IAA NEWSLETTER

September 2021 ▪ Issue Number 345

INSIDE

SEC's Gensler Discusses Gaps in the Regulation of Digital Assets

Describes Lack of Investor Protection as the "Wild West"

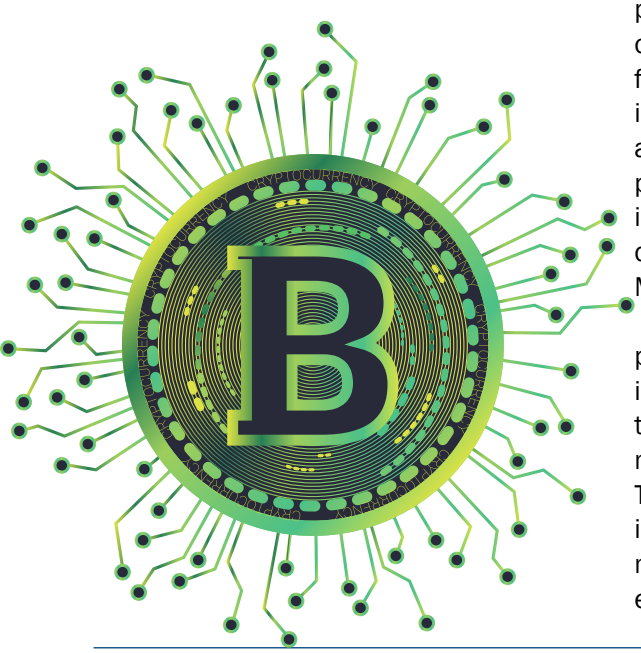
Posted to IAA Today on August 17, 2021

In a recent speech before the Aspen Security Forum, SEC Chair **Gary Gensler** raised investor protection concerns in connection with digital assets and called on Congress to provide the SEC and other regulators with authority to "write rules and attach guardrails" to trading and lending in digital assets.

Gensler agreed with statements by former SEC Chair **Jay Clayton** that these assets are often securities, and that they may lack required disclosures and market oversight. He emphasized that assets such as stock tokens, stable value tokens backed by securities (stablecoins), and other virtual products that provide synthetic exposure to underlying securities are subject to the federal securities laws.

Gensler also discussed decentralized finance (DeFi) platforms, such as digital asset trading and lending platforms, stating that they can implicate securities, commodities, and banking laws. He is concerned that investors can trade on these platforms without a broker, and that there are significant gaps in investor protection. He raised particular concerns about the use of stablecoins on digital asset platforms because users may be "seeking to sidestep" policy goals such as anti-money laundering and tax compliance, and looks forward to working on these issues with the President's Working Group on Financial Markets.

Gensler also discussed anticipated filings related to ETFs that invest in bitcoin futures, and mentioned the SEC's request for comments on custody of digital assets. The IAA plans to address this issue in a letter to the Division of Investment Management about the Advisers Act Custody Rule.



IAA, DACFP Partner to Offer Members Blockchain and Digital Asset Certificate

Members Receive a $100 Discount, 13 CE Credits

Posted to IAA Today on August 17, 2021

The Investment Adviser Association is pleased to announce a partnership with the Digital Assets Council of Financial Professionals (DACFP) to offer IAA members a special discount for a new certification program that includes 13 CE credits. Founded by **Ric Edelman**, the DACFP is dedicated to advancing the financial industry's awareness, knowledge, and understanding of blockchain

Continued on page 3

IN THIS ISSUE

IAA INVESTMENT ADVISER ASSOCIATION

Karen L. Barr
President & Chief Executive Officer
karen.barr@investmentadviser.org

Lisa Gillette
Director, Meetings & Events
lisa.gillette@investmentadviser.org

Nancy Hancock
Vice President, Business Practices
nancy.hancock@investmentadviser.org

Linda Mackey
Vice President, Finance & Operations
linda.mackey@investmentadviser.org

Herb Perone
Vice President, Communications & Marketing
herb.perone@investmentadviser.org

Neil A. Simon
Vice President, Government Relations
neil.simon@investmentadviser.org

Alain Taylor
Vice President, Membership
alain.taylor@investmentadviser.org

IAA Member Services
iaaservices@investmentadviser.org

IAA LEGAL TEAM:
iaalegalteam@investmentadviser.org

Gail Bernstein
General Counsel
gail.bernstein@investmentadviser.org

Monique S. Botkin
Associate General Counsel
monique.botkin@investmentadviser.org

Sarah Buescher
Associate General Counsel
sarah.buescher@investmentadviser.org

Laura L. Grossman
Associate General Counsel
laura.grossman@investmentadviser.org

Sanjay Lamba
Associate General Counsel
sanjay.lamba@investmentadviser.org

Investment Adviser Association
818 Connecticut Avenue, NW, Suite 600
Washington, DC 20006
(202) 293-4222
email: iaaservices@investmentadviser.org
www.investmentadviser.org

FROM THE PRESIDENT & CEO

We Wanted So Badly to See You in Person!

Karen Barr,
IAA President & CEO

Posted to IAA Today on August 27, 2021

It would be difficult to overstate our excitement here at the IAA at the prospect of holding our upcoming 2021 Leadership Conference as a live, in-person event – one where executives from our member firms would be able to meet and mingle, renew old acquaintances, create new relationships, and be greeted face-to-face by the IAA's Governors and our IAA team.

It would be equally difficult to overstate our disappointment that the surge in the COVID-19 Delta Variant has forced us to cancel our plans for an in-person event and reassemble our Conference offerings in an all-virtual format.

