conditions of the delayed-settlement securities provision are satisfied, these transactions are deemed not to involve a senior security.

Recordkeeping Provisions

Recordkeeping requirements under the Rule apply to:

- Policies and procedures that are designed to manage a fund's derivatives risks, written records of the results of any stress tests and the results of any VaR backtesting, any internal reporting or escalation of material risks under the Program and records documenting any periodic reviews of the Program.

- Any materials provided to the fund's board in connection with approving the designation of the Derivatives Risk Manager, records of any written reports provided to the board relating to the Program, and any written reports provided to the board that the Rule requires concerning the fund's non-compliance with the applicable VaR test.

- For a fund that is required to comply with a VaR-based limit on fund leverage risk, records documenting the fund's determination of (i) the VaR of its portfolio, (ii) the VaR of the fund's DRP, as applicable, (iii) the fund's VaR ratio, as applicable and (iv) any updates to any VaR calculation models used by the fund, as well as the basis for any material changes to those models.

- For a fund that is a limited derivatives user, a written record of its policies and procedures that are reasonably designed to manage its derivatives risk.

- For a fund that enters into unfunded commitment agreements, a record documenting the basis for the fund's belief regarding the sufficiency of its cash and cash equivalents to meet its obligations with respect to its unfunded commitment agreements.

- A record documenting whether the fund is treating its reverse repurchase agreements and other similar financing transactions as derivatives transactions or as senior securities subject to the asset coverage requirements of Section 18.

IV. THE LIMITED DERIVATIVES USER EXCEPTION UNDER RULE 18f-4

For funds that limit their derivatives transactions, the Rule includes an exception from the Program requirement (including the requirement to appoint a Derivatives Risk Manager) and the VaR-based limits (the "Limited Derivatives User Exception"). The Rule requires funds relying on the Limited Derivatives User Exception to satisfy the following conditions:

Derivatives exposure. The fund's "derivatives exposure"[19] must not exceed 10% of the fund's net assets, excluding currency or interest rate derivatives that hedge currency or interest rate risks associated with (i) one or more specific equity or fixed-income investments held by the fund (which must be foreign-currency-denominated in the case of currency derivatives) or (ii) the fund's borrowings, provided that in each case the currency or interest rate derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts[20] of such derivatives do not exceed the value of the hedged investments (or the par value thereof, in the case of fixed-income investments, or the principal amount, in the case of borrowing) by more than 10%.

Risk management. The Rule requires any fund that relies on the Limited Derivatives User Exception to adopt and implement written policies and procedures reasonably designed to manage a fund's derivatives risks. The Release states that the policies and procedures for a fund relying on the Limited Derivatives User Exception "should be tailored to the extent and nature of the fund's derivatives use." For example, a fund that uses derivatives occasionally and for a limited purpose, such as to equitize cash, "is likely to have limited policies and procedures commensurate with this limited use."

Breaches of the 10% limit. If the derivatives exposure of a fund relying upon the Limited Derivatives User Exception exceeds 10% of the fund's net assets, the fund has five business days to come back into compliance with the 10% limit. If the fund is not back in compliance within five business days, the fund's investment adviser must provide a written report to the fund's board informing the board whether the investment adviser intends either:

- To reduce the fund's derivatives exposure to less than 10% of the fund's net assets promptly, but within no more than 30 calendar days of the breach, in a manner that is in the best interests of the fund and its shareholders, or

- To establish a Program, comply with the VaR-based limit on fund leverage risk and comply with the related board oversight and reporting requirements, as soon as reasonably practicable (*i.e.*, to no longer rely on the Limited Derivatives User Exception).

Reporting by limited derivatives users. A fund that relies on the Limited Derivatives User Exception is required to report on Form N-PORT its derivatives exposure as of the end of the reporting period. See the discussion of Form N-PORT changes, below. Limited Derivatives Users also are required to report their reliance on the exception in Form N-CEN.

V. EFFECTIVE DATE AND COMPLIANCE DATE

The Rule's effective date is 60 days after publication of the Release in the *Federal Register*.[21] The Release provides for an 18-month transition period following the Rule's effective date for funds to prepare to come into compliance with the Rule. Following the 18-month transition period, Release 10666 will be rescinded and related no-action letters and other staff guidance (or portions thereof) will be withdrawn. At that time, funds could enter into derivatives transactions, reverse repurchase agreements and similar financing transactions and unfunded commitments only as permitted by the Rule and Section 18.

The Release states that the staff of the Division of Investment Management has reviewed its no-action letters and other guidance addressing derivatives transactions and other transactions covered by the 2019 Proposal "to determine which

letters and other staff guidance, should be withdrawn in connection with the final rule." The 2019 Proposal stated that the staff's review included, but was limited to, all of the no-action letters and staff guidance listed in the 2019 Proposal – approximately 30 no-action letters and a "Dear CFO" letter – including the staff's position on tender option bonds. The Release states that the staff's review has now included, but was not limited to, the staff no-action letters and other guidance identified in the 2019 Proposal. The Release does not provide a list of additional no-action letters, if any, that will be withdrawn.

In addition, on the compliance date for the Rule, the SEC will rescind the exemptive orders provided to leveraged/inverse ETFs, which will be permitted to rely on the ETF Rule, as amended by the Release. See Section VII, below.

VI. REPORTING/FORM REQUIREMENTS

The Release adopts amendments to the reporting requirements for funds that rely on the Rule, including amendments to Forms N-PORT, N-LIQUID (re-titled "Form N-RN") and N-CEN. Form N-2 is also amended.

Form N-PORT. Only funds that rely on the Limited Derivatives User Exception are required to report derivatives exposure as of the end of the reporting period. A fund that relies on the exception must report (i) its derivatives exposure, (ii) its exposure from currency derivatives that hedge currency risks and (iii) its exposure from interest rate derivatives that hedge interest rate risks. In addition, a fund that relies on the exception will have to report the number of business days, if any, in excess of the five-business-day remediation period permitted by the Rule that the fund's derivatives exposure exceeded 10% of its net assets during the reporting period. The derivatives exposure information reported by funds that rely on the Limited Derivatives User Exception will not be made publicly available.[22]

Form N-PORT also is amended to require funds subject to a VaR test to report their median daily VaR for the monthly reporting period. Funds subject to the relative VaR test during the reporting period will report, as applicable, the name of the fund's designated index or a statement that the fund's DRP is the fund's securities portfolio, as well as their median VaR Ratio during the reporting period (reported as a percentage of the VaR of the Fund's DRP). Funds subject to the absolute VaR test will report their median daily VaR during the reporting period (reported as a percentage of the fund's net asset value). In a change from the 2019 Proposal, a fund's median VaR information (its median daily VaR, and its median VaR ratio for funds subject to the relative VaR test) will not be made publicly available.[23]

A fund also must report the number of exceptions the fund identified during the reporting period arising from backtesting the fund's VaR calculation model, but this information will not be made publicly available.

Form N-LIQUID is renamed "Form N-RN,"[24] and the form is amended to include new reportable events for funds that are subject to the Rule's VaR-based limits. These funds are required to file a Form N-RN to report information about certain VaR-based limit breaches. Specifically, when a fund determines that it is out of compliance with the applicable VaR-based limit and has not come back into compliance within five business days after such determination, the fund is required to file a report – within one business day following the fifth business day after the fund determined that it was out of compliance – on Form N-RN providing certain information regarding its VaR-based limit breaches. The fund also is required to file a report on Form N-RN when it is back in compliance with the applicable VaR-based limit. This information reported to the SEC staff will not be made public.

Form N-CEN is amended to require a fund to identify whether it relied on the Rule during the reporting period and whether it relied on any of the exceptions from various requirements under the Rule. A fund also has to identify whether it entered into reverse repurchase agreements or similar financing transactions, or unfunded commitment agreements. A fund will also be required to identify whether it is relying on the Rule provision concerning investments in securities on a when-issued or forward-settling basis, or with a non-standard settlement cycle.

Form N-2 currently requires a closed-end fund to include a senior securities table with information about any senior securities it has issued. The Rule provides that a fund's derivatives transactions and unfunded commitment agreements are not to be considered for purposes of computing asset coverage under Section 18(h), and the Release amends Form N-

2 to provide that closed-end funds relying on the Rule are not required to include their derivatives transactions and unfunded commitment agreements in the senior securities table.

Annual reports. In a change from the 2019 Proposal, the Release does not require a fund to publicly disclose its designated index in the fund's annual report.

Conforming amendments. The Release amends Rule 22e-4 and a related reporting requirement on Form N-PORT to remove references to assets "segregated to cover" derivatives transactions.

VII. LEVERAGED/INVERSE ETFS AND AMENDMENTS TO THE ETF RULE

The Release's approach regarding leveraged/inverse funds[25] is quite different from the 2019 Proposal.[26] Specifically, the SEC recognized that, under the relative VaR test with a 200% limit, as adopted, leveraged/inverse funds that seek leveraged/inverse market exposure greater than 200% of the return/inverse return of an index ("over-200% leveraged/inverse funds") generally will be unable to satisfy the Rule's limit on fund leverage risk.[27] Therefore, the Rule includes a provision permitting over-200% leveraged/inverse funds to continue to operate at their current leverage levels, provided they comply with all the provisions of the Rule, except the VaR-based limit on fund leverage risk, and satisfy the following additional requirements:

- The fund was in operation as of October 28, 2020, and the fund has outstanding shares issued in one or more public offerings to investors, and discloses in its prospectus a leverage multiple or inverse multiple that exceeds 200% of the performance or the inverse of the performance of the underlying index,
- The fund does not change the underlying market index or increase the level of leveraged or inverse market exposure the fund seeks, directly or indirectly, to provide, and
- The fund discloses in its prospectus that it is not subject to the limit on fund leverage risk specified by the Rule.

In September 2019, the SEC adopted Rule 6c-11 (the "ETF Rule"), permitting ETFs that meet certain conditions to operate without obtaining an exemptive order from the SEC. However, as adopted, the ETF Rule expressly excluded leveraged/inverse ETFs from the ETF Rule's coverage. The Release amends the ETF Rule to permit a leveraged/inverse ETF, including over-200% leveraged/inverse funds, to rely on the ETF Rule, provided the ETF complies with the applicable provisions of the Rule. Because the amendments to the ETF Rule will permit a leveraged/inverse ETF to rely on that rule instead of an existing order, the SEC stated that, on the compliance date of the Rule, it will rescind the exemptive orders already issued to leveraged/inverse ETFs.

Separately, the Release does not adopt the sales practices rules proposed in the 2019 Proposal. The rules would have required investment advisers and broker-dealers to exercise due diligence with respect to retail investors that are natural persons before approving retail investor accounts to invest in shares of a "leveraged/inverse investment vehicle."[28]

VIII. OBSERVATIONS

"Competition" between types of leverage. The Rule applies either a relative or absolute VaR-based ceiling as a means to limit the total leverage a fund can achieve from a mix of different transactions, including loans, reverse repurchase agreements and derivatives transactions, placing such exposures in more direct competition for a fund's available "capacity" under the VaR limit.[29] For funds that have utilized transactions involving a significant amount of leverage, their investment advisers will need to assess carefully the leveraging transactions that provide the most attractive exposure in light of all relevant considerations, including cost. Such an analysis raises interesting issues of fiduciary duty, especially when an adviser may be entitled to compensation under its investment advisory agreement for some leveraging transactions (*e.g.*, borrowings, reverse repurchase agreements) and not others (*e.g.*, derivatives transactions where the investment exposure is principally notional). With the Rule in effect, there may not be a principled reason why – as is commonly the case – investment advisers to registered investment companies should earn advisory fees on the

invested proceeds from borrowings or reverse repurchase agreements (without reduction for the related liabilities), but not on the notional value of certain derivatives transactions, such as total return swaps, which can be used to provide similar economic exposure.

Objective designated indexes. Under the Rule, a fund may not use a designated index as its DRP for purposes of applying the relative VaR limit if the designated index was "created at the request of the fund or its investment adviser."[30] It is common for fund sponsors, especially ETF sponsors, to have some involvement in the formulation of an index used in the management of a fund. Additionally, index sponsors may seek to gauge commercial interest in a particular index before determining whether to invest the resources necessary to "create" an index and bring it to market. To the extent fund sponsors are (or were) so involved, they may wish to document the level of their involvement internally and to document their understandings with index sponsors as to whether (or not) the index was created at the request of the fund sponsor. Interestingly, the limitation appears to apply without limit in time, such that it would apply to indices created at the request of a fund or its investment adviser long before the Rule was formulated.

Derivatives Risk Manager. In approving the designation of a Derivatives Risk Manager, the Rule omits the 2019 Proposal's requirement that a fund's board must take into account "the derivatives risk manager's relevant experience regarding the management of derivatives risk," but the Rule still requires that the individual(s) designated have "relevant experience regarding the management of derivatives risk." The board will need to take that "relevant experience" into account, along with all other relevant factors, in appointing the Derivatives Risk Manager.

The Rule does not specify what "relevant experience regarding the management of derivatives risk" means or what qualifications or experience the derivatives risk manager must possess. The SEC notes in the Release that this aspect of the Rule is designed to provide flexibility to boards to determine what experience is relevant in light of the derivatives risks applicable to the fund, but it is unclear what kinds of experience and qualifications will be required for this position. Presumably, risk experts in the derivatives field are already gainfully employed in positions – like portfolio manager, quantitative analyst or trader – that provide more attractive compensation and bonus opportunities than a mutual fund compliance role. Some advisers (smaller advisers, in particular) may find the cost of hiring a new senior-level employee to serve in the Derivatives Risk Manager role to be burdensome as a business matter.

Derivatives Risk Manager and manager-of-managers situations. The Rule requires that the Derivatives Risk Manager be an officer or officers of the fund's investment adviser, which the Release clarifies includes sub-advisers (as long as the sub-adviser manages the fund's entire portfolio and not a sleeve of the fund's assets). Neither the Rule nor the Release otherwise addresses the allocation of responsibilities between personnel of the primary investment adviser and the personnel of a sub-adviser for funds that employ a manager-of-managers structure, leaving such a fund considerable flexibility to tailor its Program to its particular facts and circumstances. Even for a fund that designates one or more officers of its primary investment adviser as the Derivatives Risk Manager, it seems likely that the Derivatives Risk Manager will look to personnel of the sub-adviser(s) for assistance in administering the Program. At a minimum, if a fund were to be out of compliance with its VaR test, it would presumably be necessary for the applicable sub-adviser(s) to be involved in promptly returning the fund to compliance in a manner that is in the best interests of the fund and its shareholders. Because existing sub-advisory agreements were not drafted in contemplation of the Rule, it may be necessary for primary investment advisers and sub-advisers to address and negotiate their respective roles.

Derivatives Risk Manager's communications with the board.

- While the Rule does not specifically require that the Derivatives Risk Manager meet in person with the board (or the independent directors), the SEC clearly contemplates a relationship between the Derivatives Risk Manager and the board, noting multiple times in the Release that the Derivatives Risk Manager will have a "direct reporting line" to the board. As noted above, one of the reasons cited by the SEC for requiring board approval of the Derivatives Risk Manager is that the SEC believes that board approval "is important to establish the foundation for an effective relationship and line of communication" between the board and the Derivatives Risk Manager. In contrast to Rule 22e-4, where the administrator of a fund's liquidity risk management program can be the adviser itself, the SEC

noted that requiring the Derivatives Risk Manager to be an officer or officers of the adviser would "promote accountability" to the board. As a result, we expect boards may seek periodic meetings with the Derivatives Risk Manager as well as special meetings with the Derivatives Risk Manager (*e.g.*, during periods of extended non-compliance by a fund with its applicable VaR test). In addition, a board should expect to receive multiple written reports from the Derivatives Risk Manager, as required under the Rule.

- Because the Derivatives Risk Manager has discretion when determining whether to escalate a material risk arising from a fund's derivatives use to the board, a board could find itself being brought into situations where the Derivatives Risk Manager and a fund's portfolio managers disagree as to the evaluation or materiality of the risks. While the Release indicates that the Derivatives Risk Manager's decision to escalate is intended to provide the board with information to facilitate its oversight, a board will want to take care that it keeps its oversight role as opposed to becoming a referee between the portfolio management and derivatives risk management functions.

Limited Derivatives User Exception. The test for the Limited Derivatives User Exception, which requires that the derivatives exposure of a fund not exceed 10% of the net assets of the fund, is not calibrated to the risk of the fund's derivatives positions. With limited exceptions, derivatives that tend to have lower risk relative to their notional amount (such as many interest rate derivatives) are treated the same as derivatives that tend to have higher risk relative to their notional amount. Also, no credit is given for margin posted or received with respect to derivatives contracts. While the Rule excludes from this 10% threshold close-out transactions with the same counterparty, it does not exclude positions that offset or hedge derivatives transactions with a different counterparty, leading to the result that a derivatives transaction that hedges interest rate or currency risk of an equity or fixed income instrument held by a fund is excluded from derivatives exposure for purposes of the 10% test, while a derivatives transaction that hedges interest rate or currency risk of another derivatives transaction held by the fund might need to be included.

* * *

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

1. As a technical matter, the Rule exempts funds that enter into derivatives transactions from various provisions under Section 18, which generally restricts a fund's ability to issue "senior securities." The SEC notes in the Release its belief that "a derivatives transaction creating a future payment obligation involves an evidence of indebtedness that is a senior security for purposes of [S]ection 18."
2. Derivatives risks means the risks associated with a fund's derivatives transactions or its use of derivatives transactions, including leverage, market, counterparty, liquidity, operational and legal risks and any other risks the Derivatives Risk Manager (or, in the case of a limited derivatives user, the fund's investment adviser) deems material.
3. Existing funds seeking a greater-than-200% leveraged/inverse market exposure are grandfathered under the Rule, subject to conditions.
4. A derivatives transaction means (i) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument"), under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise, (ii) any short sale borrowing and (iii) if the fund treats ***all*** reverse repurchase agreements or similar financing transactions as derivatives transactions, any reverse repurchase agreement or similar financing transaction.
5. The Rule requires that any VaR model used by a fund for purposes of determining the fund's compliance with the relative VaR test or the absolute VaR test must:
    1. Take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable:
        a. Equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;
        b. Material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and
        c. The sensitivity of the market value of the fund's investments to changes in volatility;
    2. Use a 99% confidence level and a time horizon of 20 trading days; and
    3. Be based on at least three years of historical market data.
6. Securities portfolio means the fund's portfolio of securities and other investments, ***excluding*** any derivatives transactions, approved by the Derivatives Risk Manager for purposes of the relative VaR test, provided that the fund's securities portfolio reflects the markets or asset classes in which the fund invests. The Release notes that allowing a fund to use its securities portfolio may provide the fund with the ability to (i) use a VaR reference portfolio that is more tailored to the fund's investments than an index and/or (ii) avoid the expense associated with blending or licensing an index just for purposes of the Rule's VaR test.
7. If a fund's investment objective is to track the performance, including a multiple or inverse multiple, of an unleveraged index, the fund must use that index as its DRP (even if that unleveraged index would otherwise be a prohibited index under the Rule).
8. In the case of a blended index, none of the indexes that compose the blended index may be administered by an organization that is an Affiliate, unless the index is widely recognized and used. In changes from the 2019 Proposal regarding a designated reference index (i) the Rule does not require a fund's designated index to be an "appropriate broad-based securities market index" or an "additional index," as defined in the instruction to Item 27 in Form N-1A and (ii) a fund is not required to disclose its designated index in its annual report. However, a fund's designated index, if any, will be reported publicly on Form N-PORT.
9. The 2019 Proposal also would have precluded a fund from entering into new derivatives transactions (other than transactions reducing the fund's VaR) until the fund had complied with its VaR test for three consecutive business days.
10. The 2019 Proposal allowed for a three business day cure period.
11. In contrast, Rule 22e-4 requires board approval of a fund's liquidity risk management program.
12. The Release notes that the Derivatives Risk Manager does not have to be an "officer" of the investment adviser in accordance with the adviser's corporate bylaws and can be any person with a "comparable degree of seniority and authority within the organization" who is otherwise qualified for the position.
13. The 2019 Proposal would have required daily backtesting.
14. While the Rule does not require a fund's board to approve its Program, the Release clarifies that the board is responsible for overseeing compliance with Rule 38a-1 under the 1940 Act, which includes board approval of policies and procedures reasonably designed to prevent violation of the federal securities laws, of which the Rule is a part.
15. The Release notes that, "[t]o the extent that a fund engages in transactions similar to firm or standby commitment agreements, they may fall within the 'any similar instrument' definitional language, depending on the facts and circumstances."
16. This is a change from the 2019 Proposal, which would have required funds to take reverse repurchase agreements and similar financing transactions into account, together with other permissible borrowings under the 1940 Act, when calculating the fund's asset coverage ratio under Section 18.

17. An unfunded commitment agreement is a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner.
18. Some commenters asked the SEC to clarify how to-be-announced ("TBA") transactions should be treated under the Rule. The SEC notes in the Release that TBAs and dollar rolls are included in the final rule's derivatives transaction definition (because they are forward contracts or "similar instruments"), and that funds may invest in TBAs under the delayed-settlement securities provision, if its conditions are satisfied.
19. Derivatives exposure means the sum of (i) the gross notional amounts of the fund's derivatives transactions described in clause "(i)" within the definition of the term "derivatives transaction" and (ii) in the case of short sale borrowings, the value of the assets sold short. If a fund's derivatives transactions include reverse repurchase agreements or similar financing transactions, the fund's derivatives exposure also includes, for each transaction, the proceeds received but not yet repaid or returned, or for which the associated liability has not been extinguished, in connection with the transaction. In determining derivatives exposure a fund may (i) convert the notional amount of interest rate derivatives to 10-year bond equivalents and delta adjust the notional amounts of options contracts and (ii) exclude any closed-out positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the fund. According to the Release, "[d]elta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. A fund would delta adjust an option by multiplying the option's unadjusted notional amount by the option's delta."
20. The Rule does not define "notional amount" or specify how to determine notional amount. The Release states that "using gross notional amounts to measure market exposure could be viewed as a relatively blunt measurement," but using such concept in the Limited Derivatives User Exception "is designed to serve as an efficient way to identify funds that use derivatives in a limited way."
21. A fund may rely on the Rule after its effective date, but before the compliance date, provided that the fund satisfies the Rule's conditions. Any funds that do so must rely only on the Rule and may not rely on Release 10666 or any no-action letters or other staff guidance. In such cases, early compliance requirements extend to the amendments to Form N-PORT and Form N-CEN, as applicable, once these updated forms are available for filing on EDGAR, as well as filing Form N-RN to report any reportable event.
22. The 2019 Proposal would have required all funds to report their derivatives exposure.
23. While the 2019 Proposal would have required funds to report their highest daily VaR (and for funds that use the relative VaR test, their highest daily VaR ratio) and these measures' corresponding dates, the Form N-PORT amendments do not include these requirements.
24. In view of the amendments that make current Form N-LIQUID (Form N-RN) applicable to all funds (other than money market funds), the Release amends the form and Rule 30b1-10 under the 1940 Act to reflect the Rule's requirement that all funds that are subject to the relative VaR test or absolute VaR test must file current reports regarding VaR-based limit breaches under the circumstances that Form N-RN sets forth.
25. Leveraged/inverse fund means a fund that seeks, directly or indirectly, to provide investment returns that correspond to the performance of a market index by a specified multiple ("leverage multiple"), or to provide investment returns that have an inverse relationship to the performance of a market index ("inverse multiple"), over a predetermined period of time.
26. The 2019 Proposal would have exempted leveraged/inverse funds from the Rule's VaR requirements, provided the fund did not seek investment results exceeding 300% of the return (or inverse of the return) of an underlying index. Investment advisers and broker-dealers also would have been subject to sales practice rules with respect to sales of these funds to retail investors.
27. The SEC stated that there were 70 leveraged/inverse ETFs, with total net assets of $15.7 billion, that currently seek to provide leveraged/inverse market exposure exceeding 200% of the return/inverse return of an index.
28. The same day that the Release was published, Chairman Clayton, with the Director of the Division of Investment Management and the Director of the Division of Corporation Finance, issued a joint statement regarding complex products, including leveraged/inverse products. The joint statement reported that the SEC staff will be reviewing the existing regulatory requirements concerning protecting investors who invest in complex products. Based on this review, the staff will make recommendations to the SEC regarding potential new rulemakings, guidance, or other policy actions, if appropriate. The joint statement also invited public comment on these topics.
29. As noted, funds may treat reverse repurchase agreements as senior securities representing indebtedness and subject to the asset coverage requirements of Section 18 or treat them as "derivatives transactions" under the Rule.
30. This prohibition does not apply if (i) the index is widely recognized and used or (ii) the fund's investment objective is to track the performance, including a multiple or inverse multiple, of a particular index.

October 14, 2020

SEC Adopts Changes for Fund of Funds Arrangements

On October 7, 2020, the SEC issued a release (the "Release") adopting new Rule 12d1-4 and making several related rule and form amendments under the 1940 Act intended to streamline and enhance the regulatory framework applicable to funds that invest in other funds ("fund of funds" arrangements). The Release noted that the current combination of statutory exemptions, SEC rules and exemptive orders has created a regime in which substantially similar fund of funds arrangements are subject to different conditions. The Release is intended to replace the existing regime with "a consistent and efficient rules-based regime for the formation, operation, and oversight of fund of funds arrangements."

While Rule 12d1-4, as adopted, differs substantially from the version of the rule proposed by the SEC in 2018 (the "Proposed Rule," described in this Ropes & Gray Alert), and does not include the Proposed Rule's widely criticized redemption limits, many existing fund of funds arrangements may nonetheless require modifications.

EXECUTIVE SUMMARY

- Rule 12d1-4 (the "Rule") permits fund of funds arrangements subject to various conditions, including limits on control and voting, required evaluations and findings, required fund investment agreements and limits on complex (*i.e.*, more than two tier) fund of funds structures. The Rule is intended to be a comprehensive exemptive rule and, therefore, the SEC is rescinding Rule 12d1-2, as well as most exemptive orders granting relief from Sections 12(d)(1)(A), (B), (C) and (G) of the 1940 Act and related no-action letters.
    - Rule 12d1-2 currently provides funds that rely on Section 12(d)(1)(G) with flexibility to invest in securities of funds that are not part of the same group of investment companies when the acquisition is in reliance on Section 12(d)(1)(A) or (F), as well as in stocks, bonds and other securities. The rescission of Rule 12d1-2 will result in the loss of this flexibility.
    - Existing exemptive orders and no-action letters permit multi-tier fund of funds arrangements. The rescission of these orders and letters will result in the elimination of many of these arrangements, including "central funds" (three-tier affiliated fund-of-fund arrangements used to efficiently manage exposure to a specific asset class).
- In light of the rescission of Rule 12d1-2, the Release amends Rule 12d1-1 to permit funds that rely on Section 12(d)(1)(G) to invest in money market funds that are not part of the same group of investment companies.
- In general, the Rule is designed to restrict multi-tier fund of funds arrangements, where an acquired fund's investments in other investment companies or private funds exceed the limits of Section 12(d)(1)(A) of the 1940 Act. The Rule permits some multi-tier structures.
    - The Rule prohibits an acquired fund in a fund of funds arrangement relying on either Section 12(d)(1)(G) or the Rule from investing in the securities of an investment company or private fund if, subject to limited exceptions, the value of the securities of investment companies and private funds owned by the acquired fund exceeds 10% of the acquired fund's total assets (the "10% Bucket").
- The Release adds a requirement to Form N-CEN to require open-end funds, closed-end funds and unit investment trusts ("UITs") to report whether they relied on Rule 12d1-4 or, instead, the statutory exception in Section 12(d)(1)(G) during the reporting period.

- The Release does not provide additional flexibility for private funds to invest in registered investment companies, including business development companies ("BDCs").

Effective Date. The Release's effective date is 60 days after the Rule's publication in the *Federal Register*.[1] The rescission of Rule 12d1-2 is effective one year from that date, as is the rescission of various exemptive orders and no-action letters effected by the Release.

The Release is discussed in detail below. The Rule, marked to show changes from the Proposed Rule, appears in this Alert's Appendix.

BACKGROUND

In general, Section 12(d)(1)(A) contains the so-called "3-5-10%" limits governing a registered fund's investments in other funds and a private fund's[2] investments in registered funds.[3] Section 12(d)(1)(B) addresses the sell-side of such investments by limiting a registered open-end fund's sales of its securities to other investment companies.[4] Section 12(d)(1)(C) contains limitations on fund investments in registered closed-end funds.

Rule 12d1-1 allows funds to invest in shares of money market funds in excess of the limits of Section 12(d)(1), and Rule 12d1-2 currently provides funds that rely on Section 12(d)(1)(G)[5] with flexibility to invest in securities of funds that are not part of the same group of investment companies when the acquisition is in reliance on Section 12(d)(1)(A) or (F), as well as in stocks, bonds and other securities.

INVESTMENTS PERMITTED BY RULE 12d1-4

Subject to specific conditions (described below), and notwithstanding the prohibitions in Sections 12(d)(1)(A), 12(d)(1)(B), 12(d)(1)(C), 17(a), 57(a)(1)-(2) and 57(d)(1)-(2) of the 1940 Act, the Rule allows:

- A registered investment company or BDC (each, an "acquiring fund") to acquire the securities of any other registered investment company or BDC (collectively, "acquired funds").

- An acquired fund, its principal underwriter and any broker-dealer to sell the acquired fund's securities to any acquiring fund.

- An acquired fund to redeem or repurchase its securities issued to an acquiring fund.

- An acquiring fund that is an affiliated person of an ETF (or an affiliated person of such an acquiring fund) ***solely by reason of holding with the power to vote 5% or more*** of the outstanding shares of (i) the ETF or (ii) any fund that is an affiliated person of the ETF, to deposit and receive the ETF's "baskets,"[6] provided that the acquired ETF is not otherwise an affiliated person (or affiliated person of an affiliated person) of the acquiring fund.[7] An acquiring fund that transacts with an ETF through an authorized participant ("AP") that holds 5% or more of the ETF is within this group.

Currently, permitted fund of funds arrangements vary significantly based on the type of acquiring fund. In some cases, the Rule generally expands the types of permitted fund of funds arrangements. For example, the Rule permits open-end funds to invest in unlisted closed-end funds (including unlisted BDCs) in amounts that exceed the limits specified in Section 12(d)(1). The following chart, which appeared in the underlying 2018 SEC release (the "Proposing Release"), summarizes the types of fund of funds arrangements that the Rule permits.

Rule 12d1-4 Acquiring Funds	Rule 12d1-4 Acquired Funds
Open-end funds UITs Closed-end funds (listed and unlisted) BDCs (listed and unlisted) ETFs Exchange-traded managed funds ("ETMFs")	Open-end funds UITs Closed-end funds (listed and unlisted) BDCs (listed and unlisted) ETFs ETMFs

RULE 12d1-4 CONDITIONS

To rely on the Rule, a fund of funds arrangement is required to satisfy various conditions intended to protect investors from the same harms that Congress sought to prevent by enacting Section 12(d)(1) of the 1940 Act: (i) shareholders of an acquiring fund controlling – through voting power or the threat of large-scale redemptions – the assets of an acquired fund to benefit themselves at the expense of the acquired fund's other shareholders, (ii) excessive, duplicative fees that may result when one fund invests in another and (iii) overly complex structures leading to confusion among investors about who controls their fund and the value of their investments. The Rule's conditions fall into five categories:

1. Control

An acquiring fund and its "advisory group"[8] may not "control" an acquired fund. Control is determined using the definition set forth in Section 2(a)(9) of the 1940 Act, including the definition's rebuttable presumption of control. Thus, up to 25% of an acquired fund's shares normally could be acquired by an acquiring fund and its advisory group.

This condition does not apply if the acquiring fund is within the same "group of investment companies"[9] as an acquired fund, or the acquiring fund's investment sub-adviser or any control affiliate of the sub-adviser is the adviser or depositor of the acquired fund.

2. Voting

An acquiring fund and its advisory group must employ mirror voting[10] if they hold ***more than 25%*** of the voting securities of an acquired open-end fund or UIT due to a decrease in the number of those shares outstanding,[11] or ***more than 10%*** of the voting securities of an acquired closed-end fund or BDC.

There are two exceptions to these voting conditions:

i. In situations where all holders of the outstanding voting securities of an acquired fund are required by Rule 12d1-4 or Section 12(d)(1) of the 1940 Act to employ mirror voting, an acquiring fund and its advisory group are instead required to employ pass-through voting to vote securities of the acquired fund.[12] The Release cites as an example an acquired fund that is held only by acquiring funds that are relying on Rule 12d1-4 as a situation in which there may be no other investors to vote the acquired fund's shares, thereby requiring pass-through voting.

ii. As with the control condition, the voting conditions do not apply if the acquiring fund is within the same group of investment companies as an acquired fund, or the acquiring fund's investment sub-adviser or any control affiliate of the sub-adviser is the adviser or depositor of the acquired fund.

3. Required Findings

The Rule does not include the Proposed Rule's (i) limitations an acquiring fund's redemptions of an acquired fund and (ii) requirement that funds disclose whether they are or may be an acquiring fund. Instead, the Rule requires an investment

adviser to an open-end fund or closed-end fund (including a BDC) that relies on the Rule to evaluate and make certain findings regarding the arrangement ("Fund Findings")[13] discussed in this section, and also requires an acquiring fund and acquired fund to enter into a fund of funds investment agreement (discussed below). The underwriter or depositor of a UIT that is an acquiring fund, and any insurance company a separate account of which that funds variable insurance contracts and invests in acquiring fund must make similar findings and, in the latter case provide the acquiring fund with a related certification. The Fund Findings and related board-reporting requirements are as follows:

i. If the ***acquiring*** fund is an open-end fund or closed-end fund (including a BDC), prior to the initial acquisition of an acquired fund in excess of the 3% limit in Section 12(d)(1)(A)(i), the acquiring fund's investment adviser must evaluate the complexity of the structure and fees and expenses arising from the investment in the acquired fund, and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired fund.

ii. If the ***acquired*** fund is an open-end fund or closed-end fund (including a BDC), before the initial acquisition of an acquired fund in excess of the limits in Section 12(d)(1)(A)(i), the acquired fund's investment adviser must find that any concerns regarding undue influence arising from the acquiring fund's investment in the acquired fund are reasonably addressed. At a minimum, as part of this finding, the investment adviser must consider the following items:

   - The scale of contemplated investments by the acquiring fund and any maximum investment limits,
   - The anticipated timing of redemption requests by the acquiring fund,
   - Whether and under what circumstances the acquiring fund will provide advance notification of investments and redemptions, and
   - The circumstances under which the acquired fund may elect to satisfy redemption requests in kind rather than in cash and the terms of any such redemptions in kind.

iii. The investment adviser to each acquiring or acquired fund must report its evaluations and findings, including the adviser's underlying reasoning, for the required items in (i) and (ii), as applicable, to the fund's board of directors, no later than the next regularly scheduled board meeting.[14]

4. Fund of Funds Investment Agreement

Unless an acquiring fund and an acquired fund share the same investment adviser, the Rule requires the funds to enter into a fund of funds investment agreement before the acquiring fund acquires securities of the acquired fund that exceed Section 12(d)(1)'s limits. The Rule mandates that this fund of funds investment agreement must be effective for the duration of the funds' reliance on the Rule, and must include the following:

i. Any material terms regarding the acquiring fund's investment in the acquired fund necessary to make the required Fund Findings.

ii. A termination provision permitting either the acquiring fund or the acquired fund to terminate the agreement upon no more than 60 days' written notice.

iii. A requirement that the acquired fund provide the acquiring fund with information on the fees and expenses of the acquired fund reasonably requested by the acquiring fund.

The Release stated that, in negotiating the fund of funds investment agreement, the funds could set the terms of the agreement that support the Fund Findings. For example, "an acquired fund could require the acquiring fund to agree to

submit redemptions over a certain amount for a given period as a condition to the fund of funds investment agreement."[15] The Release noted that termination of a fund of funds investment agreement would not, unless the parties agreed otherwise, require the acquiring fund to reduce its holdings of the acquired fund. However, the termination of the agreement will preclude the acquiring fund from purchasing additional shares of the acquired fund beyond the Section 12(d)(1) limits.

The Release also stated that "fund of funds investment agreements are material contracts not made in the ordinary course of business" and, therefore, "they ***must be filed as an exhibit*** to each fund's registration statement." (Emphasis added).

5. Complex Structures

In general, the Rule is designed to restrict fund of funds arrangements with more than two tiers, where an acquired fund's investments in other investment companies or private funds exceed the limits of Section 12(d)(1)(A) of the 1940 Act. The Rule permits some multi-tier structures.

The Rule prohibits an acquired fund in a fund of funds arrangement relying on either Section 12(d)(1)(G) or the Rule from purchasing or otherwise acquiring the securities of an investment company or private fund if, immediately after such purchase or acquisition, the value of the securities of investment companies and private funds owned by the acquired fund exceeds 10% of the acquired fund's total assets (the "10% Bucket").[16] The 10% Bucket does ***not*** include investments by the acquired fund in:

i. Reliance on Section 12(d)(1)(E) of the 1940 Act.

ii. Reliance on Rule 12d1-1 (as amended).

iii. A subsidiary that is wholly-owned and controlled by the acquired fund.

iv. Securities received as a dividend or as a result of a plan of reorganization of a company.

v. Securities of another investment company received pursuant to exemptive relief from the SEC to engage in interfund borrowing and lending transactions.

In short, the Rule requires that an acquired fund's investments in other investment companies and private funds, other than investments excluded under (i) – (v) above, must not exceed its 10% Bucket. The Rule provides that no investment company may rely on the Rule or Section 12(d)(1)(G) to purchase or otherwise acquire, in excess of the limits in Section 12(d)(1)(A), the outstanding voting securities of an investment company (a "second-tier fund") that relies on the Rule to acquire the securities of an acquired fund, unless the second-tier fund's investments in other investment companies and private funds are limited to its 10% Bucket and securities listed in (i) – (v), above. A fund that does not satisfy these conditions may not be an acquired fund under Section 12(d)(1)(G) or the Rule.[17]

RESCISSION OF RULE 12d1-2 AND AMENDED RULE 12d1-1

To limit the hardship that the rescission of Rule 12d1-2 could have on existing fund of funds arrangements, the Release provides for a one-year period after the effective date of the Rule before Rule 12d1-2 is rescinded. The Release states that this "one year is adequate time for funds relying on current rule 12d1-2 to bring their future operations into conformity with section 12(d)(1)(G) or rule 12d1-4."

With the rescission of Rule 12d1-2, fund of funds arrangements that rely on Section 12(d)(1)(G) lose the flexibility to invest in unaffiliated money market fund securities in reliance on Rule 12d1-2(a)(3).[18] To provide funds relying on Section 12(d)(1)(G) with continuing flexibility to invest in money market funds outside of their group of investment companies, the Release amends Rule 12d1-1 to permit such investments.

RESCISSION OF EXEMPTIVE ORDERS AND WITHDRAWAL OF NO-ACTION LETTERS

The Release rescinds exemptive relief under Section 12(d)(1)(G) that permits an affiliated fund of funds to invest in assets that are beyond the scope of that statutory provision, effective one year after the Rule's effective date. The Release also rescinds fund of funds exemptive orders that "fall within the scope of Rule 12d1-4," effective one year after the Rule's effective date.

The Release states that certain "[f]und of funds exemptive relief that falls outside the scope of rule 12d1-4, as well as the relevant portions of fund of funds exemptive orders that grant relief for provisions in the Act outside of the scope of this rulemaking, will remain in place." This includes (i) interfund lending orders, (ii) exemptive orders that provide relief from Sections 17(a) and 17(d) and Rule 17d-1 under the 1940 Act permitting a registered fund to invest in private funds and (iii) portions of fund of funds exemptive orders that provide relief from Section 17(d) and Rule 17d-1 permitting fee-sharing agreements to avoid duplicative fees.

The Release states that no-action letters applicable to specific circumstances related to Section 12(d)(1) will be withdrawn one year from the Rule's effective date, and that the withdrawn letters will include only those letters that fall within the scope of Rule 12d1-4.[19] The Release does not provide a list of the no-action letters that will be withdrawn but, instead, refers interested persons to the Division of Investment Management's website. As of the date of this Alert, the Division's list of Modified or Withdrawn Staff Statements has not been amended to identify withdrawn no-action letters.

AMENDED FORM N-CEN

At present, Item C.7 of Form N-CEN requires funds to report if they relied on certain 1940 Act rules during the reporting period, including if they relied on Rule 12d1-1. The Release amends Form N-CEN to require funds and UITs to report if they relied on the Rule or the statutory exception in Section 12(d)(1)(G) during the reporting period. The effective date for the amended Form N-CEN is 425 days after publication of the Release in the *Federal Register*.

OBSERVATIONS

1. ***No Redemption Limits.*** The Rule eliminates the most controversial and unpopular condition to reliance on the Proposed Rule, which would have capped redemptions by an acquiring fund in excess of 3% of an acquired fund's shares during any 30-day period. While the conditions included in lieu of the redemption limits impose potentially burdensome new obligations on advisers and boards, the Rule dropped a condition that would have been entirely unworkable for many fund of funds arrangements.

2. ***Impact on Three-Tier Fund of Funds Arrangements.*** The Rule prohibits most three-tier fund structures, subject to the limited exceptions described above. Some fund complexes currently employ a multi-tier structure by relying on a combination of Section 12(d)(1)(G) (and Rule 12d1-2 thereunder) and either an ETF or fund of funds exemptive order. The rescission of these orders may require these complexes to restructure their investments. The SEC stated that "[w]e agree with commenters that additional flexibility to enter into multi-tier arrangements could lead to efficiencies and cost savings for fund investors." However, the SEC ultimately concluded that the "10% Bucket, when combined with the enumerated exceptions discussed above, will provide flexibility for beneficial multi-tier arrangements while limiting the harms that Congress sought to prevent." Whether the SEC will provide future exemptive relief to permit other multi-tiered structures is unknown and is likely to be contingent on experience with the Rule. In particular, it remains to be seen whether the SEC's assertion that the Rule and related changes will provide sufficient flexibility for beneficial multi-tier arrangements will be borne out.

3. ***A Mixed Bag for ETFs.*** Many funds that are acquired funds in fund of funds arrangements operating under Section 12(d)(1)(G) or Rule 12d1-2 currently invest without limit in ETFs in reliance on the ETFs' exemptive orders. Under the Rule, acquired funds' investments in ETFs (and other investment companies and private funds) will be subject to the 10% Bucket. While this imposes a new limit with respect to funds investing in ETFs with exemptive orders, it also creates new flexibility to invest in excess of the limits of Section 12(d)(1)(A) in ETFs

without exemptive orders. Separately, the Rule addresses a gap in the ETF Rule (Rule 6c-11); namely, that ETF baskets may be contributed and redeemed by acquiring funds that are technically affiliated with an ETF by virtue of owning 5% or more of the acquired ETF's shares. However, the Commission also suggests that ETFs should question potential purchasers of the ETF's shares (including purchasers acting through an authorized participant) to determine whether those persons intend to purchase ETF shares for investment companies, and adds that the ETF may want to consider adopting and implementing policies and procedures to make these inquiries.[20]

4. ***Affiliated Fund of Funds Structures.*** The impact of the Rule on most two-tier affiliated fund of funds structures could be extensive. Advisers to funds relying on the Rule, rather than Section 12(d)(1)(G), will be required to make new findings and provide new reports to fund boards, but will be exempt from the control and investment agreement requirements. Affiliated fund of funds that can operate in compliance with Section 12(d)(1)(G) may opt to do so in order to avoid the Rule's findings and reporting requirements. Of course, the rescission of Rule 12d1-2 means that funds relying on Section 12(d)(1)(G) will lose the ability to acquire the securities of other funds that are outside of the fund's group of investment companies (except for money market funds) and invest directly in stocks, bonds and other securities, as now permitted by Rule 12d1-2, and derivatives and other financial instruments that are not securities under the 1940 Act (as now permitted under the Northern Lights Fund Trust no-action letter).

5. ***Efficacy of Fund of Funds Investment Agreements and Effects on Liquidity Risk Management Programs.*** The Release specifically contemplates that advance notice requirements and redemption limits might be included in fund of funds investment agreements, but does not indicate whether such limits would actually be enforceable. Even if an acquiring fund were to agree to provide advance notice to an acquired fund and to spread out large redemptions, it may retain the legal right to redeem open-end fund shares on any business day and to receive redemption proceeds within seven days.[21] The question of whether redemption limits in fund of funds investment agreements are enforceable also has implications for the acquiring fund and acquired fund's respective liquidity risk management programs adopted under Rule 22e-4 under the 1940 Act.

6. ***No New Protections for Closed-End Funds.*** Many closed-end fund sponsors and boards hoped that a final rule would provide additional protections from activist investors, particularly given the SEC's objective of protecting funds from undue influence exerted by other funds. Many closed-end fund activist investors acquire large positions in closed-end funds by using numerous private funds, each of which acquires up to 3% of a given closed-end fund's shares. While the Rule's "control" condition requires mirror voting when an acquiring fund and its advisory group hold more than 10% of a closed-end fund's outstanding voting securities, this condition would only apply where an activist holds at least some of its shares in a given closed-end fund through a registered fund. Mirror voting would not be required where an activist exclusively uses private funds (most activists' structure of choice in any case) to acquire large positions in closed-end funds.

7. ***Disclosure.*** While the Rule does not require a fund to disclose that it is an acquired fund subject to the Rule's limitations, the fund may want to consider whether the Rule's limits on an acquired fund (*e.g.*, complying with 10% Bucket requirements) limit its investment flexibility materially.

* * *

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray attorney.

1. As of the date of this Alert, the Release has not been published in the *Federal Register*.
2. A "private fund" is an issuer that would be an investment company under Section 3(a) of the 1940 Act but for the exclusions from that definition in Section 3(c)(1) or Section 3(c)(7).
3. Section 12(d)(1)(A) generally provides that it is unlawful for any registered fund (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the "acquired company"), and for any investment company (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the "acquired company"), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate (i) more than 3% of the total outstanding voting stock of the acquired company; (ii) securities issued by the acquired company having an aggregate value in excess of 5% of the value of the total assets of the acquiring company; or (iii) securities issued by the acquired company and all other investment companies having an aggregate value in excess of 10% of the value of the total assets of the acquiring company.
4. Section 12(d)(1)(B) generally provides that it is unlawful for any registered open-end fund (the "acquired company"), any principal underwriter therefor, or any broker or dealer registered under the Exchange Act, knowingly to sell or otherwise dispose of any security issued by the acquired company to any other investment company (the "acquiring company") or any company or companies controlled by the acquiring company, if immediately after such sale or disposition (i) more than 3% of the total outstanding voting stock of the acquired company is owned by the acquiring company and any company or companies controlled by it; or (ii) more than 10% of the total outstanding voting stock of the acquired company is owned by the acquiring company and other investment companies and companies controlled by them. Private funds that rely on the Sections 3(c)(1) and 3(c)(7) are subject to the 3% limitation on investments in a registered fund in Section 12(d)(1)(A)(i) and Section 12(d)(1)(B)(i).
5. Section 12(d)(1)(G) allows a registered open-end fund or UIT to invest without regard to the limits in Section 12(d)(1)(A)(i) and Section 12(d)(1)(B)(i), provided that securities of other registered open-end investment companies and registered UITs that are part of the same "group of investment companies," government securities and short-term paper are the only investments held by the acquiring open-end fund or UIT.
6. The Rule defines "baskets" to have the same meaning as in Rule 6c-11(a)(1).
7. Section 17(a)(2) would prohibit an ETF from purchasing securities and other property (*i.e.*, securities and other property in the ETF's basket) from the affiliated acquiring fund in exchange for ETF shares. Section 17(a)(1) would prohibit an acquiring fund from selling any securities and other property (*i.e.*, securities and other property in the ETF's basket) to an affiliated ETF in exchange for the ETF's shares. The Rule codifies certain exemptive orders that provide relief from Section 17(a) to permit these transactions. Recently adopted Rule 6c-11 under the 1940 Act, as well as prior exemptive orders, provide relief from Section 17(a) for the acquisition or sale of an ETF's basket assets in connection with the creation or redemption of ETF creation units. However, that relief is insufficient to permit an ETF's in-kind transactions with another fund. The Rule thus additionally closes this gap in Rule 6c-11 and prior exemptive orders by permitting other registered funds to make investments in ETFs in excess of the Section 12(d)(1) limits through basket transactions.
8. The Rule defines "advisory group" as either (i) an acquiring fund's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor or (ii) an acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser.
9. The term "group of investment companies" is defined as "any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for investment and investor services." This definition is broader than the term defined in Section 12(d)(1)(G)(ii) because it includes BDCs.
10. Mirror voting means that votes are cast in the same proportion as the votes of all other holders.
11. This condition applies in many existing exemptive orders where an acquiring fund and its advisory group exceed 25% of the outstanding voting securities of an acquired fund passively.
12. Pass-through voting means seeking instructions from the acquiring fund's security holders with regard to the voting of all proxies of an acquired fund.
13. The Rule separately requires tailored findings regarding acquiring UITs and a certification regarding separate accounts underlying variable insurance contracts (also, "Fund Findings").
14. While the Rule does not specify the frequency of subsequent reporting regarding the Fund Findings, the Release states that "subsequent reporting regarding these Fund Findings will be conducted at least annually under the fund's compliance program."

The Fund Findings and annual reporting conditions are similar to the conditions adopted with respect to custom baskets in the SEC's 2019 ETF rule, Rule 6c-11(discussed in this Ropes & Gray Alert).

15. Release at 98.
16. The Release noted that, if an acquired fund holds more than 10% of its assets in other underlying funds due to market movements, it cannot make additional investments in underlying funds, but the acquired fund will not be required to dispose of its existing investments in underlying funds.
17. An acquiring fund or an acquired fund that satisfies the conditions of the Rule can invest directly in stocks, bonds and other securities (including financial instruments that may not be "securities").
18. Rule 12d1-2 and related exemptive and no-action relief currently provides funds that rely on Section 12(d)(1)(G) with flexibility to invest in securities of funds that are not part of the same group of investment companies when the acquisition is in reliance on Section 12(d)(1)(A) or (F), as well as in stocks, bonds and other securities (including financial instruments that may not be "securities."). The rescission of Rule 12d1-2 and the related relief will result in the loss of this flexibility, except in compliance with Rules 12d1-4 and amended 12d1-1.
19. Among the no-action letters to be withdrawn, the Release identifies (i) Northern Lights Fund Trust (pub. avail, June 29, 2015) (permitting an affiliated fund of funds arrangement relying on Section 12(d)(1)(G) and Rule 12d1-2 to invest in financial instruments that are not securities under the 1940 Act) and (ii) Franklin Templeton Investments (pub. avail. April 3, 2015) (permitting an acquiring fund relying on Section 12(d)(1)(G) to acquire shares of an underlying fund that, in turn, purchases shares of a central fund).
20. The SEC added that an ETF that explains its obligations pursuant to Section 12(d)(1)(B) to potential purchasers, and documents that exchange with the potential purchaser, generally would satisfy its obligation not to knowingly sell or otherwise dispose of any of its securities in excess of 12(d)(1)(B) limits. Further, the SEC noted that if an ETF intends to rely on Rule 12d1-4 to exceed the Section 12(d)(1) limits, such ETF must comply with the conditions of the Rule, including entering into a fund of funds investment agreement with the acquiring investment company.
21. The Release states that advance-notice requirements applicable to an acquiring fund's planned large redemption may be included in a fund of funds investment agreement. However, the Release also states that any fund of funds investment agreement would still have to comply with Section 22(e) of the 1940 Act, which provides, in part, that a registered fund may not suspend the right of redemption, or postpone the date of payment upon redemption for more than seven days after tender of the security absent unusual circumstances.

October 14, 2020

Rule 12d1-4, as Adopted, Marked to Show Changes from the Proposing Release

Exemptions for investments in certain investment companies.

(a) Exemptions for acquisition and sale of acquired fund shares.

If the conditions of paragraph (b) of this section are satisfied, notwithstanding sections 12(d)(1)(A), 12(d)(1)(B), 12(d)(1)(C), 17(a), 57(a)(1)-(2), and 57(d)(1)-(2) of the Act (15 U.S.C. 80~~a-~~a 12(d)(1)(A), 80a-12(d)(1)(C), 80~~a-~~a 17(a), 80a-56(a)(1)-(2), and 80a-56(d)(1)-(2)):

(1) A registered investment company (other than a face-amount certificate company) or business development company (an "acquiring fund") may purchase or otherwise acquire the securities issued by another registered investment company (other than a face-amount certificate company) or business development company (an "acquired fund");~~ and~~

(2) An acquired fund, any principal underwriter thereof, and any broker or dealer registered under the Securities Exchange Act of 1934 may sell or otherwise dispose of the securities issued by the acquired fund to any acquiring fund and any acquired fund may redeem or repurchase any securities issued by the acquired fund from any acquiring fund~~.~~; and

(3) An acquiring fund that is an affiliated person of an exchange-traded fund (or who is an affiliated person of such a fund) solely by reason of the circumstances described in § 270.6c-11(b)(3)(i) and (ii), may deposit and receive the exchange-traded fund's baskets, provided that the acquired exchange-traded fund is not otherwise an affiliated person (or affiliated person of an affiliated person) of the acquiring fund.

(b) Conditions.

(1) Control.

(i) The acquiring fund and its advisory group will not control (individually or in the aggregate) an acquired fund;~~ and~~

(ii) If the acquiring fund and its advisory group, in the aggregate, (A) hold more than ~~3~~25% of the outstanding voting securities of an acquired fund that is a registered open-end management investment company or registered unit investment trust as a result of a decrease in the outstanding voting securities of the acquired fund, or (B) hold more than 10% of the outstanding voting securities of an acquired fund that is a registered closed-end management investment company or business development company, each of those holders will vote its securities in the ~~manner prescribed by~~same proportion as the vote of all other holders of such securities; provided, however, that in circumstances where all holders of the outstanding voting securities of the acquired fund are required by this section or otherwise under section 12(d)(1)~~(E)(iii)(aa) of the Act (15 U.S.C. 80a-12(d)(1)(E)(iii)(aa));~~ to vote securities of the acquired fund in the same proportion as the vote of all other holders of such securities, the acquiring fund will seek instructions from its security holders with regard to the voting of all proxies with respect to such acquired fund securities and vote such proxies only in accordance with such instructions; and

(iii) The conditions in paragraphs (b)(1)(i) ~~and~~ (ii) of this section do not apply ~~when~~if:

(A) The acquiring fund is in the same group of investment companies as an acquired fund; or

(B) The acquiring fund's investment sub-adviser or any person controlling, controlled by, or under common control with such investment sub-adviser acts as an acquired fund's investment adviser or depositor.

(2) Findings and Agreements.

(i) Management companies.

(~~2~~A) ~~*Limited redemption.* An~~If the acquiring fund ~~that holds shares~~is a management company, prior to the initial acquisition of an acquired fund in excess of the limits ~~of~~in section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)) ~~does not redeem or submit for redemption, or tender for repurchase, any of those shares in an amount exceeding 3% of the acquired fund's total outstanding shares during any thirty-day period in which the acquiring fund holds~~, the acquiring fund's investment adviser must evaluate the complexity of the structure and fees and expenses associated with the acquiring fund's investment in the acquired fund, and find that the acquiring fund's fees and expenses do not duplicate the fees and expenses of the acquired ~~fund's shares in excess of that limit.~~fund;

~~(3) *Fees and other considerations.*~~

(~~i~~B) ~~*Management companies.*~~ If the ~~acquiring fund~~acquired fund is a management company, ~~before investing in~~prior to the initial acquisition of an acquired fund in ~~reliance on this section, and with such frequency as the acquiring fund's board of directors deems reasonable and appropriate thereafter, but in any case, no less frequently than annually, the acquiring~~ excess of the limits in section 12(d)(1)(A)(i) of the Act (15 U.S.C. 80a-12(d)(1)(A)(i)), the acquired fund's investment adviser must ~~evaluate the complexity of the structure and aggregate fees~~find that any undue influence concerns associated with the acquiring fund's investment in the acquired fund~~, and find that it is in the best interest of the acquiring fund to invest in the acquired fund.~~ are reasonably addressed and, as part of this finding, the investment adviser must consider at a minimum the following items:

(1) The scale of contemplated investments by the acquiring fund and any maximum investment limits;

(2) The anticipated timing of redemption requests by the acquiring fund;

(3) Whether and under what circumstances the acquiring fund will provide advance notification of investments and redemptions; and

(4) The circumstances under which the acquired fund may elect to satisfy redemption requests in kind rather than in cash and the terms of any such redemptions in kind; and

(C) The ~~acquiring fund's~~ investment adviser to each acquiring or acquired management company must report its ~~finding~~evaluation, finding, and the basis for ~~the finding to the acquiring~~its evaluations or findings required by paragraphs (b)(2)(i)(A) or (B),as applicable, to the fund's board of directors, no later than the next regularly scheduled board of directors meeting.

(ii) Unit investment trusts. If the acquiring fund is a unit investment trust ("UIT") and the date of initial deposit of portfolio securities into ~~a registered~~the UIT occurs after the effective date of this section, the UIT's principal underwriter or depositor must evaluate the complexity of the structure ~~and the aggregate fees~~ associated with the UIT's investment in acquired funds and, on or before such date of initial deposit, find that the UIT's fees and expenses do not duplicate the fees and expenses of the acquired funds that the UIT holds or will hold at the date of deposit.

(iii) Separate ~~*account*~~accounts funding variable insurance contracts. With respect to a separate account funding variable insurance contracts that invests in an acquiring fund, the acquiring fund must obtain a certification from the insurance company offering the separate account that the insurance company has determined that the fees and expenses borne by the separate account, acquiring fund, and acquired fund, in the aggregate, are consistent with the standard set forth in section 26(f)(2)(A) of the Act (15 U.S.C. 80a-26(f)(2)(A)).

(iv) Fund of funds investment agreement. Unless the acquiring fund's investment adviser acts as the acquired

fund's investment adviser and such adviser is not acting as the sub-adviser to either fund, the acquiring fund must enter into an agreement with the acquired fund effective for the duration of the funds' reliance on this section, which must include the following:

(A) Any material terms regarding the acquiring fund's investment in the acquired fund necessary to make the finding required under paragraph (b)(2)(i)-(ii) of this section;

(B) A termination provision whereby either the acquiring fund or acquired fund may terminate the agreement subject to advance written notice no longer than 60 days; and

(C) A requirement that the acquired fund provide the acquiring fund with information on the fees and expenses of the acquired fund reasonably requested by the acquiring fund.

(43) Complex fund structures.

~~(i) An investment company must disclose in its registration statement that it is (or at times may be) an acquiring fund for purposes of this section;~~

(~~i~~i) No investment company may rely on section 12(d)(1)(G) of the Act (15 U.S.C. 80a-12(d)(1)(G)) or this section to purchase or otherwise acquire, in excess of the limits in section 12(d)(1)(A) of the Act (15 U.S.C. 80~~a-~~a12(d)(1)(A)), the outstanding voting securities of ~~another~~an investment company ~~that discloses in its most recent registration statement that it may be an acquiring fund under~~(a "second-tier fund") that relies on this section to acquire the securities of an acquired fund, unless the second-tier fund makes investments permitted by paragraph (b)(3)(ii) of this section; and

(~~iii~~ii) ~~An~~No acquired fund ~~must not~~may purchase or otherwise acquire the securities of ~~another~~an investment company ~~(~~or ~~companies that would be~~private fund if immediately after such purchase or acquisition, the securities of investment companies ~~under section 3(a) of the Act but for the exclusions from that definition provided for in section 3(c)(1) or section 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7)) in excess of the limits in section 12(d)(1)(A) of the Act (15 U.S.C. 80a-12(d)(1)(A)) unless the acquired fund's investment is:~~and private funds owned by the acquired fund have an aggregate value in excess of 10 percent of the value of the total assets of the acquired fund; provided, however, that the 10 percent limitation of this paragraph shall not apply to investments by the acquired fund in:

(A) ~~In reliance~~Reliance on section 12(d)(1)(E) of the Act (15 U.S.C. 80a-12(d)(1)(E));

(B) ~~For short-term cash management purposes pursuant to~~Reliance on § 270.12d1-1~~ or exemptive relief from the Commission~~;

(C) ~~In a~~A subsidiary that is wholly-owned and controlled by the acquired fund;

(D) ~~The receipt of securities~~Securities received as a dividend or as a result of a plan of reorganization of a company; or

(E) ~~The acquisition of securities~~Securities of another investment company received pursuant to exemptive relief from the Commission to engage in interfund borrowing and lending transactions.

(c) Recordkeeping. The acquiring ~~fund~~and acquired funds relying upon this section must maintain and preserve for a period of not less than five years, the first two years in an easily accessible place, ~~a written record of~~as applicable:

~~(1) The finding required by paragraph (b)(3)(i) of this section and the basis for such finding, and the reports provided to the board of directors pursuant to paragraph (b)(3)(i) of this section;~~

(1) A copy of each fund of funds investment agreement that is in effect, or at anytime within the past five years was in effect, and any amendments thereto;

(2) A written record of the evaluations and findings required by paragraph (b)(2)(i) of this section, and the basis therefor

within the past five years;

(2[3]) ~~The~~[A written record of the] finding required by paragraph (b)(~~3~~[2])(ii) of this section and the basis for such finding; and

(~~3~~[4]) The certification from each insurance company required by paragraph (b)(~~3~~[2])(iii) of this section.

(d) Definitions. For purposes of this section:

Advisory group means either:

(1) An acquiring fund's investment adviser or depositor, and any person controlling, controlled by, or under common control with such investment adviser or depositor; or

(2) An acquiring fund's investment sub-adviser and any person controlling, controlled by, or under common control with such investment sub-adviser.

Baskets has the same meaning as in § 6c-11(a)(1).

Exchange-traded fund means a fund or class, the shares of which are listed and traded on a national securities exchange, and that has formed and operates in reliance on § 6c-11 or under an exemptive order granted by the Commission.

Group of investment companies means any two or more registered investment companies or business development companies that hold themselves out to investors as related companies for purposes of investment and investor services.

Private fund means an issuer that would be an investment company under section 3(a) of the Act but for the exclusions from that definition provided for in section 3(c)(1) or section 3(c)(7) of the Act (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7)).

August 14, 2020

SEC Proposes Modernized Fund Reports and Disclosure Amendments

On August 5, 2020, the SEC unanimously proposed rule and form amendments intended to modernize the disclosure framework for mutual funds and ETFs (the "Proposals"). This Alert summarizes the key provisions of the Proposals.

Executive Summary

The Proposals, if adopted, would modify the disclosure framework for funds registered on Form N-1A (mutual funds and ETFs) to follow a "layered" approach to fund disclosure that highlights key information for retail investors.

- For existing shareholders, the Proposals would make streamlined (3-4 page) annual and semi-annual shareholder reports the primary source of fund disclosure.[1] Certain information now required in a fund's shareholder reports, such as the fund's financial statements, would no longer appear in these reports. Instead, this information would be made available online and delivered free of charge upon request, and filed with the SEC on a semi-annual basis on Form N-CSR.
- Funds would no longer be required to deliver an updated prospectus to existing shareholders who purchase additional shares. Instead, funds would rely on their shareholder reports to keep shareholders informed, along with (i) timely notification to shareholders of any material changes to the fund through prospectus supplements and (ii) the availability of the fund's prospectus online and on request.
- The Proposals would also amend the advertising rules for funds (including closed-end funds and business development companies ("BDCs").