"It would be difficult to overstate our excitement here at the IAA at the prospect of holding our upcoming 2021 Leadership Conference as a live, in-person event… It would be equally difficult to overstate our disappointment that the surge in the COVID-19 Delta Variant has forced us to cancel our plans for an in-person event and reassemble our Conference offerings in an all-virtual format."

We will still be offering the same content-rich program on September 29-October 1. Attendees will still be hearing from the same distinguished roster of speakers. The Conference's signature peer-led AUM breakout sessions will take place as planned, and there will still be plenty of opportunities for networking. Regrettably – but realistically – not in person.

We urge you to join us for an event that's been tailored to address the interests and concerns of advisory firm C-Suite executives. Highlights include:

- A keynote by the award-winning author of *The Great Influenza* and former government health advisor John Barry on the lasting impacts of the COVID pandemic on society at large
- General sessions on topics spanning the future of the workforce, ESG, digital assets/blockchain, and more
- Peer-led AUM breakout sessions
- Topical breakout sessions on active management, cybersecurity and privacy, successful internal succession plans, and RIA consolidation and the marketplace of the future
- On-demand recordings of the Conference's keynote, general sessions, and topical breakout sessions

We're eager to see you there – virtually this time, in person as soon as we can!

All best,
Karen Barr
IAA President & CEO

IAA, DACFP Partner to Offer Members Discount—*continued from cover page*

and digital assets.

IAA members will receive a $100 discount when enrolling in DACFP's Certificate in Blockchain and Digital Assets®. Participants will learn about key practice management areas pertaining to digital assets, including tax, regulatory and compliance issues in addition to portfolio construction and management, and — perhaps most importantly — learn how to explain this new asset class to investors and clients. The certificate comprises 11 online, self-study modules and includes 13 continuing education credits.

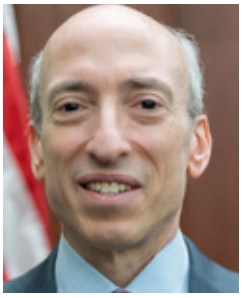
"The IAA is committed to helping investment advisers serve their clients with the most up to date and expert information," IAA President & CEO **Karen Barr** says. "Our partnership with DACFP will help IAA members stay on the cutting edge of investment knowledge and expertise about this new asset class."

IAA members can access the discount code here in the members-only section of the IAA website.

SEC's Gensler Previews Upcoming ESG Proposals

Posted to IAA Today on August 2, 2021

In a recent speech, SEC Chair **Gary Gensler** outlined the proposals that he has asked the SEC staff to develop related to ESG disclosures. He also discussed Commissioner **Allison Herren Lee**'s request for input on corporate climate disclosures, saying that over 500 unique comment letters were submitted, with three out of four commenters supporting "mandatory climate disclosure rules." The IAA's comments also called for baseline corporate climate disclosure requirements.



Gary Gensler, SEC Chair

Corporate Disclosures: Gensler has asked the SEC staff to develop a "mandatory climate risk disclosure rule proposal" for consideration by the end of this year, instructing the staff explicitly to consider whether corporate disclosures on climate should be filed in Form 10-K. He explained that these disclosures should be consistent, comparable, and decision-useful, and has asked staff to consider both qualitative and quantitative disclosures. For quantitative disclosures, he has asked for recommendations on how companies would disclose Scopes 1 and 2 greenhouse gas emissions, and whether companies should disclose Scope 3 emissions, and if so, how and under what circumstances.

Gensler also asked whether there should be metrics for specific industries, including banking, insurance, or transportation, and whether companies should "provide scenario analyses of how a business might adapt to the range of possible physical, legal, market, and economic changes that it might contend with in the future." For companies subject to climate-related requirements or commitments, such as the Paris Agreement, Gensler discussed companies informing investors about how they are meeting those obligations.

Standard Setters: Gensler mentioned the Task Force on Climate-related Financial Disclosures (TCFD) framework, and explained that, while the SEC staff should "learn from and be inspired by" external standard setters, he believes that the SEC should be the entity to "write rules and establish the appropriate climate risk disclosure regime for our markets."

Fund Disclosures: Gensler has also asked the staff to consider whether the SEC should "take a holistic look" at the Fund Names Rule, and for recommendations about whether fund managers should disclose the criteria and underlying data they use in connection with sustainability-related investing. The SEC issued a request for comment on the Fund Names Rule in 2020. The issue continues to be on the agency's long-term regulatory agenda.

See Prepared Remarks Before the Principles for Responsible Investment "Climate and Global Financial Markets" Webinar (July 28, 2021).

SEC Investor Alert Warns of Fraudsters Posing as Investment Advisers or Brokers

Posted to IAA Today on August 2, 2021

The FBI Criminal Investigative Division and the SEC's Office of Investor Education and Advocacy have issued an alert warning investors of fraudsters pretending to be registered investment advisers or brokers. These fraudsters may falsely claim to be registered with the SEC, FINRA, or a state securities regulator and may impersonate investment professionals by misappropriating a name, address, registration number, logo, photo, or website likeness.

The alert describes methods used by the fraudsters, including "spoofed websites," which use addresses or names similar to those of registered firms or investment professionals, fake profiles on social media impersonating registered investment professionals, and cold calls that appear to be from a firm's location. They may also misrepresent or falsify documents, such as a fake version of a public report.

The alert instructs investors on how to check out investment professionals on the SEC's investor.gov website and lists potential red flags, including promises of high investment returns and payment methods that are not typically used by licensed firms, including credit cards, digital assets, and wire transfers or checks to a person or a suspicious address.