THE FOLLOWING PROPOSALS ARE PARTICULARLY IMPORTANT:

1. The Proposals would preclude funds and ETFs from relying on Rule 30e-3. Many fund sponsors have been working on compliance with Rule 30e-3 since its adoption in 2018 so that their funds, beginning in 2021, could meet their shareholder report delivery requirements by making the reports accessible at a website address specified in a written notice mailed to shareholders. The Proposals would render this work, and the notices many mutual funds and ETFs have been including in their prospectuses, summary prospectuses and shareholder reports for more than a year, moot.
2. The Proposals would amend mutual fund and ETF prospectus disclosure requirements regarding fees, expenses and principal risks.
   - The Proposals would not require a fund's acquired fund fees and expenses ("AFFE") to be presented as a line item in the prospectus fee table, unless more than 10% of the fund's total assets were invested in acquired funds for the prior fiscal year.
   - A summary prospectus would be required to describe the fund's principal risks *in order of importance*, with the most significant risks appearing first. Although the staff of the SEC has inquired about the ordering of principal risks in connection with its review of disclosures, this would represent the first requirement to present risks in order of importance. Many fund complexes have been reluctant to order principal risks by significance because of the possibility that such an ordering is difficult in practice and might be criticized with the benefit of hindsight. The Proposals expressly state, however, that a fund may use any reasonable means of determining the significance of risks.

[1] First-time fund investors would continue to receive summary or statutory fund prospectuses.

- The Proposals would also introduce a standard for determining whether a risk is a principal risk – whether the risk would place more than 10% of the fund's assets at risk or is reasonably likely to do so in the future.

3. Following the occurrence of a material change with respect to certain specified topics, the Proposals would require a fund to deliver a prospectus supplement to all existing shareholders within three days of filing the supplement with the SEC, including existing shareholders that are not purchasing additional shares. Presently, a fund is not required to mail prospectus supplements to shareholders until they make an additional purchase. If the material change occurs shortly before a fund transmits a shareholder report, and the fund is unable to disclose the material change in its shareholder report, the delivery of the prospectus supplement to non-purchasing shareholders who have not consented to electronic delivery would involve additional expense.

The Proposals are summarized in detail below.

I. Proposed Rule 498B and Annual Prospectus Updates

For new investors, the Proposals would not change the requirement that a fund precede or accompany the sale of its shares with a prospectus.

The Proposals include proposed Rule 498B under the Securities Act, which would permit a fund to satisfy its prospectus delivery obligations to existing investors under Section 5(b)(2) of the Securities Act by complying with the conditions of the proposed Rule.[2] Rule 498B and its conditions are described in detail below.

Website Availability of Certain Fund Documents. To rely on Rule 498B, a fund would be required to make accessible, free of charge, at the website address identified on the cover page of the fund's streamlined annual and semi-annual reports, the fund's current summary and statutory prospectus, SAI, and most recent annual and semi-annual shareholder reports (the "Required Online Fund Documents"). The required materials are identical to the materials accessible online for funds currently relying on Rule 498 (the summary prospectus rule).

Notice of Material Changes. Rule 498B would require a fund to give existing shareholders notice of a material change with respect to certain topics specified in Rule 498B. The particular topics are the same types of material changes the Proposals require in the proposed streamlined annual report. See "Material Fund Changes" in Section II below. If one of the specified material changes occurs, the fund presumably will file a prospectus supplement (or even a post-effective amendment or "PEA") with the SEC. For new investors, the supplemented or amended prospectus would, as always, be required to precede or accompany the sale of shares. For existing shareholders, Rule 498B would require notice of the material change to be provided within three business days of (i) the filing date of the prospectus supplement filing or (ii) the effective date of the PEA, by first-class mail or other means designed to ensure equally prompt receipt. If a shareholder has not specified a delivery preference, Rule 498B would require that the notice be provided in paper. However, notices of material changes could be delivered electronically to shareholders who elect electronic delivery.

Delivery Upon Request of Certain Fund Documents. Rule 498B would require a fund (or a financial intermediary through which shares of the fund may be purchased or sold) to deliver, in a manner consistent with the requestor's delivery preference, a copy of any requested Required Online Fund Documents. If a paper copy is requested, the fund or intermediary must send requested paper documents within three business days of the request.

II. Changes to Annual Reports

The Proposals would (i) add new Item 27A to Form N-1A to specify the design and content of funds' annual and semi-annual reports and (ii) remove the portions of existing Item 27 of Form N-1A concerning annual and semi-annual reports. The Proposals limit the length and complexity of fund shareholder reports and the SEC stated that "funds generally would

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[2] In general, an "existing shareholder" is a shareholder to whom a summary prospectus or statutory prospectus has been previously sent or given in order to satisfy any obligation under Section 5(b)(2) of the Securities Act to have a statutory prospectus precede or accompany the carrying or delivery of fund shares and that has continuously held fund shares. The definition is slightly different with respect to money market fund shareholders.

be able to reduce the length of their annual reports from more than 100 pages on average to a more concise presentation that is approximately 3 to 4 pages in length."

In addition to limiting the content a fund may include in its annual report, the Proposals also would require separate annual reports for each fund so that a shareholder would receive an annual report only for the fund(s) of which he or she is a shareholder.[3] On its website, the SEC posted a three-page Hypothetical Annual Report (available here). The Proposals would require information in a fund's annual report to appear in a specified order. The changes the Proposals would make to fund semi-annual reports largely track the changes to the annual report, and are similarly specified in new Item 27A of Form N-1A. Like annual reports, the information in a semi-annual report must appear in the order specified in proposed Item 27A.

The following table outlines the information the Proposals would generally require funds to include in their annual reports, as well as the similar current Form N-1A requirements.

	Description	*Proposed Item of Form N-1A*	*Current Item of Form N-1A Containing Similar Requirements*
Cover Page or Beginning of Report	Fund/Class Name(s)	Item 27A(b)	---
	Ticker Symbol(s)	Item 27A(b)	
	Principal U.S. Market(s) for ETFs	Item 27A(b)	
	Statement Identifying as "Annual Shareholder Report"	Item 27A(b)	
	Legend	Item 27A(b)	
Content	Expense Example	Item 27A(c)	Item 27(d)(1)
	Management's Discussion of Fund Performance	Item 27A(d)	Item 27(b)(7)
	Fund Statistics	Item 27A(e)	n/a
	Graphical Representation of Holdings	Item 27A(f)	Item 27(d)(2)
	Material Fund Changes	Item 27A(g)	n/a
	Changes in and Disagreements with Accountants	Item 27A(h)	Item 27(b)(4)
	Statement Regarding Liquidity Risk Management Program	Item 27A(i)	Item 27(d)(6)(ii)
	Availability of Additional Information	Item 27A(j)	Item 27(d)(3) through (5)
	Householding Disclosure (optional)	Item 27A(k)	n/a

[3] A single shareholder report could cover multiple classes of a multi-class fund.

Some of the annual report items in this table are self-explanatory. The discussion below focuses on the items that require some elaboration.

Legend. The Proposals would require a legend on the cover page of a fund's annual report to the effect that the annual report contains certain important information for the fiscal year covered and instruct the reader how to obtain more information.

Expense Example. The Proposals replace the two expense examples now required to be included in a shareholder report with one simplified expense table in the following format, based upon a hypothetical $10,000 investment in the fund during the reporting period.

[Fund or Class Name]	Beginning account value [beginning date]	Total return before costs paid	**Costs paid**	Ending account value [end date] (based on net asset value return)	[ETFs only] Ending account value [end date] (based on market value return)	**Costs paid as a percentage of your investment**
	$10,000	+ (plus) $[x]	- (minus) $[x]	= (equals) $[x]		**___%**

For the "Total return before costs paid" column, a fund would be required to describe qualitatively in a footnote other costs included in total return, if material to the fund (*e.g.*, if material, the fund would state that investment transaction costs, securities lending costs, and/or AFFE reduced the total return). For the final "Costs paid as a percentage of your investment" column (*i.e.*, the fund's expense ratio), a fund would be required to disclose in a footnote that the expense information does not reflect shareholder transaction costs associated with purchasing or selling fund shares.

For an ETF, the expense example would be required to disclose two versions of the ending account value, based on the ETF's (i) NAV return and (ii) market value return.

Management's Discussion of Fund Performance. As described below, the Proposals would amend the management's discussion of fund performance ("MDFP") requirements.

- ***Narrative MDFP Disclosure***. The Proposals retain the existing requirement that funds' annual reports include a narrative discussion of factors that materially affected the fund's performance during the most recent fiscal year. To avoid overly long discussions, the Proposals amend this requirement to specify that the disclosure must "briefly summarize" the "key" factors that materially affected the fund's performance during the last fiscal year. The proposed instructions would also direct funds to use graphics or text features, including bullet lists or tables, to convey the key factors.

- ***MDFP – Performance Line Graph***. The Proposals would retain the requirements for the performance line graph now included in annual reports, with several changes.
  - The Proposals would delete the instruction that permits the line graph to cover periods longer than the most recent 10 fiscal years.[4]
  - The Proposals would define "appropriate broad-based securities market index" as an index that represents the overall applicable domestic or international equity or debt markets. Funds also would be able to include narrower indexes reflecting the market segments in which the fund invests. For a fund that invests in both equity and debt securities, the fund could include more than one appropriate broad-based securities market index.[5]
- ***MDFP – Performance Table***. The Proposals retain the existing requirement that a fund's annual reports must include a table showing average annual total returns for the past 1-, 5- and 10-year periods. The Proposals would also require three pieces of additional information: (i) the average annual total returns of an appropriate broad-based securities market index, (ii) the fund's average annual total returns without sales charges (in addition to current disclosure that must show returns that reflect any sales charges) and (iii) average annual total returns for each class that the report covers. In addition, the Proposals:
  - Permit a fund to include returns information for one or more other relevant indexes, including a more narrowly based index covering the market sectors in which the fund invests.
  - Replace the required statement accompanying the line graph and table with a simplified statement to the effect that the fund's past performance is not a good predictor of how the fund will perform in the future.
- ***Additional MDFP Change***. The Proposals would require a fund that has a stable distribution policy and was unable to maintain the specified level of distributions to disclose this fact. The Proposals would not otherwise affect existing disclosure concerning distributions that resulted in returns of capital.

Fund Statistics. The Proposals require a fund to disclose certain fund statistics in its annual report, including the fund's (i) net assets, (ii) total number of portfolio holdings and (iii) portfolio turnover rate. A fund would be permitted to disclose any additional statistics that the fund believes would help shareholders understand the fund's operations during the reporting period (*e.g.*, tracking error, maturity, duration, average credit quality or yield). However, if a fund discloses an additional statistic, these additional conditions would apply:[6]

- If a fund provides a statistic that is disclosed elsewhere on Form N-1A, the fund must follow the associated instructions concerning the calculation method of the statistic.
- If a statistic is included in, or could be derived from, a fund's financial statements or financial highlights, the fund must use or derive that statistic from its most recent financial statements or financial highlights.
- A fund may briefly describe the significance or limitations of any disclosed statistics in a parenthetical, footnote or similar presentation.
- Any additional statistic must be reasonably related to the fund's investment strategy.

[4] However, a fund would still be permitted to include similar presentations that cover periods greater than 10 years on its website or in other marketing materials.

[5] A fund would also be permitted to include a blended index to supplement the appropriate broad-based securities market index(es) that the fund includes. The Proposals' change to the definition of an appropriate broad-based securities market index would also affect the performance presentations in fund prospectuses.

[6] With respect to any additional statistic, the Proposals' relevant instruction encourages a fund to use tables, bullet lists or other graphics or text features to disclose the statistics.

Graphical Representation of Holdings. While the Proposals would eliminate a fund's schedule of investments from its annual report, the Proposals would maintain the existing requirements for the graphical representation of fund holdings in shareholder reports, subject to the following revisions.

- At present, a fund may base the tabular or graphic presentation of its holdings on the fund's net asset value or total investments. The Proposals permit a fund to present its holdings based on either the fund's *net exposure*, or *total exposure*, to particular categories of investments. This change is intended to provide a more meaningful presentation of holdings for funds that use derivatives to obtain investment exposures as part of their investment strategies. This change also is designed to provide a more meaningful presentation of the holdings for a fund that holds both long and short positions – the long and short positions may be presented separately (*i.e.*, total exposure) or showing the combined exposure (*i.e.*, net exposure). In all cases, the fund must select a basis of presentation (*i.e.*, according to the fund's net asset value, total investments or investment exposures) that is reasonably designed to clearly present the types of investments made by the fund.
- Currently, if a fund depicts its portfolio holdings according to credit quality, the fund must describe how the credit quality of its holdings is determined (if credit ratings are relied upon, the fund must explain why it selected a particular credit rating). The Proposals instruct funds to keep these disclosures brief and concise.

Material Fund Changes. The Proposals add a new section to a fund's annual report to disclose material changes to the fund. Specifically, the fund would be required to briefly describe any material change in an enumerated list of items (as well as any other material change that the fund chooses to disclose) that has occurred since the beginning of the reporting period or that the fund plans to make in connection with its annual prospectus update.[7] Under the Proposals, a fund would be required to briefly describe in its annual report a material change to any of the following items:

- A change in the fund's name.
- A change in the fund's investment objectives or goals.
- An increase in the fund's ongoing annual fees, transaction fees or maximum account fee.
- A change in the fund's principal investment strategies.
- A change in the principal risks of investing in the fund.
- A change in the fund's investment adviser(s), including sub-adviser(s).
- A change in the fund's portfolio manager(s).

The Proposals also would require disclosure of material fund changes in the annual report to be accompanied by a prescribed legend that, among other things, instructs an investor how to obtain more information.

Separately, there may be instances where a material change occurs shortly before a fund transmits its shareholder report. If this occurs, it may be difficult for the fund to disclose the material change in its shareholder report. Under these circumstances, the fund presumably will file a prospectus supplement (or even a PEA) with the SEC. For existing shareholders, Rule 498B would require notice of the material change to be provided within three business days of (i) the filing date of the prospectus supplement filing or (ii) the effective date of the PEA, by first-class mail or other means designed to ensure equally prompt receipt. If a shareholder has not specified a delivery preference, Rule 498B would require that the notice be provided in paper. However, notices of material changes could be delivered electronically to shareholders who elect electronic delivery (for new investors, the supplemented or amended prospectus would, as always, be required to precede or accompany the sale of shares).

[7] Because a fund's PEA disclosing the changes to its prospectus may be (i) incomplete when a fund transmits its shareholder report and (ii) subject to review by the SEC staff, a fund would need to provide only a high-level description of the anticipated changes in its shareholder report.

Changes in and Disagreements with Accountants. The Proposals would move the required disclosure regarding changes in and disagreements with accountants to Form N-CSR and replace the disclosure in the annual report with (i) a statement of whether the former accountant resigned, declined to stand for re-election or was dismissed and the date thereof and (ii) a brief description of disagreements(s) with the former accountant during the fund's two most recent fiscal years.

Statement Regarding Liquidity Risk Management Program. The Proposals replace the existing disclosure requirements regarding the operation and effectiveness of a fund's liquidity risk management program. Specifically, the Proposals would require a brief summary in a fund's annual report of (i) the key factors or market events that materially affected the fund's liquidity risk during the reporting period, (ii) the key features of the fund's liquidity risk management program and (iii) the effectiveness of the fund's liquidity risk management program over the past year. The Proposals emphasize that the disclosure must be "tailored to each fund and be concise."

Availability of Additional Information. The Proposals would require funds to include a statement in the annual report that informs investors about additional information that is available on the fund's website. The proposed new statement would consolidate several currently required statements about the availability of information (including the quarterly portfolio schedule, proxy voting policies and procedures and proxy voting record) with a single statement. In addition, the required statement would inform investors that the fund's financial statements are available and remind investors about the availability of the fund's current prospectus.

III. New Form N-CSR and Website Availability Requirements

The Proposals amend Form N-CSR and Rule 30e-1 to implement the SEC's layered disclosure framework. Certain information currently required in shareholder reports would instead be required to be filed on Form N-CSR. The Proposals' amendments to Rule 30e-1 would require a fund to make available on its website the information that it would newly be required to file on Form N-CSR (and to deliver such information upon request, free of charge).

The following table shows information now required to be included in a fund's annual and semi-annual reports and outlines how the Proposals would require a fund (i) to include the information in its Form N-CSR filings and (ii) to make the information available online.

	Current Rule and Form Requirement(s) for Shareholder Report Disclosure (If Any)	*Proposed New Disclosure Items for Filing on SEC Forms*	*Proposed Website Availability Requirements*
Financial statements for funds, including schedule of portfolio holdings	Items 27(b)(1) and 27(c)(1) of Form N-1A	Proposed Item 7(a) of Form N-CSR	Proposed rule 30e-1(b)(2)(i)
Financial highlights for funds	Items 27(b)(2) and 27(c)(2) of Form N-1A	Proposed Item 7(b) of Form N-CSR	Proposed rule 30e-1(b)(2)(i)
Remuneration paid to directors, officers and others	Items 27(b)(3) and 27(c)(3) of Form N-1A	Proposed Item 10 of Form N-CSR	Proposed rule 30e-1(b)(2)(i)
Changes in and disagreement with accountants for funds	Items 27(b)(4) and 27(c)(4) of Form N-1A; Item 304 of Reg. S-K	Proposed Item 8 of Form N-CSR	Proposed rule 30e-1(b)(2)(i)
Matters submitted to fund shareholders for a vote	Rule 30e-1(b)	Proposed Item 9 of Form N-CSR	Proposed rule 30e-1(b)(2)(i)
Statement regarding the basis for the board's approval of investment advisory contract	Item 27(d)(6) of Form N-1A	Proposed Item 11 of Form N-CSR	Proposed rule 30e-1(b)(2)(i)
Complete portfolio holdings as of the close of the fund's most recent first and third fiscal quarters	Currently required in Part F of Form N-PORT and website availability currently required for funds relying on Rule 30e-3	N/A	Proposed rule 30e-1(b)(2)(ii)

Website Availability. The Proposals would require a fund to post online all information that the Proposals newly require on Form N-CSR. A fund would be required make this information available from 70 days after the end of the relevant fiscal period until 70 days following the next respective fiscal period (*i.e.*, until the time at which the information is required to be updated for the next fiscal period).

In addition, the Proposals would require a fund (other than a money market fund) to make its complete portfolio holdings, as of its most recent first and third quarter, available on its website. This information would have to be posted within 70 days after the close of each such quarter. The fund's first and third fiscal quarter portfolio holdings would be required to remain publicly accessible online for a full fiscal year.[8] As with other materials required to be posted online, the Proposals would require a paper copy to be delivered to any requestor.

IV. Management Information Table Deleted

Currently, a fund is required to disclose certain information about each of its directors and officers in its annual report ("management information table"). This information is also required to be included in the fund's SAI. The Proposals would remove the management information table from the annual report and Form N-CSR as "unnecessarily duplicative."

V. Amendments to Fund Prospectus Disclosure Requirements

In General. The Proposals would amend Form N-1A requirements specifying disclosure of fees and risks. In addition, the Proposals permit funds that make *limited* investments in other funds to disclose Acquired Fund Fees and Expenses ("AFFE") in a footnote to the fee table and fee summary instead of reflecting AFFE as a line item in the fee table and fee summary. These changes are described below.

Fee Summary. The Proposals would replace the existing fee table in the summary section of the statutory prospectus with a simplified "fee summary." The current fee table, which now contains more detail, would be moved to the statutory prospectus. Certain terms in the current fee table would be replaced with terms that the SEC believes investors will more easily understand (*e.g.*, "Annual Fund Operating Expenses" would become "Ongoing Annual Fees").

The Proposals' requirements for the fee summary are shown in right column of the following chart, with current fee table line items shown on the left.

Current Form N-1A Fee Table	**Proposed Form N-1A Fee Summary**
Shareholder Fees (fees paid directly from your investment)	***Transaction Fees*** (fees paid each time you buy or sell)
Maximum Sales Charge (Load) Imposed on Purchases (as a percentage of offering price) _____%	Purchase Charge (as a percentage of your investment) [Up to] % (Or [up to] $___, if you invest $10,000)
Maximum Deferred Sales Charge (Load) (as a percentage of _____) _____%	Exit Charge (as a percentage of _____) [Up to] % (Or [up to] $___, if you invest $10,000)
Maximum Sales Charge (Load) Imposed on Reinvested Dividends [and other Distributions] (as a percentage of _____) _____%	Maximum Purchase Charge Imposed on Reinvested Dividends [and Other Distributions] (as a percentage _____) [Up to] _____% (Or [up to] $___, if you invest $10,000)
Maximum Sales Charge (as a percentage of _____) _____%	Maximum Combined Purchase and Exit Charge (as a percentage of _____) _____%
Redemption Fee (as a percentage of amount redeemed, if applicable) _____%	Early Exit Fee (as a percentage of amount redeemed [Up to] _____% (Or [up to] ____, if you invest $10,000)

[8] At present, funds must disclose their holdings as of the end of each fiscal quarter in reports on Form N-PORT that are filed with the SEC and available on EDGAR. The Proposals' requirements are intended to provide a central source of data available instead of requiring investors to access a fund's Form N-PORT reports separately for each quarter.

Exchange Fee _____%	Exchange Fee [Up to] _____ % (Or [up to] ____, if you invest $10,000)
Maximum Account Fee _____%	[This item moved to its own heading, see immediate below.]
	Maximum Account Fee [Up to] _____% (Or [up to] ____, if you invest $10,000)
Annual Fund Operating Expenses (expenses that you pay each year as a percentage of the value of your investment) Management Fees _____% Distribution [and/or Service] (12b-1) Fees _____% Other Expenses _____% _____ _____% _____ _____% Acquired Fund Fees and Expenses _____% Total Annual Fund Operating Expenses _____%	***Ongoing Annual Fees*** (estimated expenses you pay each year as a percentage of the value of your investment) Ongoing Annual Fees _____ % (Or $___, if you invest $10,000) Ongoing Annual Fees with Temporary Discount _____% (Or $___, if you invest $10,000) *Discount expected to end on [date]. [Funds that invest 10% or less of their total assets in acquired funds may omit AFFE from the Ongoing Annual Expenses and instead disclose this amount in footnote.]
Example This example is intended to help you compare the cost of investing in the Fund with the cost of investing in other mutual funds. The Example assumes that you invest $10,000 in the Fund for the time periods indicated and then redeem all of your shares at the end of those periods. The Example also assumes that your investment has a 5% return each year and that the Fund's operating expenses remain the same.	***Example*** This example may help you understand the costs of investing in the Fund. The example assumes that: (1) you invest $10,000 in the Fund; (2) your investment has a 5% return each year; and (3) the Fund's operating expenses are based on the table above.
1 year 3 years 5 years 10 years Although your actual costs may be higher or lower, based on these assumptions your costs would be: $_____ $_____ $_____ $_____	1 year 10 year Although your actual costs may be higher or lower, based on these assumptions, your costs would be: $_____ $_____
1 year 3 years 5 years 10 years You would pay the following expenses if you did not redeem your shares: $_____ $_____ $_____ $_____	1 year 10 year If you sold your shares at the end of the relevant period, your costs would be: $_____ $_____

Acquired Fund Fees and Expenses. The Proposals would permit a fund that invests 10% or less of its *total assets* (based on the fund's 12-month-end average holdings in acquired funds, excluding money market funds) to omit the AFFE line item in its fee table and, instead, disclose the fund's AFFE in a footnote to the fee table and fee summary. Funds that invest more than 10% of their total assets in acquired funds would continue to be required to present AFFE as a line item in their prospectus fee tables and include AFFE in the bottom-line expense figure.[9]

Portfolio Turnover. The Proposals would include portfolio turnover disclosure in both the fee summary and the full fee table, but would be reduced in length.

[9] Currently, a fund may disclose its AFFE in the "other expenses" fee table line item, without specifically identifying the AFFE amount, provided the AFFE does not exceed 0.01%, or one basis point, of the fund's average net assets.

Risk Disclosure. The Proposals include revisions to the current provisions and instructions in Form N-1A that require a fund to disclose in its prospectus the principal risks of investing in the fund.

In the summary prospectus, the Proposals include new requirements for principal risk disclosure. The Proposals insert the term "briefly" before the current requirement that the fund summarize its principal risks. A new instruction to the summary prospectus would state that a fund should describe its principal risks *in order of importance*, with the most significant risks appearing first (the new instruction would state that a fund may use any reasonable means of determining the significance of risks).

The Proposals also would affect a fund's principal risk disclosures in the statutory prospectus, as well as the summary prospectus. Specifically, the Proposals include three new instructions concerning Form N-1A Item 9(c), which requires a fund to disclose the principal risks of investing in the fund in its statutory prospectus. Because Item 4 of Form N-1A requires a fund to summarize the principal risks of investing in the fund based on the information the fund provides in response to Item 9(c), the proposed new instructions to Item 9(c) would affect Item 4 disclosure in the summary section of the statutory prospectus (or the summary prospectus, if the fund is relying on Rule 498).

- Proposed Instruction 1 states that, in determining whether a risk is a principal risk, a fund should consider both whether the risk would place more than 10% of the fund's assets at risk ("10% standard"), and whether it is reasonably likely that a risk will meet this 10% standard in the future.
- Proposed Instruction 2 is addressed to a fund that invests in other funds (an "acquiring fund" and an "acquired fund," respectively), commonly known as a "fund of funds." The proposed instruction states that, in the case of acquiring funds, risks should be included only if they are principal risks of the acquiring fund, and that a principal risk of an acquired fund should not be included unless it is a principal risk of the acquiring fund.
- Proposed Instruction 3 is targeted at "go anywhere" funds. This instruction would state that, if the fund's strategy permits discretion to invest in different types of assets, the fund must disclose that an investor may not know, and has no way to know, how the fund will invest in the future and the associated risks.

Prospectuses and SAIs Transmitted Under Rule 30e-1(d). The Proposals would rescind 1940 Act Rule 30e-1(d), which permits a fund to transmit a copy of its prospectus or SAI instead of its shareholder report, provided it includes all of the information that is required in the shareholder report. The SEC believes that funds very rarely rely on rule 30e-1(d).

VI. Investment Company Advertising Rules Amendments

The Proposals would amend the investment company advertising rules – Securities Act Rules 482, 156 and 433 and 1940 Act Rule 34b-1.

- The Proposals would amend Rules 482, 433 and 34b-1 to require that investment company advertisements that provide fee or expense figures must also include certain standardized fee and expense figures. The proposed amendments would apply to advertisements of any registered investment company or BDC. Similarly, the Proposals also would amend Rule 433, which sets forth the conditions for the use of a post-filing free writing prospectus, to require a registered closed-end fund or BDC free writing prospectus to comply with analogous fee and expense standardization requirements. Therefore, regardless of whether a registered closed-end fund or BDC advertisement relies on Rule 482 or Rule 433, the advertisement would be subject to the same standardization requirements regarding fee and expense information.
- The Proposals would amend Rule 156 to provide factors an investment company should consider to determine whether representations about the fees and expenses associated with an investment in the fund could be materially misleading.

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For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray attorney.

April 27, 2020

SEC Extends Securities Offering Reforms to Closed-End Funds and Business Development Companies

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On April 8, 2020, the SEC issued a release (the "Release") containing amended rules and forms intended to streamline the registration, communications and offering practices for business development companies ("BDCs") and registered closed-end investment companies ("registered CEFs"), including interval funds and tender offer funds (collectively, "Affected Funds"). The Release's rule and form amendments will permit Affected Funds, subject to limitations described below, to use the securities offering rules that are already available to operating companies.

In particular, once effective, the Release:

- Streamlines registration by eligible Affected Funds by introducing a short-form shelf registration statement on Form N-2 to effect securities sales "off the shelf" more quickly.
- Expands the scope of Rule 486 to permit Affected Funds that conduct continuous offerings under Securities Act Rule 415(a)(1)(ix) to rely on Rule 486 to make certain changes to their registration statements.
- Authorizes eligible Affected Funds to qualify as "well-known seasoned issuers" ("**WKSIs**") under Securities Act Rule 405.
- Permits eligible Affected Funds to satisfy their prospectus delivery requirements in the same manner as operating companies, including filing with the SEC under Securities Act Rules 172 and 173.
- Allows eligible Affected Funds to rely on communications rules currently available only to operating companies, including rules regarding the publication of factual information about the issuer or the offering (Securities Act Rule 134) (*i.e.*, "tombstone ads"), the publication and dissemination of regularly released factual business and forward-looking information (Securities Act Rules 168 and 169), the use of a "free writing prospectus" (Securities Act Rules 164 and 433), and the publication and distribution of broker-dealer research reports (Securities Act Rule 138).

In addition, the Release harmonizes the disclosure and regulatory framework applicable to Affected Funds with the other changes effected by the Release. The harmonization includes (i) structured data requirements (such as Inline XBRL) that will facilitate the evaluation of fund data by investors and others and (ii) new annual report disclosure requirements. Separately, the Release changes the method that interval funds employ to calculate securities registration fees, permitting interval funds to calculate the fees on a net basis (similar to the method that mutual funds and ETFs now employ).

The SEC adopted most of the proposals substantially in the form that they were proposed in its March 2019 proposing release. The principal differences from the proposing release are that the Release:

- Does *not* adopt a proposal that would have required registered CEFs to file Form 8-K.
- Expands the scope of Rule 486 to permit any Affected Fund that conducts continuous offerings under Rule 415(a)(1)(ix) to rely on Rule 486 to make certain changes to its registration statements on an immediately effective basis or on an automatically effective basis a set period of time after filing.
- Requires Affected Funds that rely on Rule 8b-16(b) to describe the fund's current investment objectives, investment policies and principal risks in its annual report, even if there were no changes in the past year.

- Eliminates certain undertakings within Form N-2 for eligible Affected Funds.
- Does not require an eligible Affected Fund that "forward incorporates" non-required information from its periodic reports to update its short-form registration statement to also include a statement in the periodic report, identifying the additional information that was included for updating purposes.
- Modifies Form N-14 to permit BDCs to incorporate by reference to the same extent as registered CEFs.
- Changes the method that issuers of certain continuously offered, exchange-traded products ("ETPs") employ to calculate securities registration fees, permitting these issuers to calculate the fees on a net basis (similar to the method that mutual funds and ETFs now employ).

The Release's amended rules and forms, including their effective dates, are discussed in detail below.

I. BACKGROUND

In 2005, the SEC adopted securities offering reforms applicable only to operating companies with the intent of modernizing the securities offering and communication processes. The 2005 reforms expressly excluded all investment companies, including Affected Funds, from changes effected by the reforms.

The Release is the SEC's response to fulfill two Congressional mandates intended to extend the scope of the 2005 reforms to Affected Funds. First, the Small Business Credit Availability Act (the "BDC Act"), enacted in March 2018 (summarized in this Ropes & Gray Alert), directed the SEC to amend existing rules and forms to permit BDCs to use the securities offering and proxy rules that are available to non-investment company issuers that are required to file reports under Sections 13(a) or 15(d) of the Exchange Act.[1] Second, the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Registered CEF Act"), enacted in May 2018 (summarized in this Ropes & Gray Alert), directed the SEC to propose and finalize rules to permit any registered CEF that is either exchange-listed or that makes periodic repurchase offers pursuant to Rule 23c-3 under the 1940 Act "to use the securities offering and proxy rules . . . that are available to other issuers that are required to file reports under section 13 or section 15(d) of the [Exchange Act]."[2]

[1] The BDC Act directed the SEC to effect these revisions no later than March 23, 2019. Further, the BDC Act provides:

> If the Commission fails to complete the revisions [by March 23, 2019], a business development company, during the period beginning [March 24, 2019] and ending on the date that the Commission completes those revisions, may deem those revisions to have been completed in accordance with the actions required to be taken by the Commission.

The Release, once effective, eliminates the interpretive ambiguity for BDCs that desire to use any of the securities offering and proxy rules. The Release does not discuss (i) the fact that the SEC did not effect the required revisions by March 23, 2019 or (ii) the application of the BDC Act prior to the effective date of Release's provisions. However, at the SEC meeting at which the Release was adopted, the Director of the Division of Investment Management stated that the BDC Act was "self-effectuating" and that BDCs can rely on the statute until the Release's effective date of August 1, 2020.

[2] The Registered CEF Act directed the SEC to propose these revisions by May 24, 2019 and to finalize such revisions no later than May 24, 2020. Further, the Registered CEF Act provides:

> If the Commission fails to complete the revisions . . . by [May 24, 2020], any registered closed-end company that is listed on a national securities exchange or that makes periodic repurchase offers pursuant to section [Rule 23c-3 under the 1940 Act], shall be deemed to be an eligible issuer under the final rule of the Commission titled "Securities Offering Reform."