See Fraudsters Posing as Brokers or Investment Advisers – Investor Alert (July 27, 2021).

Industry Updates SEC on Move to Shorten Settlement Cycle

Members Encouraged to Provide Feedback to IAA

Posted to IAA Today on August 23, 2021

Following their April 2021 announcement on efforts to move from a T+2 to a T+1 settlement schedule, the ICI, SIFMA, and DTCC have sent a letter to SEC Chair **Gary Gensler** to provide an update on the industry's progress. The August 13 letter explains that moving to T+1 will increase settlement efficiencies and improve the use of capital, and notes that the associations are actively engaged with stakeholders – including experts from the buy-side, sell-side, clearinghouses, custodians, and vendors – on all aspects of the move to T+1. The IAA is involved in providing feedback to the associations and to the SEC on behalf of our members and we encourage members to continue to provide us with feedback.

T+1 Challenges Are Identified. The letter notes that some of the issues involved in shortening the settlement cycle to T+1 will need "fundamental behavioral, technological, and regulatory changes" to address the reduction of 24 hours from the settlement cycle. Changes will be necessary in areas such as allocations, affirmation and disaffirmation processes, processing timelines, securities lending, prime brokerage, documentation, foreign currency exchange (FX), global movement of securities and currency, batch time cycling, and exchange-traded fund (ETF) creation and redemption. In addition, the SEC will need to amend Rule 15c6-1 under the Securities Exchange Act of 1934 to reflect the new T+1 settlement cycle. The industry time frame for the move to T+1 is expected to be published by the end of the third quarter of 2021. The plan will include: (i) an industry transition communication plan; (ii) a transition time frame; and (iii) appropriate planning and testing.

T+0 Challenges Are Too Great at this Time. The letter also addresses the numerous challenges and current impracticalities of moving to a potential T+0 or end-of-day settlement. A move to T+0 would involve massive complexity and redesign of areas such as global settlements, FX, margin investing, and securities lending to meet contractual and regulatory requirements in less than 12 hours. Today these processes take more than 24 hours. A move to T+0 could also require investors to pre-fund accounts, lead to significant burdens for smaller market participants who lack the resources needed, require the Federal Reserve to maintain services for longer, and increase risk in the settlement process. The industry will look for ways to further shorten the settlement times through cost-benefit analysis, risk mitigation, investor benefits and costs, and operational resiliency.

Member Feedback Requested. If you are interested in providing input on this initiative, please contact IAA Associate General Counsel Monique Botkin at monique.botkin@investmentadviser.org.

Increases in AUM, Net Worth Thresholds for Qualified Clients Effective Aug. 16

Posted to IAA Today on August 24, 2021

The inflation adjustments that increased the assets-under-management and net worth tests in the definition of "qualified client" under the Advisers Act became effective as of **August 16, 2021**. The dollar amount threshold of the assets-under-management test increased from $1,000,000 to $1,100,000, and the dollar amount of the net worth test increased from $2,100,000 to $2,200,000.

The definition of "qualified client" is a critical part of the rule that permits investment advisers to charge performance-based fees to qualified clients. The Dodd-Frank Act requires the SEC to adjust the dollar amount thresholds of the rule every five years to account for inflation. The SEC indicated that, for advisory relationships entered into prior to the order's effective date of August 16, the dollar amount test adjustments "would not generally apply retroactively."

SEC Approves Nasdaq's Proposals Regarding Board Diversity

New Rule Challenged in Court

Posted to IAA Today on August 24, 2021

The SEC recently approved Nasdaq's proposed rule changes requiring Nasdaq-listed companies, with certain exceptions, to disclose information regarding board diversity and offering certain companies access to a complimentary board recruiting service. Shortly after SEC approval a lawsuit was filed challenging the SEC's decision.

The rule change regarding board diversity (Board Diversity Rule Change) will require each Nasdaq-listed company to publicly disclose in aggregate the gender and racial characteristics and LGBTQ+ status of the company's board of directors. Each company will also be required to have, or explain why it does not have, two board members who are deemed "Diverse" as defined in the rule. This includes at least one director who self-identifies as female and at least one director who self-identifies as an "Underrepresented Minority" or LGBTQ+, as defined in the rule.

The other rule change (Board Recruiting Service Rule Change) will provide eligible companies with access to a board recruiting service to assist them in increasing diverse representation on their boards.

The Board Diversity Rule Change was approved by a 3-2 vote, with Commissioners **Hester Peirce** and **Elad Roisman** dissenting. The Board Recruiting Service Rule Change was approved by all Commissioners. In SEC **Chair Gary Gensler**'s view, these rule changes "will allow investors to gain a better understanding of Nasdaq-listed companies' approach to board diversity, while ensuring that those companies have the flexibility to make decisions that best serve their shareholders." Shortly after SEC approval a lawsuit was filed challenging the SEC's decision.

See Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Approving Proposed Rule Changes, as Modified by Amendment No. 1, to Adopt Listing Rules Related to Board Diversity and to Offer Certain Listed Companies Access to a Complimentary Board Recruiting Service (Aug. 6, 2021), and Statement on the Commission's Approval of Nasdaq's Proposal for Disclosure about Board Diversity and Proposal for Board Recruiting Service, Chair Gary Gensler (Aug. 6, 2021).

Dealing with the New Derivatives Rule: A Guide for Legal and Compliance Professionals

By Stephen A. Keen and Andrew P. Cross, Perkins Coie LLP*

In October 2020, the U.S. Securities and Exchange Commission (the "SEC") adopted Rule 18f-4 under section 18 of the Investment Company Act of 1940 (the "1940 Act") to regulate the use of derivatives by open-end registered investment companies other than money market funds, business development companies ("BDCs"), and closed-end investment companies ("Funds"). This Compliance Corner article provides an overview of the requirements of Rule 18f-4 and practical considerations related to the design of compliance programs under that rule. More in-depth discussions of Rule 18f-4 are available at our blogs: Asset Management ADVocate (assetmanagementadvocate.com) and Derivatives & Repo Report (derivativesandreporeport.com).

"A Fund will be a Limited Derivatives Fund if its derivatives exposure does not exceed 10% of its net assets."

Background: Limitations on Senior Securities

The 1940 Act restricts the ability of a Fund to issue "senior securities" unless it maintains a minimum level of "asset coverage." Section 18(g) defines "senior security" to mean "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness." Section 18(h) defines "asset coverage" as the ratio which the value of the Fund's assets minus liabilities other than liabilities for the relevant senior securities bears to the aggregate amount of such senior securities.

In particular, section 18 prohibits an open-end Fund from issuing or selling any "senior security," other than a borrowing from a bank, unless it maintains a 300% asset coverage ratio. Closed-end Funds must also maintain a 300% asset coverage ratio for indebtedness, although their indebtedness is not limited to bank loans. Closed-end Funds may also issue senior securities that are preferred stock, subject to only a 200% asset coverage ratio. Section 61 subjects BDCs to the limitations applicable to closed-end funds under section 18, although BDCs may decrease their asset coverage ratio to 150% if certain conditions are met.

In Investment Company Act Release 10666 (April 1979), the SEC staff took the position that purchases of to-be-announced securities and other forward contracts, as well as puts to a Fund, were senior securities for purposes of the 1940 Act, but permitted Funds to engage in these transactions if the Fund's obligation was covered by segregated assets. Subsequent no-action letters and staff guidance expanded this position to cover other derivatives transactions. Starting on August 19, 2022, Release 10666 and these no-action letters will be rescinded, and Funds will be required to comply with Rule 18f-4. Compliance with Rule 18f-4 is optional prior to August 19, 2022.

What Rule 18f-4 Does

Rule 18f-4 primarily permits funds to engage in "derivatives transactions" that would otherwise be subject to the restrictions of Section 18 of the 1940 Act. The rule's definition of a "**derivatives transaction**" includes a list of specific "derivatives instruments," borrowing assets for short sales, and a catchall for:

> ***any similar 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***

Continued on page 10

Now an Exclusively Virtual Event

Out of an abundance of caution – and with deep regret – we have decided to cancel the live version of the IAA's upcoming Leadership Conference and present its speakers, its content-rich sessions, and its networking events in an exclusively virtual format on September 29-October 1. As much as we were looking forward to bringing executives from our member firms together in person, we have concluded that given the surge of the COVID-19 Delta Variant, staging an all-virtual event this year is the most responsible course of action.

A revised, detailed agenda will be posted soon on the IAA website.

Highlights of this year's Conference include:

- A keynote and general sessions on topics spanning the future of the workforce, ESG, digital assets/blockchain, and more
- The event's signature peer-led AUM breakout sessions
- Topical breakout sessions on active management, cybersecurity and privacy, successful internal succession plans, and industry consolidation and the marketplace of the future
- Multiple opportunities for networking
- On-demand recordings of the Conference's keynote, general sessions, and topical breakout sessions

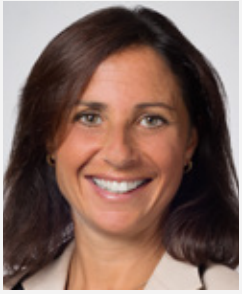
Featured Sessions and Speakers

The Past is Never Dead. It's Not Even Past. Lessons from Past Pandemics — and This One.

John Barry

Keynote speaker **John Barry**, author of the award-winning book *The Great Influenza* and adviser to government health officials, has spent much of his career studying disasters. He will join us to discuss the lasting impacts of the COVID pandemic and look ahead to its potential impact on politics, virology, and international relations.

The Future of Work, the Workplace, and the Workforce: Opportunities Ahead



Vanessa Ruda

Examining post-pandemic workplace challenges – including sustaining culture, performance, and employee and client satisfaction will be Dr. **Vanessa Ruda** of RHR International, **Elizabeth Lowrey** of Elkus Manfredi Architects, and **Cheryl Pipia** of T. Rowe Price. They will focus on workplace flexibility, space needs, on-demand and remote talent, and more.

All About Blockchain and Digital Assets: What Your Firm Needs to Know, Why Your Firm Needs to Care, and How to Proceed

Ric Edelman

This revolutionary technology is transforming commerce, with significant implications for investment firms. **Ric Edelman** of the Digital Assets Council of Financial Professionals, **Ryan Radloff** of Kingdom Trust and **Rayhaneh Sharif-Askary** of Grayscale Investments will explain why this new tech is transformational. They'll also explore the issues your firm faces in evaluating this new ecosystem.

2021 VIRTUAL Leadership Conference Registration Fees

TYPE	AMOUNT
IAA Member*	$395
Additional Participants from Same Firm** (IAA regular members only)	$100
IAA Associate Member*	$495
Non-IAA Member (Investment Advisers and Service Providers)	$750

*Individuals employed by an IAA member or associate member firm in good standing, both at the time of registration and on the date of the event, are eligible to receive the appropriate discounted member/associate member rate.