The Release, once effective, eliminates the interpretive ambiguity for registered CEFs that desire to use any of the securities offering and proxy rules. The Release does not discuss (i) the fact that the SEC did not effect the required revisions by May 24, 2020 or (ii) the application of the Registered CEF Act prior to the effective date of Release's provisions. However, at the SEC meeting at which the Release was adopted, the Director of the Division of Investment Management stated that the Registered CEF Act was "self-effectuating" and that registered CEFs can rely on the statute beginning in May 2020.

The BDC Act applies to both listed and unlisted BDCs. The Registered CEF Act applies to registered CEFs that are exchange-listed and interval funds under Rule 23c-3 of the 1940 Act, but does not apply to unlisted registered CEFs that are not interval funds.

While the BDC Act is specific about required revisions for BDCs, the Registered CEF Act does not identify specific required revisions. In the March 2019 proposing release and in the Release, the SEC decided to apply the specific requirements of the BDC Act to both BDCs and registered CEFs, subject to certain conditions.

The Release affects different categories of Affected Funds in different ways.

- Some of the Release's changes apply to all Affected Funds.
- Many of the changes effected by the Release apply only to "Seasoned Funds," which, generally, are exchange-listed Affected Funds that are current and timely in their reporting and, therefore, generally eligible to file a short-form registration statement if they have at least $75 million in "public float."
- Some of the Release's provisions apply only to Seasoned Funds that also qualify as WKSIs – exchange-listed Affected Funds that qualify as Seasoned Funds and generally have at least $700 million in public float.
- The Release also authorizes *unlisted* Affected Funds, such as closed-end tender offer funds, to make certain filings that become effective either immediately upon filing or automatically a set period of time after filing.

The **Appendix** to this Alert summarizes the Release's application to Affected Funds in the relevant category, along with conditions and exceptions that limit the Release's general applicability. In addition, the Appendix is marked to show differences between the Release and the proposing release.

II. REGISTRATION REQUIREMENTS – PARITY WITH OPERATING COMPANIES

The Release's amended rules and forms regarding registration requirements give eligible Affected Funds parity with operating companies. Specifically, the Release permits eligible Affected Funds to:

- File a short-form registration statement on Form N-2 that operates like a Form S-3. This short-form registration statement (i) can be used to register shelf offerings, including shelf registration statements filed by eligible Affected Funds that are WKSIs (which become effective automatically), and (ii) can satisfy Form N-2's disclosure requirements by incorporating by reference information from the fund's Exchange Act reports.
- Rely on Rule 430B to omit certain information from their base prospectuses, and requires them to use the Rule 424 process, currently used by operating companies, to file prospectus supplements.
- Include additional information in their Exchange Act periodic reports to update their registration statements.

These changes are described in more detail below.

A. Short-Form Registration on Form N-2

In General. The Release includes a new instruction to Form N-2 to permit eligible Affected Funds to file a short-form registration statement on Form N-2 (a "short-form registration statement") that operates like a Form S-3. The SEC posted the amended Form N-2, which incorporates the Release's changes, on its website (available here).

Eligibility. Affected Funds may file a short-form registration statement if they satisfy the requirements of General Instruction A.2 to Form N-2 (the "short-form registration instruction"). An Affected Fund is eligible to file a short-form

registration statement if it satisfies the registrant requirements[3] and transaction requirements[4] of Form S-3 (a "Seasoned Fund"). If the Affected Fund is a registered CEF, eligibility also requires that the fund (i) has been registered under the 1940 Act for at least the twelve months immediately preceding the filing of the registration statement and (ii) has timely filed all reports required under Section 30 of the 1940 Act during that period[5] (also, a "**Seasoned Fund**").

Information Incorporated by Reference. At the present time, Affected Funds have limited ability to incorporate information by reference into their registration statements and cannot forward incorporate information from subsequently filed Exchange Act reports. Instead, Affected Funds currently are generally required to file post-effective amendments to their registration statements and wait for the SEC staff to declare the amendments effective.

Under the Release, the same rules on incorporation by reference that apply to Form S-3 registration statements apply to a short-form registration statement filed on Form N-2. A Seasoned Fund relying on the short-form registration instruction is required to:

1. Specifically incorporate by reference into its prospectus and statement of additional information ("SAI") (i) its most recent annual report filed pursuant to Exchange Act Section 13(a) or Section 15(d) containing financial statements for the Affected Fund's latest fiscal year for which either a Form N-CSR or Form 10-K was required to be filed and (ii) all other reports previously filed pursuant to these sections of the Exchange Act following the end of the fiscal year covered by the annual report (***backward incorporation by reference***).
2. State in its prospectus and SAI that all documents subsequently filed pursuant to Exchange Act Sections 13(a), 13(c), 14 or 15(d) before the termination of the offering shall be deemed to be incorporated by reference into the prospectus and SAI (***forward incorporation by reference***).

The Release includes conforming changes to Form N-2's undertakings. At present, Form N-2 requires an undertaking that would prevent Seasoned Funds that file a short-form shelf registration statement from incorporating information by reference.[6] To provide parity with S-3 registrants for Seasoned Funds filing a short-form registration statement on Form N-2, the Release conforms Form N-2's undertakings to permit Seasoned Funds to incorporate information by reference. Thus, a Seasoned Fund that files a short-form registration statement could satisfy the disclosure requirements for its prospectus or SAI by incorporating by reference certain past and future Exchange Act reports. This gives the Seasoned Funds the opportunity to avoid, in most instances, making post-effective amendments. The Release includes other changes to Form N-2 undertakings in response to comments received to the proposing release.[7]

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[3] Among other things, the registrant must (i) have a class of securities registered under Section 12 of the Exchange Act, (ii) have been subject to the requirements of Sections 12 or 15(d) of the Exchange Act and have filed all materials required to be filed pursuant to Sections 13, 14 or 15(d), for at least the twelve months immediately preceding the filing of the registration statement; and (iii) have timely filed all Exchange Act reports (other than certain specified reports on Form 8-K) required to be filed during the twelve months (and any portion of the current month) immediately preceding the filing of the registration statement.

[4] Form S-3 specifies certain transaction requirements depending upon the type of the securities being offered and whether the offering is a primary or a secondary offering. Generally, a Seasoned Fund satisfies the Form S-3 transaction requirements for a primary offering if the fund has a public float of at least $75 million.

[5] This includes all annual and semi-annual reports filed on Form N-CSR, as well as Forms N-PORT and N-CEN.

[6] For example, Item 34.4.a of Form N-2 currently requires an Affected Fund registering an offering under Rule 415 to undertake to file a post-effective amendment to the registration statement under certain circumstances, including to provide any prospectus required by section 10(a)(3) of the Securities Act.

[7] For example, the undertaking in Item 34.1 – to suspend the offering of shares until the prospectus is amended if the registrant's NAV increases or decreases by specified amounts subsequent to the effective date of its registration statement – does not apply to Seasoned Funds registering an offering in reliance on Rule 415 to conduct continuous or delayed shelf offerings. The undertaking in Item 34.3 of current Form N-2 – requiring Affected Funds to undertake to supplement the prospectus or file a post-effective

As described in more detail below, the Release also eliminates a prerequisite to backward incorporation in Form N-2 for Seasoned Funds – that the fund deliver to new investors the information that it incorporated by reference into its prospectus or SAI. Instead, the fund is required only to make its prospectus, SAI and the incorporated materials available and accessible on a website identified in the fund's prospectus and SAI.

Use of Rule 415(a)(1)(x) and Automatic Shelf Registration Statements. The Release amends Rule 415(a)(1)(x) to indicate that Seasoned Funds are permitted to rely on the rule. A new general instruction is added to Form N-2 to allow Seasoned Funds that are WKSIs to file an automatic shelf registration statement, providing greater flexibility to take advantage of distribution opportunities in real time.

B. Omitting Information from a Base Prospectus and Prospectus Supplements

Reliance on Amended Rule 424. Operating companies currently rely on Rule 424 to file prospectus supplements, but registered investment companies rely on Rule 497. While broadly similar, the two rules have certain important differences. For example, Rule 424(b) is designed to work together with Rule 415(a)(1)(x), and provides additional time for an issuer to file a prospectus. Rule 497 (i) does not contain provisions specifically tailored to Rule 415(a)(1)(x) offerings and (ii) requires a fund to file a prospectus with the SEC before the prospectus is used. In addition, Rule 424 requires an issuer to file a prospectus when the issuer makes substantive changes to a previously filed prospectus, while Rule 497 requires funds to file any revised prospectus that varies from a previously filed prospectus.

To provide parity with operating companies, the Release amends Rule 424 to require Affected Funds to file a prospectus under Rule 424, instead of relying on Rule 497. This permits a Seasoned Fund to file any type of prospectus enumerated in Rule 424(b) to update, or to include information omitted from, a prospectus or in connection with a shelf takedown.[8]

Omission of Information from a Prospectus. In two circumstances, Rule 430B currently permits an issuer to omit certain information from its base prospectus and later provide that information in a subsequent Exchange Act report incorporated by reference, a prospectus supplement, or a post-effective amendment. First, a WKSI that files an automatic shelf registration statement is permitted to omit the plan of distribution, as well as whether the offering is a primary offering or an offering made on behalf of selling security holders. Once Seasoned Funds are able to qualify as WKSIs, they will be able to omit such information from their prospectuses. Second, Rule 430B also applies to an issuer eligible to file a registration statement on Form S-3 to register a primary offering, where the issuer is registering securities for selling security holders. In this second case, a prospectus can omit the same information that WKSIs are permitted to omit, as well as the identities of the selling security holders and the amount of securities to be registered on their behalf. The Release amends Rule 430B to permit Seasoned Funds to rely on Rule 430B in this second circumstance.[9]

C. Additional Information in Periodic Reports for Updating

As described above, the Release permits Seasoned Funds to forward incorporate information from their Exchange Act reports (which include, for registered CEFs, annual and semi-annual reports on Form N-CSR). These Seasoned Funds have the option of including in their periodic reports information that is not required in the reports for the purpose of updating their short-form registration statements. The Release adds a new instruction to Form N-2 that allows a Seasoned

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amendment if the securities being registered are to be offered to existing shareholders, and if not taken, to be reoffered to the public – is eliminated.

[8] The Release also amends Rule 497 to indicate that Rule 424 is the exclusive rule for Affected Funds to file a prospectus supplement, with the exception of an advertisement that is deemed to be a prospectus under Rule 482.

[9] In addition, the Release requires Seasoned Funds relying on Rule 430B to make the same undertakings in Form N-2 as those that are made by operating companies in relying on Rule 430B in Form S-3 with respect to when the information contained in a prospectus supplement be deemed part of and included in the registration statement and circumstances that trigger a new effective date of the registration statement for purposes of Section 11(a) of the Securities Act.

Fund to include this additional information in its periodic reports. The proposing release also would have required a Seasoned Fund that included the additional information to include a statement in the periodic report that identified the information included for such purposes. In a change from the proposing release, a Seasoned Fund will not be required to include this statement in the periodic report.

D. Registration Changes for Continuously Offered Funds That Are Not Seasoned Funds

Some BDCs and registered CEFs – notably, most interval funds – are not exchange-listed and, therefore, do not have a public float. Consequently, there are some Affected Funds that are not Seasoned Funds and, therefore, cannot file a short-form registration statement because they do not satisfy the transaction requirements required to file a short-form registration statement.

Interval funds are already provided with their own shelf offering provision by Securities Act Rule 415(a)(1)(xi). Rule 486 permits interval funds to file post-effective amendments and certain registration statements that are either immediately effective upon filing under Rule 486(b) or automatically effective 60 days after (or up to 80 days after if the fund so chooses) filing under Rule 486(a). In contrast, while Rule 415(a)(1)(ix) allows unlisted Affected Funds (*e.g.*, a registered CEF that is a continuously offered tender offer fund) to engage in continuous offerings, such funds are not currently able to rely on Rule 486 and do not otherwise have a mechanism that allows them to file post-effective amendments that become automatically effective.

In a change from the proposing release, the Release expands the scope of Rule 486 to permit any Affected Fund that conducts continuous offerings under Rule 415(a)(1)(ix) to rely on Rule 486 to make certain changes to its registration statements on an immediately effective basis or on an automatically effective basis a set period of time after filing.

III. WKSI STATUS

A. In General

The Release permits a Seasoned Fund to qualify as a WKSI, thereby providing the maximum flexibility accorded by the SEC to issuers regarding communications and registration. In general, a WKSI's shelf registration statement is automatically effective upon filing, which reduces the offering exposure to market changes, thereby enhancing the WKSI's ability to take advantage of distribution opportunities. WKSIs are also permitted to make oral or written offers without a statutory prospectus, prior to having a registration statement on file.

B. Eligibility

To qualify as a WKSI, a Seasoned Fund must have at least $700 million in public float,[10] and not be an "ineligible issuer." The Release amends Securities Act Rule 405 so that Affected Funds are not excluded from the WKSI definition. In addition, the Release amends the "ineligible issuer" definition to give effect to the current anti-fraud prong in that

[10] "Public float" refers to the aggregate market value of the voting and non-voting common equity held by non-affiliates of a registrant. In the Release, the SEC acknowledged that its WKSI framework, which was originally designed specifically for operating companies, "is not well-tailored to the specific characteristics of affected funds." Notwithstanding commenters' suggestions that SEC adopt alternative eligibility criteria for Affected Funds to qualify as WKSIs, the SEC stated that it was "not eliminating or modifying the $700 million public float requirement for affected funds, or permitting affected funds to qualify as WKSIs based on their aggregate NAVs." As a result, unless the SEC provides additional guidance, the calculations of an Affected Fund's public float for the purpose of determining an Affected Fund's WKSI status under Rule 405 (as amended) would be the same as for an operating company under current Rule 405.

definition in the context of Affected Funds.[11] Under the Release, an Affected Fund is an ineligible issuer if, within the past three years, its ***investment adviser*, including any sub-adviser**,[12] was the subject of any judicial or administrative decree or order arising out of a governmental action that determines that the investment adviser aided or abetted or caused the Affected Fund to have violated the anti-fraud provisions of the federal securities laws.

IV. COMMUNICATIONS REFORMS

A. Offering Communications

The Securities Act's "gun-jumping" prohibitions limit offering communications that issuers and underwriters may use before a registration statement becomes effective. The SEC has adopted rules (the "communication rules") that provide operating companies and underwriters flexibility with respect to their offering communications. Until recently, these communication rules were generally unavailable to Affected Funds, which are subject to a separate framework governing communications with investors.

The Release amends various Securities Act rules to remove the exclusions for Affected Funds from the following rules and permits Affected Funds to:

- Make certain communications prescribed by Rule 134 to publish factual information about the issuer or the offering, including "tombstone ads."
- Rely on Rule 163A, which excludes from the term "offer" any communication made by or on behalf of issuers more than 30 days before the filing of a registration statement that does not reference a registered securities offering.
- Rely on Rule 168 (if the Affected Fund is a reporting company) to publish or disseminate regularly released factual business information and forward-looking information at any time, including around the time of a registered offering.
- Rely on Rule 169 to continue communication of regularly released factual business information intended for use by persons other than in their capacity as investors or potential investors.
- Rely on Rule 164 and Rule 433 to use a free writing prospectus after a registration statement is filed.
- (Only for Affected Funds that are WKSIs) Engage in oral and written communications, including the use of a free writing prospectus at any time, before or after a registration statement is filed, subject to the same conditions applicable to other WKSIs.

B. Broker-Dealer Research Reports

Securities Act Rule 138 permits a broker-dealer that is participating in the distribution of an issuer's common stock and similar securities to communicate its research about the issuer's fixed-income securities and vice versa, provided that the communications are made in the regular course of its business. The Release amends Rule 138's references to shelf registration statements filed on Form S-3 and periodic reports on Forms 10-K and 10-Q to include parallel references to a

[11] For example, an ineligible issuer includes an issuer that was made the subject of any judicial or administrative decree or order arising out of a governmental action that (i) prohibits certain conduct or activities regarding, including future violations of, the anti-fraud provisions of the federal securities laws, (ii) requires that the person cease and desist from violating the anti-fraud provisions of the federal securities laws or (iii) determines that the person violated the anti-fraud provisions of the federal securities laws.

[12] An Affected Fund will need to ensure that the necessary information about its sub-adviser(s) is available to be used to evaluate its WKSI status on the relevant determination date.

short-form registration statement on Form N-2 and the reports that registered CEFs are required to file (*i.e.*, Forms N-CSR, N-CEN, and N-PORT).

Securities Act Rule 139 permits a broker-dealer to publish or distribute research reports concerning an issuer or an issuer's securities without such reports constituting "offers" under the Securities Act, if it does so in the regular course of its business, even if it is participating or will participate in the registered offering of the issuer's securities. The SEC did not propose to amend Rule 139 as part of the Release because it believed that Rule 139b (which was adopted in November 2018 and summarized in this Ropes & Gray Alert) satisfies the directives of the BDC Act[13] and Registered CEF Act and is consistent with Congress's core objective regarding research reports covering these funds.

V. OTHER RULE AMENDMENTS

A. Final Prospectus Delivery Reforms

Securities Act Rule 172 permits issuers and broker-dealers to satisfy final prospectus delivery obligations if a final prospectus is or will be on file with the SEC within a specified time period, subject to additional conditions. Rule 173 mandates a notice stating that a sale of securities has been made pursuant to a registration statement or in a transaction in which, absent Rule 172, a final prospectus is required to have been delivered. To implement the BDC Act, and to provide parity for registered CEFs consistent with the Registered CEF Act, the Release amends Rules 172 and 173 to permit Affected Funds to rely on the two rules and thereby permit Affected Funds to rely on the "access equals delivery" means of satisfying the final prospectus delivery requirements currently available to operating companies.

B. Rule 418 Supplemental Information

Securities Act Rule 418 provides that the SEC or the SEC staff may request supplemental information concerning a registrant, the registration statement, the distribution of the securities, market activities, and underwriters' activities. Under Rule 418(a)(3), registrants that are eligible to file Form S-3 are exempt from such requests with respect to certain specified information. The Release amends Rule 418(a)(3) to provide that Affected Funds eligible to file a short-form registration statement on Form N-2 have the same exemption.

C. Incorporation by Reference into Proxy Statements and Form N-14

Proxy Statements. Item 13 of Schedule 14A under the Exchange Act requires a registrant to provide financial statements and other information for proxy statements containing certain proposals. However, registrants that meet the requirements of Form S-3 (as defined in Note E to the Schedule) may incorporate this information by reference to previously filed documents with the SEC without delivering those documents with the proxy statement. The Release amends Item 13(b)(1) and Note E to afford Affected Funds that are eligible to file a short-form registration statement the same treatment as operating companies.

Form N-14. Form N-14 is the form used by all registered investment companies and BDCs to register securities under the Securities Act that are to be issued in a business combination, merger or an exchange offer. Form N-14 currently permits a registered CEF – but not a BDC – to incorporate by reference certain required information about the registrant and the company being acquired from its prospectus, SAI or 1940 Act reports into the Form N-14 prospectus. The

[13] Section 803(b)(2)(F) of the BDC Act directed the SEC to specifically include a BDC as an issuer to which Rules 138 and 139 applied. While Rule 139b generally extends the safe harbor available under Rule 139 to a "covered investment fund research report," Rule 139b also differs from Rule 139 (and Section 803(b)(2)(F) of the BDC Act) to the extent that Rule 139b requires that a covered investment fund research report must be published by an independent broker-dealer (*i.e.*, Rule 139b excludes a research report published or distributed by (i) the BDC or any affiliated person of the BDC or (ii) a broker-dealer that is the investment adviser, or an affiliated person of the investment adviser, for the BDC).

proposing release requested comment on whether the SEC should modify incorporation-by-reference provisions in other registration forms filed by Affected Funds. In response to comments received by the SEC, the Release modifies Form N-14 to permit BDCs to incorporate by reference to the same extent as registered CEFs.

VI. INTERVAL FUNDS & ETPs – NEW REGISTRATION FEE PAYMENT METHOD

At present, all issuers, including interval funds, must pay Securities Act registration fees to the SEC at the time of filing a registration statement, regardless of whether the issuers sell the securities.[14] The Release amends Rules 23c-3 and 24f-2 under the 1940 Act to permit interval funds to pay registration fees using the annual-net-basis methodology now employed by mutual funds and ETFs.

In response to comments received on the proposing release, the Release also contains amendments to permit certain ETPs, which are not registered under the 1940 Act, to elect to register an offering of an indeterminate number of securities and to pay registration fees for the offering in the same way permitted for mutual funds and ETFs.[15]

VII. DISCLOSURE AND REPORTING PARITY CHANGES

The Release (i) requires Affected Funds to satisfy structured data requirements in their SEC filings, (ii) requires Affected Funds to satisfy new annual and current reporting requirements and (iii) provides Affected Funds with greater flexibility to incorporate information by reference. However, the SEC did not adopt its proposal in the proposing release to require registered CEFs to file Form 8-K.

A. Structured Data Requirements

Inline XBRL Requirements for Financial Statements and Notes to Financial Statements. In general, operating companies are required to submit financial statement information in eXtensible Business Reporting Language ("XBRL") as separate interactive data file exhibits to, and concurrently with, their Exchange Act reports and certain Securities Act registration statements. Open-end investment companies (including ETFs organized as open-end investment companies) are required to submit risk/return summary information in XBRL as exhibits to registration statements on Form N-1A and in prospectuses with risk/return summary information that varies from the effective registration statement. In June 2018, the SEC adopted final rules to require operating companies and open-end investment companies, on a phased-in basis, to use Inline XBRL[16] for the submission of financial statement information and fund risk/return summary information to the SEC (summarized in this Ropes & Gray Alert).

Currently, BDCs are subject to neither the structured data reporting requirements for operating companies nor those for open-end investment companies. The Release amends Item 601 of Regulation S-K to remove the exclusion applicable to BDCs from the Inline XBRL financial statement tagging requirements and thereby subjects BDCs to the same requirements applicable to operating companies.

New Checkboxes and Structured Data Format for Form N-2 Cover Page. The Release requires all Affected Funds to tag the data points appearing on the cover page of Form N-2 (as modified by the Release and excluding the Calculation

[14] WKSIs using automatic shelf registration statements have additional flexibility to pay filing fees at or prior to the time of a securities offering. Under the Release, Affected Funds that become WKSIs also gain that flexibility.
[15] Exchange-traded funds or ETFs are registered under the 1940 Act. ETPs, as contemplated by the Release, have assets that consist primarily of commodities, currencies, or derivative instruments that reference commodities or currencies, or interests in the foregoing.
[16] Inline XBRL format permits filers to embed XBRL data directly into an HTML document, which is both human-readable and machine-readable.

of Registration Fee table) using Inline XBRL format. An analogous requirement was adopted by the SEC in a separate release issued on the same day as the proposing release (summarized in this Ropes & Gray Alert).

The Release also adds additional checkboxes on the cover page of Form N-2 to distinguish the type of registration statement being filed and to identify certain characteristics of the fund, including, among other things, whether the fund is a registered CEF, a BDC, a registered CEF that operates as an interval fund, qualified to file a short-form registration statement on Form N-2, a WKSI, or an emerging growth company.

Tagging Prospectus Disclosure Items. The Release requires all Affected Funds to tag certain information in their prospectuses using Inline XBRL format. All Affected Funds (like mutual funds and ETFs) are required to file with the SEC, using Inline XBRL, certain information in registration statements or post-effective amendments filed on Form N-2, as well as in forms of prospectuses filed under Securities Act Rule 424 that include information varying from the registration statement. Specifically, Affected Funds have to tag the following items using Inline XBRL format: Fee Table, Senior Securities Table, Investment Objectives and Policies, Risk Factors, Share Price Data and Capital Stock, Long-Term Debt and Other Securities.

An Affected Fund that files a short-form registration statement on Form N-2 also must tag information appearing in its Exchange Act reports, including Forms N-CSR, 10-K and 8-K, when the information is required to be tagged in the Affected Fund's prospectus.

Structured Data Format for Form 24F-2. The Release also requires filings on Form 24F-2 to be submitted using a structured XML format.

B. New Periodic Reporting Requirements

Fee and Expense Table, Share Price Data, and Senior Securities Table. The Release mandates that funds (including any BDCs) filing a short-form registration statement on Form N-2 must include key information in their annual reports[17] now contained in the funds' prospectuses: Fee and Expense Table, Share Price Data and Senior Securities Table.

Management's Discussion of Fund Performance. Mutual funds and ETFs are already required to include MDFP disclosure in their annual reports. BDCs, like operating companies, are already required to include a narrative discussion of the BDC's financial statements – management discussion and analysis or "MD&A" – in their annual reports. However, at present, Form N-2 does not include an MDFP or MD&A requirement for registered CEFs, although many registered CEFs choose to include the equivalent. Therefore, the Release amends Form N-2 to extend the MDFP disclosure requirement to all registered CEFs.

Financial Highlights. Registered CEFs are currently required to include financial highlights in their registration statements and annual reports to shareholders. BDCs include their full financial statements in their prospectuses, but are currently allowed to omit financial highlights disclosure summarizing these financial statements. The SEC observed, however, that it is generally market practice for BDCs to include financial highlights. In light of the importance of financial highlights information and to provide consistent requirements for all Affected Funds, the Release requires BDCs to include financial highlights in their registration statements and in annual reports to shareholders.

Material Unresolved Staff Comments. The Release requires an Affected Fund that has unresolved comments regarding its reports under the Exchange Act, 1940 Act or its registration statement not less than 180 days before the end of its

[17] For registered CEFs, this key information must be added to annual reports to shareholders on Form N-CSR, and for BDCs, this key information must be added to annual reports on Form 10-K.

fiscal period to which an annual report relates, the Affected Fund must disclose the substance of the unresolved comments that the Fund believes are material.

C. New Current Reporting Requirements

Form 8-K. The Release did ***not*** adopt provisions in the proposing release that would have required (i) Form 8-K reporting by registered CEFs and (ii) added two new Form 8-K reporting items for all Affected Funds.

Rule 103 of Regulation FD. Rule 100 of Regulation FD provides that an issuer must make either simultaneous or prompt public disclosure of any material nonpublic information regarding the issuer that the issuer selectively disclosed to certain persons. Rule 103(a) of Regulation FD provides that, if an issuer fails to make a public disclosure solely required under Rule 100 of Regulation FD, the issuer's eligibility to use Form S-3 is unaffected.

The Release amends Rule 103(a) to provide that, for purposes of Form N-2, an Affected Fund's failure to make a public disclosure solely required under Rule 100 does not affect the fund's ability to file a short-form registration statement or qualify as a WKSI.

D. Online Availability of Information Incorporated by Reference

The Release amends Form N-2's current "General Instruction for Incorporation by Reference," which will now allow all BDCs and registered CEFs, including those that are not Seasoned Funds, to backward incorporate financial information into their prospectus or SAI. In particular, the Release eliminates the prerequisite to backward incorporation of financial information that the fund deliver to new investors the information that it incorporated by reference into its prospectus or SAI. Instead, the fund is required only to make its prospectus, SAI and the incorporated materials available and accessible on a website identified in the fund's prospectus and SAI. In other words, the existing Form N-2 requirement – that a fund provide to new purchasers a copy of all materials that the fund incorporated by reference into the prospectus and/or SAI – no longer applies. However, Affected Funds are required to provide incorporated materials upon request free of charge, by mail or electronically.

E. Enhancements to Certain Registered CEFs' Annual Report Disclosure

Registered CEFs may now rely on Rule 8b-16(b) under the 1940 Act to avoid making an annual update to their registration statements. The rule requires that a registered CEF forgoing an annual update must disclose in its annual report certain important changes (*e.g.*, changes in principal investment objectives, investment policies or principal risks) that transpired during the prior year. The Release amends Rule 8b-16 to require funds to describe the material changes in their annual reports in enhanced detail. This is intended to allow investors to understand what has changed and how it may affect the fund. The Release also requires funds to preface such disclosures with a legend.

In a change from the proposing release, the Release requires Affected Funds that rely on Rule 8b-16(b) to describe the fund's current investment objectives, investment policies and principal risks in its annual report, even if there were no changes in the past year. The Release encourages funds "to tailor their disclosures to how the fund operates rather than rely on generic, standard disclosures about the fund's investment policies and risks" and to describe "principal risks in order of importance, with most significant risks appearing first (*i.e.*, not listing risks in alphabetical order)."

VIII. CERTAIN STAFF NO-ACTION LETTERS

Over the years, the SEC staff has provided no-action letters to specific listed registered CEFs that conduct delayed or continuous offerings under Rule 415(a)(1)(x) regarding their use of Rule 486(b). The Release states that various no-action letters – permitting a specific listed, registered CEF that conducts delayed or continuous offerings under Rule

415(a)(1)(x) to file post-effective amendments that are immediately effective under rule 486(b) – will be withdrawn effective August 1, 2021.[18]

IX. EFFECTIVE AND COMPLIANCE DATES[19]

Effective Dates. Other than the exceptions noted below, the Release's rule and form amendments will become effective on August 1, 2020.

- The amendments to Rules 23c-3, 24f-2, and Form 24F-23 become effective August 1, 2021 to provide sufficient time to modify the SEC's systems to accept such filings from interval funds.
- The amendments to Rules 456 and 457 and Forms S-1, S-3, F-1 and F-3 under the Securities Act become effective August 1, 2021.

Compliance Dates.

- **MDFP.** Beginning August 1, 2021, any annual report filed by a registered CEF will be required to include the MDFP disclosures.
- **Structured Data Requirements (Financial Statement, Cover Page, and Prospectus Information).** All Affected Funds subject to the Inline XBRL structured data reporting requirements for financial statement, registration statement cover page, and prospectus information that are eligible to file a short-form registration statement will be required to comply with these provisions beginning August 1, 2022. All other Affected Funds subject to these requirements must comply by February 1, 2023.
- **Structured Data Requirements (Form 24F-2).** All filers on Form 24F-2 (including existing Form 24F-2 filers, such as open-end funds and unit investment trusts, as well as interval funds) will be required to file reports on the form in an XML structured data format beginning February 1, 2022.

X. OBSERVATIONS

The Release streamlines the registration, communications and offering practices for many Affected Funds. The Release permits Affected Funds eligible to file a short-form registration statement to satisfy the disclosure requirements by forward incorporation by reference. This gives these Affected Funds the opportunity to avoid, in most instances, making post-effective amendments to update a registration statement. In turn, Affected Funds will be able to get an offering to market more promptly without risk of delay due to the SEC staff's review and comment process.

In 2019, the SEC estimated that there were approximately 500 Affected Funds that could satisfy the $75 million public float requirement to be eligible to file a short-form registration statement. Of these Affected Funds, the SEC estimated that there were 100 Affected Funds (15 listed BDCs and 85 listed registered CEFs) that could meet the WKSI $700 million public float requirement, although, due to recent market volatility, these numbers may be lower. These Affected Funds' WKSI status provides the most flexibility and greatest ability to promptly access markets for additional capital.

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[18] *See* Division of Investment Management, Staff Statement Regarding Withdrawal of Staff Letters Related to Securities Offering Reform for Closed-End Investment Companies Rulemaking (April 2020) (available here).

[19] The Release states that amended Form N-2 will become effective on August 1, 2020. It goes on to state that the SEC:

> also will need time to modify its systems to automatically reflect that automatic shelf registration statements are effective upon filing and process "pay-as-you-go" payments for affected funds that are WKSIs . . . Until such modifications are complete, which is anticipated to be September 2020, affected funds should contact the staff of the Division of Investment Management's Disclosure Review and Accounting Office **if they are filing an automatic shelf registration statement**. (Emphasis added).

The Release's communications reforms also smooth the offering process for Affected Funds. In particular, Affected Funds benefit from being able to use Rule 134 to publish factual information about the Affected Fund or the offering, and being able to use free writing prospectuses under Rule 433.

The "ineligible issuer" definition applies to an Affected Fund where the investment adviser, including any sub-adviser, aided, abetted, or caused the fund to have violated certain anti-fraud provisions within a three-year look-back period. Thus, under the definition, the actions taken by an investment adviser, including any sub-adviser, could cause an Affected Fund to become ineligible for WKSI status. Therefore, an Affected Fund will need to ensure that the necessary information about its sub-adviser(s) is available to be used to evaluate its WKSI status on the relevant determination date.

While the SEC considered alternative eligibility criteria for WKSI status, such as net asset value of a certain size for funds whose shares are not traded on an exchange, the SEC decided to not include such alternatives in the Release. As a result, most interval funds and tender offer funds, as well as unlisted BDCs, are ineligible to use the short-form registration statement on Form N-2, unless such funds list their shares and otherwise satisfy the eligibility requirements. However, the Release expands the scope of Rule 486 to permit any Affected Fund that conducts continuous offerings under Rule 415(a)(1)(ix) to make certain changes to their registration statements on an immediately effective basis or on an automatically effective basis a set period of time after filing.

Several of the reforms contained in the Release incrementally increase the compliance burden on Affected Funds. For example, Affected Funds filing a short-form registration statement are required to disclose fee and expense table, share price data, a senior securities table, and unresolved staff comments in their annual reports. In addition, Affected Funds, especially those with little Inline XBRL experience, could incur significant, initial compliance costs associated with Inline XBRL preparation and incremental, ongoing costs for tagging required information in Inline XBRL.

* * *

For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray contact.

Registered Closed-End Funds and BDCs: Rule and Form Changes

Differences from the proposing release are marked

Rule	Summary Description of Rule	Entities Affected by Changes
REGISTRATION PROVISIONS		
Securities Act Rule 415	Permits registration of securities to be offered on a delayed or a continuous basis.	Seasoned Funds*
General Instructions A.2 and F.3 of Form N-2	Provide for backward and forward incorporation by reference.	Seasoned Funds
General Instruction F.4.a of Form N-2	Requires online posting of information incorporated by reference.	Affected Funds
Securities Act Rule 430B	Permits certain issuers to omit certain information from their "base" prospectuses and update the registration statement after effectiveness.	Seasoned Funds
Securities Act Rules 424 and 497	Provide the processes for filing prospectus supplements.	Affected Funds
Securities Act Rule 462	Provides for effectiveness of registration statements immediately upon filing with the SEC.	WKSIs
Securities Act Rule 418	Exempts some registrants from an obligation to furnish certain engineering, management, or similar reports.	Seasoned Funds
1940 Act Rule 23c-3	Subjects interval funds to the registration fee payment system based on annual net sales.	Interval Funds
Securities Act Rule 486	Allows continuously offered unlisted Affected Funds to make certain filings that are immediately effective upon filing or automatically effective 60 days after filing.	Continuously offered unlisted Affected Funds not relying on Rule 23c-3
Securities Act Rules 415, 424, 456 and 457; Forms S-1, S-3, F-1 and F-3	Permits ETPs to register an indeterminate amount of certain securities and pay registration fees based on annual net sales.	ETPs
General Instruction G of Form N-14	Permits certain registrants to incorporate by reference.	BDCs
COMMUNICATIONS PROVISIONS		
Securities Act Rule 134	Permits issuers to publish factual information about the issuer or the offering, including "tombstone ads."	Affected Funds

* Some of the rule changes that are shown above as affecting "Seasoned Funds" would affect only those Seasoned Funds that elect to file a short-form registration statement on Form N-2.

Securities Act Rule 163A	Permits issuers to communicate without risk of violating the gun- jumping provisions until 30 days prior to filing a registration statement.	Affected Funds
Securities Act Rules 168 and 169	Permit the publication and dissemination of regularly released factual and forward-looking information.	Affected Funds
Securities Act Rules 164 and 433	Permit use of a "free writing prospectus."	Affected Funds
Securities Act Rule 163	Permits oral and written communications by WKSIs at any time.	WKSIs
Securities Act Rule 138	Permits a broker or dealer to publish or distribute certain research about securities other than those they are distributing.	Seasoned Funds
PROXY STATEMENT PROVISION		
Item 13 of Schedule 14A	Permits certain registrants to use incorporation by reference to provide information that otherwise must be furnished with certain types of proxy statements.	Seasoned Funds

Rule	Summary Description of Rule	Entities Affected by Changes
PROSPECTUS DELIVERY PROVISIONS		
Securities Act Rules 172 and 173	Permit issuers, brokers, and dealers to satisfy final prospectus delivery obligations if certain conditions are satisfied.	Affected Funds
STRUCTURED DATA REPORTING PROVISIONS		
Structured Financial Statement Data	A requirement that BDCs tag their financial statements using Inline extensible Business Reporting Language ("Inline XBRL") format.	BDCs
Prospectus Structured Data Requirements	A requirement that registrants tag certain information required by Form N-2 using Inline XBRL.	Affected Funds
Form 24F-2 Structured Format	A requirement that filings on Form 24F-2 be submitted in a structured format.	Form 24F-2 Filers
PERIODIC REPORTING PROVISIONS		
1940 Act Rule 8b-16	A requirement that funds that rely on ~~the rule disclose certain enumerated changes~~ paragraph (b) of the Rule describe in the annual report the fund's current investment objectives, policies and risks, and certain key changes in enough detail to allow investors to understand each change and how it may affect the fund.	Registered CEFs

Instruction 4.h(2) to Item 24 of Form N-2	A requirement for information about the investor's costs and expenses in the registrant's annual report.	Seasoned Funds
Instruction 4.h(3) to Item 24 of Form N-2	A requirement for information about the share price of the registrant's stock and any premium or discount in the registrant's annual report.	Seasoned Funds
Instruction 4.h(1) to Item 24 of Form N-2	A requirement for information about each of a fund's classes of senior securities in the registrant's annual report.	Seasoned Funds
Instruction 4.g to Item 24 of Form N-2	A requirement for narrative disclosure about the fund's performance in the fund's annual report.	Registered CEFs
Item 4 of Form N-2; Instruction 10 to Item 24 of Form N-2	Requires disclosure of certain financial information.	BDCs
Instruction 4.h.(4) to Item 24 of Form N-2	A requirement to disclose outstanding material staff comments that remain unresolved for a substantial period of time.	Seasoned Funds
CURRENT REPORT PROVISIONS		
~~Exchange Act Rules 13a-11 and 15d-11~~	~~Require registered CEFs to file current reports on Form 8-K.~~	~~Registered CEFs~~
~~Proposed Section 10 of Form 8-K~~	~~Requires current reporting of two new events specific to Affected Funds.~~	~~Affected Funds~~
Regulation FD Rule 103	Provides that a failure to make a public disclosure required solely by Rule 100 of Regulation FD will not disqualify a "seasoned" issuer from use of certain forms.	Seasoned Funds

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE
EFFECTIVE STRATEGIES & BEST PRACTICES

The Third Line of Defense: The Intersection of the Audit and Compliance Functions

Jack Thomas, *Asset Management Group, PNC*

Steve Perazzoli, *PricewaterhouseCoopers LLP*

Dan Goelzer, *Sustainability Accounting Standards Board*

Paul Glenn, *Investment Adviser Association* MODERATOR

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Agenda

- Audit Practices
- SEC Initiatives for Auditors
- Auditing Developments in Investment Adviser Firms
- The PCAOB

1st Polling Question

Is your professional role one of the following?

- Internal Audit
- Compliance Officer
- External Audit
- Other

2nd Polling Question

Does your firm currently engage external audit services such as financial statement audits, surprise custody audits, GIPS verification or SOC1 / SOC2 reports?

- YES
- NO

Audit Practices

- Audit Practices and Compliance Functions
- Internal Audit
- External Auditors

Auditing During the Pandemic

- The pandemic and corresponding shutdown/remote work impacted the execution of audits; considerations include:
  - Risk Assessment—evaluation of the impacts to liquidity, debt covenant compliance, going concern, impairments, and restructuring
  - Changes to operating environments, processes and controls—how transactions are initiated, authorized, processed, and recorded
  - Performance of walkthroughs, inventory counts, fixed asset testing, and other procedures
  - Evidence in digital form—authenticating PDFs, scans, photos, and other evidence

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021 — EFFECTIVE STRATEGIES & BEST PRACTICES

COVID-19 Compliance Risks and Considerations

- OCIE issued a Risk Alert on August 12, 2020 to share a number of COVID-19-related issues, risks, and practices relevant to SEC-registered investment advisers, including:
  - Protection of investors' assets;
  - Supervision of personnel;
  - Practices relating to fees, expenses, and financial transactions;
  - Investment fraud;
  - Business continuity; and
  - The protection of investor and other sensitive information.

View the Risk Alert: Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021 — EFFECTIVE STRATEGIES & BEST PRACTICES

SEC Initiatives for Auditors

- **SEC Rule 2a-5,** Good Faith Determination of Fair Value under the Investment Company Act of 1940
  - First time the SEC has comprehensively addressed valuation practices under the Investment Company Act since 1970.
  - Applicable to registered investment companies and business development companies
  - Compliance is 18 months after effective date (December 2020), however subject to review by the new administration
  - Board of directors ultimately responsible, although the board can designate a "valuation designee" to perform fair valuation determinations

Key Provisions of SEC Rule 2a-5

- Periodically assess and manage identified material valuation risks
- Establish and apply fair value methodologies: selecting, reviewing, and monitoring for circumstances
- Test fair valuation methodologies, although particular testing methods or frequency are not specified
- Monitor and evaluate pricing services
- Board reporting and notification provisions of material matters within a specified time period
- Recordkeeping to support fair value determinations—new Rule 31a-4

Auditing Developments in Investment Adviser Firms

- Current practices for internal audit
- Relationships with compliance
- Testing
- Training
- Implementation of new areas

3rd Polling Question

How familiar are you with the SASB and ESG disclosures?

- Extensive
- Moderate
- Somewhat
- None

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021
EFFECTIVE STRATEGIES & BEST PRACTICES

The Work of the PCAOB

Mission and Responsibilities

Relationship with the SEC

Impacts on Public Companies

PCAOB Priorities

- 2020-2024 Strategic Plan is publicly available on PCAOB's website; focus areas include:
  - "Transformation" efforts, including use of data and technology
  - Impact of Covid-19 and adoption of new accounting standards
  - Firms' system of quality controls and Auditor Independence
  - Outreach to stakeholders and PCAOB publications
  - Enforcement
  - Future standard setting projects

The PCAOB Inspection Program

- Recent inspection findings/emphasis on internal control
- Implementation of critical audit matter reporting
- Impact of the pandemic on 2021 PCAOB inspections

Final Thoughts on the PCAOB's Impact

- Understand what the PCAOB is focusing on in its inspections and how your audit could be impacted.
- Make sure your auditor alerts management and the audit committee if your audit is inspected.
- Prepare the audit committee chair for a possible PCAOB interview.
- Understand any deficiencies the PCAOB finds in your audit, how the auditor will respond, and the implications of your financial reporting.

Sustainability Accounting Standards Board

- 2021 is likely to be a watershed year for environmental, social, and governance (ESG) disclosure.
- The work of SASB and how companies can use its standards.
- The importance of controls and procedures in ESG disclosure.

4th Polling Question

How familiar are you with the Audit Directors Working Group?

- Extensive
- Moderate
- Somewhat
- None

IAA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021
EFFECTIVE STRATEGIES & BEST PRACTICES

Questions?

Thank you

- **Jack Thomas**, Senior Vice President and Audit Director, Asset Management Group, PNC
- **Steve Perazzoli**, Partner, PricewaterhouseCoopers LLP
- **Dan Goelzer**, Sustainability Accounting Standards Board, PCAOB former Chair, and former SEC General Counsel
- **Paul Glenn**, Special Counsel, IAA, Moderator

Audit Directors Working Group

- The next meeting of the IAA Audit Directors Working Group will occur on (*tentative*) March 18, 2021 3-4 pm ET by Zoom
- Further details on the IAA website or email message to group members


EFFECTIVE STRATEGIES & BEST PRACTICES
RULES
REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
IAA INVESTMENT ADVISER
COMPLIANCE
CONFERENCE 2021
MARCH 3-5, 2021
VIRTUAL CONFERENCE

SEC Final rule 2a-5 – Good faith determinations of fair value

Contents

Background

On December 3, 2020, the SEC announced adoption of rule 2a-5 (the "Rule"), largely as proposed with a few modifications incorporating certain feedback received from 60+ comment letters. The Rule directly applies to registered investment companies and business development companies, and establishes a consistent, principles-based framework for boards of directors to use in creating their own specific processes in order to determine fair values in good faith. The SEC determined an update to the Investment Company Act (which had last been amended in 1970) was needed to account for new regulatory developments (including the adoption of ASC 820, Fair Value Measurement) and the increasingly complex nature of investments held by public funds. While the ultimate responsibility of compliance with the Rule's requirements rests with the board of directors, the Rule allows the board to designate the performance of fair value determinations to a "designee", provided that such designee has a fiduciary duty to the fund such as the fund's adviser or an officer of an internally managed fund.

Key provisions

The Rule is comprised of two main areas:

1. The specific requirements that must be performed to determine fair values in good faith, which include:
   - Assessing and managing valuation risks;
   - Establishing and applying fair value methodologies;
   - Testing fair value measurements for appropriateness and accuracy; and
   - Monitoring and evaluating pricing services used.
2. The oversight responsibilities of the board should it choose to designate the performance of fair value determinations to a designee, which include:
   - Actively overseeing the valuation designee, which involves scrutinizing the information received, asking probing questions, reviewing the designee's resources, and identifying and managing conflicts of interest of the designee; and
   - Receiving reporting from the designee on a quarterly basis for any material changes in valuation risks or valuation methodologies used, and on an annual basis for an assessment of the adequacy and effectiveness of the designee's valuation process.

As part of the finalization of the Rule, the SEC separated the proposed recordkeeping requirements to new rule 31a-4, confirming that a failure to keep required records would not automatically imply that the board had not determined fair value in good faith. In addition, the SEC amended the required time period to maintain appropriate documentation to support fair value determinations to six years (in an easily accessible place for the first two years). The SEC reiterated that if the board designates fair value determinations, the valuation designee (not the fund) would be required to maintain such records.

Implications

The SEC acknowledges that funds' current fair value practices are generally consistent with the requirements of the final Rule. Nevertheless, the SEC also acknowledges that there is variation in funds' fair value processes and the practices of certain funds may be more or less extensive than the requirements of the Rule. As such, the final Rule is likely to have an impact on funds' valuation policies and procedures, whether big or small. Below, we have highlighted the main takeaways from the final Rule and outlined our initial observations as to how funds may be impacted:

Inclusion of Level 2 securities in "Fair Valued" population

The Rule bifurcates securities into those *with* readily available market quotations and those *without* readily available market quotations (which are fair valued as determined in good faith). The SEC states that this definition of readily available market quotations is consistent with the definition of a level 1 input under ASC 820, Fair Value Measurement, and therefore, all other investments should be fair valued in good faith.

- A market quotation is "readily available" only when the "quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date."

Reasonable segregation of functions

The Rule mandates the reasonable segregation of functions of the portfolio manager and those responsible for determining fair values. While portfolio managers may provide inputs used in the valuation process, they may not ultimately determine (or significantly influence the determination of) the fair values of the fund's investments.

- Funds should consider additional disclosures in periodic board reporting around investments in which portfolio managers provide inputs used in the process of determining fair value; if such inputs are significant, the board should also consider if additional controls are warranted to prevent portfolio managers from having an undue influence over determined valuations.

Emphasis on consistency of selected fair value methodologies

The Rule states that funds cannot change valuation methods without documenting why the new method is considered equally or more representative of fair value. The spirit of this requirement is to prevent funds from switching from one valuation approach to another in order to produce a desired fair value.

- The Rule allows funds to incorporate different valuation methods within the same asset class, and permits revising valuation methods if circumstances have changed that result in a different methodology serving as a better indication of fair value (e.g., changing from a model-based valuation to a transaction price upon the occurrence of a trade/round of financing).
- Funds may need to enhance their documentation practices to clearly explain the rationale behind changes in fair value methodologies from period to period in cases where a different methodology is deemed appropriate.

New requirement to test fair value methodologies

The Rule requires that funds identify the nature and frequency of tests to be performed over fair value methods, with the objective of periodically assessing chosen methodologies to determine whether they remain appropriate or need to be adjusted.

- The Rule references calibration and backtesting as examples of testing approaches but clarifies that the form (and timing) of testing is at the discretion of the board and fund.
- While calibration and backtesting have been touted as "best practices" by regulators, testing of fair value methods historically had not been specifically mandated.

Expanded definition of pricing services

The Rule charges funds with developing a process for approving, monitoring, and evaluating each pricing service used.

- Pricing services are defined as "third parties that regularly provide funds with information on evaluated prices, matrix prices, price opinions, or similar pricing estimates or information to assist in determining the fair value of fund investments."
  - This definition extends beyond simply pricing *vendors* (where many funds have written policies and procedures around approval and monitoring) and would include third-party valuation firms (where oversight and monitoring practices [post selection] are not as well documented).
- Although the Rule no longer requires that funds establish criteria for the circumstances where a price challenge would be initiated, the Rule does require that funds establish a process for initiating such price challenges. Such a process would likely encompass the thresholds for price challenges used by many funds today. Funds should consider the role of static and dynamic thresholds for purposes of monitoring prices and evaluating pricing services.

Focus on active board oversight

The Rule emphasizes that the board cannot take a passive approach to overseeing the valuation designee, and instead needs to be skeptical and objective when conducting its oversight activities (e.g., asking probing questions, requesting follow-up information, identifying conflicts of interest, and resolving identified issues).

- The board's level of scrutiny should positively correlate with the fund's increased use of subjective inputs/assumptions in its valuations.
- Boards should identify any conflicts of interest within the valuation designee, and subsequently monitor them. This includes conflicts of interest that may arise from other service providers used by the valuation designee. The Rule notes that the valuation designee has a duty to disclose its conflicts to the board and should work with the board to ensure these conflicts are managed to the board's satisfaction.
- Boards are required to probe the appropriateness of the valuation designee's fair value process, including reviewing the designee's resources and expertise, and reliance on other service providers.
- Boards may wish to review how board meetings are documented (e.g., minutes) and determine if additional records are needed to evidence their active review of the valuation designee's performance of fair value determinations and compliance.

Prompt reporting of material issues to the board

In order for the board to receive critical information in a timely manner, the Rule requires the valuation designee to report, in writing to the board, on "material matters" *no later than five business days* after identification. The Rule provides the valuation designee 20 business days to determine if the matter is material; if the materiality of the matter is still undeterminable after that period, the designee must report such matter to the board within five business days.

- Material matters include a significant deficiency or material weakness in the design or effectiveness of the valuation designee's fair value determination process, or material errors in the calculation of NAV.
- Although the SEC declined to establish a specific standard as to what constitutes materiality, the Rule acknowledges that relying upon the "NAV error threshold" ($0.01 a share or 0.5% of the NAV) as the threshold for prompt reporting would not be unreasonable.
- Given the short reporting window, boards and valuation designees may wish to consider developing guidelines in determining if different potential matters would qualify as material and therefore warrant disclosure to the board. Boards may wish to discuss with their auditors what constitutes a material matter for audit purposes to help inform them as they develop these guidelines.

Other provisions

In adopting final Rule 2a-5, the SEC rescinded ASR 118 in its entirety. ASR 118 states that auditors of funds should verify all quotations for securities with readily available market quotations. Rescission of ASR 118 may allow fund auditors to apply only PCAOB standards, which would permit sampling and other techniques to verify the value of fund investments. The Rule notes, however, that the fund's board or valuation designee retains the discretion to request that the auditors test the values of 100% of investments with a readily available market quotation. Furthermore, the Rule clarifies that the rescission of ASR 118 would not affect the SEC's ability to bring enforcement actions against funds that value odd-lot positions in securities at prices provided by vendors for round-lot quantities when the fund does not have the ability to access that round-lot market price to exit the position.

Final Rule 2a-5 includes a definition of readily available market quotations that may affect the ability of funds to cross trade certain investments. Paragraph (c) of the Rule provides that this updated definition of readily available market quotation is applicable to section 2(a)(41) of the Investment Company Act, and therefore, will apply in all contexts under the Investment Company Act, including rule 17a-7, which currently permits cross trades for level 1 and 2 investments provided such pricing is an "independent current market price." The SEC staff is reviewing historical letters and guidance to determine if such guidance (or portions thereof) should be withdrawn and/or if revisions to rule 17a-7 are necessary.

Final Rule 2a-5 no longer requires the adoption of policies and procedures that are designed to ensure compliance with Rule 2a-5. The SEC removed such provision acknowledging that rule 38a-1 (which requires the fund's board to approve fund policies and procedures, and those of each adviser) would require the adoption and implementation of written policies and procedures designed to prevent violations of Rule 2a-5 and 31a-4.

What's next

Rule 2a-5 and rule 31a-4 will have an effective date of 60 days after being published in the Federal Register (which is expected to occur sometime in Q1 of 2021), and a compliance date of 18 months after the effective date. Funds are permitted to adopt as early as the effective date of the Rule.

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Thank you

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Dan Goelzer

AUDIT COMMITTEE AND AUDITOR OVERSIGHT UPDATE

2019 PCAOB Large Firm Inspection Reports

On February 2, the PCAOB released the 2019 inspection reports for the U.S. affiliates of the six largest global network audit firms. The overall percentage of inspected audits that the PCAOB found deficient fell slightly from 27 percent last year to 24 percent. Similar to prior years, the majority of deficient audits included one or more violations of the standard governing the audit of internal control over financial reporting (ICFR); of the 70 deficient audits described in these six inspection reports, 57 included an ICFR auditing deficiency.

Comparison of Firm Inspection Reports

The table below summarizes the results of the 2019 inspections of the six firms. A similar table, which appeared in 2018 PCAOB Large Firm Inspection Reports (and the PCAOB's Guide to its New Reporting Format), June 2020 Update, showing results of the 2018 inspections, follows the 2019 table.

2019 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(All reports are dated December 17, 2020 and were released on February 2, 2021)

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	26	11	42%
Deloitte & Touche	58	6	10%
Ernst & Young	60	11	18%
Grant Thornton	31	7	23%
KPMG	58	17	29%
PwC	60	18	30%
2019 Global Network Firm Totals	293	70	
2019 Global Network Firm Averages	49	12	24%

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2018 INSPECTIONS OF U.S. AFFILIATE OF GLOBAL NETWORKS
(All reports are dated April 28, 2020 and were released on June 1, 2020)

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Percentage of Inspected Engagements with Deficiencies
BDO	23	11	48%
Deloitte & Touche	52	6	12%
Ernst & Young	54	14	26%
Grant Thornton	32	8	25%
KPMG	52	19	37%
PwC	55	14	25%
2018 Global Network Firm Totals	268	72	
2018 Global Network Firm Averages	45	12	27%

The tables above focus on the percentage of inspected engagements found to have at least one audit deficiency. Another way of comparing the six inspection reports is to look at the number of auditing standard (AS) violations cited in each report. That metric differs from the percentage-of-deficient engagements measure because an engagement may involve more than one auditing standard violation. The following table compares the 2019 inspection results of the six firms based on the number of auditing standards violations in each report.

AUDITING STANDARD VIOLATIONS IN SIX FIRM 2019 INSPECTION REPORTS

Firm	Engagements Inspected	Deficient Engagements Described in Part I.A	Auditing Standard Violations in Part I.A	Average # of AS Violations Per Inspected Engagement	Average # of AS Violations Per Part I.A Engagement
BDO	26	11	36	1.38	3.3
Deloitte & Touche	58	6	18	0.31	3.0
Ernst & Young	60	11	39	0.65	3.5
Grant Thornton	31	7	60	1.94	8.6
KPMG	58	17	76	1.31	4.5
PwC	60	18	107	1.78	5.9
2019 Global Net Firm Totals	293	70	336		
2019 Global Net Firm Averages	49	12	56	1.15	4.8

Aggregate Deficiency Data

The ten auditing standards most frequently cited as the basis for audit deficiencies in the 2019 inspection reports of the six firms are listed in the table below. The table also shows the percentage of deficiencies in the six reports that were based on each auditing standard. The same auditing standard may have been cited more than once in the Board's description of a deficient engagement.

TOP TEN AUDITING STANDARDS REFERENCED IN SIX FIRM PART I DEFICIENCY FINDINGS

PCAOB Auditing Standard	Number of Times Standard Cited as Deficiency Basis	Percentage of Total Deficiencies Citing Standard
AS 2201, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of the Financial Statements	115	34.2%
AS 2301, The Auditor's Response to the Risks of Material Misstatement	55	16.4%
AS 2101, Audit Planning	53	15.8%
AS 2315, Audit Sampling	24	7.1%
AS 2501, Auditing Accounting Estimates	19	5.7%
AS 1105, Audit Evidence	18	5.4%
AS 2502, Auditing Fair Value Measurements and Disclosures	17	5.1%
AS 2810, Evaluating Audit Results	17	5.1%
AS 2305, Substantive Analytical Procedures	6	1.8%
AS 2310, The Confirmation Process	4	1.2%

Each inspection report lists the most frequently identified audit deficiencies, divided between the most frequent deficiencies in financial statement (FS) audits and the most frequent deficiencies in ICFR audits. The table below aggregates these deficiencies lists for the six firms. The table also indicates what percentage of the engagements in Part I of the six reports included these deficiencies.

MOST FREQUENTLY IDENTIFIED AUDIT DEFICIENCIES IN 2018 SIX FIRM INPSECTION REPORTS

Deficiency Description	Number of Times Deficiency Was Identified	Audit Affected	Percentage of All Deficiencies
Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing.	41	ICFR	23.8%
Did not identify and test any controls related to a significant account or relevant assertion.	34	ICFR	19.8%
Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate.	22	FS	12.8%
Did not perform sufficient testing related to an account or significant portion of an account or to address an identified risk.	22	FS	12.8%
Did not identify and/or sufficiently test controls over accuracy and completeness of data and reports issuer used in the operation of controls.	18	ICFR	10.5%
Did not perform substantive procedures to obtain sufficient evidence as a result of overreliance on controls (due to deficiencies in testing controls).	16	FS	9.3%
Did not perform sufficient testing of the accuracy and completeness of data and reports used in the firm's substantive testing.	8	FS	4.7%
Did not sufficiently evaluate the appropriateness of the issuer's accounting method or disclosure for one or more transactions or accounts.	5	FS	2.9%
Did not perform sufficient testing of the sample transactions selected for testing.	2	FS	1.2%
Did not sufficiently evaluate the appropriateness of issuer's accounting method or disclosure for one or more transactions or accounts.	2	FS	1.2%
Did not appropriately evaluate control deficiencies.	2	ICFR	1.2%

Each report also lists the financial statement accounts or auditing areas in which deficiencies in Part I of that report most frequently occurred. For the six firms, on an aggregate basis, these areas were:

- Revenue and related accounts – 41 deficiencies
- Inventory – 9 deficiencies
- Allowance for loan losses – 7 deficiencies
- Business combinations – 7 deficiencies
- Income Taxes – 7 deficiencies
- Investment securities – 7 deficiencies
- Goodwill and intangibles – 3 deficiencies
- Long-lived assets – 3 deficiencies
- Derivatives – 2 deficiencies

Part I.B Deficiencies

The 2019 inspection reports include a section (Part I.B) that describes auditing standard or PCAOB rule violations discovered in the inspections that did not affect the auditor's opinion. The 54 violations in the six reports related to:

- Rule 3211, Auditor Reporting of Certain Audit Participants (requiring the auditor to file Form AP with the PCAOB identifying, among other things, other participating audit firms) – 18 violations
- AS 1301, Communications with Audit Committees (requiring the auditor to communicate certain matters to the audit committee) – 11 violations
- Rule 3524, Audit Committee Pre-approval of Certain Tax Services (requiring the auditor to document discussion with the audit committee of potential effects of permissible tax services) -- 8 violations
- AS 1215, Audit Documentation (requiring the auditor to assemble a final set of work papers) – 7 violations

- AS 1205, Part of the Audit Performed by Other Independent Auditors (requiring the principal auditor to, among other things, review and retain management representation letters that component auditors obtained) – 5 violations

- AS 2201, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (requiring, among other things, the auditor's report on the ICFR audit to include certain disclosures) – 2 violations

- AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (requiring the audit opinion to describe and discuss critical audit matters) – 1 violation

- AS 2805, Management Representations (requiring the auditor to, among other things, provide management with a list of uncorrected misstatements to be included in the management representation letter) – 1 violation

- Rule 3526, Communication with Audit Committees Concerning Independence (requiring the auditor to document discussion with the audit committee of potential effects of relationships that might bear on independence) – 1 violation

Comments and Analysis

In its inspection reports, the PCAOB cautions against drawing broad conclusions from its inspections because "our inspection results are not necessarily comparable over time or among firms." While that warning should certainly be kept in mind, below are some observations that seem to emerge from the 2019 reports.

1. Audit quality may have improved slightly. As measured by these PCAOB inspection findings, audit quality seems to have improved, compared to last year. For the six U.S. global network firm affiliates as a group, the overall deficient engagement rate fell from 27 percent of inspected engagements in 2018 to 24 percent in 2019. For the Big Four, the deficiency rate declined from 25 percent to 22 percent of all inspected engagements. D&T's deficiency rate dropped to 10 percent – a record low for these six firms.

   It is however possible that the improvement in aggregate deficiency rates is a result of a change in the engagements selected for review. In the 2019 inspection cycle, the PCAOB increased the percentage of inspected engagements selected at random from 18.7 percent to 23.7 percent and, correspondingly, decreased the percentage of those selected based on an assessment of the engagement's risk. Deficiencies are presumably less likely to be found in engagements selected at random than in those selected because they involve elevated risk.

2. There is a range of inspection results among the six firms. The gap between the firm with the lowest deficiency percentage in 2019 reports (D&T) and the firm with the highest (BDO) was 32 percent (10 percent for D&T versus 42 percent for BDO). There are also wide differences between the inspection results based on the number of auditing standards violations cited in each report. On average, the inspectors found 1.15 auditing standards violations in each engagement they inspected. (This is a small increase from 1.06 deficiencies per inspection last year.) However, in the D&T inspection, eighteen violations were found out of 52 engagements inspected – an average of 0.31 violations per engagement. At the other end of the spectrum, in 31 Grant engagements inspected, the staff found 60 violations – an average of 1.94 per engagement. PwC was not far behind (or ahead of) Grant with 107 auditing standard violations in 60 inspected engagements or 1.78 violations per inspected engagement.

3. ICFR audit deficiencies continue to dominate. The 2019 inspection results suggest that the PCAOB continues to focus on ICFR auditing – and that this focus continues to uncover deficiencies. The PCAOB found deficiencies in the ICFR audit in 23 percent of the integrated audits it inspected, and 81 percent of all audit engagements with deficiencies included an ICFR deficiency. By comparison, in 2018, the Board found ICFR deficiencies in 26 percent of the integrated audit engagements it inspected, and 89 percent of all deficient engagements included an ICFR audit deficiency. Moreover, over half (55.3 percent) of the most frequently cited deficiencies affected the ICFR audit, and the two most common audit deficiencies were control-related, with “Did not perform sufficient testing of the design and/or operating effectiveness of controls selected for testing” at the top of the list.

4. Estimates remain a financial statement audit challenge. The PCAOB found violations in the financial statement audit in 21 percent of the engagements it inspected, and 87 percent of all deficient audit engagements included a financial statement audit deficiency. In 2018, the Board also found financial statement audit deficiencies in 21 percent of the audits it inspected, and 79 percent of all deficient engagements included at least one financial statement audit deficiency. (Deficiencies in the financial statement audit do not, of course, necessarily mean that the financial statements were misstated.) The most frequent deficiencies affecting the financial statement audit were “Did not sufficiently evaluate significant assumptions or data that the issuer used in developing an estimate” and “Did not perform sufficient testing related to an account or significant portion of an account or to address an identified risk” – each of which accounted for 12.8 percent of all frequently-cited deficiencies. Deficiencies related to evaluating assumptions underlying estimates also topped the 2018 list of financial statement audit deficiencies.

As noted in past years, the audit deficiency description and auditing standard deficiency tables could be used as a checklist for topics audit committees may want to discuss with their auditor to understand how the auditor addressed, or plans to address, the most challenging areas in the company's audit.

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The Update seeks to provide general information of interest to audit committees, auditors, and their professional advisors, but it is not a comprehensive analysis of the matters discussed. The Update is not intended as, and should not be relied on as, legal or accounting advice.

Prior Updates issued between January 1, 2019 and May 31,2020 are available here. Updates issued after June 1, 2020 are available here.