**First individual pays full applicable registration fee. Each additional registrant from the same firm receives a $295 discount. Email iaaevents@investmentadviser.org for the discount code before registering.

Sponsorships & Exhibitors

Interested in sponsoring or exhibiting at this event? Contact IAA Marketing & Partnerships Manager Alex Ioannidis for more information.

Thanks to Our Conference Sponsors!

ACA™

BERKSHIRE GLOBAL ADVISORS

Continued from page 7

as margin or settlement payment or otherwise."

Additionally, Rule 18f-4 regulates the application of section 18 to reverse repurchase agreements and unfunded commitment agreements. The final rule also provides that certain "non-standard settlement transactions" are not senior securities. These aspects of Rule 18f-4 are beyond the scope of this article, which focuses on how Rule 18f-4 impacts the use of derivatives by Funds.

Rule 18f-4: The Big Picture

At its most basic level, Rule 18f-4 will require a Fund to either:

- *Operate as a Limited Derivatives Fund* - Limit the way and extent to which the Fund engages in derivatives transactions; or
- *Operate as a VaR Fund* - Adopt a Derivatives Risk Management Program (a "DRM Program") that, among other requirements, limits the Fund's value-at-risk ("VaR") relative to (i) an index, (ii) its non-derivatives portfolio or (iii) its net assets. Rule 18f-4 defines VaR as an estimate of potential losses based on at least three years of historical market data expressed as a percentage of the value of a Fund's net assets over a 20 trading day time horizon and at a 99% confidence level, taking all significant, identifiable market risk factors into account.

A Fund may opt to be a VaR Fund even if it could qualify as a Limited Derivatives Fund. If a Fund's adviser already uses VaR models in its risk management program, the VaR Fund approach may be a viable alternative. But we anticipate that advisers that do not currently employ VaR models, and do not have an independent reason to start, will try to operate their Funds as Limited Derivatives Funds.

"[For VAR Funds, t]he DRM Program must specify in what circumstances the Risk Manager will provide VaR Fund portfolio managers with stress testing results and notify them of violations of the risk guidelines or other material risks arising from the Fund's derivatives transactions."

Limited Derivatives Funds: Key Concepts and Considerations

To qualify as a Limited Derivatives Fund, a Fund must satisfy three principal requirements:

1) Adopt and implement written policies and procedures reasonably designed to manage the Fund's derivatives risks, including idiosyncratic risks;

2) Limit its "derivatives exposure" to no more than 10% of its net assets; and

3) Should its derivatives exposure exceed this 10% threshold for more than five business days, either: (a) promptly (within no more than 30 calendar days) reduce that exposure to 10%, in a manner that is in the best interests of the Fund and its shareholders; or (b) adopt and comply with a DRM Program as soon as reasonably practicable.

Accordingly, calculating derivatives exposure can be described as the cornerstone of a Limited Derivatives Fund's compliance program. The following is a six-step process for calculating derivatives exposure.

Step #1 - Identify Derivatives Transactions - A Fund must first identify all of its "derivatives transactions". The touchstone of this analysis is whether the transaction creates a future payment obligation for the Fund. *Table 1* summarizes what is, is not, and may be a "derivatives transaction" in light of this touchstone consideration and the literal definition of "derivatives transaction" under Rule 18f-4.

Continued on page 11

Table 1: Identifying Derivatives Transactions

Not Derivatives Transactions	May Be Derivatives Transactions	Are Derivatives Transactions
Non-standard settlement trade Unfunded commitment agreement Purchased option Prepaid swap Non-recourse structured investment product	Reverse repurchase agreement or similar transaction **Note:** A Fund can choose to treat reverse repos as derivatives transactions. Limited Derivatives Funds should not treat reverse repurchase agreements as derivatives transactions, since this would increase their derivatives exposure.	"Derivatives instrument" under which the Fund is obligated to make a future payment or delivery, including a: • Periodic-payment swap or security-based swap, • Futures contract, • Forward contract, • Written option, • Firm or standby commitment that is not an unfunded commitment agreement (*e.g.,* a to-be-announced ("TBA") trade), and any combination thereof. Short-sale borrowing.

Continued from page 10

Table 2: Calculating Derivatives Exposure

Type of Derivatives Transaction	Exposure Amount
Options	Delta adjusted gross notional amount
Interest rate derivatives	10-Year bond equivalent of the gross notional amount
Short sale borrowings	Market value of assets sold short
All other derivatives transactions	Gross notional amount

Step #2 - Quantify Derivatives Transactions - A Fund should quantify the amount of each transaction's exposure (its "Exposure Amount"). *Table 2* shows how Exposure Amount should be quantified for different types of derivative transactions.

You will find a more detailed discussion of issues related to this calculation in our blog post, *Derivatives Exposure: A Circuitous Path to "Gross Notional Amounts"* (June 3, 2021) at Asset Management ADVocate.

Step #3 - Identify Hedges Excluded from Exposure - Rule 18f-4 excludes from a fund's derivatives exposure currency or interest rate derivatives transactions that:

- are entered into and maintained by the fund for hedging purposes;
- hedge currency or interest rate risks associated with one or more specific equity or fixed-income investments held by the fund, or a fund's borrowings (*i.e.,* the hedge must be "directly matched" to the particular investment or borrowing); and
- have a notional amount that does 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 percent.

"A Fund may opt to be a VaR Fund even if it could qualify as a Limited Derivatives Fund. If a Fund's adviser already uses VaR models in its risk management program, the VaR Fund approach may be a viable alternative. But we anticipate that advisers that do not currently employ VaR models, and do not have an independent reason to start, will try to operate their Funds as Limited Derivatives Funds."