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

MARCH 3-5, 2021 / VIRTUAL CONFERENCE

EFFECTIVE STRATEGIES & BEST PRACTICES

The New Marketing Rule for Advisers

IA INVESTMENT ADVISER COMPLIANCE CONFERENCE 2021

EFFECTIVE STRATEGIES & BEST PRACTICES

Speakers

Pamela F. Pendrell, Chief Compliance Officer/Partner, GlobeFlex Capital, L.P.

Melissa Harke, Senior Special Counsel, SEC Division of Investment Management

Michael W. McGrath, Partner, K&L Gates LLP

Sanjay Lamba, Associate General Counsel, Investment Adviser Association (Moderator)

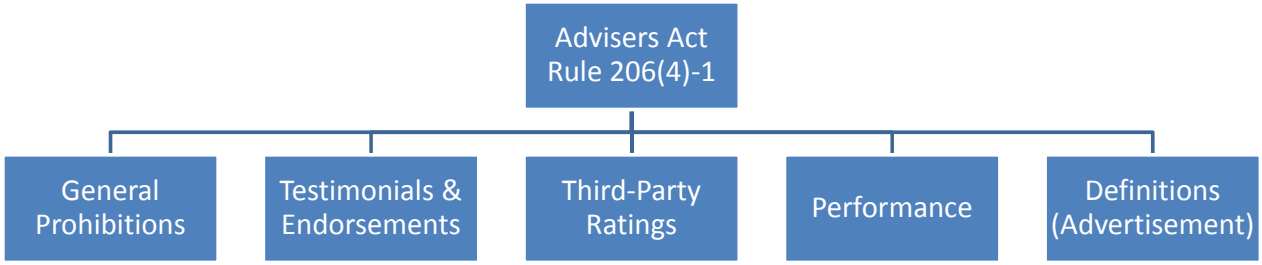
Agenda

- Marketing Rule 206(4)-1
  - Advertising
  - Solicitation
- Transition Period and Compliance Date
- Questions

Overview

- SEC Adopts Rules on December 22, 2020
  - New Marketing Rule 206(4)-1 (advertising and solicitation)
  - Amended Form ADV
  - New recordkeeping requirements
- 18 month transition period between effective date and compliance date
- New Marketing Rule Consistent with IAA Advocacy
  - No patchwork regulation (withdrawal of applicable no-action letters)
  - Principles-based
  - No *per se* prohibitions - permits past specific recommendations and testimonials
  - Permits third-party ratings
  - Addresses social media
  - Sensible framework for performance advertising
  - No new pre-review and approval procedural requirement

Structure of New Marketing Rule



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EFFECTIVE STRATEGIES & BEST PRACTICES

Two Prong Definition of Advertisement

Prong 1

Any ***direct*** or ***indirect*** communication to ***more than one person***, or to ***one or more persons*** if the communication includes ***hypothetical performance***, that:

(i) offers the investment adviser's investment ***advisory services*** with ***regard to securities*** to prospective clients or ***private fund investors***, or

(ii) offers ***new*** investment advisory services with regard to securities to ***current*** clients or private fund investors

Does ***not*** include:

Extemporaneous, ***live***, ***oral*** communications

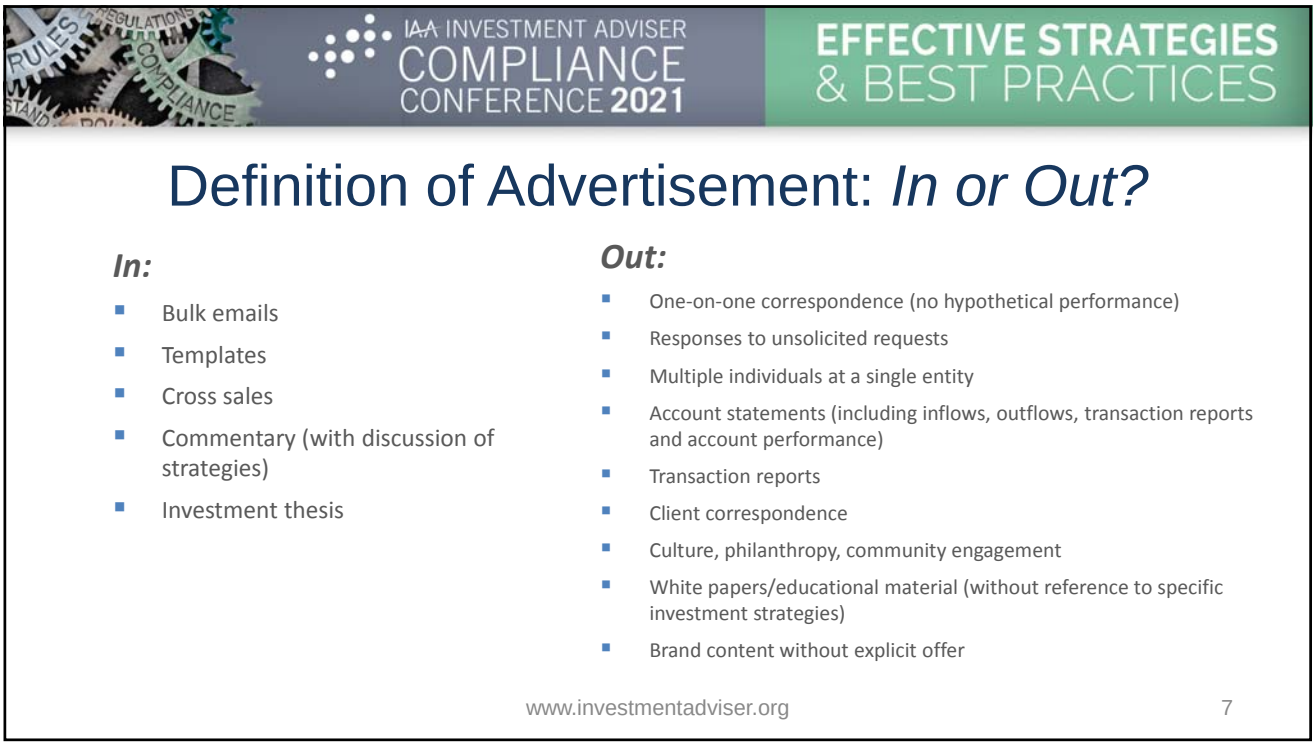
Information in a ***required*** notice or filing

Communication that ***includes hypothetical*** performance that is provided:

1) In response to an ***unsolicited request*** for such information; or
2) To a prospective or current ***investor in a private fund*** advised by the investment adviser in a ***one-on-one*** communication

Prong 2

Any ***endorsement or testimonial*** for which an adviser provides ***cash and non-cash*** compensation directly or indirectly (*e.g.,* directed brokerage, awards or other prizes, and reduced advisory fees)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& BEST PRACTICES
Definition of Advertisement: In or Out?
In:
Bulk emails
Templates
Cross sales
Commentary (with discussion of strategies)
Investment thesis
Out:
One-on-one correspondence (no hypothetical performance)
Responses to unsolicited requests
Multiple individuals at a single entity
Account statements (including inflows, outflows, transaction reports and account performance)
Transaction reports
Client correspondence
Culture, philanthropy, community engagement
White papers/educational material (without reference to specific investment strategies)
Brand content without explicit offer
www.investmentadviser.org
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Definition of Advertisement: In or Out?
Intermediaries and Third-Party Content
In:
Adviser takes affirmative steps with respect to the third-party content:
Provides to intermediaries for distribution to third parties
Participates in creation or dissemination of material (including related persons)
Third-party content incorporated into adviser's communications
Selectively highlighting, prioritizing, or deleting third-party material
Out:
Unauthorized modifications made by third parties to adviser communications
Unedited commentary on adviser's social media site
Edits to content based on balanced and objective criteria (social media!)
Employees' personal social media, if the adviser exercises oversight and supervision
www.investmentadviser.org
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Social Media

- Expanded scope of rule, regardless of how disseminated
- Third party content depends on adviser's ***adoption*** or ***entanglement***
- No *per se* ban on testimonials
- Hyperlinking required disclosures—***consider the general prohibitions!*** (prominence / fair and balanced)
- Use of social media by firm employees in personal capacity (importance of adviser oversight and supervision)

General Prohibitions

Applicable to all advertisements and consider facts and circumstances (*e.g.,* nature of audience):

- Untrue Statements and Omissions
- ***Unsubstantiated Material Statements of Fact***
- Untrue or Misleading Implications or Inferences
- Failure to Provide ***Fair and Balanced*** Treatment of Material Risks or Material Limitations
- Anti-Cherry Picking Provisions (presented in fair and balanced manner): ***References to Specific Investment Advice*** and Presentation of Performance Results
- Otherwise Materially Misleading

Testimonials and Endorsements

Testimonials: Any statement by a ***current client or investor*** in a private fund advised by the investment adviser:

- About the client's or investor's experience with the investment adviser or its supervised persons;
- That directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser; or
- That refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser

Endorsements: Any statement by a person ***other than*** a current client or investor in a private fund advised by the investment adviser that:

- Indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person's experience with the investment adviser or its supervised persons;
- Directly or indirectly solicits any current or prospective client or investor in a private fund for the investment adviser; or
- Refers any current or prospective client of, or an investor in a private fund advised by, the investment adviser

Testimonials and Endorsements

- First prong: ***compensated and uncompensated*** testimonials and endorsements included in certain adviser communications
  - Communication made directly or indirectly ***by the adviser***
  - *Direct: republication of testimonials and endorsements*
  - *Indirect: third-party testimonials that the adviser is "entangled" with*
- Second prong: ***compensated*** testimonials and endorsements
  - Communications made orally or in writing
  - Communications made to one or more persons
  - Directly or indirectly provides *de minimis* or higher compensation
  - *Lead-generation firms, placement agents, adviser referral networks*
  - *Compensated bloggers, influencers, website reviews*

Testimonials and Endorsements

	Required Disclosures	Oversight and Compliance		Disqualification	General Prohibitions
		Written Agreement	Reasonable Basis for Believing the T/E Complies with the Rule		
Compensated	✓	✓	✓	✓	✓
De minimis Compensation	✓		✓		✓
Uncompensated	✓		✓		✓
Affiliated Personnel			✓	✓	✓
Registered Broker-Dealers	Exempt from some if rec is subject to Reg BI or non-retail	✓	✓	'34 Act disqualification	✓
Covered Persons in 506(d) Offerings	✓	✓	✓	506(d) disqualification	✓

Third-Party Ratings

Defines "third-party rating" as a "rating or ranking of an investment adviser provided by a person who is ***not a related person***, and such person provides such ratings or rankings ***in the ordinary course of its business***"

- ✓ **Due Diligence:** Reasonable basis for believing that any questionnaire or survey used in preparation is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result

- ✓ **Disclosure:**
  - (i) Date on which the rating was given and the period of time upon which the rating was based;
  - (ii) Identity of the third party that created and tabulated the rating; and
  - (iii) If applicable, that compensation has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating

Performance Advertising

- Elimination of Proposed Schedule of Fees Requirement and Investor Sophistication
- Net Performance Requirement and Prescribed Time Periods ***for All Advertisements***
- Calculation of Net Performance
- Statements about Commission Approval
- Related Performance and Extracted Performance
- Hypothetical Performance
- Performance Portability

Performance Advertising

Key Changes to the *Content* of Advertisements

- Net Performance in Institutional Communications
- Performance Targets in Retail Communications
- Composites with Carve-Outs
- 1-, 5-, and 10-Year Performance

Key Changes to *Policies and Procedures*

- Hypothetical Performance Policies
- Representative Account/Related Performance Materiality Review
- Net Performance Calculations
- Advertising in January! "No less recent than the most recent calendar year-end…"

Transition Period and Compliance Date

New Marketing Rule and Recordkeeping

18 month transition period between effective date and compliance date

May begin complying anytime after effective date

- No partial compliance permitted
- No reliance on staff guidance that will be withdrawn
- Recordkeeping kicks in

Form ADV

- Filings after transition period required to complete amended form
- Only responsible for filing amended form that includes responses to amended Item 5 questions in next annual updating amendment that is filed after transition period
- If early compliance, adviser not expected to do "off cycle" Form ADV update; could provide new required information at the time it next updates the form

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EFFECTIVE STRATEGIES & BEST PRACTICES
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REGULATIONS
COMPLIANCE
STANDARDS
POLICIES
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K&L GATES

Asset Management and Investment Funds Alert

THE SEC'S MODERNIZED MARKETING RULE FOR INVESTMENT ADVISERS

Date: 20 January 2021

By: Michael S. Caccese, Michael W. McGrath, Pamela A. Grossetti, Richard F. Kerr, Pablo J. Man, Kasey L. Lekander, Britney E. Ryan, Catherine O'Neill, Lindsay R. Grossman, Jennifer A. DiNuccio

On 22 December 2020, the U.S. Securities and Exchange Commission (SEC) adopted amendments (the final rule) to Rule 206(4)-1 under the Investment Advisers Act of 1940 (the Advisers Act) to modernize the regulation of investment adviser advertising and solicitation practices.[1] Rule 206(4)-1 was the SEC's first antifraud rule governing the activities of investment advisers, and in many respects, it remains the most important. This action represents the first substantive amendments to the rule since its adoption in 1961 and will have vast implications for the compliance and business practices of nearly every investment adviser in the United States.

Citing the need to address evolving marketing practices in light of advancements in technology and changes within the asset management industry, the SEC elected to replace the current versions of Rule 206(4)-1 (the advertising rule) and Rule 206(4)-3 (the solicitation rule) with a single "Marketing Rule." In connection with the implementation of the new Marketing Rule, the SEC will also withdraw dozens of SEC staff no-action letters interpreting the existing advertising rule and solicitation rule. In the place of these no-action letters, which have provided a compliance framework for marketing by investment advisers for decades, investment advisers will need to comply with the Marketing Rule's combination of "principles-based" prohibitions and prescriptive requirements for certain content.

The Marketing Rule takes effect 60 days after publication in the *Federal Register*.[2] Investment advisers subject to the rule may transition their practices to comply with the final rule in full at any point during the 18-month transition period after the effective date.

Investment advisers currently subject to the advertising rule and the solicitation rule will note several material changes from the SEC's current framework. Although the final rule relaxes certain restrictions on marketing content, it also introduces several new obligations. Certain key aspects of the final rule are summarized below.

- Activities currently subject to the advertising rule and solicitation rule will be regulated under a single Marketing Rule.
- Investment advisers must ensure that marketing activities related to their private funds adhere to the requirements of the Marketing Rule, even when fund interests are distributed by a placement agent or other intermediary.
- Existing *per se* prohibitions of the current advertising rule on certain advertising content will be replaced with more flexible principles-based standards, and the rule expressly permits past specific recommendations, testimonials, and third-party ratings under certain conditions.
- Testimonials and endorsements made by third parties will be considered advertisements of the investment adviser if the adviser compensates the third party for these activities.

[1] *See* Investment Adviser Marketing, SEC Release No. IA-5653 (Dec. 22, 2020) [hereinafter Adopting Release].
[2] As of the date of this alert, the Marketing Rule has not been published in the *Federal Register*.

- Hyperlinks and layered disclosures will be permitted subject to certain conditions.
- The Marketing Rule provides a standardized, rule-based framework for performance advertising that is similar to the current framework in many respects, but it also contains many novel prescriptive requirements.
- The final rule does not require formal preapproval of most communications with clients and prospects by designated employees, which had been contemplated by the SEC in amendments to the advertising rule proposed by the SEC in 2019.[3]
- The final rule does not exclude communications to sophisticated institutional investors from certain requirements related to investment performance intended to protect unsophisticated "retail" investors, but it does include certain exceptions for private funds.
- One-on-one communications tailored to a single prospective investor are excluded from the requirements of the Marketing Rule, unless the communications include hypothetical performance.

This client alert presents a brief outline of the final rule, as well as a discussion of certain key questions and compliance considerations introduced by the final rule. Given the complexities of the Marketing Rule and the significance of these changes to the asset management industry, K&L Gates will publish a series of supplemental alerts focused on specific provisions of the Marketing Rule and its impact on different market participants in the coming months.

[3] Investment Adviser Advertisements; Compensation for Solicitations, SEC Release No. IA-5407 (Nov. 4, 2019), (the proposed rule).

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I. DEFINITION OF "ADVERTISEMENT"

The definition of an "advertisement" under the Marketing Rule is the first step to understanding the rule's requirements. All communications by U.S. investment advisers are subject to the antifraud provisions of the Advisers Act, but only "advertisements" of investment advisers registered, or required to be registered, with the SEC will be subject to the specific requirements of the rule.[4]

In response to numerous comment letters voicing concerns over the breadth of the proposed rule's definition of advertisement, which seemed to include most communications with existing clients, the SEC narrowed the definition of "advertisement" in the final rule, and it stated in the Adopting Release that the definition is "designed to capture communications that are commonly considered advertisements."[5] Despite these actions, the definition of "advertisement" in the final rule is still quite broad. As adopted, the Marketing Rule defines "advertisement" in two prongs. The first prong includes communications traditionally treated as investment adviser advertising, while the second prong includes compensated testimonials and endorsements that are currently treated as solicitations under the solicitation rule.

A. First Prong – Advertisements

The first prong defines an "advertisement" to include:

> "any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser[.]"

Certain specific categories of communications receive special treatment under the first prong of the definition of "advertisement."

- *Extemporaneous, Live, Oral Communications*. Extemporaneous, live, oral communications are excluded from the definition of advertisement, regardless of whether they are broadcast. However, prepared remarks and speeches, such as those delivered from scripts, as well as slides or other written materials distributed to an audience in connection with a presentation, would not be excluded to the extent they otherwise meet the definition of an advertisement. Notably, the exclusion is not available to extemporaneous, live, *written* communications, such as texts or electronic chats.

- *Notices and Filings.* Information contained in required statutory or regulatory notices and filings will not be considered an advertisement, provided such information is reasonably designed to satisfy the requirements of the notice or filing. For example, information reasonably designed to satisfy the requirements of Form ADV Part 2 or Form CRS will not be an advertisement. However, information included in a regulatory filing that is not reasonably designed to satisfy the adviser's obligations under the filing and that otherwise meets the definition of advertisement would remain subject to the Marketing Rule.

- *Hypothetical Performance.* Presentation of hypothetical performance[6] is excluded from the definition of advertisement *only if* the communication is (i) in response to an unsolicited client request or (ii) to a private fund investor in a one-on-one communication. Hypothetical performance included in all other

[4] In this alert, discussion of the obligations of "advisers" or "investment advisers" under the Marketing Rule generally refer only to obligations of investment advisers registered, or required to be registered, with the SEC.
[5] Adopting Release at 33.
[6] As discussed in further detail below, "hypothetical performance" is defined under the final rule as performance results that were not actually achieved by any portfolio of the adviser, including model performance, back-tested performance, and target or projected performance returns.

> communications that offer investment advisory services, including one-on-one communications to prospective advisory clients, will be advertisements subject to the Marketing Rule.

Private Funds. Communications to "investors in a private fund" are included in the definition of "advertisement" under the final rule. The term "private fund" is defined as an issuer that would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended.[7] While investors in private funds are not "clients" of an adviser and the specific requirements of the advertising rule historically have not applied to these communications as a technical matter, investment advisers have always been subject to antifraud standards under the federal securities laws when communicating with private fund investors, and the SEC staff often references the advertising rule when considering whether communications to private fund investors are misleading.[8] The definition of "advertisement" in the Marketing Rule will formalize the application of the rule's specific antifraud standards to most adviser communications with private fund investors. Information contained in a private placement memorandum (PPM) regarding the material terms, objectives, and risks of the fund offering would not be considered an advertisement;[9] however, content in a PPM that goes beyond such statements to promote the investment advisory services of the adviser would be subject to the Marketing Rule.

Communications to investors and prospective investors in registered investment companies and business development companies, as well as investors in other pooled investment vehicles that do not rely on section 3(c)(1) or 3(c)(7), such as a collective investment fund that relies on section 3(c)(11), are outside the scope of the Marketing Rule.[10]

Third-Party Content and Social Media. The definition of advertisement includes "any direct or indirect communication" of an adviser. This means that a communication distributed by an agent or intermediary on behalf of an adviser would generally be considered an "advertisement" of the adviser. Echoing prior staff guidance regarding "adoption" and "entanglement" in the context of third-party content on company websites,[11] the Adopting Release also notes that third-party information may be an indirect "advertisement" if the adviser has either endorsed or approved the information after publication or involved itself in the preparation of the information.[12] For example, if an adviser includes in an advertisement performance information received from a third party, the third-party content will be attributed to the adviser and the adviser will be responsible for that content to the same extent it would if it had created the content itself. However, an adviser would not be viewed as involving itself in preparation of an advertisement to the extent the adviser edits a third-party communication based on pre-established, objective criteria that do not favor or disfavor the adviser.

B. Second Prong – Compensated Testimonials and Endorsements

The second prong defines an "advertisement" to also include:

> "any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly, but does not include any information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication[.]"

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[7] *See* Section 202(a)(29) of the Advisers Act.
[8] Rule 206(4)-8 prohibits an adviser from making misstatements or omissions of material facts to investors or prospective investors in a private fund managed by the adviser; as with other general anti-fraud provisions (*e.g.*, Section 206 of the Advisers Act, Rule 10b-5 under the Securities Act of 1933, as amended), the Marketing Rule overlaps with this prohibition but provides more specificity regarding actions the SEC deems to be untrue or misleading statements or omissions.
[9] *See* Adopting Release at 62.
[10] Although such communications are not subject to the Marketing Rule, advisers disseminating such communications will likely find the guidance provided under the Marketing Rule helpful in analyzing the contents of such communications in connection with applicable anti-fraud provisions.
[11] *See, e.g.*, Interpretive Guidance on the Use of Company Websites, Release No. IC-28531 (Aug. 1, 2008).
[12] *See* Adopting Release at 21.

This prong includes solicitation activities historically governed by the existing solicitation rule. “Testimonial” is defined to include statements by current clients or private fund investors[13] about their experience with the adviser, and “endorsement” is defined to include statements by a person other than a current client or private fund investor that indicate approval, support, or a recommendation of the adviser or describes the person's experience with the adviser. Communications considered to be a testimonial or endorsement include statements regarding an adviser's investment advisory expertise or capabilities, as well as the adviser's qualities, expertise, or capabilities in other contexts where it is suggested that such qualities, expertise, or capabilities are relevant to the adviser's investment advisory services.

Whether an adviser provides direct or indirect compensation is a facts and circumstances determination. The term may include, for example, gifts and entertainment, fee rebates, and other forms of indirect benefits, provided that these benefits are designed to incentivize the recipient to make a positive statement about an adviser, although an employee's regular salary and bonus for investment advisory activities or clerical, administrative, support, or similar functions would not be considered compensation in exchange for a testimonial or endorsement. In the Adopting Release, the SEC specifically declined to define what may or may not be considered *indirect* compensation, and therefore, the term will be subject to broad interpretation.[14]

Unlike the first prong of the definition of “advertisement,” the second prong applicable to testimonials and endorsements does not exclude one-on-one communications or extemporaneous, live, oral communications.

Definition of "Advertisement" FAQs

- The final rule defines an “advertisement” as “any direct or indirect communication” made by an investment adviser. How would this apply to communications prepared by or disseminated by intermediaries (e.g., solicitors, placement agents)?
- When is an investment adviser to an underlying fund responsible for marketing materials disseminated by the sponsor of a fund-of-funds (or a feeder fund in a master-feeder structure)?
- How can an investment adviser avoid communications posted on the personal social media accounts of an investment adviser’s associated persons being attributed to the investment adviser for purposes of the Marketing Rule?
- When will third-party website content be attributed to an investment adviser?
- Under the Marketing Rule, what constitutes a “one-on-one presentation”? May investment advisers create template inserts that are included in customized presentations for a particular client or private fund investor meeting, or include hypothetical performance information in one-on-one presentation materials?
- Are brand content and whitepapers considered advertisements under the final rule?
- Would a communication to an existing client or existing private fund investor be considered an “advertisement”? What if the investment adviser subsequently forwarded that communication to a prospective client or prospective private fund investor?
- Under the Marketing Rule, would websites maintained by lead-generation firms or adviser referral networks constitute a compensated testimonial or endorsement for purposes of the second prong of the “advertisement” definition?

[13] Note that the inclusion of private fund investors in the definitions of testimonial and endorsement results in communications used in solicitation activities of a private fund being subject to the Marketing Rule.
[14] *See* Adopting Release at 51.

II. GENERAL PROHIBITIONS

The Marketing Rule replaces the four "prescriptive" prohibitions contained in the current advertising rule with seven principles-based prohibitions as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts. Pursuant to the general prohibitions, an advertisement may not:

1. Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading.
   Example: *Compensating a person to refer investors to the investment adviser by stating that the person had a positive experience with the adviser when such person is not a client or private fund investor of the adviser for its advisory services.*

2. Include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC.
   Example*: Making a statement regarding the performance of securities markets in a given region without maintaining a record or ongoing access to a benchmark securities index for that region that substantiates the statement.*

3. Include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser.
   Example*: Making a series of statements in an advertisement that literally are true when read individually, but whose overall effect creates an untrue or misleading implication about the investment adviser.*

4. Discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits.
   Example*: Advertising only an adviser's history of profitable investments on a webpage and then including a hyperlink to another page that included all material risks and material limitations.*

5. Include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced.
   Example*: An advertisement referencing favorable past specific investment advice without providing sufficient information and context to evaluate the merits of that advice (e.g., a "thought piece" describing specific investment advice provided in response to a major market event without disclosing appropriate contextual information, such as the circumstances of the market event and relevant investment constraints, such as liquidity constraints during that time).*

6. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.
   Example*: An advertisement where additional information is necessary for an investor to assess performance results included in the advertisement (e.g., information relating to the state of the market at the time, any unusual circumstances, or other material factors that contributed to performance).*

7. Otherwise be materially misleading.
   Example*: Including accurate disclosures in an advertisement but presenting them in a font size that is too small to read.*

"Facts and Circumstances" Analysis. The general prohibitions described above, including whether certain information is presented in a fair and balanced manner, should be interpreted based on all relevant facts and circumstances of each advertisement. Consequently, an investment adviser should take into account the sophistication of the target audience, including whether an investor is a retail or institutional investor. For example, a communication intended for a retail investor that contains past specific investment advice may require detailed disclosure to ensure the investor understands that past specific investment advice does not guarantee future results; the same communication directed to a sophisticated institutional investor may require less disclosure, or none at all. The SEC noted that current no-action letters on past specific recommendations may provide investment advisers with useful guidance when determining whether a communication is presented in a fair and balanced manner, but these letters are not the sole means of

satisfying the fair and balanced standard.[15] As a result of the additional flexibility afforded to investment advisers by these principles-based rules, compliance professionals will be in a position to exercise more judgment and discretion to tailor advertisements to an investment adviser's marketing needs.

Practical Implications of Certain Provisions. While the final rule does not require burdensome pre-use and approval requirements that were contemplated in the proposed rule, an adviser must implement policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons.[16] Additionally, an investment adviser is required to have a reasonable belief that it will be able to substantiate material statements of fact upon demand from the SEC. Importantly, the Adopting Release states that the staff will presume that an investment adviser that is unable to substantiate material claims of fact upon demand did not have a reasonable basis to believe it could do so.[17] Accordingly, investment advisers should consider implementing policies and procedures that document the source of and reasonable efforts to verify each material statement of fact made in an advertisement.

Consistent with the proposed modernization of registered fund prospectus and shareholder reporting disclosures,[18] the Adopting Release facilitates the use of layered disclosure. Although not addressed directly in the rule, the SEC notes in the Adopting Release that hyperlinked or other layered disclosure is generally permitted under the Marketing Rule, subject to certain conditions. For example, information that must be presented in a "clear and prominent" manner generally could not be hyperlinked,[19] and each layer of disclosure related to a statement subject to a "fair and balanced" standard must be fair and balanced without requiring reference to other layers of disclosure.[20]

General Prohibitions FAQs

- Under the Marketing Rule, an investment adviser may only make a material statement of fact in an advertisement if the adviser has a reasonable basis for believing it can substantiate such statement upon demand by the SEC. How may investment advisers prove the required "reasonable basis" standard with respect to material statements of fact?
- Will case studies be permitted under the Marketing Rule?
- How may an investment adviser ensure performance time periods are presented in a manner that is fair and balanced?
- How may an investment adviser layer disclosure consistent with the Marketing Rule?
- How may an adviser present or reference testimonials consistent with the general prohibition against including in an advertisement information that would reasonably be likely to cause an untrue or misleading implication or inference concerning a material fact relating to the investment adviser?

III. TESTIMONIALS AND ENDORSEMENTS

Providing more flexibility than the current advertising rule, the Marketing Rule permits the use of testimonials and endorsements subject to certain disclosures and conditions. However, there are many specific requirements imposed on the use of testimonials and endorsements, in part because the SEC incorporated

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[15] *See, e.g.*, Adopting Release at 81. The SEC staff also notes that advisers may consider Financial Industry Regulatory Authority (FINRA) interpretations relating to the meaning of "fair and balanced," but FINRA Rule 2210 and its body of decisions are not controlling or authoritative on the Marketing Rule. Adopting Release at 79.
[16] *See* Advisers Act Rule 206(4)-7.
[17] Adopting Release at 71.
[18] *See* Clifford J Alexander et al., SEC Proposes Major Changes to Prospectus and Shareholder Report Disclosure Scheme, K&L GATES HUB (Aug. 19, 2020).
[19] Adopting Release at 90. See "Testimonials and Endorsements – Disclosure Requirements" below for a detailed discussion of the "clear and prominent" requirement.
[20] Adopting Release at 76–77.

many aspects of the solicitation rule into the Marketing Rule by treating paid solicitors under the rubric of testimonials and endorsements. In addition, the Marketing Rule broadens the scope of the current solicitation rule to include *non-cash* compensation.

A. Disclosure Requirements

- *Prominent Disclosures.* The Marketing Rule requires that an adviser disclose, or reasonably believe that the person giving the testimonial or endorsement discloses, *clearly and prominently*, the following at the time the testimonial or endorsement is disseminated:
  - That the testimonial was given by a current client or private fund investor, and the endorsement was given by a person other than a current client or private fund investor, as applicable;
  - That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and
  - A brief statement of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person.

- *Other Disclosures*. The Marketing Rule also requires that an adviser disclose the following information to recipients of testimonials and endorsements, although these disclosures are not subject to any special prominence requirement:
  - The material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement; and
  - A description of any material conflicts of interest on the part of the person giving the testimonial or endorsement resulting from the adviser's relationship with such person and/or any compensation arrangement.

- *Adviser Oversight and Compliance.* All testimonials and endorsements, including uncompensated testimonials that are distributed directly by the adviser, are subject to an adviser oversight and compliance provision under the Marketing Rule. Specifically, the Marketing Rule requires the adviser to have:
  - A reasonable basis for believing that any testimonial or endorsement complies with the requirements of the rule, and
  - A written agreement with any person giving a *compensated testimonial or endorsement* that describes the scope of the agreed-upon activities and the terms of the compensation for those activities when the adviser is providing compensation for testimonials and endorsements that exceeds US$1,000 over a 12-month period (written agreement requirement).

B. Disqualification for Persons Who Have Engaged in Misconduct

The Marketing Rule prohibits an adviser from compensating a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an *ineligible person* at the time the testimonial or endorsement is disseminated (disqualification provision). The disqualification provision does not apply to uncompensated testimonials or endorsements.

Under the Marketing Rule, an “ineligible person” is a person who is subject to an SEC opinion or order barring, suspending, or prohibiting the person from acting in any capacity under the federal securities laws or to any one of many enumerated “disqualifying events.” The definition extends to employees, officers, directors, general partners, and elected managers of an ineligible person. The Marketing Rule includes a ten-year lookback period across all “disqualifying events,” which aligns with disciplinary disclosure reporting on Form ADV Part 1A.

C. Exemptions

The Marketing Rule provides the following exemptions from certain requirements otherwise applicable to testimonials and endorsements:

- *De Minimis Compensation*. A testimonial or endorsement disseminated for no compensation or *de minimis* compensation (US$1,000 or less during the preceding 12 months) is not subject to the disqualification provision for ineligible persons or the written agreement requirement. However, these communications remain subject to the rule's disclosure and general adviser oversight requirements.

- *Affiliated Personnel*. A testimonial or endorsement by an employee or other affiliate of an adviser is not subject to the disclosure requirements, or written agreement requirement, but remains subject to the disqualification and general adviser oversight requirements. The affiliation between the adviser and such person must be *readily apparent* to or disclosed to the client or investor at the time the testimonial or endorsement is disseminated, and the adviser must document such person's status.

- *Registered Broker-Dealers*. A testimonial or endorsement by a broker or dealer registered under Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act) is not required to comply with:
  - Any disclosure requirements if the testimonial or endorsement is a recommendation subject to Regulation Best Interest;
  - The "other disclosure" requirements if the testimonial or endorsement is provided to a person that is not a retail customer (as that term is defined in Regulation Best Interest); and
  - The disqualification provision, if the broker or dealer is not subject to statutory disqualification under the Exchange Act.

- *Covered Persons Under Rule 506(d) of Regulation D*. A testimonial or endorsement by a person that is covered by Rule 506(d) of the Securities Act of 1933 with respect to a Rule 506 securities offering and whose involvement would not disqualify the offering under that rule is also excluded from the disqualification provision. As a practical matter, this will mean that placement agents that are not broker- dealers, including banks and other intermediaries like registered investment advisers and family offices, do not have the burden of complying with two different standards of disqualification when recommending private funds offering interests pursuant to Rule 506 of Regulation D.

Testimonials and Endorsements FAQs

- Will current "solicitors" under the solicitation rule be considered "promoters" under the Marketing Rule?

- What does the term "clear and prominent" mean with respect to the required disclosures? Can investment advisers use hyperlinks to the prominent disclosures required by the Marketing Rule?

- What terms and conditions will be required in an investment adviser's agreement with a promoter? Will current solicitation agreements need to be amended?

- What level of diligence will be required to satisfy the requirement that an investment adviser have a reasonable basis for believing that a testimonial or endorsement complies with the requirements of the Marketing Rule?

- What level of diligence will be required in order for an investment adviser to determine that a person is not disqualified from acting as a solicitor or promoter?

- Will the Marketing Rule require an investment adviser to monitor the eligibility of compensated promoters with respect to website postings that remain available for a long period of time?

- Would a compensated testimonial or endorsement made by an adviser's employee in a one-on-one presentation be considered an "advertisement"?

IV. THIRD-PARTY RATINGS

The Marketing Rule prohibits including third-party ratings in an advertisement, unless the investment adviser complies with the rule's general prohibitions and certain other conditions. The Marketing Rule defines a third-party rating as a rating or ranking of an adviser provided by a person who is not a "related person"[21] and who provides such ratings or rankings in the ordinary course of business.

In addition to compliance with the Marketing Rule's general prohibitions and conditions, an investment adviser may not include a third-party rating in an advertisement unless the adviser:

- Has a reasonable basis for believing that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses and is not designed or prepared to produce any predetermined result (due diligence requirement); and

- Clearly and prominently discloses, or the investment adviser reasonably believes that the third-party rating clearly and prominently discloses:
  - The date on which the rating was given and the period of time upon which the rating was based;
  - The identity of the third party that created and tabulated the rating; and
  - If applicable, that compensation[22] has been provided directly or indirectly by the adviser in connection with obtaining or using the third-party rating

Third-Party Ratings FAQs

- How can an adviser form a reasonable basis to believe that the questionnaire or survey upon which a third-party rating is based is not designed to produce any predetermined result?

- Can a third-party rating accompanied by the three required disclosures described above still violate the Marketing Rule?

V. PERFORMANCE INFORMATION

The Marketing Rule sets specific conditions on the presentation of performance, reflecting the SEC's belief that there is a heightened risk that the presentation of performance results may mislead investors. In a notable shift from the proposed rule, the Marketing Rule does not set forth separate requirements for performance advertising in materials intended for retail persons and nonretail persons, with the consequence that certain performance- related requirements primarily intended to protect unsophisticated retail investors *must* be included in performance advertisements directed to sophisticated institutions.

In particular, the Marketing Rule prohibits including in *any* advertisement:

- Gross performance results (including hypothetical performance and extracted performance presented on a gross basis) *unless* the advertisement also presents net performance results (i) with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance results; and (ii) calculated over the same time period, and using the same type of return and methodology, as the gross performance results;

- Any performance results, *unless* they are provided for one-, five- and ten-year time periods or are the performance results of a private fund;

[21] For purposes of the Marketing Rule, "related person" is defined by reference to the Form ADV Glossary of Terms to be "[a]ny *advisory affiliate* and any person that is under common *control* with your firm."
[22] Consistent with other aspects of the Marketing Rule, compensation includes both cash and non-cash compensation.

- Any statement, express or implied, that the calculation or presentation of performance results has been approved or reviewed by the SEC;

- The presentation of "related performance," which is the performance of portfolios similar to the offered strategy or fund, unless the related performance includes *all portfolios* with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement or certain conditions are met;[23]

- Performance results of a subset of investments extracted from a portfolio (commonly known as a "carve-out" or "segmented" performance), unless the advertisement provides or offers to provide promptly the performance results of the total portfolio from which the performance was extracted; and

- Hypothetical performance,[24] *unless* the adviser:
  - Adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement;
  - Provides sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating such hypothetical performance; and
  - Provides (or, if the intended audience is a private fund investor, provides or offers to provide promptly) sufficient information to enable the intended audience to understand the risks and limitations of using hypothetical performance in making investment decisions.

Hypothetical Performance FAQs

- How can an investment adviser determine that hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience?

- Does the Marketing Rule classify performance generated by investment analysis tools as "hypothetical performance"?

- Is target performance really classified as "hypothetical performance" under the Marketing Rule?

Net Performance FAQs

- What are the general requirements for calculating net performance under the Marketing Rule?

- Can model fees be used to calculate net performance under the Marketing Rule?

Carve-Out or Extracted Performance FAQs

- Under the Marketing Rule, may an investment adviser present carve-out performance?

Related Performance FAQs

- Will the related performance requirement restrict a private fund adviser from presenting a single fund track record if the investment adviser manages other funds with a similar strategy?

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[23] The Marketing Rule generally allows related performance to exclude related portfolios as long as (i) the advertised performance results are not materially higher than if all related portfolios had been included, and (ii) the exclusion does not alter the presentation of any applicable prescribed time period.

[24] "Hypothetical performance" is defined in the final rule as "performance results that were not actually achieved by any portfolio of the investment adviser" and explicitly includes, but is not limited to, model performance, back- tested performance, and targeted or projected performance returns.

- What constitutes a "related portfolio" for purposes of determining whether related performance is relevant to the investment product being offered?

Prescribed Time Periods for Performance FAQs

- May an investment adviser include in advertisements performance results for periods other than the prescribed one-, five-, and ten-year periods?

VI. PORTABILITY OF PERFORMANCE

The current advertising rule does not address the portability of investment performance when investment professionals move from one investment adviser to another, and historically, this issue was addressed through guidance provided by the SEC staff in a series of no-action letters.[25] The SEC codified these positions for the first time in the Marketing Rule, adopting four explicit requirements for the presentation of predecessor investment performance in all advertisements.

Under the Marketing Rule, an advertisement may only present performance achieved at a prior firm if:

- The person or persons who were primarily responsible for achieving the prior performance results manage accounts at the advertising adviser;
- The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising investment adviser that the performance results would provide relevant information to clients or investors;
- All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of the required one-, five- and ten-year time periods, as applicable; and
- The advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

In addition to the above conditions, prior firm performance is also subject to the other provisions of the Marketing Rule, such as the general prohibition on presenting performance in a manner that is not fair and balanced.

With respect to recordkeeping, advisers presenting predecessor performance are now required to maintain all written communications related to the performance. The Marketing Rule also requires an adviser to have a reasonable basis for believing that it will be able to substantiate (upon demand from the SEC) all material statements of fact contained in an advertisement. In practice, therefore, an adviser seeking to present the performance of a prior firm must have all *original* records necessary to substantiate the performance presented. Although the SEC recognized in the Adopting Release that advisers often have difficulty complying with this requirement, it explicitly declined to provide additional flexibility.

[25] *See* Horizon Asset Management, LLC, SEC Staff No-Action Letter (Sept. 13, 1996) [hereinafter *Horizon*]; Great Lakes Advisers, Inc., SEC Staff No-Action Letter (Apr. 3, 1992); Fiduciary Management Associates, Inc., SEC Staff No-Action Letter (Feb. 2, 1984); South State Bank, SEC Staff No-Action Letter (May 8, 2018). The SEC has stated that it will withdraw several no-action letters previously issued by the SEC staff with respect to portability, but it is not presently certain that each of these letters will be withdrawn. However, the SEC will not withdraw letters that address an adviser's use of performance generated by predecessor accounts (*e.g.*, separate accounts or private funds) in registered investment company advertisements and filings.

Portability FAQs

- How would an investment adviser determine the person or persons "primarily responsible" for achieving prior performance results?
- Is it permissible to present the performance of a representative account from a prior firm?
- Can an investment adviser substantiate prior firm performance using publicly available information or audit or verification statements?
- Are testimonials, endorsements, third-party ratings, and specific investment advice portable?

VII. AMENDMENTS TO FORM ADV

Along with the Marketing Rule, the SEC adopted amendments that add a new subsection L entitled "Marketing Activities" to Item 5 of Part 1A of Form ADV. This subsection requires an adviser to answer "Yes/No" questions regarding certain of the marketing activities they engage in. In the Adopting Release, the SEC stated that this Form ADV amendment is intended to enhance the data available to support the SEC staff's enforcement and examination functions.

Specifically, new Item 5.L will require advisers to disclose whether their advertisements include performance results, specific investment advice, testimonials, endorsements, third-party ratings, and (in a change from the proposed rule) hypothetical performance and predecessor performance. In addition, advisers that include testimonials, endorsements, or third-party ratings in their advertisements must disclose whether they have paid any cash or non-cash compensation in connection with their use.

Amendments to Form ADV FAQs

- When will an investment adviser be required to update the information required by new Item 5.L?

VIII. RECORDKEEPING

The SEC also adopted amendments to Rule 204-2 under the Advisers Act (the recordkeeping rule) to reflect the new requirements under the Marketing Rule. Investment advisers must make and keep records of *all* "advertisements" they disseminate, subject to alternative methods of compliance for oral advertisements, including oral testimonials and oral endorsements. This requirement expands the current recordkeeping rule of requiring advisers to retain advertisements sent to ten or more persons to advertisements sent to *more than one* person. The SEC indicated that this recordkeeping enhancement is intended to support the SEC staff's enforcement and examination function.

In addition, the Marketing Rule requires advisers to retain the following key records:

- Written or recorded materials used or disclosures provided for oral advertisements;
- Written communications relating to the performance or rate of return of any portfolios;
- Accounts, books, internal working papers, and other documents necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any portfolios;
- For supporting records that display hypothetical performance, copies of all information provided or offered pursuant to the hypothetical performance provisions of the Marketing Rule;
- Documentation of communications relating to predecessor performance;

- Records of who the "intended audience" is pursuant to the hypothetical performance and model fee provisions of the Marketing Rule;[26]
- Any communication or document related to an adviser's determination that it has a reasonable basis for believing that a testimonial or endorsement complies with the Marketing Rule and a third-party rating complies with the Marketing Rule's due diligence requirement; and
- A copy of any questionnaire or survey used in the preparation of a third-party rating included in any advertisement.[27]

Recordkeeping FAQs

- Investment advisers frequently send advertisements via email. Are email archives an acceptable method of complying with the recordkeeping requirements?

IX. EXISTING SEC STAFF NO-ACTION LETTERS

The SEC staff will withdraw no-action letters and other guidance addressing the application of the advertising and solicitation rules to the extent such no-action letters and guidance are incorporated into the Marketing Rule or are no longer applicable. A list of such no-action letters and guidance, which will be withdrawn effective as of the compliance date, will be published on the SEC's website.

Accordingly, each investment adviser should use the 18-month transition period to review its marketing practices and determine whether it is relying on no-action relief that is superseded by the Marketing Rule and take steps to transition its advertising and solicitation practices into compliance with the Marketing Rule. Notably, the Adopting Release maintains that after the effective date of the Marketing Rule, advisers may continue to use as guidance any SEC staff positions in no-action letters that do not conflict with the Marketing Rule.

Existing No-Action Letter Guidance FAQs

- If an investment adviser is relying on current no-action relief, when should the adviser transition away from the no-action relief and comply with the Marketing Rule?
- Which no-action letters will be withdrawn?
- Will the SEC fully withdraw current no-action relief or guidance that addresses activities both within and outside the scope of the Marketing Rule? What about the use of related performance for registered funds?

X. TRANSITION PERIOD AND COMPLIANCE DATES

The effective date of the Marketing Rule is 60 days after publication in the *Federal Register*.[28] The Marketing Rule provides an 18-month transition period between the effective date and the compliance date, and advertisements disseminated on or after the compliance date would be subject to the final rule's requirements. The amendments to the recordkeeping rule are also subject to the 18-month transition period.

We expect that the SEC staff will allow for early adoption after the effective date and before the compliance date, but it will likely require that an investment adviser *complies fully* with the Marketing Rule. This approach

[26] The Adopting Release states that the SEC's examination staff may choose to review an adviser's policies and procedures against the records retained in connection with this new provision when determining whether an adviser has satisfied the hypothetical performance policies and procedures condition.
[27] The Marketing Rule does not require the adviser to obtain a copy of the questionnaire or survey; rather, an adviser must retain a copy only in the event that they receive one.
[28] As of the date of this alert, the Marketing Rule has not been published in the *Federal Register*.

would be consistent with other recent rulemaking[29] and would prevent an investment adviser from cherry-picking elements of the current advertising and solicitation rules and the Marketing Rule. Attaining full compliance with the Marketing Rule will be a significant undertaking for many investment advisers, particularly given the expanded scope of the Marketing Rule to cover solicitation practices, as well as advertising activities, and the need to revise existing policies and prepare new policies on several topics.

Transition Period and Compliance Dates FAQs

- What are the drawbacks of adopting the Marketing Rule before the compliance date?

[29] *See e.g.*, Good Faith Determinations of Fair Value, SEC Release No. IC-34128 (Dec. 3, 2020); Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC- 34084 (Nov. 2, 2020).

FREQUENTLY ASKED QUESTIONS ABOUT THE MARKETING RULE

Answers to the following frequently asked questions (FAQs) are derived from the discussion of the Marketing Rule published by the SEC in the Adopting Release. These answers are provided for informational purposes only, do not contain or convey legal advice, and do not represent guidance by the SEC or its staff. These FAQs are current only as of the publication date.

Definition of Advertisement

1. The final rule defines an "advertisement" as "any direct or indirect communication" made by an investment adviser. How would this apply to communications prepared by or disseminated by intermediaries (e.g., solicitors, placement agents)?

The Marketing Rule provides that an "indirect communication" may constitute an advertisement of an investment adviser, even if it is not actually disseminated or prepared by the investment adviser. Some examples of indirect communications cited in the Adopting Release are materials provided by the adviser to intermediaries (including consultants and funds of funds) when the adviser intends that these materials will be disseminated to third parties. An intermediary's communication will also constitute an advertisement where the investment adviser has participated in the creation of or authorized an intermediary's communication addressing the investment adviser's advisory services with regard to securities.

Although investment advisers are not required to oversee all intermediary activities, the investment adviser remains responsible under the Marketing Rule for ensuring that all advertisements attributed to the investment adviser comply with the rule, whether the investment adviser's role in creating or disseminating the materials was direct or implicit. However, an investment adviser's participation in the creation of material is not dispositive of the material's attribution to the investment adviser. For example, if an intermediary does not accept the investment adviser's comments on a communication, or the intermediary makes unauthorized modifications to a marketing piece, the investment adviser will not be responsible for any revisions to the marketing piece that were made independently of the investment adviser and without the investment adviser's approval.

[BACK]

2. When is an investment adviser to an underlying fund responsible for marketing materials disseminated by the sponsor of a fund-of-funds (or a feeder fund in a master-feeder structure)?

An investment adviser to an underlying fund will be responsible for marketing materials that it provides to a sponsor of a fund-of-funds (or feeder fund in a master-feeder structure) if the adviser authorizes the sponsor to disseminate the materials on to third parties. By contrast, the investment adviser would not be responsible for materials that were provided to a sponsor of a fund-of-funds if the materials were provided solely to facilitate the sponsor's due diligence of the adviser and the funds it manages, and the sponsor disseminated those materials to third parties without the adviser's consent. If the sponsor made unauthorized changes to the materials prior to dissemination, the portions of the communication changed by the sponsor would not represent an "advertisement" of the adviser, even if the adviser anticipated that the sponsor would redistribute the materials.

[BACK]

3. How can an investment adviser avoid communications posted on the personal social media accounts of an investment adviser's associated persons being attributed to the investment adviser for purposes of the Marketing Rule?

In the Adopting Release, the SEC indicated that investment advisers should consider adopting and implementing policies and procedures reasonably designed to prevent the marketing of the investment adviser's advisory services with regard to securities on an associated person's social media accounts. If an investment adviser does not prohibit such communications outright, the SEC indicated in the Adopting

Release that it may instead consider policies and procedures that involve periodic training, obtaining attestations, and periodically reviewing content that is publicly available on all associated persons' social media accounts, among other controls.

[BACK]

4. When will third-party website content be attributed to an investment adviser?

Whether content posted by third parties on an adviser's website or social media pages would be attributed to the adviser depends on the facts and circumstances of the adviser's involvement in the posts. Advisers should continue to ensure their policies and procedures regarding the display and modification of content posted to their websites and social media pages are not designed to favor or disfavor the adviser.

[BACK]

5. Under the Marketing Rule, what constitutes a "one-on-one presentation"? May investment advisers create template inserts that are included in customized presentations for a particular client or private fund investor meeting, or include hypothetical performance information in one-on-one presentation materials?

Unlike the proposed rule, which would have expanded the definition of "advertisement" to include communications addressed to one person, the Marketing Rule retains the advertising rule's exclusion of one-on-one communications from the definition. The SEC also clarified that this exclusion applies to communications with multiple natural persons representing a single entity or account. For example, if an investment adviser's prospective client or private fund investor is an entity, the one-on-one exclusion permits the investment adviser to provide communications to multiple natural persons employed by or owning the entity.

The SEC also identified certain types of communications that will not meet the requirements of the one-on-one exclusion. For example, bulk emails or algorithm-based messages that are nominally directed at or "addressed to" only one person but are in fact widely disseminated to numerous investors do not meet the one-on-one requirements and are considered advertisements under the Marketing Rule. Similarly, customizing a template presentation or mass mailing by filling in the name of an investor and/or including other basic information about the investor would not constitute a one-on-one communication. Notably, a bona fide one-on-one communication that includes hypothetical information will be also be subject to the Marketing Rule unless the hypothetical information is included specifically in response to an unsolicited investor request or provided to a private fund investor.

[BACK]

6. Are brand content and whitepapers considered advertisements under the final rule?

Brand content designed to raise the profile of an adviser generally, but not offering any investment advisory services, typically would not be considered an "advertisement" under the Marketing Rule. This includes, for example, displays in connection with sponsorship of sporting events; whether brand content is an advertisement in any specific situation will necessarily be a facts and circumstances analysis. The Adopting Release extends the same analysis to general educational materials and market commentary produced by an adviser. Whitepapers and other types of general commentary on investment strategies, asset classes, and market or regulatory developments that do not include references to the services of the adviser generally would not be an advertisement. However, if the discussion includes aspects of the advisory services provided by the adviser, this portion of the material would be subject to the Marketing Rule.

[BACK]

7. Would a communication to an existing client or existing private fund investor be considered an "advertisement"? What if the investment adviser subsequently forwarded that communication to a prospective client or prospective private fund investor?

The Marketing Rule provides that a communication to an existing client or private fund investor is an advertisement only when it offers new or additional investment advisory services to the existing client or private fund investor. Accordingly, communications disseminated to existing clients or private fund investors that merely discuss the results of the advisory services previously contracted for would not constitute an "advertisement." However, the same communication sent to a prospective investor would likely constitute an advertisement if provided in connection with offering advisory services to that investor.

[BACK]

8. Under the Marketing Rule, would websites maintained by lead-generation firms or adviser referral networks constitute a compensated testimonial or endorsement for purposes of the second prong of the "advertisement" definition?

The second prong of the Marketing Rule's advertisement definition includes "compensated testimonials and endorsements," which are similar in scope to traditional solicitations under the current solicitation rule. In the Adopting Release, the SEC clarified that lead-generation firms or investment adviser referral networks (operators) that solicit investors for, refer investors to, match, or otherwise make an investment adviser's advisory services accessible to clients in exchange for compensation from the investment adviser would all be considered compensated promoters. This includes model portfolio provider services. Although these operators may not actively promote or recommend particular services or products accessible on the platform, and because operators typically offer to "match" an investor with one or more investment advisers compensating it to participate in the service, operators typically engage in solicitation or referral activities.

By contrast, where an investor hires a consultant to assist with a request for proposal or manager search subject to the understanding that the investor will only entertain investment advisers that agree to pay the expenses of the consultant for managing the search, the SEC provided in the Adopting Release that the consultant would not be considered a compensated promoter if the compensation paid by the adviser is not tied to any endorsement by the consultant.

[BACK]

General Prohibitions

9. Under the Marketing Rule, an investment adviser may only make a material statement of fact in an advertisement if the adviser has a reasonable basis for believing it can substantiate such statement upon demand by the SEC. How may investment advisers prove the required "reasonable basis" standard with respect to material statements of fact?

If an investment adviser is unable to substantiate a material statement of fact made in an advertisement upon SEC demand, the SEC will presume the investment adviser did not have a reasonable basis for its belief. To overcome this presumption, an investment adviser may make a record contemporaneous with the advertisement to demonstrate the basis for its belief that it can substantiate such claim. Advisers may also consider implementing policies and procedures to address how this requirement will be met. Even if an adviser is ultimately unable to substantiate a statement upon demand due to changed circumstances or error, these records and policies may show that the adviser had a reasonable basis to believe it could do so when the statement was made.

[BACK]

10. Will case studies be permitted under the Marketing Rule?

Yes, subject to certain conditions. The Marketing Rule requires any specific investment advice provided by the investment adviser and included in an advertisement to be presented in a manner that is fair and balanced. It likely would not be fair and balanced for an investment adviser to highlight case studies

reflecting its most profitable investments (when there are also similar unprofitable investments). To meet the fair and balanced standard, an adviser may, depending on the circumstances, also highlight unprofitable case studies and/or present the entire performance of the relevant investment strategy or private fund for at least the relevant period covered by the list of investments. There are many different ways to present case studies in a fair and balanced manner, including, but not limited to, the situations contemplated in prior no-action relief.

[BACK]

11. How may an investment adviser ensure performance time periods are presented in a manner that is fair and balanced?

In the Adopting Release, the SEC notes that presenting performance results over a very short period of time (*e.g.*, two months), or over inconsistent periods of time, may result in the presentation of performance that is not reflective of the investment adviser's general results. Such performance would not be considered fair and balanced, and it would be prohibited. The SEC also stated that an advertisement highlighting one period of extraordinary performance with only a footnote of disclosure describing any unusual circumstances that have contributed to such performance may not meet the fair and balanced requirements. In order to provide a fair and balanced portrayal of its performance results, an investment adviser should consider (in addition to presenting performance for the periods prescribed by the rule) providing information related to the state of the market at the time the performance was generated, any unusual circumstances, and other material factors that contributed to such performance. Advisers seeking to highlight certain periods of performance (*e.g.*, to demonstrate the performance of a strategy under certain historical conditions) should ensure that the reader also receives in the advertisement a complete picture of the adviser's performance over time.

[BACK]

12. How may an investment adviser layer disclosure consistent with the Marketing Rule?

Consistent with the proposed modernization of registered fund prospectus and shareholder reporting disclosures, the Adopting Release suggests that the adoption of a “fair and balanced” standard for including disclosures in advertisements will help facilitate layered disclosure. Hyperlinks, QR codes, mouse-over popup windows, or other similar practices are permitted to provide additional content so long as such practices do not render the communication misleading or obscure important information. Further, for content that must be presented in a “fair and balanced” manner, each layer of disclosure must meet the fair and balanced standard. For example, an adviser likely could not meet this standard by disclosing only periods of positive performance on its webpage and including a hyperlink to another page that includes its entire performance history as well as material risks and material limitations (this practice may violate other requirements of the Marketing Rule as well.) Additionally, certain specific disclosures must be presented clearly and prominently; these disclosures generally could not be detached from the material to which they relate. See **FAQ 15** below.

[BACK]

13. How may an adviser present or reference testimonials consistent with the general prohibition against including in an advertisement information that would reasonably be likely to cause an untrue or misleading implication or inference concerning a material fact relating to the investment adviser?

This general prohibition requires the adviser to consider the context and totality of the information presented. The Adopting Release maintains that an investment adviser would not be required to present an equal number of negative testimonials alongside positive testimonials in an advertisement or otherwise balance endorsements with negative statements. An adviser could instead include a disclaimer that the testimonial provided was not representative of all testimonials and provide a link or other direction as to where to find a representative sample of testimonials about the adviser. See **FAQ 12** above regarding layering disclosure. However, general disclaimer language, such as “these results may not be typical of all investors,” typically would not be sufficient to overcome the general prohibition.

[BACK]

Testimonials and Endorsements

14. Will current "solicitors" under the solicitation rule be considered "promoters" under the Marketing Rule?

The requirements of the Marketing Rule reach the activities of current "solicitors" under the solicitation rule, as well as a new, broad group of other "promoters." Notably, the SEC also expanded the application of the Marketing Rule to cover the solicitation of private fund investors (rather than just advisory clients).[30] As a result, placement agents, consultants, capital introduction groups, and other parties involved in marketing a private fund during fundraising will be considered promoters in most cases. Investment advisers will need to examine their relationships with these parties to determine whether compensation is paid directly or indirectly (*e.g.*, through gifts, entertainment, awards, or directed brokerage) for their services, whether amendments to existing agreements are necessary, and how to exercise sufficient oversight over these promoters.

[BACK]

15. What does the term "clear and prominent" mean with respect to the required disclosures? Can investment advisers use hyperlinks to the prominent disclosures required by the Marketing Rule?

In the Adopting Release, the SEC clarified that an adviser must include disclosures *within the testimonial or endorsement* to meet the "clear and prominent" standard. In the case of an oral testimonial or endorsement, these disclosures must be provided contemporaneously. The Adopting Release explains that these disclosures should be read at the same time as the associated statement and that hyperlinking "clear and prominent" disclosures is prohibited. See **FAQ 12** above for further information regarding layering disclosure.

[BACK]

16. What terms and conditions will be required in an investment adviser's agreement with a promoter? Will current solicitation agreements need to be amended?

The Marketing Rule requires the written agreement between an adviser and a promoter to (i) describe the scope of the agreed-upon activities and (ii) set forth the terms of compensation for those activities, including non-cash compensation that could be construed as indirect compensation under the Marketing Rule. In addition, agreements should be drafted to facilitate the adviser's forming a reasonable basis for believing that any endorsement by the promoter complies with the requirements of the Marketing Rule. To that end, advisers should consider specifying the respective roles and responsibilities of the adviser and the promoter regarding creation, review, and delivery of required disclosures to prospective investors and documenting any circumstances that may allow endorsements by the solicitor to qualify for the exemptions set forth in the Marketing Rule. Consistent with the adviser's oversight obligation under the Marketing Rule, advisers should also consider representations, warranties, and covenants requiring the promoter to periodically provide, or provide upon request, sample endorsements and related disclosures for the adviser's review and requiring notification of a change in eligibility status or other material terms of the promoter's compliance with the agreement.

[BACK]

17. What level of diligence will be required to satisfy the requirement that an investment adviser have a reasonable basis for believing that a testimonial or endorsement complies with the requirements of the Marketing Rule?

In the Adopting Release, the SEC stated that in the context of solicitation or referral activity, a "reasonable basis" could involve periodically making inquiries of a sample of investors solicited or referred

[30] The Adopting Release makes no reference to the SEC staff's 2008 Mayer Brown no-action letter, which expressly provides that the solicitation rule does not apply to an adviser's engagement of placements agents or other persons that solicit investors in funds managed by the adviser. See Mayer Brown LLP, SEC Staff No-Action Letter (July 15, 2008). Presumptively, this letter will be withdrawn in connection with the Marketing Rule's implementation.

by the promoter in order to assess whether that promoter's statements comply with the rule. In addition, an adviser could implement policies and procedures to form a reasonable basis for believing the testimonial or endorsement complies with the rule; for endorsements by "influencers" or other public statements, this could involve a direct sampling of a promoter's statements. An adviser could also include representations, warranties, and other terms in its written agreement with the solicitor or promoter to help form such a reasonable belief. Such agreements could provide mechanisms, for example, to enable advisers to pre-review testimonials or endorsements or otherwise impose limitations on the content of those statements.

[BACK]

18. What level of diligence will be required in order for an investment adviser to determine that a person is not disqualified from acting as a solicitor or promoter?

The Marketing Rule does not require an adviser to monitor the eligibility of promoters on a continuous basis to satisfy the "reasonable care" standard set forth in the rule. The SEC stated in the Adopting Release that the frequency with which an adviser must monitor eligibility and the steps an adviser must take in making this assessment will vary depending on the facts and circumstances. The SEC noted in the Adopting Release that advisers could likely take a similar approach to monitoring promoters as that used to monitor their own supervised persons, though advisers may assess the eligibility of their supervised persons more frequently in light of their obligations to report promptly certain disciplinary events on Form ADV.

[BACK]

19. Will the Marketing Rule require an investment adviser to monitor the eligibility of compensated promoters with respect to website postings that remain available for a long period of time?

The SEC stated that in some cases where an endorsement or testimonial is posted on a public website and disseminated over a long period, it may not be practical for an adviser to update its inquiry continuously. In these cases, the SEC would expect an adviser to update its inquiry into the compensated promoter's eligibility *at least annually* while the endorsement or testimonial is available to clients and investors in order to demonstrate that it did not know, or have reason to know, that the promoter had become ineligible at the time of dissemination.

[BACK]

20. Would a compensated testimonial or endorsement made by an adviser's employee in a one-on-one presentation be considered an "advertisement"?

Potentially, yes, depending on the type of compensation. Although the first prong of the definition of "advertisement" under the Marketing Rule excludes one-on-one presentations (unless hypothetical performance is included), the second prong includes "*compensated* testimonials and endorsements," including oral or written communications in one-on-one solicitations. However, for these purposes compensation will *not* include regular salary or bonuses paid to an adviser's personnel for their investment advisory activities or for clerical, administrative, support, or similar functions.

Even if an adviser's employee receives transaction-based compensation, however, the final rule *partially* exempts compensated testimonials and endorsements made by an adviser's employees. For this exemption to apply, the affiliation between the adviser and employee must be *readily apparent to or disclosed* to the client or investor at the time the testimonial or endorsement is disseminated, and the adviser must document such person's status at the time the testimonial or endorsement is disseminated. These testimonials and endorsements will be exempt from the final rule's disclosure requirements, but they must still comply with the adviser oversight and disqualification provisions. However, the final rule will not subject an adviser's employees to the written agreement requirement under the adviser oversight and compliance provision.

[BACK]

Third-Party Ratings

21. How can an adviser form a reasonable basis to believe that the questionnaire or survey upon which a third-party rating is based is not designed to produce any predetermined result?

In the Adopting Release, the SEC stated that an adviser could satisfy this due diligence requirement by accessing the questionnaire or survey that was used in the preparation of the rating. However, noting that third-party rating agencies may be reluctant to share proprietary survey or questionnaire information to advisers (such as their calculation methodology), the SEC clarified that obtaining the questionnaire or survey used in the preparation of the rating is not the only means to satisfy this requirement. In the alternative, an adviser could seek representations from the third-party rating agency regarding general aspects of how the survey or questionnaire is designed, structured, and administered, or it could review similar information publicly disclosed on the rating agency's website.

[BACK]

22. Can a third-party rating accompanied by the three required disclosures described above still violate the Marketing Rule?