A Fund should identify these "Excluded Hedges," which are narrowly defined. For example, derivatives used by a Fund to manage its portfolio duration will not qualify as Excluded Hedges. Our blog posts, *Trimming Hedges - Hedges Included in Derivatives Exposure* (August 3, 2021) and *Trimming Hedges - Hedges Excluded From Derivatives Exposure* (July 29, 2021), at Asset Management ADVocate discuss Excluded Hedges in more detail.

Step #4 - Identify "Closed-Out" Positions - A Fund should identify derivatives that directly close-out a derivatives transaction with the same counterparty. A Fund can use a derivative that is not a derivative transaction to close-out a derivative transaction. For example, an option purchased by a Fund (which would not be a derivative transaction) can offset an option written by the Fund (which would be).

Step #5 - Calculate a Fund's Derivative Exposure - The Fund should sum its Exposure Amounts after excluding transactions identified in Steps 3 and 4. The result is the Fund's derivatives exposure. For those mathematically inclined, our blog post, *The Derivatives Exposure Equation* (April 21, 2021), at Asset Management ADVocate, provides an equation for calculating derivatives exposure.

Step #6 - Determine Whether the Fund is a Limited Derivatives Fund - A Fund will be a Limited Derivatives Fund if its derivatives exposure does not exceed 10% of its net assets.

DRM Program: Key Concepts and Considerations

A Fund that does not qualify as a Limited Derivatives Fund (*i.e.,* a VaR Fund) must adopt a DRM Program, a key characteristic of which is the daily testing of the Fund's VaR. Rule 18f-4 identifies three varieties of VaR Funds:

- *Grandfathered Leveraged/Inverse Funds* - Open-end funds that, as of October 28, 2020, disclosed in their prospectus that they seek to provide investment returns that exceed 200% of the performance or the inverse performance of a market index over a predetermined period;
- *Closed-End with Preferred Funds* - Closed-End Funds that have already leveraged themselves by issuing preferred stock in compliance with section 18 or 61; and
- *Other VaR Funds* - All other VaR Funds.

Continued on page 12

Continued from page 11

Table 3: VaR Test Limits			
	VaR Test Limit		
	Relative		Absolute
Type of VaR Fund	Index	Portfolio	
Grandfathered Leveraged/ Inverse Fund	As disclosed in Prospectus	N/A	N/A
Closed-End with Preferred Fund	250%	250%	25%
Other VaR Fund	200%	200%	20%

Each variety of VaR Fund has to comply with one of the VaR Test Limits shown on *Table 3*.

A relative VaR Test Limit is the percentage of the VaR of the referenced index or non-derivatives portfolio; the Absolute VaR Test Limit is the percentage of the Fund's net assets.

In addition, Rule 18f-4 requires every DRM Program to have five key elements.

Element #1 - Derivatives Risk Manager

A VaR Fund's board of directors, including a majority of independent directors (its "Board"), must approve the designation of an officer (or committee of officers) of the Fund's investment adviser to act as the "derivatives risk manager" (the "Risk Manager"). The Risk Manager administers the DRM Program, including making certain determinations and reports to the Board required by Rule 18f-4. The Risk Manager cannot be a portfolio manager or, if a committee is designated, a majority of its members cannot be portfolio managers.

Element #2 - Internal and Board Reporting

Before implementing the DRM Program and at least annually thereafter, the Risk Manager must represent in a written report to the Board that the DRM Program is reasonably designed to manage the Fund's derivatives risks and to incorporate all required elements of Rule 18f-4. The DRM Program must specify in what circumstances the Risk Manager will provide VaR Fund portfolio managers with stress testing results and notify them of violations of the risk guidelines or other material risks arising from the Fund's derivatives transactions. The program must also specify the (presumably more significant) circumstances in which the Risk Manager will notify the Board of such matters. At intervals established by the Board, the Risk Manager must report to the Board the results of stress and back testing and any violations of the risk guidelines.

Element #3 - Risk Identification and Guidelines

A VaR Fund must identify and assess its derivatives risks, and establish, maintain, and enforce guidelines that: (i) provide for quantitative or otherwise measurable criteria, metrics, or thresholds of the Fund's risks; and (ii) specify levels of the given criterion, metric, or threshold that a Fund does not normally expect to exceed and the measures to be taken if they are exceeded. *Table 4* sets forth derivative risks explicitly identified in Rule 18f-4, which must also be addressed in the policies of a Limited Derivatives Fund.

Continued on page 15

Table 4: Risks Commonly Associated with Derivatives	
Type of Risk	Description
Leverage	Derivatives can magnify gains and losses
Market	Adverse market movements related to a Fund's derivatives positions; change in market volatility adversely impacts fund returns, obligations and exposures
Counterparty	The risk that a counterparty to a derivatives transaction may not be willing or able to perform its obligations under the derivatives contract, and the related risks of having concentrated exposure to such a counterparty
Liquidity	Liquidity demands may result from the Fund's obligations to make margin, collateral or settlement payments to counterparties
Operational	Potential operational issues, including documentation issues, settlement issues, systems failures, inadequate controls, and human errors
Legal	Insufficient derivatives documentation, insufficient capacity or authority of counterparty, or legality or enforceability of derivatives contract

SEC Brings More Revenue Sharing Disclosure Cases

Posted to IAA Today on August 17, 2021

Revenue sharing disclosure violations are at the heart of two new enforcement actions by the SEC.

In the first case, the SEC found that a Missouri-based adviser provided inadequate disclosures and failed to seek best execution for clients arising from the purchase of mutual funds and cash sweep money market funds when lower-cost options were available. The adviser updated its disclosure in 2017 but the SEC found it to be inadequate and noted that the adviser also did not identify the updated disclosure as a material change. The adviser stopped collecting revenue sharing on these funds prior to the SEC's investigation and converted clients to lower-cost shares.

The SEC also found that the adviser's affiliated broker received mark-ups of fees charged by a clearing broker to the adviser's clients that were not adequately disclosed. An example was an additional charge for statements. The SEC noted the remediation steps already taken by the adviser and required the adviser to evaluate and update its policies and procedures and notify affected clients. The SEC found that the adviser violated certain antifraud provisions and the Compliance Program Rule and ordered the adviser to pay disgorgement of $745,941.91, prejudgment interest of $99,586.41, and a civil penalty of $200,000.

In another case, the SEC fined a Michigan-based dual-registrant for inadequate disclosure of revenue sharing and related conflicts of interest in connection with money market fund cash sweep accounts. In this case and the case described above, each adviser recommended and invested clients' cash in money market funds that paid the highest amount of revenue sharing when other options were available that paid less or no revenue sharing. The firm later converted its clients to money market funds that did not pay revenue sharing. The firm was found to have violated certain antifraud provisions and the Compliance Program Rule and agreed to review and correct relevant disclosures, evaluate whether clients needed to be moved to other share classes, evaluate and update policies and procedures, and notify affected investors. The firm was ordered to pay disgorgement of $162,918.49, prejudgment interest of $26,537.20, and a civil penalty of $60,000.

See In the Matter of First Heartland Consultants, Inc. (Aug. 2, 2021), and In the Matter of USA Financial Securities Corporation (Aug. 3, 2021).

SEC Adds Lack of Disclosure of Margin Interest Mark-Ups to Share Class-Related Violations

Posted to IAA Today on August 4, 2021

In another case that underscores the SEC's harsher findings and penalties for share class selection-related violations, the SEC has fined a Connecticut-based dual-registrant for breaches of fiduciary duty in connection with advising clients to purchase and hold mutual fund share classes that charged 12b-1 fees when lower cost fund shares were available. The firm was eligible to but did not self-report under the SEC's Share Class Selection Disclosure Initiative.

As in similar enforcement cases, the SEC also determined that the adviser breached its duty to seek best execution. In addition, the SEC found in this particular case that the firm received mark-ups on the rate of margin interest paid by clients from an unaffiliated clearing broker without disclosing the compensation or related conflicts of interest. The firm earned the difference between the interest paid by its clients and the interest paid by the firm to the clearing broker.

The SEC found that the firm violated certain antifraud provisions and the Compliance Program Rule, and the firm was censured and ordered to cease and desist from future violations. The firm is required to review and correct its disclosure documents, evaluate whether clients should be moved to lower-cost share classes and move them, evaluate and update as necessary compliance policies and procedures, and notify clients. The SEC also ordered the firm to pay disgorgement of $201,778.55, prejudgment interest of $32,562.37, and a civil money penalty of $65,000.

See Coburn & Meredith, Inc. (July 30, 2021).

Adviser Pays $300K to Settle Proprietary ETF Disclosure Charges

Posted to IAA Today on August 24, 2021

The SEC has fined a San Francisco-based digital adviser for failing to adequately disclose the adviser's conflicts of interest relating to investing client assets into new ETFs sponsored by the adviser's parent company. The SEC also found that the adviser had not analyzed the related tax consequences of these transactions for clients.

The adviser had invested client as-

Continued on page 14

Continued from page 13

sets into two new proprietary ETFs that replaced third-party ETFs. The SEC found that, during the relevant period, the adviser had not adequately disclosed its conflicts of interest relating to the placement of clients into the proprietary ETFs rather than keeping them in the third-party ETFs. The adviser was found to have invested client assets in the proprietary ETFs to help market the parent company's brand and to have intended to use client assets to provide significant assets to the proprietary ETFs to make them more attractive to other investors. As a result of these transactions, the adviser caused its clients to incur short-term and long-term capital gains.

The SEC noted that the adviser "represented that taxable account strategies would be optimized using generic tax assumptions" and that the advisers' lack of consideration of the tax impact of these transactions "was inconsistent with its duty to clients." The adviser reimbursed clients for tax liabilities after the SEC opened its investigation.

The SEC found that the adviser violated certain antifraud provisions and the Compliance Program Rule and ordered the adviser to pay a penalty of $300,000. The adviser also agreed to certain undertakings, including reviewing and correcting all relevant disclosure documents concerning its use of proprietary ETFs and the associated conflicts of interest, providing each affected investor with a copy of the SEC's order, and updating policies and procedures.

See In the Matter of SoFi Wealth, LLC (Aug. 19, 2021).

DOL Issues FAQs on Lifetime Income Illustrations

Posted to IAA Today on August 2, 2021

The Department of Labor's Employee Benefits Security Administration (EBSA) has issued temporary implementing FAQs on the requirement to add lifetime income illustrations to pension benefit statements that was adopted under the SECURE Act and for which the DOL published an Interim Final Rule last September.

The FAQs state that participant-directed plans that provide quarterly benefit statements can include their first lifetime illustration in any quarterly statement up to the second calendar quarter of 2022 ending June 30, 2022. For non-participant-directed plans, lifetime income illustrations must be on the statement for the first plan year ending on or after September 19, 2021.