Yes. While the Marketing Rule explicitly requires that specific disclosures accompany a third-party rating, these disclosures alone would not cure a rating that is otherwise false or misleading under the Marketing Rule's general prohibitions or under the general anti-fraud provisions of the Advisers Act. For example, where an adviser's advertisement references a recent rating and discloses the date, but the rating is based upon an aspect of the adviser's business that has since materially changed, the advertisement would likely be misleading. Likewise, an advertisement would be misleading if it indicates that the adviser is rated highly without disclosing that the rating is based solely on a criterion, such as assets under management, which may not relate to the quality of the adviser's services.

[BACK]

Hypothetical Performance

23. How can an investment adviser determine that hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience?

The Adopting Release clarifies that the Marketing Rule does not require an investment adviser to inquire into the specific financial situation and investment objectives of the intended audience in all cases. Instead, the investment adviser's past experiences with particular types of investors should lead the investment adviser to design reasonable policies and procedures that distinguish among investor types. These criteria may include, for example, whether an investor is an existing client of the investment adviser, the net worth or investing experience of the investor (if such information is available to the investment adviser), certain regulatory categories (*e.g.*, qualified purchasers, qualified clients, or even qualified institutional buyers), or whether the investor type includes only natural persons or only sophisticated institutions. An investment adviser may also reference requests the investment adviser has previously received from an investor or class of investors to determine that certain hypothetical performance presentations are relevant to the likely financial situation and investment objectives of such investors.

Private fund managers may feel this condition poses a compliance challenge because they frequently do not have insight into the characteristics of potential investors prior to the time that offering documents are disseminated. The Adopting Release notes that a private fund manager in this situation could develop policies and procedures that take into account its experience managing prior funds and whether investors in the prior fund valued a particular type of hypothetical performance.

[BACK]

24. Does the Marketing Rule classify performance generated by investment analysis tools as "hypothetical performance"?

No. Under the Marketing Rule, investment analysis tools[31] are excluded from the definition of hypothetical performance, and they may be presented in advertisements without meeting the conditions applicable to hypothetical performance. An advertisement including an interactive analysis tool must include disclosures that: (i) provide a description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions; (ii) explain that the results may vary with each use and over time; (iii) if applicable, describe the universe of investments considered in the analysis, explain how the tool determines which investments to select, disclose if the tool favors certain investments and, if so, explain the reason for the selectivity, and state that other investments not considered may have characteristics similar or superior to those being analyzed; and (iv) state that the tool generates outcomes that are hypothetical in nature.

[BACK]

25. Is target performance really classified as "hypothetical performance" under the Marketing Rule?

Yes. Although the SEC noted in the Adopting Release that the disclosure burden associated with presenting target performance would likely be lighter than for other types of hypothetical performance, target performance is subject to the same requirements as model performance, back-tested performance, and other types of hypothetical performance, even when presented in a one-on-one communication to a sophisticated institutional investor. This includes the requirement to adopt and implement policies and procedures reasonably designed to ensure that the target performance is relevant to the likely financial situation and investment objectives of the intended audience.

[BACK]

Net Performance

26. What are the general requirements for calculating net performance under the Marketing Rule?

"Net performance" is defined to include the performance results of a portfolio (or portions of a portfolio that are included in extracted performance, if applicable) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio. The Marketing Rule includes a non-exhaustive list of the types of fees and expenses to be considered. Notably, the Adopting Release clarifies that "advisory fees" include performance-based fees and carried interest that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio.

The SEC also clarified in the Adopting Release that administrative fees and expenses an investment adviser agrees to bear as a result of negotiations with investors in a private fund do not need to be included in the calculation of net performance (at least when marketing advisory services). In addition, capital gains taxes paid outside of the portfolio are not fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services, and they are therefore not required to be deducted in the calculation of net performance.

Consistent with market practice, custodian fees paid to a bank or third-party organization for safekeeping funds and securities may be excluded from the calculation of net performance. Since advisory clients commonly select and directly pay custodians, investment advisers frequently do not have knowledge of the amount of such custodian fees and, accordingly, cannot deduct those fees for purposes of establishing net performance. To the extent a client or investor pays the investment adviser, rather than a

[31] The Marketing Rule imports the definition of "investment analysis tool" from FINRA Rule 2214. "Investment analysis tool" means an interactive technological tool that produces simulations and statistical analysis that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of potential risks and returns of investment choices. The Marketing Rule requires that a current or prospective investor use the tool (i.e., input the information into the tool or provide information to the investment adviser to input into the tool).

third party, for custodial services (*e.g.*, the investment adviser provides custodial services with respect to the funds or securities for which the performance is presented and charges a separate fee for those services), the investment adviser must deduct the custodial fee in calculating net performance.

[BACK]

27. Can model fees be used to calculate net performance under the Marketing Rule?

Net performance may reflect the deduction of a model fee in two circumstances. First, model fees may be used when the resulting net performance figures are not higher than they would have been if the actual fee(s) had been deducted. For example, an investment adviser to a private fund with multiple series or classes where each series or class has different fees may display the net performance of the highest fee class. Second, a model fee equal to the highest fee charged to the advertisement's intended audience may be deducted from the net performance. For example, an investment adviser that manages accounts for different types of investors, each using the same investment strategy, may present in an advertisement the net performance calculated using a model fee equal to the highest fee charged to a certain type of investor when presenting performance to that type of investor. Likewise, a private equity fund manager could calculate net performance of a model track record based on the fees and expenses of the fund being offered, even if the track record contains transactions from funds that charged higher fees and expenses.

[BACK]

Carve-Out or Extracted Performance

28. Under the Marketing Rule, may an investment adviser present carve-out performance?

The Marketing Rule allows presentation of a subset of investments (i.e., a carve-out) extracted from a single portfolio, which is referred to as “extracted performance,” only if the advertisement provides or offers to provide promptly the performance results of the total portfolio from which the performance was extracted. Accordingly, a performance carve-out from a single portfolio is fairly straightforward under the Marketing Rule.

The Marketing Rule does not prohibit an adviser from presenting a composite of carve-outs from multiple portfolios in an advertisement, including carve-out performance that complies with the Global Investment Performance Standards® (GIPS standards). However, such a composite would be considered hypothetical performance under the Marketing Rule and subject to the additional requirements that apply to advertisements containing hypothetical information. Consequently, firms may find it difficult to present the performance of composites that contain carve-outs on their websites.

[BACK]

Related Performance

29. Will the related performance requirement restrict a private fund adviser from presenting a single fund track record if the investment adviser manages other funds with a similar strategy?

No. Under the Marketing Rule, an investment adviser offering a particular fund may show the track record of only that fund. However, if the investment adviser wishes to show the prior performance of funds with a similar investment strategy, it would need to comply with the related performance requirements of the Marketing Rule. The Marketing Rule generally requires that any “related performance” include all related portfolios, subject to an important exception noted below.

[BACK]

30. What constitutes a “related portfolio” for purposes of determining whether related performance is relevant to the investment product being offered?

A “related portfolio” is defined as a portfolio managed by the investment adviser with substantially similar investment policies, objectives, and strategies as those of the services being offered in the advertisement. The SEC confirmed in the Adopting Release that the same criteria used by investment advisers to

construct any composites for purposes of the GIPS standards could be used to satisfy the "substantially similar" requirement of the Marketing Rule. However, an investment adviser may only have one composite aggregation for each stated set of criteria. Additionally, investment advisers may exclude one or more related portfolios from the presentation of related performance if the advertised performance results are not materially higher than they would be if all related portfolios were included and if the exclusion does not alter the prescribed time periods for the performance returns.

[BACK]

Prescribed Time Periods for Performance

31. May an investment adviser include in advertisements performance results for periods other than the prescribed one-, five-, and ten-year periods?

Yes. An investment adviser is free to include performance results for other periods as long as the advertisement also presents the results for the prescribed time periods. All such additional performance results must otherwise comply with the Marketing Rule's requirements. For example, an investment adviser may present annual returns for a ten-year period, which is a requirement for investment advisers that claim compliance with the GIPS standards, as long as the investment adviser also presents performance results in compliance with the time periods prescribed by the Marketing Rule.

[BACK]

Portability

32. How would an investment adviser determine the person or persons "primarily responsible" for achieving prior performance results?

The "primarily responsible" requirement is substantially identical to the existing guidance from the SEC staff in the *Horizon* no action letter, and it generally turns on the role that the individual or individuals played in producing the performance (i.e., the extent of the person's investment decision-making authority). Where more than one person is responsible for the performance, a "substantial identity of the group" responsible for achieving the prior performance must continue to manage the applicable accounts.

[BACK]

33. Is it permissible to present the performance of a representative account from a prior firm?

Yes, if the following conditions are met: (1) the performance of the representative account is not materially higher than the performance of all accounts managed in a substantially similar manner at the prior firm; (2) the presentation of the representative account would not impact the adviser's ability to show performance (combined prior firm and new firm) for one-, five-, and ten-year periods, as applicable; and (3) adequate records are maintained to support both of the preceding determinations. If the first condition is not met, representative account performance may still be shown so long as the performance of any related portfolios is included in the advertisement either separately or in a composite, consistent with the related performance requirements in the Marketing Rule.

Consistent with the above, for example, it would not be permissible to present the performance of a representative account from a prior firm with eight years of performance if the aggregate performance of the strategy at the prior firm has a ten-year track record (because the adviser would be omitting the ten-year return).

[BACK]

34. Can an investment adviser substantiate prior firm performance using publicly available information or audit or verification statements?

No. Predecessor performance can be substantiated only by maintaining the original books and records underlying the performance. The SEC has stated explicitly that using audit or verification statements, or

recreating performance based on a sampling of client statements and/or display performance, would not be deemed sufficient to substantiate prior firm performance and, in the SEC's view, would present significant cherry-picking concerns.

[BACK]

35. Are testimonials, endorsements, third-party ratings, and specific investment advice portable?

The SEC did not specifically address the portability of testimonials, endorsements, third-party ratings, or specific investment advice in the final rule, but the Adopting Release states the portability of this information depends on the application of the general prohibitions, which would prohibit an adviser from using outdated testimonials, endorsements, and third-party ratings in most cases.

[BACK]

Amendments to Form ADV

36. When will an investment adviser be required to update the information required by new Item 5.L?

Annually. Because subsection 5.L is included under Item 5 of Form ADV, advisers will be required to update responses to these questions in their annual updating amendment only. Additionally, advisers will not be responsible for filing a Form ADV that includes responses to new Item 5.L until the next annual updating amendment filed after the compliance date of the Marketing Rule (or after the adviser adopts compliance with the rule, for early adopters). Consequently, most advisers with December 31 fiscal year-ends will not complete the new Item 5.L until their annual update filed in March 2023.

[BACK]

Recordkeeping

37. Investment advisers frequently send advertisements via email. Are email archives an acceptable method of complying with the recordkeeping requirements?

Yes. The Adopting Release expressly states that it would be permissible for an adviser to store records using email archives (including in cloud storage or with a third-party vendor), provided that the adviser can promptly produce records in accordance with the recordkeeping rule and SEC guidance.

[BACK]

Existing No-Action Letter Guidance

38. If an investment adviser is relying on current no-action relief, when should the adviser transition away from the no-action relief and comply with the Marketing Rule?

An investment adviser may comply with the Marketing Rule as soon after the effective date as it is ready to comply with all provisions of the rule, and it must comply with the Marketing Rule no later than the compliance date. During the 18-month transition period between the effective date and the compliance date, each investment adviser should review its advertising practices, including its reliance on no-action relief superseded by the Marketing Rule. Notably, the Adopting Release maintains that current no-action letters that do not conflict with the general prohibitions may provide investment advisers with useful guidance on compliance with the Marketing Rule.[32]

[BACK]

[32] *See, e.g.*, Adopting Release at 81. The SEC staff also notes that advisers may consider FINRA interpretations relating to the meaning of "fair and balanced," but FINRA Rule 2210 and its body of decisions is not controlling or authoritative on the Marketing Rule. Adopting Release at 79.

39. Which no-action letters will be withdrawn?

As discussed above, the SEC is expected to publish a list of no-action letters that will be withdrawn prior to the compliance date. That said, based on language in the Adopting Release, the SEC is likely to withdraw, either in whole or in part, certain no-action relief addressing misleading advertisements, past specific recommendations, and performance portability, as most no-action letters addressing these topics are superseded by the general prohibitions in the Marketing Rule. Additionally, certain no-action letters related to model and hypothetical performance conflict with the Marketing Rule's general prohibitions and specific requirements regarding the presentation of performance and will likely be withdrawn in whole or in part. Finally, the SEC will likely withdraw no-action letters superseded by the definition of "advertisement" in the Marketing Rule. Because the solicitation rule is being rescinded, all no-action letters that address that rule will also be withdrawn.

[BACK]

40. Will the SEC fully withdraw current no-action relief or guidance that addresses activities both within and outside the scope of the Marketing Rule? What about the use of related performance for registered funds?

The SEC may fully or partially withdraw no-action letters or guidance depending on the applicability of the topics addressed within such no-action relief or guidance. For example, the Marketing Rule addresses the portability of adviser performance, and accordingly, the SEC staff is expected to withdraw no-action letters issued on this topic.[33] However, related no-action letters that address additional or different activities other than the activity covered by the Marketing Rule on predecessor performance will not be withdrawn, including those that address the presentation of performance generated by an adviser's predecessor accounts (*e.g.*, separate accounts or private funds) in registered investment company advertisements and filings and the adoption by registered investment companies of the performance track records of predecessor investment pools.

[BACK]

Transition Period and Compliance Dates

41. What are the drawbacks of adopting the Marketing Rule before the compliance date?

In considering whether to comply with the Marketing Rule before the compliance date, advisers should weigh both the benefits and pitfalls of complying with the rule. While the Marketing Rule presents many favorable provisions for investment advisers, such as the opportunity to present specific investment advice, third-party ratings, and layered disclosure, it also introduces many complexities and new burdens. Many provisions of the Marketing Rule will require advisers to enact new policies and procedures; the aggregate burden of preparing and implementing these policies and procedures will be substantial. Additionally, the Marketing Rule will require education and training for advisory personnel, and it may also require additional staffing and/or adjustments to reporting lines. Finally, the SEC may provide additional guidance on the Marketing Rule during the transition period that would need to be taken into account.

[BACK]

[33] *See* Adopting Release at 236.

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Implementing the New Marketing Rule

Frequently Asked Questions

March 2021

These Frequently Asked Questions are provided as a service to IAA members. They are neither intended as legal advice, nor as a substitute for professional legal counsel. These FAQs are current only as of the date of publication.

On December 22, 2020, the SEC announced it had finalized reforms to modernize rules that govern investment adviser advertisements and compensation to solicitors under the Investment Advisers Act of 1940.

The amendments create a single rule that draws from and replaces the current advertising and cash solicitation rules, Rule 206(4)-1 and Rule 206(4)-3, respectively. The new Marketing Rule is designed to comprehensively regulate advisers' marketing communications. The SEC also made related amendments to Form ADV and Rule 204-2, the books and records rule.

What is the compliance date? Is there a transition period?

Yes, advisers will have an 18-month transition period after the effective date to comply with the new Marketing Rule. The effective date will be 60 days after publication in the *Federal Register*, which has not yet occurred as of March 1, 2021. The amendments to the recordkeeping rule are also subject to the 18-month transition period. The Biden Administration has directed government agencies to delay the effective date of new or pending rules pending further review and has ordered

that rules not yet published in the *Federal Register* be delayed. Although it is an independent agency, the SEC could decide to follow this directive. However, as a practical matter, we expect the rule will eventually be finalized despite a delay in the rule's effective date.

Advisers filing Form ADV after the transition period will be required to complete the amended form, which includes amended Item 5 questions, in the next annual updating amendment that is filed after the transition period.

Are early and partial compliance permitted?

Yes, advisers may begin complying with the new rule anytime after the effective date, but may not begin to comply until the effective date. Advisers must fully comply after the compliance date. Under current SEC staff guidance provided informally to the IAA, partial compliance will not be permitted. In other words, advisers will have the option to comply with the entire rule at any time during the transition period, but will not be permitted to "pick and choose" provisions of the new rule. Similarly, the new recordkeeping requirements begin once an adviser starts complying with the new rule.

Advisers that elect early compliance will not be expected to file an "off cycle" Form ADV update (*i.e.,* they will not need to update responses to Item 5 either by filing an other-than-annual amendment or by including updated responses if submitting an other-than-annual amendment).

What is the definition of "advertisement" under the new Marketing Rule?

The amended definition of "advertisement" contains two prongs: one that captures communications traditionally covered by the advertising

rule and another that governs solicitation activities previously covered by the cash solicitation rule.

The **first prong** of the definition includes any ***direct*** or ***indirect*** communication to ***more than one person***, or to ***one or more persons if*** the communication includes ***hypothetical performance***, that:

(i) offers the investment adviser's investment ***advisory services*** with ***regard to securities*** to prospective clients or ***private fund investors;*** or

(ii) offers ***new*** investment advisory services with regard to securities to ***current*** clients or private fund investors.

Under this prong of the definition, an "advertisement" does ***not*** include:

- ✓ Extemporaneous, live, oral communications (not based on prepared remarks)
- ✓ Information in a required notice or filing
- ✓ Communication that includes hypothetical performance that is provided:

a) In response to an ***unsolicited request*** for such information; or

b) To a prospective or current ***investor in a private fund*** advised by the investment adviser in a ***one-on-one*** communication

The **second prong** of the definition generally includes any endorsement or testimonial for which an adviser provides cash and non-cash compensation directly or indirectly (*e.g.,* directed brokerage, awards or other prizes, and reduced advisory fees).

Does the new Marketing Rule permit references to past specific recommendations?

Yes, the new Marketing Rule replaces the current rule's *per se* prohibition against past specific recommendations with a principles-based prohibition on presentations of specific investment advice that are not presented in a manner that is "fair and balanced." For example, under the new rule, an adviser will be permitted to share a "thought piece" to describe the specific investment advice it provided in response to a major market event provided that the advertisement includes disclosures with "appropriate contextual information for investors to evaluate those recommendations (*e.g.,* the circumstances of the market event, such as its nature and timing, and any relevant investment constraints, such as liquidity constraints, during that time)."

Are testimonials and endorsements permitted under the new Marketing Rule?

Yes, the new Marketing Rule permits testimonials and endorsements, which include traditional referral and solicitation activity, provided the adviser satisfies certain disclosure, oversight, and disqualification provisions.

- ✓ **Testimonial** – Any statement of a ***client's or investor's*** experience with the investment adviser or its supervised persons
- ✓ **Endorsement** – Any statement made by a ***non-client or non-investor*** that describes the endorser's experience with the adviser or its supervised persons

What about existing SEC staff guidance and no-action letters?

The SEC staff plans to withdraw no-action letters and other guidance addressing the application of the advertising and cash solicitation rules to the extent those positions are either incorporated into the final rule or the staff determines they will no longer apply. A list of the withdrawn letters will be available on the SEC's website.

Will the SEC publish additional guidance or FAQs?

Yes, it is very likely the SEC staff will provide additional guidance or FAQs over time. The SEC has stated that "[w]hile the rule reflects current best practices in marketing, it may result in practice changes for advisers, including private fund advisers. In order to assist advisers with planning for compliance with this new rule, we encourage advisers to actively engage with Commission staff as questions arise in planning for implementation. You may send your questions by email to IM-Rules@sec.gov."

The **IAA Marketing Implementation Group** also provides a forum for members to share interpretive and operational concerns and questions through regular conference calls. The group will also help the IAA develop requests for guidance or clarification from SEC staff.

IAA INVESTMENT ADVISER ASSOCIATION

Your Voice. Your Resource. Your Community.

The Investment Adviser Association is the largest organization exclusively representing the interests of SEC-registered investment advisers. Its member firms range from global asset managers to the medium- and small-sized firms that make up the majority of our industry. Together, IAA members manage some $25 trillion in assets for a wide range of individual and institutional clients.

The IAA offers its members a wide range of benefits, including:

Strong Adviser Advocacy

- **Legislative Advocacy** — The IAA serves as an energetic and effective voice for our industry on Capitol Hill. Every June, we invite members to join us to discuss critical legislative and policy issues with their elected federal representatives on **Adviser Advocacy Day**.
- **Regulatory Advocacy** — The IAA represents the advisory profession before the SEC, DOL, CFTC, Treasury and other regulators in the U.S. and abroad.

Strategic Networking Opportunities

- Participation on our more than 20 issue-specific **Committees and Working Groups**.
- Participation in the **IAA's Executive Roundtables,** where C-Suite executives meet in small groups to hear from expert speakers on timely topics and discuss matters of mutual concern.
- Participation in the **IAA Exchange**, our online community platform.

Robust Regulatory/Compliance Resources

- Access to the **IAA Legal Team**
- Members-Only **Online Resource Library**
- Complimentary **Webinars**

Up-to-the-Minute News & Information

- **IAA Member Alerts** inform members immediately of significant developments affecting them and are delivered quickly via email.
- **IAA's Newsletter** covers developments in the regulatory and legislative arenas.
- **IAA's Quarterly Update** reviews recent news and IAA activities on our members' behalf.
- **IAA's YouTube Channel** features videos on regulatory and business issues, and more.

Content-Rich Events & Education

- **IAA's Investment Adviser Compliance Conference** provides advisers with the most current information available on the changing regulatory landscape.
- ***View for the C-Suite*, the IAA Leadership Conference,** brings together IA executives to explore industry trends, exchange ideas, and develop valued professional relationships.
- **IAA's Compliance Workshop Series** features SEC officials and compliance experts offering new information and practical insights on challenging legal and regulatory issues.

Strong Advocacy. Strategic Networking. Essential Resources.

You can learn more about the benefits of belonging to the IAA — and hear what our members have to say — by visiting our YouTube channel at https://www.youtube.com/c/InvestmentAdviserOrg or on our website at www.investmentadviser.org.

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IAA INVESTMENT ADVISER ASSOCIATION

WELCOME TO THE IAA

Your Voice. Your Resource. Your Community.

IAA INVESTMENT ADVISER ASSOCIATION

What Members Say About the IAA

IAA President & CEO Karen Barr, welcomes a record number of attendees to the Association's Investment Adviser Compliance Conference in Washington, D.C.

- There is simply no other organization or association that focuses on the issues and concerns of investment advisers like the IAA. The IAA's advocacy and influence make a real business difference for our firm, and all registered investment advisers."
  MANAGING DIRECTOR/REGIONAL BUSINESS HEAD, $600+B AUM

- The IAA is the leading investment management "watch dog/user friendly" organization in the USA and has the ultimate interests of RIAs at heart."
  FOUNDING PARTNER, $600M AUM

- For a smaller firm with fewer internal resources, the IAA is a valuable source of legal and compliance information. Our firm strongly supports the IAA as an advocate for our portion of the investment industry."
  VICE PRESIDENT AND CCO, $3.2B AUM

- The IAA gives us a real voice in Washington. That's key. And the participation on committees, the ability to really meet and directly interact with my counterparts at other firms who are grappling with the same issues, is essential."
  GENERAL COUNSEL AND CCO, $70B AUM

- The IAA is critical to us. The IAA provides great opportunities for members to get together to share best practices in the industry, and it facilitates dialogue with regulators. The IAA really helps us improve ourselves for our clients."
  MANAGING COUNSEL AND VICE PRESIDENT, $760B AUM

- The IAA is the only financial industry organization that shares and promotes our firm's values."
  MANAGING PARTNER, $30B AUM

- The legal/compliance brain trust is of exceptional value. The IAA's advocacy is a huge benefit to the profession and is worth the cost on its own."
  CCO, $9B AUM

The IAA has programs and resources to meet the needs of the broad range of investment advisers – and firms of all types and sizes find great value in their IAA membership. To see video testimonials from IAA members, go to www.investmentadviser.org>>News>>IAA Vlog or to www.youtube.com/c/InvestmentAdviserOrg.

Strong Advocacy. Strategic Networking. Essential Resources.

The Investment Adviser Association is the leading organization exclusively serving SEC-registered investment advisers. **Its more than 650 members range from many of the world's largest asset managers to the medium-sized and smaller RIAs that are the mainstay of the advisory industry**. Collectively, IAA member firms manage some $25 trillion in assets.

The IAA has resources and programs to meet the needs of the broad range of firms in the investment adviser community. And its value to your firm, and our industry, has never been greater.

Increasing layers of regulation, heightened financial sector competition, and rapid technological change are just a few of the forces transforming the investment advisory profession. The IAA helps member firms navigate this ever-changing landscape – so they can achieve their business goals and serve the interests of investors, the capital markets, and the economy – with exceptional resources and benefits:

Adviser Advocacy – A credible and trusted voice on Capitol Hill and with regulators, the IAA is in the forefront of advancing and protecting investment advisers' interests and concerns with policymakers. **Members actively participate in formulating IAA policy positions and comment letters through our member committees.** The IAA also arranges for interested members to meet with policymakers to discuss legislative and regulatory issues that directly affect advisory firms.

Access to the IAA Legal Team – Discuss specific issues with our knowledgeable attorneys. **You'll receive practical information on a variety of regulatory and compliance matters**, such as Form ADV, custody, pay-to-play, privacy, cybersecurity, AML, state filing issues and more. IAA staff can serve as a sounding board for issues, connect firms with similar challenges, and point a firm's compliance officers, counsel and other executives in the right direction for further information.

Members-Only Legal, Regulatory and Compliance Library – The IAA's online resource library receives thousands of visits from members seeking information on a wide range of issues. It also **features a series of issue-specific Compliance Guides with practical information** for building a successful compliance program and preparing for SEC exams.

Powerful Educational Programs and Resources – The IAA's **high-value educational offerings** include annual compliance and leadership conferences, regional compliance workshops and valuable webinars on timely compliance and business practice topics. In addition, each year the IAA produces three indispensable survey reports – *Evolution Revolution,* the definitive analysis of the state of the investment advisory industry; *Executive Outlook*, which identifies and tracks C-Suite attitudes, strategies and concerns; and the *Investment Management Compliance Testing Survey*, which benchmarks practices in the "hot topics" of greatest concern to CCOs and documents industrywide trends in compliance practices.

News and Alerts – IAA members **stay up-to-date on news and developments that impact the industry** and their firms through the monthly *IAA Newsletter*; regular legal, regulatory and compliance updates; updates on advocacy activities, and exclusive electronic Member Alerts, which immediately announce significant breaking developments. Video postings on the IAA Vlog also address compliance and business issues facing investment advisers.

Engagement with Professional Peers – From C-Suite executives to legal and compliance officers, professionals at the more than 650 IAA member firms **form mutually beneficial, lasting relationships** through participation in IAA committees and forums, as well as through regional in-person peer-to-peer events and IAA workshops and conferences.

Professional Designation Programs – The IAA's Chartered Investment Counselor Program recognizes qualifications and experience in the investment adviser profession. The IAA also co-sponsors the Investment Adviser Compliance Certificate Program, which is designed to **advance investment adviser compliance as a profession** and leads to the professional designation of Investment Adviser Certified Compliance Professional (IACCP).

Clockwise from top:

Advocacy: *Senate Finance Committee member Sen. Ben Cardin (D-Md. – center) meets with IAA President & CEO Karen Barr (extreme left), former IAA Board of Governors Chairman Jonathan Roberts (left) of New York's Klingenstein Fields Wealth Advisors, and TD Ameritrade's Albert ("Skip") Schweiss (right) to discuss IAA legislative priorities. Pictured at far right is Cardin aide Marga Pasternak.*

International: *IAA Special Counsel Paul Glenn (right) with Jose Taragano of Sao Paulo's BrickStone Consulting during a recent IAA briefing for a 20-member Brazilian Trade Delegation visiting Washington, D.C.*

Education: *The Value of Active Management in a Powerful Portfolio was one of the key presentations at a recent IAA Leadership Conference. On the panel were (from left to right): moderator Rolf Agather of FTSE Russell; Professor Martijn Cremers of the University of Notre Dame; Natixis Advisors Chief Market Strategist David Lafferty; Investment Manager Scott Gonsoulin of the Teacher Retirement System of Texas; and Anne Lester, Head of U.S. Retirement Solutions at J.P. Morgan Asset Management.*

Education: *Steve Stone, a partner at IAA Associate Member Morgan, Lewis & Bockius LLP, guides IAA Compliance Workshop attendees in Chicago through an interactive exercise called Surviving and SEC Exam.*

- As the sole industry group representing registered advisers, it is a must do."
  DEPUTY GENERAL COUNSEL, $460B AUM

- The IAA provides so much of everything for a small firm like ours."
  MANAGING PARTNER, $235M AUM

Engage with the IAA – and Your Peers – to Help Shape Your Business and Our Industry

Professionals at member firms **contribute to the development of IAA policies, legislative priorities, and regulatory comment letters through participation** on an IAA committee or forum. These groups typically meet via conference calls to share their insights, expertise and experience. IAA committees and forums also provide an excellent opportunity for those who share a common professional interest to exchange information, discuss best practices and hear from guest speakers.

IAA committees and forums address legal and regulatory matters, government relations, international issues, cybersecurity, challenges faced by smaller firm compliance officers, retirement and pension matters, derivatives, issues specific to private equity advisers and bank-affiliated asset managers, social media, and more. From time to time, ad hoc groups are set up for specific purposes.

The IAA also hosts a wide range of issue-specific Online Communities to facilitate connections among member firm employees with common concerns or interests.

For Investment Advisers Only

Full membership in the IAA is exclusively for SEC-registered investment advisory firms. All employees of IAA member firms enjoy complete access to the Association's member benefits and resources.

The Association was established in 1937 and played a major role in the shaping and enactment of the Investment Advisers Act of 1940 – the federal law regulating the investment advisory profession. Throughout its history, the IAA has promoted high standards of fiduciary conduct for investment advisers, which are incorporated in the IAA Standards of Practice. These principles have been used by Congress and the SEC as the basis for legislation and regulations governing the conduct of investment advisers. The U.S. Supreme Court has relied on those principles to define the standard of fiduciary conduct that applies to all investment advisers.

Advocacy: (bottom) *Neil Simon (left), IAA Vice President for Government Relations and Peter Tuz (extreme right), of Chase Investment Counsel Corporation, discuss SEC funding and adviser oversight with House Financial Services Committee member French Hill (R-Ark.) and aide Holli Heiles during an IAA Adviser Advocacy Day visit to Capitol Hill.*

Advocacy: (right): *A team of IAA staffers and members visited Treasury Department officials to discuss FinTech and Financial Innovation issues. From left to right: Ryan Burks of T. Rowe Price; Todd Bowker and Larry Griffin of Legal and General Investment Management; Penny Morgan of Western Asset Management; IAA President & CEO Karen Barr; IAA General Counsel Gail Bernstein; Justin Williams of FutureAdvisor Inc.; IAA Special Counsel Paul Glenn; Todd Cook of J.P. Morgan Chase; Alex Gavis of Fidelity Investments; and Bob Grohowski of T. Rowe Price.*

How to Join

To learn more about the benefits of membership, or to apply for membership online, go to www.investmentadviser.org and click on the **Membership Info** tab on our homepage.

You can also contact IAA Member Marketing Director **Alain Taylor** at alain.taylor@investmentadviser.org or at 202-507-7200.

Preview the Members-Only Resource Library

Interested in seeing the extensive legal, regulatory and compliance materials available to members in the IAA's online Resource Library? Contact us for an introductory tour.

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- The IAA allows us to tap into many resources we couldn't otherwise access."
  LEAD PARTNER, $475M AUM

- Effective representation on adviser issues. Great networking opportunities. Committee membership."
  CCO, $700B AUM

- The IAA provides us with invaluable information absolutely necessary to the running of our firm. The staff is accessible and very responsive."
  PRINCIPAL AND CCO, $2.5B AUM

- For the legal and compliance support, the advocacy efforts, and the information about best practices in the industry."
  GENERAL COUNSEL, $140B AUM

Peer-to-Peer: *Susan Rudzinski of Chicago's Oak Ridge Investments kicks off a Smaller Adviser Compliance Forum Peer-to-Peer meeting. In addition to the forum's regular teleconference meetings, the IAA hosts in-person meetings in conjunction with its Fall Compliance Workshops around the country.*

Engagement with Regulators: *SEC Commissioner Hester Peirce was keynote speaker for a recent IAA Investment Adviser Compliance Conference in Washington, DC.*