There's also an FAQ on lifetime income illustrations that are based on a framework that the DOL published in an advance notice of proposed rulemaking (ANPRM) in 2013. The FAQs state that "[a]lthough the SECURE Act requires plan administrators to provide participants with lifetime income illustrations that differ from the illustrations proposed in the Department's 2013 ANPRM, the Department's rule specifically allows for additional lifetime income illustrations."

In response to a question about whether the final rule will provide some transition relief, the FAQs state that the DOL intends to issue a final rule "as soon as practicable" and appreciates commenters' concerns in this area.

IAA Comments on Australian Consultation on Foreign Financial Services Providers Regulation

Posted to IAA Today on August 2, 2021

The IAA recently filed a comment letter with the Australian Government on its July 9 Consultation Paper on potential options for the regulatory regime that will apply to foreign financial services providers (FFSPs) in Australia. The IAA has asked that the Australian Government follow a streamlined approach to restore the former sufficient equivalence and limited connection class order relief for FFSPs that permitted them to provide services to wholesale clients and professional investors in Australia without having to obtain a license from the Australian Securities & Investments Commission (ASIC) to do so.

In addition to restoring the class orders, the IAA also urges the Australian Government to extend the class order relief to add additional jurisdictions that are already approved under the funds management relief issued by ASIC. We believe this approach would result in facilitating competition and giving access to a wider range of products and services to Australian wholesale investors.

SEC, ECB Sign Agreement for Oversight of Security-Based Swap Dealers

Posted to IAA Today on August 17, 2021

In their first Memorandum of Understanding (MOU), the SEC and the European Central Bank (ECB) have agreed to cooperate and exchange information related to the supervision, enforcement, oversight, and cross-border inspections of security-based swap dealers and major security-based swap participants (SBS Entities) that are registered with the SEC and supervised by the ECB.

The MOU will also support the SEC's oversight of the substituted compliance orders that the SEC already issued for SBS Entities in France and Germany and for future substituted compliance orders in other EU Member States. Substituted compliance allows SBS Entities to comply with U.S. requirements of the Dodd-Frank Act through compliance with comparable EU laws and EU Member State laws.

The SEC announced the MOU on August 16.

SEC Issues Interim Updates to Whistleblower Procedures

Commissioners Peirce and Roisman Take Issue

Posted to IAA Today on August 24, 2021

The SEC adopted amendments to its Whistleblower Program rules in September 2020 that address the criteria for making an award where another agency's whistleblower program may apply to an action as well as for deter-

Continued on page 15

 Continued from page 14

mining an appropriate award amount. The amendments have drawn criticism and a lawsuit charging that they could discourage whistleblowers from coming forward.

SEC Chair **Gary Gensler** recently directed SEC staff to consider potential amendments to these rules, and the SEC then released a statement describing interim procedures in situations where another agency's whistleblower program may apply. The statement also provides that the SEC staff will inform claimants if the SEC deviates from its current practice regarding determining award amounts. In both situations, a claimant may request that a matter be held in abeyance during what is described as the "Interim Policy-Review Period." SEC Commissioners **Hester Peirce** and **Elad Roisman** responded that the statement "effectively nullifies" the rules, also arguing that this type of action "reduces the certainty of the law."

See Statement in Connection with the SEC's Whistleblower Program, Chair Gary Gensler (Aug. 2, 2021), Procedures for the Commission's Use of Certain Authorities Under Rule 21F-3(b)(3) and Rule 21F-6 of the Securities Exchange Act of 1934 (Aug. 5, 2021), and Statement on the Commission's Action to Disregard Recently-Amended Whistleblower Rules, Commissioner Hester M. Peirce and Commissioner Elad L. Roisman (Aug. 5, 2021).

Please direct any questions or comments about these or other matters in the Legal & Regulatory Update to the IAA Legal Team at IAALegalTeam@investmentadviser.org.

COMPLIANCE CORNER—*continued from page 12*

In developing and implementing these guidelines, a VaR Fund should consider the composition of its investment portfolio and disclosures to investors.

Element #4 - Stress Testing

At least weekly, a VaR Fund must conduct stress tests that evaluate potential losses 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. These tests must account for correlations of relevant market risk factors and resulting payments to derivatives counterparties.

Element #5 - Back Testing

At least weekly, a VaR Fund must compare the result of its VaR model with its actual gains or losses that occurred on each business day during the prior test period *(e.g.,* the prior week), and identify any exceptions in excess of estimated losses under the VaR calculation model. In the adopting release, the SEC observed that, "[If] 10 or more exceptions are generated in a year from backtesting ..., it is statistically likely that such exceptions are a result of a VaR model that is not accurately estimating VaR."

Closing Thoughts

As noted earlier, Funds will have to comply with Rule 18f-4 beginning on August 19, 2022. In light of that pending deadline, many Funds and their advisers are presently focused on the design of the compliance programs required by that rule.

** Andrew Cross, a Partner in Perkins Coie's Investment Management Group, has deep experience in the investment management and derivatives practice areas. Andrew's derivatives practice focuses on regulatory and transactional issues related to the use of derivatives by registered investment companies and their advisers. He may be reached at ACross@perkinscoie.com. Stephen Keen, Senior Counsel in Perkins Coie's Investment Management Group, focuses primarily on the regulation of registered investment companies. With 25 years of experience, Steve is a nationally recognized authority on money market funds and money market instruments and has written extensively on these topics. He also advises clients on the application of federal and state laws to structured products and derivative contracts and their valuation. He may be reached at SKeen@perkinscoie.com.*